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A Review on the Issues of Vertical and Horizontal Fiscal Imbalances in India

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ABSTRACT

India is known for its diversity in terms of ethnicity, religion, language, etc. There is also a wide spectrum of subnational or local governments that largely differ in territorial size, population, volume of economic activities, and endowments. One of the main manifestations of this inequality could be the persistence of vertical and horizontal fiscal imbalance across states and local governments and between different tiers of local governments. This imbalance led to a series of equalization measures taken by the central government by way of transferring resources based on certain criteria. This paper reviews issues relating to vertical and horizontal fiscal imbalances in India which highlight the low level of own resource generation found in many states and in most local governments, which hampers the scope of autonomous local decision-making.

Introduction

India has three tiers of government namely the union, state, and, local governments. Indian states are arranged on a linguistic basis following the States Reorganisation Act of 1956. Presently, there are 28 states and 8 Union territories (territories administered by the President through administrators appointed by him/her). Local governments, the third tier of governance in India mainly consists of two distinct forms of rural local governments known as Panchayati Raj Institutions (PRIs) and urban local governments in the form of Municipalities. The provisions for PRIs and Municipalities in India are established by the 73rd and 74th Constitutional Amendments (CAA) respectively. In addition to the two main forms of local governments, the third type of local government known as Autonomous District Councils (ADCs) is found in four North Eastern states. These ADCs are formed under the Sixth Schedule of the Indian Constitution to protect and supplement the traditional governing system of the tribal people. PRI system is found in 25 states with more than 300000 village units, around 6500 units at the block level, and 600

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Volume:09, Issue: 11 "November 2024"

units at district levels. Municipalities are found in all the states with around 4800 units across the country and there are 10 ADCs in the four states of North East India.

The institutional differences (powers, finances) or factual inequalities between subnational or local governments can be studied through the horizontal and vertical imbalances existing in these governments which are further discussed in the following sections.

Horizontal Imbalances

There has been uneven regional development in India which has become quite polarised since the 1960s. Among the 28 states, states such as Gujarat, Maharashtra, Punjab, Haryana, Tamil Nadu, and Karnataka are considered to be the "rich club" while states such as Odisha, Bihar, Rajasthan, Madhya Pradesh, and Uttar Pradesh are considered to be relatively low-income states. This difference among states arises due to many factors including the nature of the state, planning, and development, fiscal federalism, tax system, investment, education, infrastructure, and spillover effect of economic growth among states (“Why Is Economic Growth Across Indian States Uneven?” 2013).

The existence of regional disparities and diverse social economic structures across Indian States led to variations in resource mobilization and expenditure responsibilities. The differences in revenue-generating capacity and expenditure commitments across states also arise from a number of issues including populist fiscal measures such as non-levy of certain taxes, differences in tax rates, and other state-specific expenditure schemes. The fiscal differences created are known as horizontal fiscal imbalances. According to Raut (2011), the extent of horizontal fiscal imbalance among states increased during the 1990s and in the first half of the 2000s but declined during 2005-06 to 2010-11. A report submitted to NITI Aayog, the Government of India’s premier think-tank in 2017 also highlighted that India has large and growing horizontal fiscal imbalances. General purpose grants were given to states to offset the fiscal disabilities so that states are enabled to provide comparable public services at comparable tax rates. However, given the large variations in fiscal disabilities in Indian states with per capita income in the highest income state is five times that of the lowest income state, it becomes difficult to design the general-purpose transfers to fully offset the revenue and cost disabilities. However, due to the large variations in fiscal disabilities in Indian states with per capita income in the highest income state is five times that of the lowest income state, it becomes difficult to design the general-purpose transfers to fully offset the revenue and cost disabilities among states (Rao, 2017).

Among the PRIs in India, the imbalances could be found across states. The PRIs from those states belonging to the 'rich club' as mentioned earlier on average have larger amount of expenditure, own resources as well as share of own revenue in total expenditure. This evidence

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Volume:09, Issue: 11 "November 2024"

has been given in a study by Alok (2019) which shows that between 2012-13, PRIs of the richer states have higher average of Expenditure (Rs. 14425.7), higher average of Own Resources (Rs. 1648) and higher average of Share of Own Revenue in Total Expenditure (21.5%) compared to PRIs of lower income states which have an average Expenditure of Rs. 4539.5 with average Own Resources of Rs. 634.25 and average Share of Own Revenue which is 12%. If we check the same data with respect to the PRIs in the states of North East India, we could find that their average performance and resource base is still lower than that of the previously mentioned lower income states.

Urban Local Governments (Municipalities) in India are considered to be among the weakest in the world in terms of fiscal autonomy and their capacity in service delivery to meet the demands of growing urbanisation and rapid economic growth. There have been large disparities among Municipalities across Indian states as well as between the larger municipalities and smaller municipalities. A study by Ahluwalia et al., (2019) shows that in 2017-18, three states, Maharashtra, Gujarat and Madhya Pradesh have highest municipal revenue per capita and the highest own revenue per capita among the Indian states. On the other hand, municipalities in the state of Bihar had the lowest own revenue per capita and excessively depend on transfer from higher tiers of governments. The study also highlighted that while the ratio of own revenues to total revenues declined across the urban local governments, the smaller municipalities are far worse than the larger municipalities.

The disparity among the ADCs across the four states of the North East India (Assam, Meghalaya, Mizoram and Tripura) could also be found in terms of their revenue and expenditure size as well as their sources of income, sources of expenditure, and fiscal decentralization. A quick glance at the annual financial statements of the ADCs across the states showed us that the revenue and expenditure of ADCs in Assam and Tripura is relatively larger than that of Meghalaya and Mizoram. A study by Umdor (2014) also found that while shared revenue (which is mainly from royalty on major and minor minerals) is the main source of revenue for the ADCs of Meghalaya, the ADCs in Assam, Mizoram and Tripura depend mainly on grants from state government. A large majority (over 70 per cent) of the expenditure of these ADCs are utilised for meeting current and running expenditure and the level of fiscal decentralization is low across the states.

Vertical Imbalances

The imbalances created by allocation of taxation powers and expenditure responsibilities between Centre and States is known as vertical fiscal imbalances. The Indian constitution allocates taxation between the Centre and the States based on some economic and administrative considerations and also determine certain expenditure responsibilities including subjects of

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Volume:09, Issue: 11 "November 2024"

regional concerns. However, the states do not have adequate revenue raising powers to meet their expenditure responsibilities which led to the States' increasing dependence on transfer of funds from the Centre to finance their expenditure assignments. The vertical imbalance comes from the assignment of revenue generating powers and functional responsibilities of Union and States on the basis of comparative advantage. The Union government generally collects 60-68% of combined revenue receipts to buoyant and broad-based tax assigned to it and the states together collect the balance (Institute of Economic Growth, 2019). While the Union Finance Commission has been pitching the need for reducing these imbalances by raising the States' share in Central taxes, the imbalances do not seem to reduce significantly and the share of States' revenue receipt in combined revenue receipt of the Centre and the States declined marginally from 63.7 per cent in 1980-81 to 62.8 per cent in 2010-11 (B.E) (Raut, 2011). A study by Koley and Mandal (2019) analysing the finances of 24 states of India also found that the average Vertical Fiscal Imbalance is 62.43% across the states from 1990-91 to 2015-16. The XV Finance Commission (2020) also noted that in 2018-19, the Union Government raised 62.7 per cent of the aggregate resources raised by both the Union and States, whereas the States spent 62.4 per cent of the aggregate expenditure of the Union and the States. At an aggregate level in 2018-19, the States' own resources could meet only 44.8 per cent of their total expenditure. This implies that the remaining 55.2 per cent needed financing through vertical resource transfers and/or by contracting debt.

In case of local governments, the evidence of vertical fiscal imbalance could be easily understood from the low level of own resource generation among the PRIs, Municipalities and the ADCs. A study by Centre for Budget and Policy Studies (2014) observed that the total revenue of PRIs in the country had grown more than twice between 2002-03 to 2007-08. However, according to Alok (2019) The average share of own revenue in total expenditure of PRIs between 2012-13 to 2017-18 across all the states of India is only 10.3 per cent. The remaining expenditure is funded by higher tiers of governments in the form of grant in aid and other schemes. As for the Municipalities, there is also a growing mismatch between their responsibilities and revenues. Ahluwalia et al., (2019) observed that municipal revenues and expenditures as percent of GDP are in a state of decline and municipal own revenues lack buoyancy leading to a decline in their financial autonomy and increase in their dependence on transfer from higher levels of government. One of the most significant drawbacks is the introduction of Goods and Services Tax (GST) which has subsumed local taxes such as octroi, local body tax, entry tax and advertisement tax without compensating the loss of such revenue sources at the municipal level. The ADCs are also known to have a very minimal own revenue and most of the ADCs depend on the grant in aid from central and state governments. A quick analysis of the budget of one ADCs from four states shows that the share of own revenue in their total revenue is quite low. The ADC in Assam raised 10 percent of its total revenue, the ADC

ISSN: 2455-8834

Volume:09, Issue: 11 "November 2024"

from Meghalaya raised 18 per cent of its total revenue and both the ADCs from Mizoram and Tripura raised a mere 1 percent of their total revenue from their own sources.

Conclusion

The problem of horizontal and vertical fiscal imbalance in the Indian federation is being addressed by the Union Finance Commission by taking measures of decentralization for state and local governments. Apart from laying down criteria of transferring resources such as population, area, tax and fiscal efforts etc, the commission also introduced performance-based grants to state governments to incentivise them in their tapping of resources from the central government. It also introduced incentives for PRIs and municipalities by suggesting a proper criterion for maintenance of their accounts and financial statements. The ADCs have also been granted “Special Assistance” in 2015-16 to support and strengthen the delivery of basic civic services and other services within the functions assigned to them. However, the intrinsic problem of many states and all the local governments is their inability to raise their own revenue. Among states, the differences in population, resource endowments and volume of economic activity created the disparity in the amount of own revenue sources. For the local governments, lack of functional devolution which involves transferring of decision-making including taxing and spending authority seems to have led to the low level of own resource generation. Unless this issue is successfully tackled, transfer of financial resources merely will not empower lower tier of governments and instead, it could lower their accountability towards the citizens they served (Therkildsen, 2001).

For empowering and upliftment of citizens at the grassroots level, decentralization measures particularly in the form of fiscal decentralization is needed. This empowerment through fiscal decentralization will create a space for citizens to make autonomous decision for the well-being of their community and society. According to Yates (1996), in countries that draw most of their income from extractive industries such as oil, timber or mining exports, are less dependent on their people for revenues, also creating a disconnect between state and society. The same would hold true in case of taxation in India where the Goods and Services Tax (GST) has been centralized and people do not usually see their direct contribution in the schemes and policies of government. However, the transfer of taxing and spending authority will involve ceding of powers and functions from the higher authorities including the government at the centre and state level which has always been an obstacle in the past. The way forward is to avoid over emphasis on the distribution of finances from the union government, but focus more on improving revenue generation from each of the state and local governments. State and local governments should try and be empowered to tap more resources from within, rather than from outside of their territory.

ISSN: 2455-8834

Volume:09, Issue: 11 "November 2024"

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ISSN: 2455-8834

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