INTERGOVERNMENTAL FISCAL ARRANGEMENTS IN INDIA

1. In India’s federal structure, state governments enjoy strong autonomy with a clear demarcation or concurrency of subjects between the central and state governments. However, the fiscal relationship is characterized by a large vertical imbalance. The central government in India collects over 60% of general government revenue and spends about 45% of general government expenditure.¹ To address this fiscal gap, the central government provides fiscal transfers to the state governments.

A. Intergovernmental Fiscal Transfers in India

2. Fiscal transfers from the central government to subnational governments address the vertical imbalance by compensating subnational governments for differences between incurred expenditures and own revenues. They also address the horizontal imbalances between subnational governments to ensure national uniformity in the provision of public services to citizens across the country. However, transfers based on gap-filling approach can also cause moral hazard issues since the state governments can then afford to be fiscally profligate. This issue has been partly addressed in the past by adopting a formula-based approach for tax sharing, and with conditional grants to incentivize good performance in fiscal management and service delivery by the subnational governments.

3. Following the dissolution of the Planning Commission in 2015, there are two operating channels for transfer of resources from the center government to the states in India: (i) statutory transfers through the awards of the finance commission, comprised of (a) formula-based tax devolutions and (b) grants-in-aid; and (ii) discretionary transfers by various union ministries.

4. **Formula-based transfers.** As per Article 270 and Article 280(3)(a) of the Constitution, the Finance Commission determines the percentage of the divisible pool that is to be assigned to the states (vertical distribution) and the percentages that are to be allocated to states inter-se (horizontal distribution). Once the formula with different weights to parameters is applied, no conditions can be set on the right of the state to receive such funds. In the past, indicators such as population size, area, forest cover, and infrastructure index distance (from average of top three states), per capita income distance (from the average of top three highest states), inverse income, poverty ratio, index of backwardness were considered for determining these tax devolutions. For performance incentivization, indicators measuring tax collection, tax effort (tax/gross state domestic product [GSDP]) and fiscal discipline were incorporated in various Finance Commission formulae.

5. **Grants-in-aid.** Under Article 275 of the Indian Constitution, finance commissions recommend conditional or unconditional grants-in-aid to help states provide comparable levels of services, at comparable tax rates, while ensuring a budget balance in the revenue account. There are broadly three types of grants-in-aid: (i) gap-filling grants to meet the difference between the assessed current expenditure and the projected revenue including the share of a state in central taxes, (ii) local bodies grants to supplement the resources of local bodies, and (iii) specific-purpose grants are conditional transfers given to states to (i) ensure minimum

¹ Most broad-based taxes have been assigned to the central government, such as customs duties, income tax, corporation tax, and central goods and services tax (GST) while state taxes include state GST, motor vehicle tax, value-added tax on petroleum, stamp duty and registration fees, state excise duties, and electricity duty. On the other hand, key service deliveries such as public health and sanitation, education, industries, law, and order are under the purview of the state governments.
standards of certain basic services, (ii) provide grants for natural calamities, (iii) cover capital expenditure needs of states in certain sectors, and (iv) incentivize better fiscal management and planning amongst states.

B. State Government Borrowings

6. The Constitution of India provides safeguards against excessive borrowings by both the central and state governments. Articles 292 and 293 (1) of the Constitution state that the Parliament and state legislatures may respectively require the union or the state governments to pass laws to specify the limits on borrowing and giving guarantees. The states can borrow only from domestic sources and are required to seek permission from the union government if they are indebted to the latter (Article 293). External financing to state governments is routed through the union government. Currently, the annual borrowing limit for states is 3% of GSDP, which has been relaxed to 5% by the central government in FY2021 in view of the recent pandemic.

7. The sources for financing of gross fiscal deficit for state governments in India are (i) state development loans (market bonds), (ii) central government loans including external financing, (iii) national small savings fund, (iv) ways and means advances from the Reserve Bank of India, (v) institutional loans, and (vi) public accounts, including provident funds, deposit accounts, and reserve funds. External financing, which is lent to the state as loans from the central government, is estimated to comprise 3.6% of the Government of West Bengal (GOWB)'s gross fiscal deficit in FY2020. GOWB's deficit and debt servicing requirement is financed almost entirely by the state development loans, which are estimated to constitute 136.6% of the gross fiscal deficit in FY2020 (budget estimates).²