

# Centre-State Financial Relations in India

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1. Forthcoming: unified taxation of goods and services through a value added GST

- Taxation of goods presently has a separate structure from taxation of services.
- Taxation of goods:
  - A Central excise on manufacturing (a CENVAT, with offset on input excise)
  - States tax sales of goods (sales tax replaced by VAT on goods from 1 April 2005)
  - States also levy octroi/entry tax/inter-state sales tax on movement of goods
- Taxation of services only by the Centre, offsetable against CENVAT.

The 115th Constitutional Amendment Bill, to unify domestic taxation of goods and services and make India a common market, was moved in March 2011 in Parliament. Awaits ratification.

## 2. Issues with introduction of the destination-based dual-levy GST

- The Constitutional Amendment
- Rate structure: Issues
- Eco-taxes

## The Constitutional Amendment

The idea of a GST Council, a Constitutionally mandated body, with powers to decide on the following issues, is seen as a formal erosion of subnational fiscal autonomy:

- Taxes subsumed in the GST
- The tax base
- Exemptions
- Recommend (not set) rates
- Dispute settlement

## The rate structure

Present	GST: FC-XIII	GST: Likely?
CENVAT excise 10% ( 5%)	Agg flat 12% CGST 5%	Goods std 20% (12%)
Central service tax 10%	SGST 7%	Services 16%
State VAT 12.5-15% (4-5%) (20%+)	Additional: Petroleum Alcohol Tobacco	In 3rd year, all: 16% Even split C:S
Distinct bases	Compre've base	Not compre've
Diff thresholds	Uniform thresh	Thresholds unknown

Concessional rates in parentheses

## The proposed rate structure: Impact on post-tax prices Services

Some B2C like railway fares newly coming under the GST will see a jump from 0 to 16 %. But the August announcement of a shift away from the present prescribed list of taxable services to universal taxation of services with a short negative list, prepares the ground for the B2C shift under the GST.

### Processed foods:

The Centre's component will go up from ~2.5% to 6%, and the state component from 4-5 to 6%.

A big issue with food inflation at 8-10% (FY11-12, yoy), following 15.44 percent average annual inflation over 2009-11.

[http://eaindustry.nic.in/Download\\_Data\\_0405.html](http://eaindustry.nic.in/Download_Data_0405.html)



## The proposed rate structure: Revenue impact for states

The revenue neutral rate (RNR) for states depends on the weights given to present concessional [ $W_1$ ] and std [ $W_2$ ] rates on goods, assuming that the additional right to tax services will be revenue neutral, if compensation for B2B services = revenue gain from B2C.

The issue is the even split of the proposed rates for Centre and states, with each getting 10% (standard), 6% (concessional)  
For states, this replaces 12.5-15% (standard), 4-5% (concessional)

By contrast, the Centre presently levies 10% (standard) and 5% (concessional) at the *manufacturing stage*, which amounts to ~5% (standard), ~2.5% concessional on the retail price.

Clearly, the revenue advantage to the Centre is greater.

## Rate structure: Issues for states

- Why have a uniform rate structure across states: Why not a uniform floor? Or a uniform band?
- If uniform across states, will there be exceptions in macroeconomic downturns?
- If uniform for ease of administration, must it be a single rate? Why not multiple rates, with higher rates on luxury goods?
- Must the list of exemptions be common across all states?

## Eco taxes (and subsidies)

- Eco taxes, which correct for negative externalities, will have to be levied as non-rebatable cesses or surcharges superimposed on GST.
- Petroleum exclusion from the GST tax base achieves this, but will not ensure Pigouvian calibration to the marginal damage costs of the pollutant. Kerosene will need a subsidy.
- Negative externalities in production call for a non-rebatable cess at origin, intruding on the destination-base principle.
- From FY 10-11, a first earmarked eco-tax in India: A nationally-levied clean energy cess on coal at Rs. 50 per tonne, both domestic and imported, to go into National Clean Energy Fund, that will promote renewable energy (principally transmission lines to evacuate renewable energy from remote locations). This is a non-rebatable overlay on the VAT structure. The rate is ad hoc, not calibrated to marginal damage cost.

### 3. Centre-State financial flows

Combined revenue Centre+states	2000-05	2005-10
Share of Centre (%) in:		
Collection (before transfers)	67.6	64.1
Retention (after transfers)	43.3	37.8
Centre-state transfers (%)	24.3	26.3
Statutory transfers (%)	16.6	17.2
Non-statutory transfers (%)	7.7	9.1
Total expenditure		
Share of Centre (%)	43.6	45.4

Averages over recent years could change with issue of audited actuals.

The statutory transfers are prescribed for five-yearly horizons by Finance Commissions. These bodies are required to be freshly constituted every five years to re-set the formulae governing states' share of Central tax revenue, and individual states' shares in the total.

Statutory transfers are in two parts:

- A dominant component configured as a share of the *tax* revenue of the *Centre*.
- A subsidiary component configured as absolute grants.

#### 4. Structural incentives for fiscal discipline 2010-15

- Prescribing FRBM-II to succeed FRBM -I at the Centre(2004-09) and States (2005-10)
- FRBM ambit extended beyond targets to include substantially enhanced disclosures

## Prescribing FRBM-II to succeed FRBM -I at the Centre(2004-09) and States (2005-10)

- Both Centre and states to start fiscal correction in 2011-12; gap year: 2010-11
- State enactment of FRBM incentivised through conditional grant access
- Dominant target is the "Golden Rule" for a zero current account deficit
- The permissible fiscal deficit protects capital expenditure, projected at ~7% of GDP in 2014-15
- Adjustment path for states cognisant of different starting points
- Consolidated debt/GDP at 78.8 % in 2009-10 to go down to 68 % by 2014-15



## Progress in 2010-11 (the gap year) on fiscal discipline

### Fiscal Stimulus at the Centre

% FD of the Centre/GDP

Definition	Actual - Target (3%)
2008-09	3.04
2009-10	3.39
2010-11	1.69

Budgeted FD in 2011-12: 4.56%. Likely to be exceeded.

But FRBM at Centre still not enacted.

17 States had enacted FRBMs upto July 2011.

## Enhanced disclosures

- Centre's MTFP to carry:
  - Committed non-statutory flows to states, to improve predictability of total transfers
  - Tax expenditures with explicit methodology
  - Revenue consequences of capital expenditure
- From 2013-14:
  - All departments and PSUs to prepare an inventory of vacant land and buildings valued at market prices.

5. Green incentives for States 2010-15: three grants Rs. 50 billion each

- To reward states for holding forested area
- To incentivise states to add to their renewable energy capacity
- For better water resource management with a reward for an independent regulatory framework

## The forest grant

$G_i$ , the share of state  $i$ :  $Num_i / \sum Num_i$

$$Num_i = \left[ \left\{ \frac{F_i}{\sum F_i} + R_i \right\} * \left\{ 1 + ((M_i + 2H_i) / A_i) \right\} \right]$$

$$R_i = \max \left[ 0, \left\{ \frac{F_i}{A_i} - \frac{\sum F_i}{\sum A_i} \right\} / 100 \right]$$

- 25% over 2010-12, to cover costs of making working plans.
- 75% over 2012-15, conditional on well-documented working plans. 25 per cent earmarked for forests, the rest usable for any developmental purpose.

## Renewable energy grant, payable to states in fiscal year 2014-15

### Based on

- States' relative achievement in renewable energy capacity addition in MW 1 April 2010 - 31 March 2014, assessed on the basis of a two-part weighted formula
- The capacity addition may be by private developers or public private partnerships. Ownership of the renewable energy capacity is not an issue

### Weights for components

- 75 % for installed capacity addition (over 2010-14) relative to aggregate addition across all states
- 25 % for installed capacity addition (over 2010-14) relative to unachieved potential of each state

## Improved water management

- Incentive grant for independent Water Regulatory Authority by deadline of 31 March 2012, subject to:
  - Normative state-specific revenue recovery rates
  - Additionality over and above routine maintenance expenditure by states