INTERGOVERNMENTAL TRANSFERS IN SELECTED COUNTRIES

M. Govinda Rao
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Intergovernmental Transfers in Selected Countries

M. Govinda Rao*

The instrument of intergovernmental transfers has been employed in all multilevel fiscal systems to achieve a variety of economic and political objectives. The economic objectives of intergovernmental transfers include: (i) offsetting the mismatch in the capacity to raise revenues with expenditure commitments between different levels of government (vertical fiscal imbalances) or among different governmental units within each of the levels (horizontal imbalance) to enable all governmental units to provide comparable levels of public services at comparable tax rates. This is achieved by giving grants to offset fiscal disabilities arising from low taxable capacity and high unit cost of providing public services; (ii) ensuring socially optimum levels of public services with large inter-jurisdictional spillovers by providing “Pigovian” subsidies. The transfers are also given to ensure prescribed minimum levels of supply in case of specified merit goods. These transfers are purpose-specific and may involve varying degrees of cost sharing by the recipient governments. The political functions of the transfer systems are equally, if not more, important. In many countries, the transfer systems have played a critical role in building the nation. The instrument has helped to hold diverse ethnic, religious, linguistic and cultural groups within a country together by ensuring an acceptable minimum level of basic social and economic services. This has also served as a potent instrument for the higher level governments to influence expenditure decisions at lower levels.

Although much of the analytical discussion on intergovernmental transfers focuses on economic objectives, in

* The author is grateful to Dr. Raja Chelliah and G. Thimmakka for useful comments on the paper. However, he alone is responsible for errors of both omission and commission.
the evolution of transfer systems, in most federations, historical, political, cultural, and linguistic factors are often more important. The design and implementation of transfer systems in every country, to a lesser or greater extent, represents a political compromise. To the extent that intergovernmental transfers influenced by non-economic factors are contrary to economic objectives, this constrains the ability of the governments to design and implement effective transfer systems. The experiences of different countries in designing and implementing transfer systems, therefore, helps to understand the common features as well as the contrasts, strengths and weaknesses in designing and implementing effective intergovernmental transfer systems. Such a study provides valuable lessons for evaluating and designing intergovernmental transfers in multilevel governmental systems.

This note analyses the evolution of intergovernmental transfer systems in four countries to draw lessons from their diverse experiences. Two countries in the sample, Australia and Canada, are relatively developed democratic federal countries with experience of designing transfers for over a century. India is a developing democratic federal polity with a population of almost a billion. The quasi-federal nature of the Constitution and the embracing of an import-substituting planned development strategy have impacted on the design and implementation of the intergovernmental transfer system in the country. The economic liberalisation process initiated in 1991 has, however, brought to the surface a number of contradictions in the transfer system. China, the fourth country analysed in this note, has been making rapid transition to a market economy with a considerable degree of fiscal decentralization. Although the governmental system in China is not federal, there are important issues relating to incentives and distortions arising from the transfer system which make examination of the experience of this country worthwhile. The experience of China
will provide useful lessons to transitional economies with similar institutional structures.

1. AUSTRALIA

1.1 Background

The fiscal transfer system in Australia has evolved for almost a century. After a decade of intense negotiations, the six British colonies\(^1\) came together to form a federal Commonwealth of Australia in 1901. These states were expected to be financially independent but, as customs duty, their main source of revenue before forming the confederation was assigned to the Commonwealth, an imbalance between their revenue capacities and expenditure needs was inevitable. According to the agreement, the Commonwealth was required to return the surplus collections to the states, but by 1909, it had expanded its own operations so that there was no surplus available for transfer. The resulting dissatisfaction of the states eventually led to an arrangement wherein the Commonwealth agreed to give fixed per capita grants in equal amounts to the states. In recognition of its higher collection of customs duties before the federation, Western Australia was given a special grant by inserting a section in the Constitution, which stated, "the Parliament may grant financial assistance to any state on such terms and conditions as it thinks fit". This provision was extensively used to make ad hoc grants to meet the grievances of states from time to time.

Throughout the 1920s, the financial grievances in the less populous states of South Australia, Tasmania and Western Australia were dealt with by giving ad hoc special grants. The growing dissatisfaction with this arrangement ultimately culminated in a referendum in favour of secession by Western

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\(^1\) The six British colonies were New South Wales, Queensland, South Australia, Tasmania, Victoria and Western Australia.
Australia, in 1933. This eventually led to the recognition that the federation had serious vertical and horizontal imbalances that needed to be resolved through general-purpose transfers, given in an objective and transparent manner. Thus, the Parliament enacted a law to establish a permanent and independent authority, the Commonwealth Grants Commission (CGC) in May 1933, to assess the claims of the states and determine their relative shares in equalising transfers.

Over the last 65 years, the federal transfer system in Australia has evolved primarily as an instrument to offset vertical and horizontal fiscal imbalances. It started as a “claimancy” system in which the fiscally disadvantaged states (at various times this included Queensland, South Australia, Western Australia and Tasmania) applied to the Commonwealth government for special grants to meet their current expenditure needs. The applications of the “claimant” states were assessed by the CGC on the basis of the latest audited results of their finances available to it. As there were considerable lags in the availability of audited results, the grants were given in two parts: (i) an advance grant determined on the basis of the forecast made by the Commission and, (ii) the final payment/adjustment after the audited accounts of the year became available. The CGC’s assessment, however, took into account the fiscal disabilities arising from lower taxable capacity, higher unit cost of delivering services, as well as the effects of any changes in Constitutional assignments and Commonwealth policies.

An important change in the intergovernmental transfer system occurred in 1942 when the Commonwealth government took over the collection of individual and corporate income taxes from the states to meet the financial pressures of fighting the war. This development accentuated vertical fiscal imbalance and firmly established the need for general-purpose transfers in the Australian federation. Thus, along with the claimancy grants, an income-tax reimbursement grant was introduced, and the
latter was given on the basis of average income tax collections in 1939-41. The states have become heavily dependent on these transfers from the Commonwealth ever since.

The quantum of tax reimbursement grants as well as its inter-state distribution changed frequently. The amount of transfers was initially determined by a formula in which the total was escalated by the growth rate of population in the six states added to the rate of increase in the average wage rate in the country. Inter-state distribution of the transfers was determined on the basis of the population of each state, adjusted for population density and the number of school-age children. With the expansion of these tax reimbursement grants, efforts were made to negotiate with the claimant states to opt out of the system, and by the late 1970s only Queensland remained a claimant state. At the same time, many supplementary grants called ‘special revenue assistance’ were introduced for various purposes and by the late 1970s, the transfer system, which began as a simple tax reimbursement scheme, was submerged in a maze of complex and opaque deals, bringing the system into disrepute.

The serious political and academic criticisms during the 1970s that the lack of a principled transfer system was inimical to the healthy development of the federation led to a review by the Commonwealth and state treasury officials in 1977. Consequently, the Grants Commission legislation was changed and the second phase in the role of CGC began, in which it assumed a more active and important role in the distribution of general-purpose transfers in Australia. The first comprehensive review by the CGC, which was completed in 1981, brought out the inadequacies in the transfer system and the need for substantial changes in the methodology. The 1982 review mandated the CGC to develop separate criteria for the distribution of health grants which, until then, were considered on a par with the distribution of general revenue transfers. The CGC, in its subsequent reviews, developed a comprehensive
methodology for estimating the 'relativities', taking into account both the shortfalls in the capacity to raise revenues, differential expenditure needs and unit cost of providing public services. These became the basis for the distribution of general revenue transfers. The Northern Territories (NT) as well as the Australian Capital Territory (ACT) were brought within the purview of CGC assessments for determining the relativities in 1988 and 1989 respectively.

Interestingly, as the distribution of general revenue transfers was placed on a more objective footing, the Commonwealth government tried to expand its influence over states’ expenditure decisions by increasing specific purpose transfers. Thus, over the years, the share of revenue recurrent grants distributed by the CGC declined steadily from more than 75 per cent in 1970-71 to 45 per cent in 1994-95. Commensurately, the share of specific purpose recurrent and capital grants increased. At present, besides the general revenue recurrent grants distributed by the CGC, specific purpose grants are given to the states for a variety of programmes administered by the relevant ministry of the Commonwealth government and also for capital purposes\(^2\). In addition, funds are also transferred through the states and territories for services, which are not provided for in their budgets. These transfers are made either for carrying out the agency function or to finance services falling within the states' domain. These include payments to universities, local government authorities and for non-government education.

1.2 Assignments and Vertical Fiscal Imbalances:

Australia is a two-tier federation and the Constitution assigns revenue and expenditure powers to the Commonwealth

\(^2\) These are called general revenue capital grants under the Commonwealth Building Better Cities Programme, and its distribution is determined by the Commonwealth Department of Housing and regional development based on agreements with the states after assessing individual projects.
and the state governments, and the latter in turn devolve some powers and functions to local (municipal) governments. A unique feature of Australian federalism is the high degree of centralisation of tax powers, which has resulted in large vertical imbalances - certainly the largest among the federations in the developed world. The state governments have been excluded from levying income taxes, customs and taxes on production and distribution. In fact, they do not have access to any broad-based taxes and their revenues accrue mainly from payroll taxes, stamp duties and motor vehicle taxes. At the same time, the states have the responsibility to provide most of the social and community services. Thus, in 1994-95, while the Commonwealth government collected almost 70 per cent of the total revenues, it incurred about 53 per cent of the expenditures. The state governments, in contrast, raised only about 26 per cent of total revenues, but incurred about 42 per cent of the expenditures. Almost 43 per cent of spending by the state governments was financed by transfers from the Commonwealth government.

Horizontal imbalances in Australia, however, are not very significant. As shown in Table 2, the index of revenue capacity (as assessed by the CGC) among the states ranged from 75 in Tasmania to 107 in New South Wales. The differences in cost disabilities, too, were not very large except in the Northern Territory, where the low density of population pushed up the unit costs of providing public services significantly.

While the large vertical fiscal imbalance has warranted a very important role for intergovernmental transfers in Australia, the relatively low level of horizontal imbalances has taken away the need for targeting the transfers. Even the state with the highest revenue capacity and lowest cost disability has to depend on the Commonwealth government to finance a part of its expenditures and, therefore, transfers have to be given to all the
states. Thus, the amount of transfers needed to offset fiscal imbalances is large, but the inter-state differences in the fiscal disabilities are not very high, except, as mentioned earlier, in the Northern Territory.

### Table 1.1
**Vertical Imbalances in Australia, 1994-95**

<table>
<thead>
<tr>
<th>Level of Government</th>
<th>Own Revenues (Million $)</th>
<th>Percentage of Total Revenues</th>
<th>Own Expenditures * (Million $)</th>
<th>Percentage of Total Expenditures</th>
<th>Percentage of Own Revenues to Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commonwealth</td>
<td>114309</td>
<td>69.87</td>
<td>94805</td>
<td>53.54</td>
<td>120.57</td>
</tr>
<tr>
<td>State</td>
<td>42554</td>
<td>26.01</td>
<td>74017</td>
<td>41.80</td>
<td>57.49</td>
</tr>
<tr>
<td>Local</td>
<td>6745</td>
<td>4.12</td>
<td>8245</td>
<td>4.66</td>
<td>81.81</td>
</tr>
<tr>
<td>Total</td>
<td>163608</td>
<td>100.0</td>
<td>177067</td>
<td>100.0</td>
<td>92.40</td>
</tr>
</tbody>
</table>

*Note: Excludes all transfers including payments to other governments.
Source: Rye and Searle (1997).*

### Table 1.2
**Horizontal Imbalances in Australia**

<table>
<thead>
<tr>
<th>State</th>
<th>Household Income Per Capita 1991-92 (A.$)</th>
<th>Relative Income Index 1991-92</th>
<th>Relative Revenue Raising Capacity*</th>
<th>Relative Cost of Service Provision*</th>
</tr>
</thead>
<tbody>
<tr>
<td>New South Wales</td>
<td>15657</td>
<td>105</td>
<td>107</td>
<td>98</td>
</tr>
<tr>
<td>Victoria</td>
<td>15424</td>
<td>104</td>
<td>98</td>
<td>92</td>
</tr>
<tr>
<td>Queensland</td>
<td>13239</td>
<td>89</td>
<td>98</td>
<td>100</td>
</tr>
<tr>
<td>Western Australia</td>
<td>13913</td>
<td>94</td>
<td>108</td>
<td>109</td>
</tr>
<tr>
<td>South Australia</td>
<td>14227</td>
<td>96</td>
<td>86</td>
<td>102</td>
</tr>
<tr>
<td>Tasmania</td>
<td>12647</td>
<td>85</td>
<td>75</td>
<td>108</td>
</tr>
<tr>
<td>Northern Territory</td>
<td>13621</td>
<td>92</td>
<td>98</td>
<td>273</td>
</tr>
<tr>
<td>Australian Capital Territory</td>
<td>19204</td>
<td>129</td>
<td>91</td>
<td>90</td>
</tr>
<tr>
<td>Australia</td>
<td>14855</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

*Note: * Average of 1988-89 to 1992-1993
1.3 Intergovernmental Transfers in Australia:

There are four types of transfers in the Australian intergovernmental transfer system, which constituted A$ 32.1 billion or 28.1 per cent of Commonwealth revenues in 1994. First and foremost is the general revenue recurrent grants given to the states to offset their vertical and horizontal imbalances. This item of transfers constitutes about 45 per cent of the total transfers. Next in importance, accounting for about 38 per cent of the transfers is the specific purpose payments made to the states to cover both current and capital expenditures. Third, some specific purpose transfers, constituting about 16 per cent, are also made through the states to universities, non-government education and for local governments. Finally, some minor grants are also given for urban infrastructure under the Better Cities Programme, initiated in 1991-92. The first three programmes constitute over 99 per cent of the total transfers and are discussed in some detail below.

Notably, total intergovernmental transfers as a proportion of GDP has steadily declined from about 9.5 per cent in 1982-83 to 6.7 per cent in 1994-95 (Mathews and Grewal, 1998). Both general purpose and specific purpose grants (including transfers through the state governments) have declined - the former more than the latter. Consequently, the share of general-purpose grants in the total declined from about 55 per cent to 46 per cent during the period. The decline in the share of grants to the states and, within it, the decrease in the share of general-purpose grants, represent an increasing degree of Commonwealth control and discretion in expenditure decisions in the Australian federation.

(i) General revenue recurrent grants:

General revenue recurrent grants given to the states and territories are intended to offset their revenue and cost disabilities. The total amount of these general-purpose grants
is determined at the annual Premiers’ conference\(^3\), and in this task, macroeconomic perceptions by the Commonwealth government play a decisive role. The distribution of grants between different states is also decided in the Premier’s conference, but this is based on the recommendations of the CGC.

The most important feature of the general revenue grants in Australia is the institution of the CGC. It is an independent advisory body appointed by the Commonwealth government (after taking into account the views of the states) consisting of a chairman and three members who are appointed on the basis of their professional qualifications. It is a permanent body undertaking continuous research on intergovernmental transfers to improve the methodology of measuring fiscal capacities and expenditure needs of the states. Since 1993, when the first comprehensive review was undertaken, the CGC has been required to undertake comprehensive reviews every five years mainly to estimate the relativities of the states. In between these reviews, the CGC is also required to do annual updates to ensure that these relativities are in line with the states’ latest financial positions. The objective of the exercise is to enable each of the states to have the capacity to provide the average standard of public services, at the average level of efficiency when the states put in the average tax effort from the sources of revenue assigned to them.

The methodology employed by the Commission to estimate the states’ relativities takes into account both shortfalls from the standard (average) in revenue raising capacity and excess over the standard (average) unit costs and expenditure needs. To estimate these fiscal parameters, the Commission first puts each of the states’ revenues and expenditures into a

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\(^3\) The Premiers’ conference is the annual meeting of the Prime Minister and the Commonwealth Treasurer with the state Premiers and treasurers on fiscal transfers.
common framework by excluding all capital transactions and predominantly Commonwealth funded items (expenditures on Universities). There are 19 revenue items and 41 expenditure categories.

The next step is to estimate the two major sources of fiscal imbalances - the differences in per capita revenue capacity and the differences in the unit cost of providing public services. This involves identifying the beneficiary population for the relevant service and estimating the unit cost of providing the services. Only those cost elements that are beyond the control of the states are taken into account in estimating cost disabilities. Similarly, revenue-raising capacity is estimated by estimating the tax base or its closest proxy and multiplying it by the average rate.

The grants recommended by the CGC are meant to enable every state to provide the average level of services and, therefore, take into account the all-state average budgetary position (surplus/deficit), in addition to standardised revenues and expenditures. They also include the specific purpose transfers received by the states in the equalisation scheme. Thus, the general revenue grants recommended by the CGC are calculated as standardised expenditure plus standard (average) budget deficit minus standardised revenue minus specific-purpose grants received by the states\(^4\). All these calculations are done in per capita terms and then multiplied by the population to arrive at total general revenue assistance.

**(ii) Specific purpose grants:**

In 1994, specific purpose payments given to the states amounted to A$ 12.5 billion, constituting about 38 per cent of

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\(^4\) The per capita general revenue assistance (Gc) is estimated as follows:

\[ Gc_i = Eci + B - Ri - Gsi, \]

where, \(Eci\) is the per capita standardised expenditures of the \(i\)th State, \(B\) is the standard (average) per capita budget deficit/surplus, \(Ri\) is the per capita revenue capacity of the \(i\)th State and \(Gsi\) is the per capita specific purpose grants received by the \(i\)th State.
the grants given by the Commonwealth to the states. Almost 80 per cent of these transfers were for recurrent expenditures. The objective of specific purpose payments by the Commonwealth is to influence state expenditure policies to fulfil the national objectives. Unlike the revenue recurrent grants, these grants are purpose-specific, given to ensure performance equalisation.

Specific purpose payments are given for a number of reasons. Between 1990 and 1995, more than 90 specific purpose grant programmes were designed to transfer funds (Rye and Searle, 1997). Prominent among them are those for education and health sectors. In 1994-95, for example, grants to these two sectors formed almost 70 per cent of total specific purpose grants. Grants given through the states to local governments constituted another 6.5 per cent of specific purpose grants. Other activities that received significant (more than 5 per cent) funding from specific purpose grants were social security and welfare payments, housing and community services, and transport.

The performance equalisation in respect of specified public services is sought to be achieved by stipulating conditions, and these fall into broadly four groups: (i) the requirement that granted funds be expended on the specified programme or purpose; (ii) some aided functions require programme requirements. The hospital-funding grants, for example, are given only when the state provides free public hospital treatment to those who do not choose private treatment; (iii) adhering to the Commonwealth-state agreements on the principles of service provision and delivery mechanisms; and (iv) meeting the conditions on the execution of joint expenditure programmes including project design and approval, cost sharing and information requirements. Although there are many complaints about Commonwealth interference, no state has so far resisted the temptation of additional funds from special purpose payments.
(iii) Transfers through the states:

Specific purpose payments through the states are funds transferred to the states for administrative convenience, or because the aided functions fall in the domain of the states rather than the Commonwealth government. The most important component of this is the transfers, which the states have to pass on to the local governments. Payments to universities and non-government education are also included in this category. These payments constitute about 16 per cent of Commonwealth grants to state governments.

The major item of transfers through the states is the grants given to local governments. As mentioned earlier, the Constitutional assignments refer to only two levels of government - the Commonwealth and the states. The local (municipal) governments are the creatures of the states as their form (in terms of boundaries or population) and existence depend upon the states' decisions. There are about 900 local government authorities in Australia at present.

In the early 1970s, the Commonwealth government tried to distribute general-purpose transfers directly to local governments, and the CGC was asked to assess their requirements. However, the states did not like the idea and the CGC found estimating relativities for the local governments unmanageable. Since 1976-77, Commonwealth transfers to local governments have been passed through the state governments on an equal per capita basis. Each state is required to establish a local government grants commission to recommend the distribution of these grants between different local governments within their respective jurisdictions. These commissions are totally independent of the CGC, and base their recommendation on the equalisation principle, though they do not follow as rigorous a methodology as is instituted by the CGC. In 1976-77, the amount of transfers to local governments was fixed at 1.52 per cent of the income tax collections in the previous year,
which was later raised to 1.75 per cent in 1979-80 and further to 2 per cent in 1980-81.

1.4 Concluding Remarks

The foregoing description shows that the Australian intergovernmental transfer system is probably one of the most comprehensive, and the approach and methodology of transfers have infused a sense of objectivity and transparency. It has a mix of both general purpose and specific purpose transfers. The most important is the general-purpose transfer or revenue recurrent grants given to offset revenue and cost disabilities of the states. The Commonwealth government also tries to influence the expenditure decisions of the state governments to ensure performance equalisation through specific purpose transfers. In addition, grants are also given through the states, mainly to the local governments and educational institutions like universities.

The total quantum of revenue recurrent grants is determined every year by the Premiers’ conference, where both the Commonwealth and each of the state governments are represented. Although the issue of the quantum of these general-purpose transfers is debated in the conference, the Commonwealth government’s views receive dominant consideration and play a decisive role. The distribution of these transfers, however, is done on the basis of the relativities (revenue and cost disabilities) estimated by the CGC. The Commonwealth government, however, determines both the quantum of transfers and inter-state distribution of specific purpose grants. Of course, these are given on the basis of objective criteria.

An important feature of the general-purpose transfer system is the institution of an independent expert body, the CGC, to determine the relative shares of different states and territories in total revenue recurrent grants. The CGC has been able to
develop a scientific methodology acceptable to all the parties, incorporating both the revenue capacities and expenditure needs to estimate the relativities on which the transfers are based. The transparent approach by the commission, as well as robust methodology and good quality of statistics used in the estimation of relativities infuse a sense of objectivity and fairness into the transfer system. The commission works closely with both the Commonwealth and state governments and the frequent and informal interaction helps it to gain the trust and confidence of all the parties concerned. The approach and methodology adopted by the CGC has reduced the scope for various lobbies in the determination of general purpose transfers and has shifted their focus to influencing specific purpose transfers to ensure performance equalisation in specific services.

Although, by and large, the Australian transfer system has many desirable features, there still exist important problems. The states and, even more, the local governments have very little say in determining the transfers, though formally the quantum of transfers is decided in the annual Premiers’ conference, in which the state premiers are present. Even more important is the fact that the determination of specific purpose transfers is entirely within the discretion of the Commonwealth government. In fact, this component of transfers has increased steadily over the years. Although specific purpose transfers too are formula based, the increase in the proportion of such transfers gives the central government greater control over sectoral and regional expenditure allocations.

In spite of these shortcomings, the transfer system in Australia has served well in resolving vertical and horizontal imbalances in a manner broadly acceptable to both the centre and the states. While the harmonised tax system has helped businesses, the vertical imbalances have been satisfactorily resolved through the intergovernmental transfers given in a formula-based transparent manner.
2. CANADA

2.1 Background

With the adoption of the British North America Act in 1867, Canada became a "country" with its own national government. Despite the fact that the population consisted predominantly of settlers from Great Britain and continued close link with the British Commonwealth, the country evolved itself as a federation for over a century. Canada, when it was evolved as a federal country, had only United States and Switzerland as models before it. Surprisingly, even the proximity to, and close relationship with, the United States did not influence the shaping of its federal institutions or intergovernmental transfer programmes; Canadian federalism evolved as a distinct entity with a strong emphasis on egalitarianism and welfare, much different from the American federalism.

Canada is a large country with about 10 million sq. kms in area, but is inhabited by only about 29 million people. The Constitution determines the legislative and fiscal powers of the federal government and provinces, and the latter, in turn, delegate powers to the local governments. There are 10 provinces and two northern territories (Yukon and north-west), with about 5000 municipalities below them. Except the three Maritime Provinces in Eastern Canada (Nova Scotia, New Brunswick, and Prince Edward Island) where about 6 per cent of the population lives, all provinces have large areas with limited inter-provincial spillovers.

The majority of the population speaks English, while about a quarter of the total population, residing in the province of Quebec speaks French. The concentration of French-speaking population in Quebec, and its strong resistance to central domination, including the possibility of the province leaving the federation not only necessitated a high degree of fiscal decentralization, but has also contributed significantly to the
design and implementation of the federal transfer system in Canada. The expenditure responsibilities as well as tax powers assigned to provincial and local governments are larger than in most other federations. For the same reason, unlike its southern and dominant neighbour, the United States, the transfer system in Canada has moved in the direction of giving more general purpose transfers. Even when they have to be purpose specific, the trend has been to broad-band them and impose less restrictive conditions on their use.

2.2 Evolution of the Transfer System

The evolution of the intergovernmental transfer system in Canada can be traced to the British North America Act of 1867 itself, which confederated four colonies\(^5\). The Act empowered the federal government to raise revenue "by any mode of taxation", but restricted the provinces to levying only "direct taxes". As almost 80 per cent of the revenues of the colonies before the confederation accrued from customs and excise taxes, the provinces lost this lucrative source of revenue. To compensate them, the federal government introduced three types of assistance. First, a predetermined amount of grants was given. Second, the federal government assumed the debt burden of all the four provinces. Finally, a statutory subsidy at the rate of 80 cents per capita subject to a ceiling of 400,000 persons was given to each of the provinces. These grants and subsidies were extended to other provinces when they joined the confederation and later, due to persistent requests from more populous provinces, the ceiling was raised to 2.5 million persons. The low revenue capacity of the three Maritime Provinces (Nova Scotia, New Brunswick and Prince Edward Island) prompted the Royal Commission in 1926 to recommend doubling of the statutory subsidies to them. The Royal Commission in 1934

\(^5\) The four colonies which initially joined together to form a confederation were Ontario, Quebec, Nova Scotia and New Brunswick.
further increased payments to the Maritime Provinces, and instituted special grants to depression-ridden provinces.

Although the objective of these unconditional grants was to equalise the levels of public services in fiscally disadvantaged provinces, the language of equalisation was not used until the report of the Royal Commission on Dominion-Provincial Relations (Rowell-Sirois Commission) in 1937. The Commission, having been influenced by the Great Depression, placed heavy emphasis on stabilisation. It recommended that the provinces vacate the field of income tax on individuals and companies. In return, the federal government should (i) take over the two shared-cost functions, unemployment relief and old age pensions entirely, and (ii) should give “National Adjustment Grants” - unconditional equalising transfers to achieve “...average standard of services in every province”. The provinces did not agree to give up their income taxes, and rejected the recommendations.

However, what financial reasoning could not achieve, patriotism did. When the Second World War broke out, the provinces agreed to the federal proposal to “rent” personal and company income tax bases to the federal government. This arrangement started in 1941 and continued until 1947. Thereafter, Quebec and Ontario broke off the arrangement, but it continued in other provinces in a modified form. In 1957, a proposal was made in which the provinces could choose between renting the tax base to the federal government to receive revenues equivalent to 10 per cent income tax, 9 per cent company tax and 50 per cent succession duties based on a three-year average, or levying their own tax, and the federal government would provide an abatement equal to the above percentages. All provinces except Quebec entered into the tax rental arrangement in the case of income tax. In the case of company taxes, Quebec and Ontario were the exceptions. As the revenues to the provinces accrued according to the principle of derivation, the
federal government agreed to pay to each province an amount equivalent to the difference between its own yield and the average of the top two provinces from the three standard taxes. In addition, the federal government introduced stabilisation payments to compensate the provinces for any fall in revenues below 95 per cent of the average of the three previous years. Thus, equalisation was introduced essentially to neutralise the inequities arising from the tax rental arrangement, but it took firm roots to remain even after the rented taxes were returned to the provinces under the tax collection agreement of 1962. In 1982, Section 36 (2) was added to the Constitution to mandate equalisation payments. It states, “Parliament and the Government are committed to the principle of making equalisation payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.”

As mentioned above, under the tax collection agreement the federal government returned the rented tax bases to the provinces in 1962 on the condition that the provinces should accept federal definitions of the personal and corporate tax bases and apply the tax at only a single rate\(^6\). The federal government, on its part, agreed to abate 16 per cent of personal income tax and 9 per cent of corporate income tax to the provinces, and these percentages were increased later. It also agreed to return 50 per cent of the revenue from succession duties.

The basic framework of equalisation, formally introduced in 1957, has changed as the coverage of provincial revenues was broadened over the years. In 1962, revenue from natural resources was added to the equalisation programme. Gradually, all the provincial revenues from taxes, rates and fees as well as

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\(^6\) The condition has become less restrictive in recent years since the provinces are allowed to give various tax credits and surcharges. See, Courchene, (1984).
those from their enterprises were included. Finally, in 1973 and 1982, equalisation coverage was extended to property taxes to assist school and municipal purposes respectively. At present, about 30 separate revenue sources are considered for equalisation.

2.3. Assignments:

The foregoing description shows that concurrency is an important feature of tax assignment in Canada. The federal government can levy taxes on all tax bases and the local governments are restricted to levying only direct taxes. However, as the courts in Canada have interpreted retail sales tax as a "direct tax", concurrency extends to both income and consumption taxes. Interestingly, in spite of overlapping tax assignments, the country has a relatively harmonised tax system. The tax base harmonisation achieved in the tax collection agreements has continued; the existence of large provinces has minimised inter-jurisdictional tax competition and the prohibition of taxation on inter-provincial trade has reduced tax spillovers.

2.4. Vertical and Horizontal Imbalances:

Access to broad-based revenue sources by the sub-national governments in Canada has ensured a fair degree of vertical fiscal balance. Both in raising revenues and in incurring expenditures, the share of provincial and local governments in Canada was higher than that of the federal government. In 1993, for example, the provincial and local governments together raised about 53 per cent of total revenues and incurred about 60 per cent of total expenditures. Together, the provincial and local governments raised revenues to finance about 77 per cent of their expenditures. The analysis shows that revenues raised from own sources were adequate to meet the expenditures of the provinces fully and much of the federal transfers were actually passed on to the local governments (Table 2.1).
Notably, the assignment of broad-based revenue sources to provinces, combined with large regional disparities, has produced significant inter-provincial fiscal imbalances. The problem has been exacerbated by the assignment of the right to the provinces to tax natural resources, which are concentrated in the high-income provinces of Alberta and British Columbia. Ontario is the most advanced province in terms of agricultural and industrial development. The four Atlantic provinces (Newfoundland, Nova Scotia, New Brunswick and Prince Edward Island) have neither natural resources nor significant agricultural and manufacturing bases. Thus, the difference between the lowest and the highest fiscal capacity provinces in 1994-95 was almost two times, ranging from an index of 65.6 in Newfoundland to 130 in Alberta.

<table>
<thead>
<tr>
<th>Table 2.1</th>
<th>Vertical Imbalances in Canada, 1993</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Level of Government</strong></td>
<td><strong>Own Revenues (Million $)</strong></td>
</tr>
<tr>
<td>Federal</td>
<td>137447</td>
</tr>
<tr>
<td>Provincial and Local</td>
<td>158388</td>
</tr>
<tr>
<td>Total</td>
<td>295835</td>
</tr>
<tr>
<td>Provincial only</td>
<td>120827</td>
</tr>
<tr>
<td>Local only</td>
<td>36119</td>
</tr>
<tr>
<td>Hospital only</td>
<td>1442</td>
</tr>
</tbody>
</table>

Source: Department of Finance, Government of Canada

2.5. **Intergovernmental Transfers:**

At present, the intergovernmental transfer system in Canada has three main components. First, the *equalisation payments* is a general purpose transfer scheme designed to offset the disabilities of those provinces with less than the specified
standard revenue capacity. Second, under the Established Programme Financing (EPF), the federal government contributes to the financing of two important services under the provincial domain, namely, health care (to provide insurance cover for individuals regarding services by doctors and hospitals) and post-secondary education. Third, the Canada Assistance Plan is a shared cost programme designed to provide welfare services for vulnerable groups. The federal transfers are given mainly to the provincial governments, but the municipal and school authorities also receive small amounts.

In addition to these three main components, which constitute over 90 per cent, transfers are also given to the two Territories in northern Canada, which do not have provincial status. Specific-purpose transfers are also given for a variety of programmes in agriculture, economic development, energy, housing, environment, forestry, fisheries and justice. In addition, there are two special programmes given to stabilise provincial revenues. The fiscal stabilisation programme is intended to offset any year-to-year reduction in total revenues from taxation due to economic conditions (and not rate reduction), equalisation and the EPF. The Revenue Guarantee Programme compensates individual provinces for a reduction in personal income tax revenue of over one per cent, if the reduction is due to changes in the federal income tax law with which provincial taxes are harmonised. The financial implications of all these programmes are, however, not very significant.

a. Equalisation payments:

The equalisation entitlement for each of the provinces is quantified by estimating the shortfall in taxable capacity of the province from the "standard" capacity. Taxable capacity of individual provinces for each of the 30 different taxes\(^7\) levied

\(^7\) In Canada, for equalisation purposes, taxes are defined in a broad sense to include various non-tax items like rates, fees, and natural resource revenues.
by the provincial and local governments is estimated by using the Representative Tax System (RTS) approach. According to this approach, first, the base of each of the taxes to be equalised is quantified. Next, the average effective tax rate for each of the taxes is estimated by dividing revenue collection from the individual taxes by their respective bases summed over all the provinces. By multiplying the average effective tax rate of individual taxes with the value of the tax base in each of the provinces, the taxable capacity from the tax in different provinces is arrived at. By adding the capacity over all the 30 taxes and dividing it by the population of the province, per capita taxable capacity in individual provinces is estimated. For the provinces with lower than the standard per capita capacity, the shortfall is

<table>
<thead>
<tr>
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<th>Population (Million)</th>
<th>Index of Fiscal Capacity</th>
<th>Fiscal Capacity After Equalisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alberta</td>
<td>2.71</td>
<td>129.9</td>
<td>122.6</td>
</tr>
<tr>
<td>British Columbia</td>
<td>3.59</td>
<td>110.6</td>
<td>104.3</td>
</tr>
<tr>
<td>Ontario</td>
<td>10.91</td>
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<tr>
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<tr>
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<td>84.5</td>
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<tr>
<td>Non-receiving Provinces</td>
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Source: Department of Finance, Government of Canada.
standard revenue capacity. Second, under the *Established Programme Financing* (EPF), the federal government contributes to the financing of two important services under the provincial domain, namely, health care (to provide insurance cover for individuals regarding services by doctors and hospitals) and post-secondary education. Third, the *Canada Assistance Plan* is a shared cost programme designed to provide welfare services for vulnerable groups. The federal transfers are given mainly to the provincial governments, but the municipal and school authorities also receive small amounts.

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Source: Department of Finance, Government of Canada.
multiplied by the population of the province to determine equalisation payments.

The choice of the "standard" holds the key to determining the extent to which inter-provincial disparities in taxable capacity are reduced. In the initial years, the equalisation standard was based on the per capita revenue-raising capacity of the two richest provinces. As the coverage was extended to include more tax bases in 1967, the standard had to be lowered, first to the average of all the ten provinces and later to the average of five middle income provinces in 1982 (excluding the richest province Alberta, and the four poorest provinces, Atlantic provinces). To contain the cost of equalisation to the federal government, and to reduce volatile fluctuations in the volume of transfers (which at that time was due to large fluctuations in the price of oil and natural gas) a programme ceiling was added in 1982 which limits the total amount of transfers as a percentage of GNP. The ceiling was changed in 1987-88, 1992-93 and 1994-95 and is placed at 1.2 per cent of GNP at present.

Unlike in Australia where the relativities for equalisation are estimated by the CGC, equalisation payments in Canada are determined by the Ministry of Finance itself. However, the ministry administers the programme in close consultation with the provinces at the level of both ministers and officials. In fact, provincial equalisation entitlements are calculated before the commencement of the financial year (April 1), are revised twice during the course of the fiscal year, and final calculations are made after the end of the fiscal year.

By all accounts, equalisation payments in Canada are a well targeted and highly successful transfer programme. The total cost of equalisation to the federal government is only 1.2 per cent of GNP, and yet the targeted nature of equalisation results in a significant reduction in the disparities in revenue capacities across provinces. In 1994-95 for example, all the provinces eligible for entitlement were brought up to 93.6 per
cent of the average capacity. A major weakness of the programme, however, is that the transfer system offsets only the shortfalls in revenues and not cost disabilities across provinces. Further, the equalisation entitlements do not take into account the capacity differences arising from other transfers, though care is taken to see that the progressivity of the transfer system is not reduced in designing other transfers.

b. Other instruments of federal-provincial transfers:

(i) Established Programme Financing (EPF):

EPF is a specific purpose transfer programme in which the federal government contributes to the financing of two important services in the provincial domain, namely, healthcare and post-secondary education. Prior to 1977, the federal government provided specific purpose transfers to a variety of programmes within the two services on a matching basis. These were consolidated into block funding to be spent on the two services with certain conditions. The conditions in the case of health are that the coverage must be universal, access must be uniform (premiums should not be high for high risk individuals), the programme must be administered by a public agency (not private insurance company), the benefits should be 'portable' when a resident of the province moves to another, and all medically necessary services must be covered under the programme. Interestingly, in 1984 a condition was added that if a province imposed user charges, the federal grants would be reduced by an equivalent amount. These conditions have ensured near uniformity of the two services throughout the country.

The shared-cost nature of the programmes led to their rapid expansion with increasing complexity. The attempt to impart simplicity on the one hand and contain expenditures on the other, led to changes in 1977 in which cost-sharing was given up and the EPF was converted into a 'block grant' with the amount of
payments growing at a rate equivalent to the rate of growth of the economy from the base year, 1975. Transfers to the provinces were given on an equal per capita basis, paid partly in cash and partly in terms of tax abatement or ‘tax room’, by reducing the federal income tax rate to enable the provinces to leave larger tax room to occupy.

In later years, to contain the federal government’s budget deficit, several expenditure restraints were introduced into the EPF. In 1989, the increase in the grant every year was limited to GNP growth minus 3 per cent. In 1990, the rate of growth of the grant was limited to that of the population. Finally, in 1994-95, the federal government announced that from 1996-97, the post-secondary education component of the EPF, along with the Canada Assistance Plan, would be rolled back to the 1993-94 level.

(ii) The Canada Assistance Plan (CAP):

CAP is a specific purpose programme with matching requirements from the provinces in the field of welfare. In 1966, the four shared cost programmes on blind persons’ allowances, old-age assistance, disabled persons’ allowances and unemployment assistance were consolidated into a broad programme for assisting persons in need. The programme has since been expanded and has changed significantly. At present, it has two basic components: (i) assistance for children (including food, shelter, clothing, fuel, utilities, household supplies), and (ii) welfare services, which include day-care services for children, home support, counselling, training, and rehabilitation. The programme is designed and implemented by each province. The federal government shares 50 per cent of the cost of these programmes. Nine provinces receive the transfers entirely in cash and Quebec gets a portion in the form of tax transfers. However, to contain its budget deficit, the federal government has introduced limits on the growth of payments to 5 per cent
per year for those provinces not entitled to receive equalisation payments.

(iii) Other transfer programmes:

There are a number of other transfer programmes, but they constitute less than 10 per cent of the total transfers. Almost a quarter of this is given for financing the two northern territorial governments, which cover 39 per cent of the total area of the country but have only about 0.3 per cent of the population. Transfers are given mainly to offset their fiscal disabilities, but they are not considered along with the provinces because in their equalisation the high unit cost of providing public services needs to be explicitly considered in addition to their low fiscal capacity, given their low population density and extremely cold climate. There is also a transfer programme to ‘stabilise’ revenues - to ensure that combined revenues from own sources (excluding the effect of reduction in rates if any) and equalisation payments do not decline from the previous year. Transfers are also given under the revenue guarantee programme to compensate individual provinces for year-to-year reductions exceeding one per cent in personal income tax revenue, due to changes in federal income tax law.

2.6. Provincial Transfers to Local Governments

The local governments raise only about 56 per cent of the expenditure requirements from their own sources of revenue and depend upon transfers from provincial and, to a minor extent federal governments, to finance the remaining expenditures. The bulk of the transfers received by the local governments are purpose specific and most have matching requirements. The only exception seems to be the transfers from federal and provincial governments given to local governments in lieu of the levy of property taxation of federal and provincial properties, respectively.
An important feature of Canadian fiscal federalism is the direct transfers from the federal government to local governments, bypassing the provinces. Grants to municipal governments are given mainly in lieu of taxation of federal property within the geographical boundaries of municipalities. Some grants are also given by the federal government directly to municipalities for housing, industrial development, urban renewal, and home insulation and for strengthening municipal infrastructure. Interestingly, these direct transfers to local governments the provinces do not object to partly because the amount thus transferred is not large, and also because a similar arrangement exists in the USA.

Unlike federal transfers to provinces, the transfers from provinces to local governments are mostly purpose specific. General-purpose transfers constitute less than 15 per cent of the total provincial transfers to local governments. These include a small grant given for general purposes on a per capita basis and the grants given in lieu of taxes on provincial property within their geographical boundaries. The largest component (about 60 per cent) of provincial transfers to local governments is for education, followed by grants to hospital authorities. Other specific purpose transfers include grants for police, water and sewer services, neighbourhood improvements, road maintenance, urban transportation, and cultural and recreational activities.

2.7 Concluding Remarks:

The Canadian intergovernmental transfer system has evolved over the years to adjust to the changing requirements of the economy. Like Australia, Canada has a firm commitment to its equalisation programme and makes the largest proportion

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8 The local governments are prevented from taxing provincial and federal property within their jurisdictions and in lieu of it both the governments give grants.
of transfers through general-purpose transfers to offset revenue disabilities of poorer provinces. These transfer payments are formula based, though they are designed to offset only fiscal capacity, but not cost disabilities. The formula itself has been changed from time to time to accommodate changing requirements. Even the distribution of specific purpose transfers is mostly formula determined, which reduces the subjectivity and makes the transfer system more transparent.

As in Australia, the federal government has an important say in determining the total volume of transfers, and, hence, can push the deficits down to the provinces when required for stabilisation. Interestingly, even the distribution of transfers among the provinces is done by the federal government and not any independent body like the CGC in Australia. Nevertheless, the formula-based nature of transfers and objectivity and transparency makes them acceptable to the provinces.

An important reason for the acceptability of the transfer system is the critical role of the provinces in evolving the transfer system. First, unlike in Australia, vertical fiscal imbalance is not a major problem in Canada and, as such, equalising grants do not have to be given to more affluent (powerful) provinces. More importantly, over the years, under the influence of the provinces, there has been increasing substitution for specific purpose transfers, particularly transfers under the EPF, with giving the provinces greater tax room. The influence of the provinces is seen also in making the EPF a block grant for post-secondary education and health care and also in consolidating the specific purpose programmes under the CAP to give the provinces greater flexibility in executing these shared cost programmes.

The Australian and Canadian systems of tax assignment and transfer present contrasting, yet satisfactory alternatives from the viewpoint of the business lobby as well. The Australian tax
system is centralised and the high degree of vertical fiscal imbalances is corrected through the transfer system. In the Canadian case, the assignment is highly decentralised, yet the tax collection agreements which the provinces have entered into with the federal government have resulted in a remarkable degree of tax harmonisation while equalisation transfers have had to deal mainly with the issue of horizontal imbalances. In fact, the concurrent and harmonised levy of taxes by both federal and provincial governments has given the federal government greater flexibility in designing transfers, particularly in giving more tax room to the provinces instead of cash transfers.

While there is much to commend in the Canadian transfer system, it is not free from weaknesses. The equalisation transfers attempt to equalise only taxable capacities and not cost disabilities. This does not ensure equalisation of public services according to the five-province average if there are significant differences in the unit cost of providing public services. Not taking into account expenditure needs or cost disabilities in equalisation payments in Canada is considered to be a major weakness in the Canadian transfer system. Another emerging issue is that as tax room is increasingly substituted for cash transfers, particularly to richer provinces, macroeconomic control by the federal government tends to get reduced.
3. CHINA

3.1 Introduction

The evolution of the fiscal system, more particularly intergovernmental transfers in the Peoples Republic of China (PRC), has very useful lessons to offer to similarly placed transitional economies. The experience of the PRC brings out the problems of transforming a fiscal system, which was originally designed to meet the needs of economic construction in a centrally planned economy, to adapt to the requirements of public goods provision in a market-oriented economy. It also demonstrates the incompatibility of the fiscal system evolved in the context of a planned economy with a market economy where investment decisions are decentralised.

China is a unitary country, but the Constitution recognises the importance of local government when it declares in Article 3: "...giving full play to the initiative and enthusiasm of the local authorities under the unified leadership of the central authorities". There are four hierarchically ordered administrative levels of government below the centre totalling about 50,000 entities (Figure 3.1): (i) 31 provinces, autonomous regions and municipalities directly under central government; (ii) 333 prefectures and municipalities at prefecture level; (iii) 2148 counties, autonomous counties, and cities at county level; and (iv) 48697 townships, towns, and city districts. All sub-national governments are referred to as "local governments".

3.2. Evolution of Intergovernmental Transfer System in China:

Before 1980, the fiscal system was centralised and intergovernmental transfers in the PRC were evolved in an environment of centralised resource allocation. Government revenues accrued predominantly from profits of state-owned enterprises (SOEs), and taxes played a subsidiary role. In 1975,

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9 Excluding Taiwan and Hong Kong
for example, enterprise income constituted almost 55 per cent of government revenues. The major taxes consisted of cascading type turnover taxes (industrial-commercial taxes) and income taxes levied on non-state enterprises. The centre determined all tax bases and tax rates, but the local tax administration collected the taxes and remitted them upward according to the negotiated arrangements. Administered prices transferred the resources in favour of the industrial sector by setting the terms of trade against the agricultural sector. Such implicit resource transfers were not neutral across regions either. Fiscal arrangements required that all the revenues from taxes and profits collected by the local governments should be remitted to the central government, which transferred them back to the provinces to meet the expenditures as determined by the Centre in the process of budget formulation. Thus, revenue sharing rates varied widely, from 0 per cent to more than 90 per cent (Wong, 1995).

**Figure 3.1: Levels of Government in China**

1/Beijing, Tianjing, Shanghai, Chongqing
2/ Under cities at all levels
After economic reforms were initiated, particularly since 1980, three distinct phases in the evolution of the intergovernmental transfer system can be identified. The basic framework for revenue assignment and the sharing system for future years was provided in 1980, when the highly centralised system was replaced by the ‘contract responsibility system’ in which the revenues were classified into central-fixed revenues, local-fixed revenues and shared revenues. The three classifications have continued ever since, but the items within the list have been changed over the years, partly to take account of the effect of tax and price reforms and changing structure of revenues. As regards shared revenues, the central government fixed its share at 80 per cent and gave 20 per cent to the local governments. The centre also determined the base and the rates in respect of all taxes, but the local finance bureau collected all revenues except a few central-fixed revenues. The system, while providing incentives to the local governments, had inherent inequity. The more prosperous provinces could collect larger revenues and the uniform sharing formula left richer provinces with surpluses and poorer ones with large deficits.

The second phase of reform started with the State Council redesigning the revenue sharing system in 1985 to remedy the problems arising from undesirable surpluses and deficits. In the new arrangement, varying schedules were set for revenue sharing based on the provinces’ budget balance in previous years. The financially strong or surplus provinces _ those whose local fixed revenues exceeded their expenditure needs (Shanghai, Beijing, Tianjin, Liaoning, Jiangsu and Zhejiang) _ were required to transfer the surplus revenue to the centre; the financially weak (deficit) provinces were allowed to retain more revenues. In the case of provinces where both local fixed revenues and shared revenues could not meet the expenditure requirements, cash transfers were given. The system had adverse incentives for
revenue effort, and consequently, revenues in surplus provinces increased at a much slower rate than the national average.

The fiscal contract system introduced in 1988 by the State Council was intended to minimise disincentives by enhancing the revenue shares of those provinces, which contributed significantly to central revenues. The new system had six types of central-provincial sharing mechanisms, each applied to different categories of provinces: (i) in the case of 10 surplus provinces, there was contracted revenue increase. Taking 1987 as the base year, provinces were allowed to retain a specified percentage of all revenues ranging from 28 to 80, if the revenues grew at rates from 3.5 per cent to 6.5 per cent. If the revenue growth was above 6.5 per cent, the provinces would retain them entirely; (ii) in the case of three provinces, a fixed share ranging from 46.5 per cent to 87.6 per cent was to be retained; (iii) in three provinces, a certain basic proportion was retained up to a quota, and if the province collected revenues in excess of the quota, a higher proportion was to be retained by it; (iv) in three other provinces, a specified amount was contracted to go to the centre in the initial year and in subsequent years, the contracted amount was increased by 7 to 9 per cent per year; (v) in Shanghai and two other provinces a fixed amount was specified for transfer to the centre; (vi) in the case of 15 high deficit provinces, a specified amount was to be transferred from the centre to the provinces.

The consequence of the fiscal contract system was to increase the provincial share in revenues further. As the 10 fast growing surplus provinces could retain the entire revenue collections if growth was above 6.5 per cent, they benefited greatly from the scheme. At the same time, as both the ratio of total revenue collections to GDP and the central share of revenues significantly declined, the centre had to repeatedly revise the contracts in respect of some of the provinces. In spite
of the shortcomings, in the absence of a satisfactory alternative, the arrangements continued until the end of 1993 with some modifications and revisions in the contracts.

The fiscal contract system prevailing before comprehensive fiscal reforms were initiated in 1994 had a number of salient features. First, the local governments had a great deal of autonomy in both revenue and expenditure decisions unlike other “deconcentrated” systems. The major reason for this has to be found in the fiscal arrangement in which the local governments were given the authority of revenue collection. Thus, in spite of clearly assigning revenues to central and local governments and vesting de jure powers to determine tax bases and rates with the centre, the collection of revenues by the local tax administration meant that they could control effective tax rates and flows of funds to the centre. The overlapping expenditure assignments in respect of many social and economic services between the levels of government enabled the centre to push the expenditure responsibilities down to adjust to lower revenues. This also led to the practice of pushing the responsibilities of providing certain services to the state enterprises at both central and local levels.

The fiscal contract system of revenue sharing led to perverse incentives. Local governments, particularly the provinces with large revenue collections, had no incentive to increase revenues for the increased revenues had to be shared with the centre. This led to a strategic reaction by the local governments. First, the local government reduced their tax effort. A common method of reducing tax effort was by giving liberal tax concessions even when they were not authorised. In the early 1990s, all 30 provinces and a number of counties and

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10 In the de-concentrated system, the subnational governments are merely administrative units carrying out expenditure functions devolved to them by the line ministries at the centre. See, Parker, (1995)
townships initiated their own “opening up” programme and established different types of “zones” like special economic zones, economic development zones, economic and technology development zones, high and new-tech zones, special zones for Taiwanese investors and border trade zones, and offered liberal tax concessions\textsuperscript{11}. By 1993, there were almost 1800 such zones, mostly initiated by the provincial and county authorities.

The second type of local government strategic reaction was to shift resources from the budget to extra-budgetary funds. Official statistics show that extra-budgetary funds as a share of GDP grew from 2.6 per cent in 1978 to over 4 per cent in 1994 and further to about 6 per cent in 1996. Over 85 per cent of these funds were locally administered. The proportion of extra budgetary funds in total provincial revenues increased from 40 per cent in 1978 to 50 per cent in 1992.

Local governments created two types of extra-budgetary funds. The first consisted of taxes and charges controlled by local finance bureau and these included items like 10 per cent public utility surcharge, surcharge on agricultural tax, revenues received from public housing and public property. The second category consisted of retained earnings of locally owned state enterprises (technical transformation funds, depreciation fund and special purpose funds) and various incomes of government agencies including road maintenance fees, agriculture-forestry-water income, income of enterprises attached to government agencies, real estate management fees and tuition fees in schools. Although, in principle, the latter category of funds is controlled by the enterprises, in recent years the local governments have

\textsuperscript{11} The tax preferences consisted of levying a 15 per cent flat rate on corporate incomes, a two-year tax exemption for the first profit-making year and three-year 50 per cent tax reduction thereafter. Some zones offered even more liberal concessions like five-year tax exemption, and five-year tax reduction of 50 per cent. See, Jun Ma (1995, p. 214-15).
been increasingly tapping this source to finance government expenditures.

As the control over resources diminished over time, the central government adopted several non-standard adjustments to influence revenue remittance by the provinces. The central government resorted to ad hoc revision of fiscal contracts, particularly in respect of provinces with large resources. In some cases, the centre also borrowed from the localities and even forced them to "buy" central government bonds at low prices (Ma Jun, 1996). Arbitrarily transferring expenditure responsibilities to local governments and reclaiming ownership of profitable local enterprises were other measures adopted. The strategic reaction of provinces to these measures was to reduce the tax effort.

The consequence of these events was to cause what the observers labelled as the decline in "the two ratios" - the ratio of total budgetary revenue to GDP and the ratio of central revenues to total revenues. Government revenues as a ratio of GNP declined from over 31 per cent in 1978 to 13.9 per cent in 1993 and even after the 1994 reforms, declined further to 12 per cent in 1996. While this was partly due to the policy of allowing the enterprises to retain more profits for their reinvestments in the early 1980s, the disincentives on tax effort and the creation of extra-budgetary funds also contributed to this phenomenon. Similarly, the share of central government in total revenues declined from 51 per cent in 1978 to 37 per cent in 1993. The expenditure share of the centre closely followed the revenue-GNP share as it declined from about 51 per cent in 1979 to 37 per cent in 1993 (Ma Jun, 1995). Even after the 1994 radical tax reforms, the central government administered only 27 per cent of all expenditures and about half of the revenues in 1996.

The sharp decline in the central budgetary operations since 1978 severely constrained the ability of the central government
to effectively undertake macroeconomic stabilisation. Since major proportions of both revenues and expenditures are controlled by local governments, the centre’s major preoccupation has been to somehow balance competing demands for spending from various sectors rather than use fiscal instruments to stabilise the economy. Nor did it have adequate resources to effect redistribution across provinces. As mentioned earlier, much of the transfers during the reform period were of the revenue return variety, the significant exceptions being large resources taken from Shanghai, the richest province, and large transfers to Tibet, one of the poorest provinces. The analysis for 1990 showed that when the two provinces were excluded, per capita transfers to provinces had a significant positive relationship with their per capita incomes (Ma Jun, 1996).

3.3 Intergovernmental Transfer System After the 1994 Reform:

(i) The assignment system:

The attempt to raise the two ratios and restore the central government’s ability to undertake macroeconomic stabilisation and effect regional redistribution brought in comprehensive fiscal reforms to replace the fiscal contract system with the tax assignment system. In the new system, the tax assignment was changed to match the expenditure responsibilities better. The central government was vested with the responsibilities of national defence, international affairs, armed police, key construction projects, internal and external borrowings, and spending on its own administration. The remaining expenditures were assigned to local governments.

As in the earlier system, taxes are divided into central-fixed taxes, local-fixed taxes and shared taxes. The central-fixed taxes comprise customs, consumption tax collected by customs department, value added tax and income tax on centrally
owned enterprises, turnover taxes on railway, banking and insurance companies, and income tax from financial institutions set up by the People's Bank of China. The local-fixed taxes include business tax, income tax from local enterprises and personal income tax. The shared taxes are VAT, securities trading tax, and tax on natural resources. The centre retains 75 per cent of the proceeds from VAT and 25 per cent is devolved to local governments. In the case of the securities trading tax (stamp duty) which is collected mainly in Shanghai and Shenzhen, the centre and these provinces share the proceeds equally. The proceeds from the natural resources tax are retained entirely by the local governments. The centre also assured that any province getting less revenue from tax return transfers than what it retained in 1993 would be compensated.

The most important reform, however, is in tax collection arrangements. The central government, instead of relying on the local tax collection machinery, has set up its own tax collection agency - the National Tax Service, to collect revenues from all central-fixed and shared taxes. The objective of the reform is to gain control over effective tax collections by the centre, to eventually enhance its share of revenues to about 60 per cent of the total. It plans to spend about 40 percentage points on its own expenditure commitments and the remaining 20 points are meant for intergovernmental transfers.

(ii) Other Intergovernmental Transfers:

At present, there are two major types of transfers in PRC. The first is based on the old fiscal contract system. After the reforms, with the revenue collection arrangement given to the National Tax Service, the transfer system involves only a downward flow to the provinces of devolving 25 per cent revenue from the VAT, and 50 per cent revenue from securities trading tax, while the deficit provinces are given cash transfers. In addition, when the reforms were introduced in 1994, the centre
also gave "revenue return" transfers to ensure that the shared revenue in no province was less than the amount received by it in 1993. The two general-purpose transfers constitute about 70 per cent of net transfers from centre to provinces. (Ma Jun, 1996)

In addition to these general-purpose transfers, the central government also gives a significant amount of earmarked grants. These include transfers to capital construction projects, price subsidies for urban grain consumption, social relief funds, special subsidies for health and education of the poor, minority and residents in border provinces. In 1994, these transfers constituted about 30 per cent of the total. Analysis also shows that the specific purpose transfers have increased significantly after 1985. As the centre's own revenues and expenditures declined, it resorted to specific purpose transfers mainly to achieve equalisation in selected activities. As these transfers also had matching requirements from the provinces, the extent of influence over provincial expenditures was twice the amount of earmarked grants.

The revenue return transfers accrue to the provinces on the basis of origin and, as such, have a significant positive relationship with per capita incomes of the provinces. The only exception is the significant cash transfers given to Tibet, one of the poorest provinces. As the richer provinces, due to their better financial position, can access the earmarked transfers more effectively, the transfer system has tended to be regressive. Thus, after Tibet, Shanghai, the richest province, received the highest per capita transfers in 1996.

**Implicit transfers in China:**

In addition to these explicit transfers, there are some important sources of implicit transfers, which affect the resource allocation across different regions in unintended ways. In all economies subject to price and quantity controls, implicit
transfers are unavoidable. The most important sources of such transfers in PRC are provincial tax exportation and competitive offer of incentives and tax expenditures. The main source of tax exportation is the origin-based VAT which contributes over 42 per cent of total government revenues. Even after the reforms, PRC levies the producer-type, origin-based VAT and not the destination-based consumption type VAT. In a substantially regulated and closed economy, forward shifting of these taxes could result in significant inter-provincial tax exportation, from the richer producing provinces to the poorer consuming ones. Similarly, competitive offer of incentives by local governments to attract businesses into their jurisdictions, and local protectionism using regulatory and fiscal instruments and impediments can also be a source of inter-regional transfers. It is, however, difficult to quantify the effect of these measures.

Increasing resort to bank financing of local expenditures is another source of implicit transfers. Most of these loans are directly or indirectly financed by the People’s Bank of China. Although local governments by themselves are not allowed to borrow, their ownership of SOEs enables them to push public sector deficits to them. Again, in principle, the credit plan prescribes the overall borrowing limits to the SOEs, but in practice, local government pressures have often led to adjustment in the plans. Similarly, subsidised lending by the financial system to the non-government sector too can be a source of inter-regional transfers. Priority sectors like energy and transport receive the maximum subsidy (World Bank, 1993).

Another source of implicit inter-provincial transfers arises from the central government’s borrowing from the provinces. The decline in the two ratios led to the central government’s forcing the local governments, particularly the more affluent provinces, to lend resources to it at subsidised interest rates. The debt was also written off from time to time upon
renegotiating the contracts. Even in 1990, Shanghai had to lend Y 0.4 billion to the central government, though this practice seems to have stopped in more recent years.

**Sub-Provincial transfers in PRC:**

The lack of equity in the transfer system has adversely affected the poorer counties and townships much more than the richer ones. Lack of resources in these local areas has reduced the standards of services provided and, in some cases, imposed higher user charges. Given that the revenue capacities in poorer provinces are lower, the transfers have often tended to get stuck at the provincial and, in some cases, prefecture levels, thereby reducing the ability of counties and townships to target the services to poor persons residing within their jurisdictions.

There is much ambiguity in the assignment of responsibilities below the provincial level as well. As the provinces work out the division of labour with the governmental levels below them, there are considerable variations in the expenditure responsibilities at the level of prefectures (cities under provinces), counties (cities under prefectures) and townships. The system of transfers before the 1994 reforms was more or less similar to the transfer system that existed between the centre and provinces. Each province negotiated the revenue remittance with the governmental units below them. In Hubei province for example, there were four different kinds of contracts. In respect of 22 cities and counties, 7.5 per cent to 60 per cent of revenue collections in excess of 1988 collections were to be remitted upwards to the province. For 19 cities and counties the remittance was fixed in nominal terms. A number of special economic zones neither received any cash transfer nor remitted any amount to the province, and 21 cities and counties with deficits received cash transfers from the province. After the reforms, with the centralisation of tax collections, the governmental units below the provincial level receive a share
in taxes or cash transfers based on their negotiated expenditure needs.

**Concluding Remarks:**

The evolution of intergovernmental transfers in China provides valuable lessons on the pitfalls to be avoided as much as on the desirable measures to be taken in designing the transfer system. The analysis shows how an ill-designed transfer system can adversely impact on the economy by constraining the ability of the central government to undertake stabilisation and distribution functions and by distorting the resource allocation in unintended ways, through perverse incentives to central and sub-national governments. The analysis also highlights the undesirability of the negotiated system of transfers. Most importantly, the experience underlines the importance of central control over the finances necessary to undertake stabilisation and distribution functions and the undesirability of dependence on upward transfers.

The reforms in intergovernmental transfers in China undertaken since 1994, particularly those intended to vest central control over the tax handles, are far-reaching. They have significantly changed the roles of central and provincial governments and altered the incentive system. The primacy of central government in tax collections has restored its control over fiscal management. The stable tax sharing system has helped to impart a certain measure of stability and certainty to the fiscal transfer arrangements. In spite of these developments, however, several problems have continued to persist. Many arbitrary elements in the transfer system still exist as the system continues to be non-transparent and discretionary. Specifically, the estimation of expenditure needs, which are an important parameter in determining the cash transfers of those provinces with expenditure needs in excess of shared revenues, continues to be negotiated and, therefore, ad hoc. This leads to high
lobbying and bargaining costs and creates disincentives for fiscal management in the provinces.

Nor does the general purpose transfer, as it is designed at present, fulfil the objective of equity. The shared taxes accrue to the provinces according to origin, and as expenditure needs are not scientifically measured, the general purpose transfers can hardly be expected to offset revenue and cost disabilities to enable all provinces to provide a given level of public services at a standard tax rate. The problem is compounded by the centre making significant amounts of earmarked grants with matching provisions, which tend to favour the more prosperous provinces.

Even a well-designed transfer system does not ensure fiscal equity due to its limited scope. At present almost a half of the expenditures of a public nature are incurred outside the budget, through extra-budgetary funds. Excluding these expenditures in examining the needs of the provinces can give only a partial picture. Besides, inter-regional resource transfers occur also due to inter-provincial tax exportation, distribution of subsidised loans and various regulatory measures, though measurement of the volume and direction of such resource flows is difficult.

The transfer system in China is still evolving and will change significantly in the coming years. With the contemplated changes in the role of the state, the role of different levels of government and, with this, the intergovernmental transfer system will also be redefined. As the prices get determined in the market rather than administratively, and as the public enterprise profits give way to tax revenues, the central and local governments will have to concentrate on providing social and merit goods and provide the right incentives to the market rather than directly participating in production and distribution activities. The need to minimise bargaining and transaction costs will eventually necessitate a formula-based, transparent transfer system.
4. INDIA

4.1. Background

India is a democratic polity, a classical federation with Constitutional demarcation of functions and finances between the centre and the states\(^\text{12}\). Close to a billion people in the federation are spread over 25 states and 7 centrally administered territories (a decision has already been taken in June, 1998 to create three more new states and confer statehood on one of the territories). Separate legislative, executive and judicial arms of government are constituted at both central and state levels. The seventh schedule to the Constitution specifies the legislative domains of the central and state governments in terms of union (central), state and concurrent lists. The Constitution also requires the President of India to appoint a Finance Commission every five years to review the finances of the centre and the states and recommend devolution of taxes and grant-in-aid for the ensuing five years.

Historical factors have played an important part in the adoption of a federal Constitution with strong unitary features in India. During the British rule, which lasted until 1947, administrative and fiscal centralisation was a colonial necessity. However, the difficulty of administering a vast country with a number of principalities and diverse languages, cultures and traditions, necessitated some decentralization. Although there were strong arguments in favour of adopting a highly decentralised three-tiered federal structure\(^\text{13}\), the system that was

\(^{12}\) The recent (73rd and 74th) Constitutional amendments have sought to specify the domain of the governmental units below the state level (rural and the urban local bodies), as well. However, they exercise their functions concurrently with the state governments, with the latter enjoying overriding powers.

\(^{13}\) The U.K. Cabinet Mission Plan set up on the eve of independence actually recommended a three-tier federal structure.
eventually adopted by the Indian Republic closely followed the Government of India Act, 1935—a two-tiered structure with a pronounced centripetal bias.

The centralisation inherent in the Constitutional assignments was accentuated by the adoption of a planned development strategy. Although economic planning has been implemented in a mixed economy framework, the strategy of a public sector dominated, heavy industry based, import-substituting industrialisation required the Planning Commission to allocate resources according to the envisaged priorities. Concentration of economic powers with the central government in this autarchic regime was inevitable; it had to ensure conformity to the envisioned priorities through industrial licensing policy, nationalisation of banking and financial sectors, import licensing and exchange control. This economic regime was somewhat liberalised in the late 1980s, and was abandoned when market-oriented reforms were introduced in 1991.

4.2 Tax and Expenditure Assignments in India:

The revenue raising powers and expenditure responsibilities of the central and state governments specified in the seventh schedule to the Indian Constitution point towards a substantial mismatch between revenues and expenditures, particularly at the state level. While the expenditure responsibility assigned to the states in the Constitution is large and growing, most of the broad-based taxes are assigned to the centre.

The expenditure functions of the centre and the states are specified in the union, state and concurrent lists. The states have been given exclusive responsibility over activities like agriculture and forestry development, irrigation and water supply. The main expenditure responsibility of the centre consists of defence, railways, national highways, ports, shipping
and navigation, international trade and commerce, mineral
development, inter-state river waters, atomic energy and space.
All other subjects are in the concurrent list, but the states are
primarily responsible for providing social services, particularly
education, health and family welfare. The assignment of
overriding powers to the centre in regard to items included in
the concurrent list has enabled it to decisively influence the
expenditure patterns at the state level as well.

In the assignment of tax powers three important problems
should be noted. First, there is a very high degree of revenue
centralization. Most of the broad-based taxes are assigned to
the centre, the only exception being the sales tax. The centre
also has the residuary tax powers (all items not specified in the
Constitution). A number of tax handles have been assigned to
the states as well, but from the point of view of revenue
productivity, only sales tax is important. Much of the borrowing
powers are vested with the centre. The states can borrow from
the centre and the market, but for the latter, they need the centre’s
permission if they are indebted to the centre.

Second, the Constitution follows the principle of
’separation’ in tax assignment in contrast to that of ‘concurrence’
followed in federations like the USA and Canada. The tax
powers are distributed either to the centre or the states. This,
however, could not avoid de facto overlapping particularly in
regard to consumption taxes. Thus, the centre levies excise duty
(manufacturers’ sales tax), the states levy sales taxes, and the
local governments levy a tax on the entry of goods into a local
area for consumption, use or sale called octroi. This has resulted
in an uncoordinated, and a distorting tax regime in the country
and the disharmony is much more than even in countries such
as USA and Canada, where the Constitution permits concurrency
in the levy of taxes.

Third, unlike in federations like Canada where the
Constitution expressly forbids the levy of taxes on inter-
provincial trade, in India the Constitution allows the levy of certain taxes which severely impede the inter-state movement of goods. The levy of a tax on inter-state sale of goods by the exporting state (subject to a ceiling rate of 4 per cent) besides creating resource distortions, has caused perverse transfer of resources from the poorer consuming states to the more affluent producing states. Similarly, the states can empower the local governments to levy a tax on the entry of goods into a local area for consumption, use or sale, and this levy has not only impeded the free movement of goods but has also erected a number of tariff zones coinciding with the localities in the country.

4.3 Vertical and Horizontal Imbalances:

A major consequence of assignments is the high degree of vertical fiscal imbalance and chronic dependence of the states on the centre for financing their expenditures. Thus, the states raise only about 40 per cent of the total revenues, but incur about 58 per cent of the total public expenditures. From the revenue sources assigned to them, they can finance only about 57 per cent of their current expenditures and 45 per cent of their total expenditures (Rao, 1998). About 55 per cent of the states’ expenditure is financed by intergovernmental transfers or borrowings.

Another important feature of Indian fiscal federalism is the wide inter-state differences in the ability to raise revenues and, consequently, per capita expenditures. There are 14 relatively more homogenous general category states, but even these have wide differences in revenue raising capacities, efforts, expenditure levels and fiscal dependence on the centre. In addition, in terms of economic characteristics and endowments, the 10 mountainous states of the north and the north-east differ markedly from the rest and are, therefore, considered 'special category' states. Inter-state disparities in per capita incomes even among the general category states are extremely high. In
1994-95, for example, the index of per capita income in Bihar, the poorest state, was 47 (all state average = 100) whereas in the richest state, Punjab, it was 175. In other words, the richest state had 3.7 times the per capita income of the poorest state. Consequently, there are wide variations in revenue raising capacities among the states in India.

4.4 Intergovernmental Transfers in India

A notable feature of intergovernmental transfers in India is the existence of multiple channels of transfer from the centre to the states. The Constitution provides for the appointment of the Finance Commission by the President of India every five years to assess the fiscal resources and needs of the centre and individual states and recommend the shares of personal income tax and union excise duty and grants-in-aid to the states. However, with development planning gaining emphasis, the scope of the Finance Commissions’ recommendation was restricted to meeting the states’ non-plan requirements in the current (revenue) account. The Planning Commission became a major dispenser of funds to the states by way of grants and loans to meet their plan requirements. In addition to these two channels, various central ministries give specific purpose transfers with or without matching requirements. Of the total, the transfers given on the basis of the Finance Commission’s recommendations constitute 58 per cent, the plan transfers account for 22 per cent and the grants given to central sector and centrally sponsored schemes account for the rest (20 per cent).

(i) Finance Commission transfers: The Constitution (Article 280) specifies that the Finance Commission is required to (i) distribute the shares of personal income tax and Union excise duty between the centre and the states and among the states inter-se; (ii) recommend grants to the states in need of additional assistance; and (iii) address any other matter referred
to them. Although the Constitution does not restrict the scope of the Commission, with the Planning Commission dispensing a significant share of transfers, the scope of the Finance Commission is now restricted to meeting non-plan current expenditure needs of the states.\textsuperscript{14} So far, ten Finance Commissions have submitted their reports, and the government has, by and large, accepted their recommendations.

The Finance Commissions’ approach to making federal transfers consists of (i) assessing overall budgetary needs of the centre and the states to determine the volume of resources to be transferred during the recommendation period; (ii) forecasting states’ own current revenues and non-plan current expenditures; (iii) distributing assigned taxes broadly on the basis of origin; (iv) distributing sharable taxes—the personal income tax and Union excise duties between the centre and the states and among the states inter se; and (v) filling the post-devolution gaps between non-plan current expenditures and revenues with grants. This is known as the “gap-filling” approach.

Notably, the criteria adopted for tax devolution are different from the principles of grants-in-aid. Tax devolution is recommended mainly on the basis of general economic indicators like population, per capita income and indicators representing economic and social backwardness. Grants, on the other hand, are given to offset the residuary expenditure needs of the states as quantified by the Commissions. Tax devolution is less targeted and all the states receive their shares, as population receives predominant weights. Besides, sometimes contradictory

\textsuperscript{14} The grants (Gi) receivable by the ith state are given by:
\[ Gi = E_i - (Roi + Rai + Rsi) \]
\[ Gi > 0. \]

Ei denotes projected non-plan current expenditures of the ith state
Roi denotes projected own revenues of the ith State. Rai denotes projected share of assigned revenues of the ith state, and Rsi denotes shared taxes of the ith state.
factors like ‘contribution’ and ‘backwardness’ are included in the devolution formula, thus rendering the achievement of the overall objective of transfers difficult. The criteria adopted for the distribution of tax shares among the states by the latest Finance Commission (Tenth) are summarised in Table 4.1.

The ‘gap-filling’ approach outlined above has two important weaknesses. First, the transfers made by the Finance Commissions were not designed specifically to offset fiscal disadvantages of the states arising from lower revenue raising capacity and higher unit cost of providing public services. Tax devolution is determined on the basis of general economic indicators and grants are given on the basis of their projected post-devolution budgetary gaps. Second, the design of the grants can have serious disincentives on the fiscal management of the states.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Income Tax</th>
<th>Excise Duty</th>
</tr>
</thead>
<tbody>
<tr>
<td>States' share</td>
<td>77.5</td>
<td>40 + 7.5*</td>
</tr>
<tr>
<td>Criteria for distribution</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Tax effort</td>
<td>10.0</td>
<td>10.0</td>
</tr>
<tr>
<td>2. Population</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>3. Per capita SDP</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(ii) Distance formula</td>
<td>60</td>
<td>60</td>
</tr>
<tr>
<td>4. Area**</td>
<td>5.0</td>
<td>5.0</td>
</tr>
<tr>
<td>5. Index of infrastructure</td>
<td>5.0</td>
<td>5.0</td>
</tr>
</tbody>
</table>

* 7.5% is given only to the states with post tax devolution deficits.

** subject to each state receiving the minimum of 2% and maximum of 10% of sharable taxes.

1. Distance formula = \((Y_h - Y_i)P_i/\sum(Y_h - Y_i)P_i\), where \(Y_i\) and \(Y_h\) represent per capita SDP of the \(i^{th}\) and the richest state, \(P_i\) - the population of the \(i^{th}\) state, \((Y_h - Y_i)\) for the ‘h’ state is taken to be equivalent to the value of the second highest per capita SDP state.
The more recent commissions have tried to reduce the post-devolution gaps of the states by substantially enhancing the share of tax devolution in total transfers\(^{15}\). To reduce the cost to the centre, as mentioned earlier, the commissions tried to target them by including different elements of backwardness, besides the “inverse” and “distance” variants of per capita income\(^{16}\). This has complicated the devolution formula. The recent commissions have also tried to introduce selective norms by targeting the rates of growth of revenues and expenditures and by assuming certain rates of return on their loans and investments. Nevertheless, the overall approach has not changed, and the disincentives arising from the “gap-filling” approach persist.

The sharing of over 77.5 per cent of income tax collections and 47.5 per cent of excise duties has led to disincentives to the centre to collect more revenues from these taxes. Instead, it could concentrate on non-sharable revenues like customs duties and increasing administered prices on public monopolies. Thus, over the years, while the share of income taxes has steadily declined, the dependence on import duties has increased. Seized of this disincentive to the central government, the Tenth Finance Commission suggested an alternative scheme to broaden tax devolution to proceeds from all central taxes instead of the two taxes prevailing at present. It is recommended that the centre give 29 per cent of revenues from all its taxes to the states and

\(^{15}\) The seventh Finance Commission, for example, increased the states' share of union excise duty from 20 to 40 per cent.

\(^{16}\) The inverse formula = \((P_i Y_i)/\Sigma P_i Y_i\) and the Distance formula = \((Y_h - Y_i)P_i/\Sigma(Y_h - Y_i)P_i\), where, \(Y_i\) and \(Y_h\) represent per capita SDP of the \(i^{th}\) and the richest state, \(P_i\) - the population of the \(i^{th}\) state, \((Y_h - Y_i)\) for the ‘h’ state is taken to be equivalent to the value of the second highest per capita SDP state.
freeze it for 15 years. Inter-state distribution of the states' share will be decided by the Finance Commissions every five years. The new government, which came to power in April, 1998 has accepted this recommendation in principle and the process is under way to implement it.

(ii) Plan transfers: The Planning Commission gives both grants and loans to the states to finance their plans. Before 1969, the volume of assistance as well as the loan - grant components were project-specific, which was objected to as being arbitrary and non-transparent, resulting in the adoption of a formula for distribution agreed upon by all the parties in the National Development Council\(^\text{17}\). At present, 30 per cent of the assistance to the states is set aside for the special category states and the remaining 70 per cent is given to the general category states. Assistance to the general category states is distributed with 60 per cent weight assigned to population, 25 per cent to inverse of per capita SDP, 7.5 per cent to fiscal management and the remaining 7.5 per cent to special problems of the states. These states receive 30 per cent of assistance as grants and 70 per cent as loans. The 30 per cent funds earmarked to the special category states are distributed on the basis of their approved plan projects. 90 per cent of the assistance to these states is given by way of grants and 10 per cent as loans. Thus, plan transfers, and their grant-loan components, are determined independently of the required plan investments, their sectoral composition, the resources available to the states or their fiscal performances.

\(^{17}\) The National Development Council (NDC) is constituted by the cabinet ministers at the centre, chief ministers of the states and the members of the Planning Commission and is chaired by the Prime Minister.
iii. Assistance to the central sector and centrally sponsored schemes:

This is the third component of transfers and is given for specified purposes with or without matching provisions. Grants for the central sector schemes are given to the states to execute central projects and are entirely funded by the centre. The centrally sponsored schemes, on the other hand, are shared cost programmes with matching ratios that are uniform across the states, but vary with the projects. There were 262 such schemes in 1985, and some more have been added in subsequent years. These transfers have attracted the sharpest criticism due to their discretionary nature and conditionality attached to them. They accounted for about 36 per cent of the total plan assistance, and about 20 per cent of total current transfers were given to these schemes in 1994-95.

4.5 Equalizing Effect of Intergovernmental Transfers:

The analysis of intergovernmental transfers in India shows that intergovernmental transfers, on the whole, have had an equalising impact. Figure 4.1 shows that per capita transfers had a significant negative relationship with per capita incomes. This was mainly due to the high weightage given to factors representing backwardness in determining inter-state distribution of both Finance Commission and Plan transfers. The analysis shows that Finance Commission transfers have the highest equalising impact. The plan transfers too are equalising but the distribution of transfers on central sector and centrally sponsored schemes is not equitable (Rao, 1998). Further, even though the transfer system as a whole is equalising, per capita expenditures of the states have a significant positive relationship with per capita incomes. Thus, while the transfer system is equalising, it is not strong enough to offset the fiscal disabilities of the poorer states entirely.
4.6. Implicit Transfers and Inter-State Equity:

In a planned economy, besides explicit transfers, various price and quantity controls can cause significant implicit transfers across regions. The important inter-state resource transfer mechanisms besides the intergovernmental fiscal transfers include targeting investments in specific locations by the central government (regional policies), lending to the states at below market rates of interest, allocating a certain proportion of the resources of the banking system and financial institutions to different states\textsuperscript{18}, and making subsidised "priority sector" loan allocations. Besides these, there can be resource transfers due to inter-state tax exportation as well.

\textsuperscript{18} In India, the statutory liquidity ratio stipulated for the commercial banks stipulates them to keep 35 per cent of their resources in the form of government securities.
4.7 Transfers Below the State Level:

As mentioned earlier, the Constitution adopted a two-tier federalism with division of functions between the centre and the states. Decentralisation below the state level was a local responsibility. Although in some states local governments in rural (called the panchayats) and urban areas (municipalities and municipal corporations) were instituted, they depended on the state governments for their political existence and finances. Elections to these local governments were irregular, and even when elected governments took office, cases of superseding them with direct rule by the state governments were fairly common. The assignment of tax powers varied from state to state. The most commonly assigned tax was the property tax. Some states also assigned the tax on the entry of goods into local areas to the urban local bodies. Other taxes assigned partially or fully include entertainment tax, profession tax and, in some cases, land revenues. The transfers were given by the state governments, and consisted mostly of earmarked transfers or were given specifically to meet administrative expenditures.

To activate the forces of decentralization and involve the local governments in the process of development, the Constitution was amended to formalise the creation of rural and urban governments below the state level in 1994. The states were required to create enabling legislation listing the functions and sources of finances to urban and rural local bodies. In the case of supersession of the elected local governments, the states are required to hold elections and hand over the administration to elected representatives within six months. They are also required to appoint state finance commissions to examine the resources and needs of the local bodies and recommend transfers to them for the ensuing five years. The system has been operating for the last couple of years, and now transfers are given on the basis of the recommendations of the state finance commissions.
Thus, the transfer arrangement to local bodies has been extended on lines similar to that to states in the last three years. While the envisaged measures have a great potential to activate the forces of decentralised development from the grass-roots level, it is premature to indicate the extent to which this potential will be realised.

4.8. Concluding Remarks:

The intergovernmental transfer system in India, evolved over the last half a century, has played a significant role in achieving the objective of equity and, more importantly, in keeping the country together. The progress is all the more impressive in the sense that over 75 per cent of the transfers are formula-based and transparent. By and large, the transfer system has been found equitable though it does not completely offset the fiscal disabilities of poorer states. The existence of an independent expert body to recommend transfers has the potential of evolving an equitable and efficient transfer system for the country. However, there have been a number of problems constraining the realisation of this potential.

Although the framers of Indian Constitution had envisaged a critical role for the Finance Commissions in making intergovernmental transfers, this has been undermined by the actions of the central government itself. The adoption of centralised planning as a development strategy vested the central government with enormous powers in fiscal matters. As the central government used other channels to make plan and discretionary transfers, the Finance Commission was relegated to the background. Nor did the Finance Commissions chart a course to design transfers for themselves that would fulfil the objective of equity without impairing fiscal management.

Thus, in the Indian context, the central government plays an active role in dispensing transfers even though there is a
specialised Constitutional body instituted for this purpose. Almost 42 per cent of the transfers are given outside the recommendations of the Finance Commissions. The central government has an important role in determining inter-state allocation of discretionary specific purpose transfers as well, particularly the distribution of discretionary transfers for centrally sponsored schemes.

The state governments can also influence transfers in some ways. First, they can claim larger transfers from the Finance Commission by enlarging their fiscal gaps by either laxity in tax effort or profligacy in spending. As plan transfers are based on a consensus formula arrived at in the NDC, individual states have very little say in determining their shares. In the case of transfers for centrally sponsored schemes, the bargaining ability of an individual state plays a very important part in determining their shares. Much more important is the ability of the states to influence implicit transfers arising from subsidised loans and inter-state tax exportation.

The Indian experience demonstrates what not to do in designing and implementing the transfer systems. First, it is important to ensure that the objectives of transfers are kept in mind while designing the transfers; the existence of multiple agencies with overlapping jurisdictions can blur the overall objectives. Second, accommodating different interests in the transfer formula can unduly complicate it with unintended consequences. Third, it is not enough to have formula-based transfers; it is also important to ensure that the formula itself is scientifically designed to avoid disincentive effects on fiscal management in the states. Fourth, it is not enough to have an independent body to dispense transfers; it must also have the necessary expertise and competence and be able to undertake continuous research and use the results in designing and implementing the transfer systems.
5. Designing Intergovernmental Transfer Systems - Lessons from Experience in Selected Countries

This note analyses the evolution of intergovernmental transfer systems in four countries with disparate economic and political systems and different levels of development. Two countries in the sample, Australia and Canada, are developed country federations with democratic systems of government. They have had almost two centuries of history in evolving and shaping their intergovernmental transfer systems. On the other hand, India, the most populous democracy in the world, with a quasi-federal Constitution, has had the experience of evolving the transfer system within the framework of a planned economy for about half a century. It has been facing the challenge of evolving an incentive-based transfer system to meet the needs of economic transition with the introduction of a market-oriented system since the early 1990s. China presents yet another case of the most populous transitional economy, with a turbulent experience of reorienting its fiscal system including intergovernmental transfers. The analysis of the experiences of the four countries brings out the common features as well as contrasts, successes and failures, and offers valuable lessons in evolving efficient transfer systems in transitional economies.

All the four countries have regional equalisation as an important goal, and general-purpose transfers play relatively more important roles at regional levels. Nevertheless, they also have substantial specific purpose transfers. Interestingly, many of the transfers from regions to local levels are purpose specific. This is partly because expenditure programmes at local levels are probably more clearly defined; or the emphasis is on ensuring uniform standards in local services; or more importantly, most regional governments doubt the capacity of the local governments to initiate programmes and policies.

It is difficult to stipulate an ideal composition of general purpose and specific purpose transfers. The theoretical literature
is, at best, indicative, though it can be used to provide ex-post justification. At the same time, no matter what the ideal composition is, central governments, even in mature federations like Australia and Canada, have been able to intervene and give discretionary transfers for activities they wished to influence. The states or provinces, on the other hand, have accepted these transfers, often in spite of serious reservations on conditionality and constraints on their own choice.

The evolution of intergovernmental transfer systems in Australia and Canada has spanned over two centuries. Not surprisingly, they have been more effective in dealing with the issue of regional equalisation. The rule-based and transparent nature of transfer systems and wide discussion and participation of the contending parties at both political and bureaucratic levels has contributed to the acceptability and effectiveness of these systems. They have helped to equalise the levels of basic public services across these federations. At the same time, the primacy of macroeconomic stabilisation in fiscal policies in these countries has involved the sub-national governments in fiscal compression when in need, as the recent experiences of the two countries have demonstrated.

Even as equalising transfer systems in the two mature federations are rule based, there are, nevertheless, important differences between them. While the transfer system in Canada involves equalising only the revenue capacities of the provinces, the Australian system attempts to equalise both revenue capacities and cost disabilities. In Canada, the federal government tries to exercise control over the volume of transfers by changing the formula as the situation demands and giving more tax room to the provinces instead of cash transfers. In Australia, on the other hand, the central government effectively controls the volume of transfers even though, formally, the issue is decided in the Premiers' conference; only inter-state distribution is decided by the CGC.
Whether the volume and distribution of intergovernmental transfers should be determined by a professional body or the Ministry of Finance of the central government itself is an interesting issue. Canada's experience shows that transparent and formula-based system given by the central government directly can be perceived to be as impartial and objective as is given by a professional body specially appointed for the purpose like the CGC in Australia. At the same time, the Indian experience shows that having a specialised body in itself may not ensure an objective and efficient transfer system. The system should not only be impartial but should also be seen to be so. The confidence in the mechanism is high among the contending parties when there is a lot of interaction at formal and informal levels between the agency determining the transfers and sub-national governments, the transfer design and implementation are transparent and based on in-depth research and reliable statistics, as in both Australia and Canada.

The review of experiences brings out another important lesson—rule or formula-based system is a necessary but not a sufficient condition for an efficient transfer system. The sufficient condition is that the designed formula should not cause disincentives. As the Indian experience demonstrates, transfer systems based on actual or projected fiscal parameters of the states can influence their fiscal behaviour and can create serious disincentives for fiscal management in them.

The countries analysed in the sample make general-purpose transfers through tax devolution as well as grants, and there can be no general rule on the desirability of one over the other so long as the criteria adopted for distribution serve the objective of such transfers. In a system where transfers are decided at intervals and not from year to year, tax devolution has the advantage of indexing for inflation, but this can also be achieved by block grants by adjusting them for inflation. However, a major shortcoming with tax devolution, particularly
if individual taxes are shared with the sub-national governments, is that it can create disincentives to the central government in raising revenues from these taxes. This can distort the tax structure, as the Indian experience with such an arrangement has shown.

Assignment of the tax and expenditure functions to different levels of government is a basic precondition for evolving a sound system of intergovernmental transfers. Assignment of tax powers according to the principle of separation, as the Indian experience shows, is not necessarily superior to concurrency seen in countries like Canada or the USA. Nor is the Australian model of centralising all broad-based taxes a feasible option in many federations with diverse economic, social and cultural characteristics. In making the tax assignments, it is important to keep the trade-off between the advantages of uniformity and harmony in the tax system in the country on the one hand and the disadvantages of fiscal dependence and severing the link between revenue and expenditure decisions on the other.

It is also important to ensure that fiscal arrangements leave the central government with adequate resources to function effectively. While there is a lot of merit in assigning adequate tax powers to the subnational governments, China's experience shows that vesting the sub-national governments with powers to collect major central taxes and transferring the proceeds upwards to the centre can lead to serious budgetary distortions and inadequate resources with the centre, and can severely undermine the ability of the central government to undertake macroeconomic stabilisation and regional equalisation.

Invisible transfers arising from controls on prices and quantities, directed resource allocation, and inter-state tax exportation due to the levy of origin-based taxes can be an important source of inequity, particularly in transitional
economies. Such subterranean transfers can be regressive and can offset the progressivity of explicit transfers considerably. While market-oriented reform could eliminate these implicit transfers in the long run, the effect of the past and prevailing invisible transfers in terms of a regressive distribution of infrastructure among different regions can continue to be an important source of inequity. Such implicit transfers should therefore be identified and, to the extent possible, be taken into account in designing the explicit transfer system.

It is also important to note that, in the ultimate analysis, design and implementation of the transfer system in any country is conditioned by political economy considerations and a number of non-economic factors. While the economic rationale for transfers helps to define the objectives of the transfer system clearly and provide a benchmark, the importance of non-economic factors cannot be underestimated. The success of policy reform in any economy depends upon easing the constraints posed by the non-economic factors and on building the capacity of the institutions and incentives necessary to implement an efficient transfer system.

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