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Fiscal federalism in India and Canada: A comparative study

Dr. BN Harisha
Post Doctoral Fellow, Department of P G Studies in Economics, Kuvempu University, Shimoga, Karnataka, India

Abstract
The traditional Theory of fiscal federalism lays out a general normative framework for the assignment of functions to different levels of government and the appropriate fiscal instruments for carrying out these functions. This Theory contends that the central government should have the basic responsibility for the macroeconomic stabilization function and for income distribution in the form of assistance to the poor. Decentralized levels of government have their responsibility in the provision of goods and services whose consumption is limited to their own jurisdictions.
The present paper makes attempt to bring out the comparision of both India and Canada's federal fiscal structure and the lesions to learn each other.

Keywords: decentralization, fiscal instruments, functions

1. Introduction

The traditional Theory of fiscal federalism lays out a general normative framework for the assignment of functions to different levels of government and the appropriate fiscal instruments for carrying out these functions. This Theory contends that the central government should have the basic responsibility for the macroeconomic stabilization function and for income distribution in the form of assistance to the poor. Decentralized levels of government have their responsibility in the provision of goods and services whose consumption is limited to their own jurisdictions.

Federalism in India is characterized by constitutional demarcation of revenue and expenditure powers among the three levels of government. The constitution of India, like the 1935 Act, provided the three fold distribution of powers (Article 246). It transferred a few minor subjects from the Central list to the Provincial list and vested greater powers to the Central government in the spheres like national highways, inter-state trade and commerce to foster national economic unity and promote a common market. The matters of national importance were included in the union list (list I) and those of regional importance were included in the State list (list II) and those subjects relevant to both levels of government were included in the Concurrent list (list III).

The States in India are, obviously, heterogeneous in nature in respect of the size of population, area, resources, and geographical features, etc. This heterogeneity affects the size of government, the quantum and quality of publicly provided goods and their needs. Fiscal transfers in India are overseen by two major institutions, viz., Finance Commission and Planning Commission. The Finance Commission looks after the current account needs of the States while the Planning Commission has been primarily concerned with the developmental needs of the States, which comprise both current and capital needs. Following the 80th Amendment to the constitution, all the central taxes have been brought into a divisible pool and it is mandatory to assign a share from each central tax to the States.

In this context, it would be useful to undertake a comparative study of issues and problems of fiscal federalism in other countries. The present study has analyzed the federal- fiscal relation in Canada and compared it with the Indian scenario.

The intergovernmental transfers in Canada consist of equalization grants, Canadian Health and Social service Transfers (CHST) and Territorial Formula Financing (TFF). In addition to these, there is a new facility called the Health Reform Fund (HRF). The equalization grants aimed at equalizing fiscal capacities are mandated in the constitution since 1982.

Fiscal imbalances refer to the mismatch between own revenue raising capacity and expenditure needs of governments functioning at different levels. Vertical fiscal imbalance has been given primary importance in the discussions relating to the fiscal imbalances. In India, it is said, that the vertical imbalance is fairly high. A high degree of centralization of revenue has been the main cause for a high degree of vertical imbalances.

Vertical transfers can be justified on four principal grounds. First, transfers may be response to the extant asymmetric decentralization of expenditure responsibility and revenue-raising authority. Second, they may be used to equalize the fiscal capacity of the regions to avoid inefficient migration of persons and business among regions and to faster horizontal equity across the country. Third, these may also be used in conditional forms to neutralize fiscal externalities imposed by regional governments on other regions. Finally, these may be used as instruments for protecting regions against shocks to their fiscal capacities. Generally, the amount of grants-in-aid and share in central taxes are provided to the states by Finance Commissions. The availability of resources and expenditure requirements of the Centre and the states has been assessed on the basis of certain norms. Having estimated these, the vertical and horizontal devolution of taxes is determined. Grants are then allocated to states, based on certain criteria.

Intergovernmental transfers have been employed as an instrument to resolve fiscal imbalances, both vertical and horizontal. It needs to be noted that intergovernmental transfers from a large and sometimes a predominant portion of lower-level government expenditures. The design of the transfer system therefore plays a key role in federal financial systems. There is an imperative need to reallocate the resources and responsibilities between the Centre and the States in terms of minimizing vertical as well as horizontal fiscal imbalances.

2. Objectives of the Study

1. To Study the trends and patterns of fiscal transfers in Indian federation excluding local governments.
2. To analyze the cases of vertical as well as horizontal fiscal imbalances in India and examine the trends in imbalances.
3. To study the trends and patterns of fiscal transfers in the Canadian federation.
4. To examine the policies aimed at minimizing fiscal imbalances in the Canadian federation.
5. To identify the best practices and policies in Canadian fiscal federation which could be replicated in India.

3. Hypothesis

1. Fiscal imbalances in India federation are, reported to be, on the rise, especially after the introduction of economic reforms.
2. The system of fiscal transfers, currently followed in India, are not conducive to minimize horizontal and vertical imbalances.

4. Methodology

The study draws heavily from the secondary sources of information. The data have been taken from the published sources of the Government of India as well as the Republic of Canada. The study has made maximum use of reports of the successive Finance Commissions, especially the Thirteenth Finance Commission (THFC). The study has been done through RBI publications such as budget documents and annual reports of various years, the handbook of statistics on Indian Economy, Economic Survey of Government of India, Indian Public Finance Statistics by Ministry of Finance, India. Different publications of Business Centre for Tax Research, Canada, Federal and Provincial Budget Outlooks by Republic of Canada, annual reports and Projections by Department of Finance, Canada were used to analyze the fiscal imbalances. The study covers the time period of 22 years. I.e., from the beginning of the year 1990-91to 2011-12. Simple statistical techniques such as simple growth rate, compound annual growth rate, Average, have been used, wherever found necessary.

5. Results and Discussion

The study has been presented in six chapters. The background pertaining to the study, along with the review of literature, are included in the introductory chapter. The second chapter analyzes the theoretical framework of the Fiscal Federalism.

In the third chapter, issues related to Indian Fiscal Federalism have been discussed. The Chapter focuses on trends in vertical as well as horizontal fiscal imbalances. It can be revealed from the study that the percentage share of state's own current revenues to states' current expenditure has shown a declining trend and remaining had come from central transfers. It indicates the states' dependency on the Centre and caused for very high vertical fiscal imbalance.

Horizontal imbalances among the states have been widen over the study period in terms of revenue raising capacity. States Own Tax Revenue (SOTR) to Revenue expenditure, it can be seen, varies from as low as 3.8 percent to as much as 71.2 percent in Karnataka i.e., the highest is about 22 times of the lowest in the year 2010-11. And the variation in States Own Non-Tax Revenue (SONTR) to revenue expenditure is also so much as 2.6 percent in Bihar and 47.4 percent in Goa. But highest is still about 18 times of the lowest figure.

The state's own revenues finance about 50 percent of their revenue expenditure and about a half of their total expenditure. The state's own revenues in the total have shown a marginal decrease from 37 percent in 1990-91 to 32 percent in 2011-12. However, their share in expenditures has increased from about 55.7 percent in 1990-91 to 57.6 percent in 2011-12.

The fourth chapter is devoted to the analysis of Canadian fiscal federalism. The main focus of this chapter has been on in depth analysis of the Canada Health and Social Transfers (CHST). In Canada, the tax collection agreement between the federal and provincial governments provide for the joint use of the same income tax base. The smaller vertical gap in Canada can be attributed to the fact that the provinces of Canada have access to all the major broad – based taxes and there are no constitutional rules on the tax base. The federal revenue as a percent of GDP is higher than the program expenses. Budgetary deficit has come down ('-'indicates deficit) from – 5.0 percent in 1990-91 to – 1.5 percent in 2011-12.

Canada Health and social Transfers (CHST) was introduced in 1996-97 to replace the Canada Assistance Plan, education support, insurance and medical care. CHST was about three-fourth of the total transfers in 2011-12. Among provinces, own source revenue as a percent of total expenditure was very high as 87.9 percent in Alberta per capita expenditure of Nunavut was very high of 43624 CAD. There is no such considerable imbalance after transfer for either of the two tiers. The fifth chapter has been devoted to the comparative analysis of Indian fiscal federalism and Canadian fiscal federalism. The design and Implementation of intergovernmental transfer schemes in India suffer from a number of important weaknesses. Transferring central resources with the overlapping roles result in wasteful duplication in functioning. The absence of a clear and coordinated approach is a major weakness in the Indian federation. States Own Current Revenue (SOCR) as percent of total revenue has been high in Canada Compared to India. SOCR in Canada, was stable at 77-79 percent, whereas in case of India it varies between 31-40 percent during the study period. Compared to India, the provinces in Canada are better placed, owing to the huge federal transfers. In respect of fiscal indicators Canada's position is far better.

Finally, in the sixth chapter, the major findings of the study have been presented, suggestions have also been offered based on the issues identified in the study.

7. Conclusions

The present study has brought out the features and trends of Indian as well as Canadian Fiscal Federalism. Many successful practices are there in Canada which can be adopted by Indian Government. Canada's revenue capacity is quite higher than India during the study period. In expenditure situation also, Canadian provinces would meet three fourth of the total expenditure with their own revenue, while in India, the state's own revenues finance about 50 percent of their revenue expenditure and about a half of their total expenditure. The states' own revenues in the total have shown a marginal decrease and their share in expenditures has shown an increasing trend.

Compared to Canada, Indian states are very much imbalanced regarding their revenue capacities and expenditure needs. Because, they are differing in taxable capacity as well as in natural resources. The tax (including SCT) and the non-tax revenue that they are supposed to get is very less compared to their expenditure responsibilities. Due to the geographical and demographic factors, the unit cost of providing various public goods and merit goods is relatively high in special category states, as a result, their revenue capacity is low compared to their high per capital public expenditure, leading to fairly high degrees of fiscal imbalances.

Canada Health and social Transfers (CHST) was introduced in 1996-97 to replace the Canada Assistance Plan, education support, insurance and medical care. Canada Health and Social Transfers had the lion's share in total transfers. CHST was about three-fourth of the total transfers in 2011-12. CHST is the revolutionary step taken by the Government of Canada to overcome vertical fiscal imbalances. In case of revenue position after transfers, the differences between India and Canada depicts 6-9 percent of GDP. Compared to India, the provinces in Canada are better placed in terms of revenue position, owing to the huge federal transfers. In respect of fiscal indicators Canada's position is far better. All provinces in Canada were sufficient to reach their expenditure needs.

However, the present study has concentrated on weaknesses and best practices of both the federations. There are many successful practices like CHST, and equalization grants in Canada. India may adapt these reforms because there are to be considerable changes in discretionary grants and unconditional grants which are having vital role in minimizing fiscal imbalances. Sharing of opinions, policies and practices between federations are more required in the present critical days of globalized era.

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