Gist of Economic Survey 2017-18 [Chapter 4]: Reconciling Fiscal Federalism and Accountability: Is there a Low Equilibrium Trap?

INTRODUCTION

- Taxation is not just a vehicle for raising state revenue. It can also be critically important for economic and political development.

Social contract between citizens and the state:

- The state's role is to create the conditions for prosperity for all by providing essential services and protecting the less well-off via redistribution.
- The citizen's part of the contract is to hold the state accountable when it fails to honor that contract.
- But a citizen's stake in exercising accountability diminishes if he does not pay in a visible and direct way for the services the state commits to providing.
    - If a citizen does not pay, he becomes a free rider and cannot complain if the state provides a poor quality service.
    - If he exits (not using the service at all), he loses interest in holding the state accountable.
- Only if he pays and uses the service will he try to hold the state accountable. Hence the expression: no representation without taxation.
- In other words, taxation is the economic glue that binds citizens to the state in a necessary two-way relationship.

The "aid" and "natural resource" curses illustrate what happens when countries rely on non-tax sources of government revenues: economic and institutional development is stunted.

But does this glue rely on taxation broadly or on direct taxation in particular? It seems that a citizen's stake would be greater the more it "hurts" to pay taxes. Direct taxes are felt more by the taxpayer. Direct taxes feel more like expropriation because they reduce citizens' disposable income, the earnings that they get to keep. With indirect taxes, citizens are burdened but that sense is leavened to the extent that citizens feel they are exercising choice.

Two international stylized facts help motivate issues relating to fiscal federalism, taxation, and accountability:

- **Direct taxation and development: General Government:**
    - **First**, economic and political development has been associated with a rising share of direct taxes in total taxes.
    - **Developed countries:**
        - Using data from the Organization for Economic Cooperation and Development (OECD) it shows that the share of direct taxes in total taxes

evolved over time in these countries as they developed (proxied by PPP adjusted per capita GDP).
        - It reveals that advanced countries collect a substantially higher proportion of their taxes as direct taxes than do emerging markets. This proportion has also risen over time.
        - Early on in the development process, import taxes (an indirect tax) and property taxes (an income tax) were the primary sources of revenue.
        - Later, as the welfare states expanded in Europe and the US, government collections shifted toward income taxes, so that workers could contribute to their social insurance.
        - Against this trend, Europe in the 1970s discovered the value added tax (VAT) as an important source of revenue, which led to a renewed rise in the share of indirect taxes. But even today direct taxes account on average for about 70 percent of total taxes in Europe.
    - **India:**
        - India has the one of the lowest share of direct taxes in total taxes (like China)
        - India is not an outlier: its direct tax share is similar to other countries at a comparable stage of development.
        - However, unlike in other countries its reliance on direct taxes seems to be declining, a trend that will be intensified if the Goods and Services Tax (GST) proves to be a buoyant source of revenue.
- **Direct taxation and development: Sub-federal levels:**
    - A second stylized fact relates to direct tax contributions at sub-federal (state and urban/ rural local bodies) levels of government.
    - **Fiscal decentralization:**
        - Fiscal decentralization is often embraced as not just a desirable economic but also as a political and philosophical principle, as Tagore envisaged.
        - This is captured in the idea that spending and tax decisions must reflect local preferences as far as possible.
        - To what extent is this principle followed? That is, what is the share of own revenues (compared to devolved sources) in total revenues at lower levels of government, and what is the relative contribution of direct taxes?
    - Before considering the data, an important issue must be noted. There is an important legal argument for the case that resources received by the states as part of successive Finance Commission verdicts are not "devolved" resources but shared resources. In this view, the Center is merely collecting the taxes in the divisible pool on behalf of the states and sharing it with them. But this position must be assessed against the following realities:
        - it is difficult to dispel the association (in the eyes of taxpayers) of the Center with the income taxes and customs duties that form a major part of the divisible pool;
        - if the Center were a mere collecting agency the funds would be apportioned according to states' tax bases; they would not have sizable redistributive components;

        - the new GST provides a sharp contrast in that it is clearly more "shared" because decisions and tax administration are done by both.
        - In sum, whatever their de jure status, de facto resources from the divisible pool to the states have the strong whiff of devolution.
    - **Comparison of Germany, Brazil and India:**
        - Data on own resources and direct taxes for three countries which have three tiers of government: Germany, Brazil, and India.
        - **At the second tier:**
            - All countries are broadly comparable in their reliance on devolved resources, but India stands out as a country where the second tier (states) generate a very low share of its revenue from direct taxes: about 6 percent in India compared to 19 percent in Brazil in 2016 and a hefty 44 percent in Germany.
        - **At the third tier:**
            - **Rural Local Governments:**
                - India's rural local governments (RLGs) stand out on both counts.
                    - RLGs' reliance on own resources is just 6 percent compared to 40 percent for third-tier governments in Brazil and Germany.
                    - RLGs raise about 4 percent of their overall resource envelope in the form of direct taxes, compared with about 19 and 26 percent in Brazil and Germany respectively.
            - **Urban Local Governments:**
                - India's urban local governments (ULGs) are much closer to international norms.
                    - Their own revenues as a share of total revenues are actually higher than Brazil and Germany,
                    - Their direct tax share (about 18 percent of total revenues) is only marginally lower than Brazil (19 percent) and somewhat lower than Germany (26 percent).
                - This is evidence that ULGs have emerged more fiscally empowered than RLGs so far in India.
                - However, in the Indian case, we have considered only selected large cities, for which data are available, and which may have larger own resource bases than smaller ones.
- These two stylized facts provoke the obvious question: is the current system in India appropriate, and if not, can it be changed? This chapter sheds light on this question.

LOCAL GOVERNMENTS: WHAT DO WE KNOW?

- **73rd and 74th amendment to the Constitution:**

- The 73rd amendment to the Constitution (1992) recognized panchayats as institutions of self-government. The simultaneous 74th amendment bestowed the same status on urban local governments.
- RLGs or panchayats were mandated to have three tiers (at the district, intermediate and village levels) in states with population of over 20 lakh.
- States were mandated to devolve such functions and authorities to RLGs which would enable them to function as institutions of self-governance.
- Illustratively, the Constitution listed 29 matters which could be the focus of their governance, such as agriculture and land reforms, minor irrigation, small scale industries, rural communication, drinking water, poverty alleviation programmes.
- States were also supposed to constitute a quinquennial State Finance Commission (SFC) to determine the share of their financial resources going to the local tiers, analogous to the Finance Commissions at the union level.
- Empowered in such a manner, ULGs and RLGs were mandated to prepare and implement plan(s) for economic development and social justice.
- Following the amendment, most states have constituted three levels of RLGs.

- Over the past two decades, local governments have gained prominence as institutions with substantial 'say' in grassroots development issues, albeit with significant spatial variations, and spaces of intense political contestability. However, the tied nature of a considerable part of resource flow constrains spending autonomy in RLGs.

Expenditure patterns of different tiers of government

- The central and state governments spend on an average 15- 20 times more per capita than do RLGs.
- ULGs spend about 3 times more.
- More importantly, this gap has persisted over time despite per capita spending by RLGs increasing almost four-fold since 2010-11.

Overwhelming reliance on devolved funds

- From where do ULGs and RLGs derive their resources for spending? Analysis based on available data confirms the following:
  - **ULGs are different:**
    - ULGs seem to be doing much better in terms of own revenue generation. They generate about 44% of their total revenue from own sources.
    - RLGs, in contrast, rely overwhelmingly (about 95%) on devolution.
    - Per capita own revenue collected by ULGs is about 3% of the urban per capita income while the corresponding figure is only 0.1% for RLGs.
  - **Variation across states:**
    - There is significant variation across states in the extent of own revenue generation.

        - There are also vast differences between RLGs within each state. Broadly, there are two categories—
            - RLGs of those States that collect some direct taxes and own tax revenue (e.g. Kerala, Andhra Pradesh and Karnataka).
            - RLGs of states like Uttar Pradesh that almost entirely depend on transfers.
        - This variation is much starker in case of RLGs than ULGs.
- **Type of spending by gram panchayats:**
    - Given the overwhelming reliance on devolved funds which, to a large extent, are tied to sectors and schemes, it is not surprising that gram panchayats (GP) spend the bulk of such funds on earmarked areas, such as roads, other basic services, sanitation and community assets.
    - The spending on purely local public goods like irrigation are not a priority out of such funds.
- **Institutional accountability:**
    - Institutional accountability is not readily measured. However, the trends in fiscal performance of local governments can broadly be considered as a proxy for local-level accountability.
    - The better the performance in generating own revenue via taxes, the stronger accountability is expected to be.

<u>**Other issues**</u>

- Standard discourse seem to overwhelmingly focus on the extent of devolution of powers to panchayats. This has drawn attention away from the pressing questions relating the performance of RLGs in fiscal accountability and delivery of services.
- Discussions instead have primarily focused on the following:
    - Has there been adequate tax and expenditure devolution to the RLGs by the states?
        - In many states, RLGs and ULGs have not been devolved enough taxation powers.
        - Successive Devolution Reports of the Ministry of Panchayati Raj (MoPR) show that the share of revenues assigned to local governments in many states are much less vis-à-vis expenditure assignments.
        - From these reports, however, it is seems that several states—notably Kerala, Maharashtra, Karnataka, Gujarat and West Bengal—are consistently improving on this front.
    - Have State Finance Commission's recommendations been followed?
        - On the second issue, even though most states have constituted SFCs, very few seem to have accepted their recommendations in full or even to a significant extent, especially those that carry financial implications for them.
        - As per the latest MoPR Devolution Report (2015-16) the percentage of acceptance of such recommendations varies from as low as 11 percent in

Karnataka to above 50 percent in West Bengal, Andhra Pradesh and Rajasthan to full acceptance in Kerala.

- **How RLGs have fared?**
  - Meanwhile, there is little data on how RLGs have fared over the past 25 years.
  - There has been no comprehensive survey of how RLGs have fulfilled their mandates.
  - And the only database on the effectiveness of RLGs in providing goods and services is the National Council of Applied Economic Research's (NCAER) Rural Economic and Demographic Database (REDS), which has not been updated since 2006-07.

STATE AND LOCAL GOVERNMENTS: POSING AN ENTIRELY DIFFERENT QUESTION

- RLGs collect less than 10 percent of their total resources from own revenues and ULGs around 45 percent. Why is their own revenue collection, especially from direct taxes, so poor?
  - A common answer is that higher levels especially the states have not devolved enough taxation powers to the Panchayats. For example, the permissible taxes for panchayats include property and entertainment taxes but not land taxes or tolls on roads (except local panchayat roads).
- **Given their powers to tax, how have third tier performed:**
  - Much less examined has been a different question: given their powers to tax, how have they performed and have they collected revenues close to the potential conferred by these powers?
  - The property taxes collected at the second and third tiers of government are
    - land tax assessed and collected at the state level; and
    - building tax, including property/house tax, collected at the municipality (ULG) and grama panchayat (RLG) levels.
  - Property taxes are the principal sources of direct tax revenue at the third tier of government, apart from professional taxes.
  - The collections from these potentially buoyant sources of revenue are generally stacked at very low levels because of:
    - archaic base values—far below market values—applied to properties,
    - low rates of taxes levied, and
    - lack of powers to local bodies in some states like Odisha and Rajasthan.

Potential for these taxes

- **Land tax vis-à-vis potential: States**
  - Different states follow different methodologies to assess land values and apply different rates of land tax.
  - The all-India average is boosted by the collections in States like West Bengal and Gujarat which are doing much better in this regard.

  - The stark finding is that the states collect a small fraction of their potential: an all-India average of 19 per cent if unreasonably low land values are assumed, and about 7 per cent on more realistic land value assessments.
  - Complaints about inadequate tax and revenue devolution are less persuasive under such conditions of serious under-collection.
- **House tax vis-à-vis potential: RLGs**
  - RLGs are empowered to a much greater extent by states to collect taxes on house and commercial properties than land taxes of any kind.
  - But while the population census (2011) gives an inventory of houses in the rural areas, there is no such data available for commercial properties in rural areas. Hence, in this analysis the total property tax collection of RLGs is set against their house tax potential.
  - This procedure thereby overstates performance. The procedure for this estimation, including date sources and valuation, is outlined in Annex 4.
  - As with land taxation, states follow different methodologies to assess value of houses and the land values embedded in a property; they also apply different rates of house tax. States such as Kerala apply unit rates of taxes on a given plinth area while states such as Karnataka and West Bengal apply ad valorem rates.
  - Even in states viz. Kerala and Karnataka that are ahead of others in devolution of powers to RLGs, the collection vis-à-vis potential is only around one-third. And all these are upper bounds on tax collection vis-à-vis potential given the lack of data on commercial property taxes.
- **Land tax vis-à-vis potential: Center**
  - How the Center itself has done at the third tier. Some Union Territories (UTs) such as NCT of Delhi and Puducherry have their own administrations, which take charge of land tax collection. But there are UTs where the central government assumes this responsibility, including Chandigarh, Dadra and Nagar Haveli, Daman and Diu, Lakshadweep, and Andaman and Nicobar Islands.
  - In these UTs, the question can be legitimately asked about central government performance.
  - Actual collection in these UTs is, on average, around 30 per cent of potential. For instance:
    - There is no land tax realization in Chandigarh, which has about 923 hectares of some agricultural land.
    - The collection from Dadra and Nagar Haveli was only Rs.0.19 crore as per the revised estimates for 2016-17 from its 21,856 hectares of agricultural land (the Agricultural Census 2010-11).
  - In sum, the under-collection of direct taxes relative to potential afflicts the Center as much as the other two tiers.

CONCLUSION: A LOW EQUILIBRIUM TRAP?

- The 73rd and 74th amendments were watershed developments in India's federal structure, its governance and accountability. But twenty years on, it is necessary to realistically evaluate their performance. Severe data constraints handicap efforts to gauge the performance of RLGs and ULGs. Consequently, policy making is hampered.

- In comparison with their counterparts in some other federal countries, state and local governments in India (federal tiers 2 and 3) rely much more on devolved resources and much less on their own tax resources, and they collect less direct taxes. And the reason does not seem to be so much that they don't have enough taxation power. Rather, the bigger problem is that they are not fully utilizing the taxation powers they already possess.
  - **Possible Reasons:**
    - Under-collection may be a matter of capacity and resources, perhaps even related to expenditure? After all, there is little reason to collect more taxes if they cannot be spent efficiently.
    - There may be a potential unwillingness to tax by the State, stemming possibly from the very proximity between state and citizens upon which decentralization is premised.
    - Perhaps taxpayers/citizens are able but unwilling to pay more, because they are dissatisfied with the quality of services they are receiving.
  - **Another possibility: "Low equilibrium trap"**
    - The status quo can be an equilibrium desired by all actors with higher tiers (both Centre and states) using their devolution powers to control and influence lower levels; and
    - the latter, unable and unwilling to tax their proximate citizens, need outside resources even if they are not always untied. But this is a low-equilibrium, perhaps even a trap.
- **How to break low equilibrium trap?**
  - Factors discussed above must inform future discussions of devolution and decentralization. For unless the underlying problems are identified and solved, local governments could remain stuck in a **low equilibrium trap**. That is, the fiscal model of the states and third tier institutions could forever be based on outside resources which—like foreign aid and natural resources or other forms of 'redistributive resource transfers' —come with weak accountability mechanisms and weak own resource generation capacity.
  - In the context of growing decentralization of economic and political power, how to break this equilibrium could well be one of the more pressing issues confronting fiscal federalism going forward.
  - Indian policy makers can perhaps no longer avoid this question: *should vertical and horizontal resource devolution to second and third tier fiscal institutions be credibly linked to their performance in increasing reliance on own taxes, especially direct taxes?*
- **Centre's own performance:**
  - Linking resource devolution to second and third tier to their performance will raise raise the question of the Center's own performance.
  - The previous Section showed with respect to the Center's collection of direct taxes in the UTs and the first Section highlighted on the broader performance of direct tax collections.

  - So, it is not obvious that the states and third tier fiscal institutions are the only ones unable or unwilling to collect direct taxes.
  - To any suggestion of the Center incentivizing second and third tiers toward better direct tax performance, the natural rejoinder of these tiers could be: Quis Custodiet Ipsos Custodes ("*who will guard the guardians themselves*")?
- **Broader challenge is limited ability to collect direct taxes:**
  - Perhaps there is a broader challenge— afflicting all tiers of government—in the limited ability to collect direct taxes.
  - Given the quality of public service delivery, such taxes are often viewed as a "tribute" to a state rather than a contribution to and acknowledgement of the state in raising the quality of life.
  - One consequence is middle-class exit to more privately-provided services (safety, health, and education) that only serves to exacerbate the problem.
  - Breaking that self-reinforcing cycle of *inadequate delivery-low direct taxes-weak accountability-inadequate delivery* is perhaps the heart of the governance challenge in India.