Fiscal Decentralisation: What Does the International Experience Suggests

Nauman Reayat[1], Iftikhar Ahmad[2], Jehanzeb Khalil[1], Dr.Tariq Rahim[3]

[1]Department of Political Science Abdul Wali Khan University Mardan, Khyber Pukhthunkhwa, Pakistan
[2.]Pakistan Institute of Development Economics (PIDE),Islamabad, Pakistan
[1]Department of Political Science, Abdul Wali Khan University Mardan, Khyber Pukhthunkhwa, Pakistan
[3] Institute of Development Studies (IDS), Agriculture University Peshawar, Pakistan
nauman381a@gmail.com ; iftikhar@pide.org.pk ; jehanzeb.regi@gmail.com ; trdaudzai@yahoo.com

Abstract: World has turned into a global village where every country has the opportunity to benefit from other's best practices. This study presents review of international practices for fiscal resource distribution. Study presents experiences both from the developed as well as developing countries to provide grounds for an amicable resource distribution mechanism. It was noted that developed countries are concerned about equity and equalization while the developing countries, due to lack of resources, generally are aiming at the formula transfers to ensure stability in provincial budgets. Thus this exercise provides an opportunity to assess available alternatives and possibilities. [Nauman R, Iftikhar A, Jehanzeb K, Tariq R. **Fiscal Decentralisation: What Does the International Experience Suggests.** *Life Sci J* 2014;11(7s):1-10]. (ISSN:1097-8135). http://www.lifesciencesite.com. 1

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1. Introduction

In order to design an amicable fiscal resource distribution mechanism, it is imperative to familiarise with the international best practices that are adopted in the world. The purpose of this study is to have an overall, broad view of the international practices that are in custom for the distribution of intergovernmental fiscal resource. This review will provide the grounds for finding an amicable resource distribution mechanism and would also give a review of other countries behaviour towards tackling the issue of fiscal federalism. No country of the world can exactly replicate another country's system because each country has its indigenous qualities as well as disabilities. They differ in the level of prosperity as well as have different potential for revenue generation. Another important difference is the distinct political systems which reinforces the desirability as well as ability of the rulers to cure the grievances of its people. Analyzing the world best practices in the fiscal resource distribution will provide a basis for looking at different alternatives and possibilities. Thus the practicable elements will come out and would be analysed according to needs, abilities and capabilities of the country in question i.e. Pakistan.

Each country has distinct stance and approaches differently towards the problem of intergovernmental resource sharing, which is broadly determined by their level of development. The developed countries (being able to provide the basic necessities to its people) are generally more concerned about achieving equalization among its masses. On the contrary, developing countries are striving for the provision of basic necessities to its people which is again conditional upon their capabilities to do so. Thus in the case of developing countries there is a need to design resource distribution in such a way which on one hand can achieve stability and predictability but at the same time can also augment economic efficiency. Transfer system needs to be modified in such a way that it becomes more equitable and at the same time to be consistent with needs and capabilities of nations.

2. Review of International Experience

Around the world, developing countries are now persuaded more towards decentralization so as to solve the problems of inefficient governance, macroeconomic instability and the resulting inadequate economic growth (Bird and Vaillancourt, 1999). It is general observation that in most of the countries, taxes are concentrated in favour of the centre. There are certain reasons for it as various political & economic rationales acts behind it. The most powerful argument behind heavy concentration of major taxes at the centre is due to the inability of the provincial level to collect major taxes. This is followed by the argument that central government can collect certain taxes with higher efficiency and even more effectively. Furthermore, central government needs more resources to guard national interests and thus it cannot depend on funds allotment from the provinces. Sometimes political leaders are also an obstacle in rationalizing the resource distribution between the centre and the provinces as they are unwilling to forego the excess resources which their provinces avail under the prevailing mechanism of resource distribution. Hence, number of countries like Argentina, India, Colombia and Pakistan collect huge taxes at the federal level (Table I).

Table I: Collections at Federal level

Country	Tax collection at centre (%)
Pakistan	95
Colombia	85
India	68
Argentina	62

Source: Kim and Smoke, 2003, India, 2004.

Following the collections at the centre, federal government then redistribute a certain proportion of these taxes among its constituent parts. These revenue resources are redistributed in two stages to fulfil the needs of lower tiers of government. First stage is the distribution of resources to bridge vertical fiscal imbalances i.e. to take care of differences in the collections of revenues at a particular level. At second stage, resources are distributed horizontally among the states generally to bring equity and to make them able to provide basic services to its masses. For horizontal resource distribution, both developed and developing countries are using distinctive measures to disaggregate the federal tax revenues e.g. China, Malaysia and Indonesia take "collection" as a major element of resource distribution while Pakistan uses population as a single criterion for this purpose. However, in most of the countries like India, Argentina, Brazil, Japan, and Philippines etc, multiple criteria including population, area, income distribution, fiscal effort, backwardness, collections, income distance etc are used to decide the provincial share under the horizontal resource distribution mechanism.

In the same manner, vertical fiscal imbalances are brought down in different ways including revenue decentralization, expenditure decentralization, by more centralization of expenditure responsibilities towards the federal government or by compensating the sub national governments for fiscal gaps that arise due to mismatch between their fiscal needs and fiscal capacities. Among the given alternatives, 'centralization of responsibilities at the federal level' is not economically efficient. It not only results in higher cost of providing basic services but also comes out with ill-identification of development projects. Therefore vertical fiscal imbalances are generally cured through the resource allocation mechanism (i.e. definition f divisible pool). In the developing countries, transfers from national government finances around 60% of expenditures made by the sub national governments. The central government tries to achieve the aspects of equity and efficiency among the provinces. These transfers are tried to be so designed so as to improve the living standards of the people to a comparable level across different areas of the country (Shah, 2003).

Taking international experience in to account, the Indian Finance Commission (which is responsible for fiscal resource distribution) decides on both the share of the states out of the central taxes as well as allocates certain grants to the states. These are supplemented by the Planning Commissions grants and discretionary grants from central ministries. Finance Commission decides about 65 % of the total transfers to the states (India, 2004). It is important to note that Indian Finance Commission decides upon the recurrent expenditures required by the states while Indian Planning Commission is responsible for the disbursements of development funds to the states. In Pakistan, the National Finance Commission (NFC) is responsible to address the problem of both vertical and horizontal fiscal imbalances. In Pakistan's case, vertical fiscal imbalances are caused both due to limited stagnant fiscal capacity of the provinces while the substantial increases in total provincial expenditures (current and development) over time are also the contributory factors. On the other hand, horizontal fiscal imbalances among the provinces are due to the distinct characteristics regarding revenue raising capacities and cost disabilities of the provinces.

3. Institutional Setup

Going into the institutional details, broadly **four** different approaches are used worldwide to bridge fiscal gaps:

1. The **most common** method is that federal government alone decides the shares of provinces according to their development needs. It is partly exercised in India because in the case of development grants allocation to the states, Planning Commission is responsible for disbursement of the substantial development funds. This mechanism best serves the national development plan; however, it undermines the equity aspect among the provinces. Hence, this arrangement never proved to be a representative and desirable system as it provides the federal government with the luxury to impose decisions on the provincial governments. That's why, in certain countries, the federal to provincial transfer mechanism is guarded by law.
2. In this connection, the **second** mechanism adopted is the formation of a semi-independent body which makes recommendations about fiscal resource distribution for certain specified period of time (generally five years). The body/commission can either be permanent as like in Australia (Commonwealth Grants Commission) and South

Africa (Financial and Fiscal Commission) or can be founded from time to time as in India (Finance Commission) to submit reports either to the parliament or to the central government. However, it has been observed over time that due to its non-mandatory nature, federal government ignores its recommendations at times mainly due to political reasons.

3. The **third** method in practice is that both the federal and provincial government representatives negotiate for amicable transfers as is done in Canada.

4. Lastly the **fourth** approach is the extension of the third one i.e. the federal government chairs the session consisting of provincial government representatives along with certain nominated experts both by federal and provincial government. They work together to reach at an acceptable resource sharing mechanism. Same system is adopted in Pakistan. Though this method is simple, transparent and accommodating but on its negative side it can also result in deadlocks, as is witnessed in Pakistan (Shah, 2003).

4. Developed versus Developing Countries Behaviour

Once the institutional setup is completed and decided, different alternative approaches are given to address vertical and horizontal fiscal imbalances. There is a clear divide among the developed and developing countries in their approach towards addressing fiscal gaps. The developed countries generally resort to the three distinct policies (Ahmad and Craig, 1997), which are elaborated as follows:

4.1 Separate policies to correct both imbalances:

In this approach, both the horizontal and vertical fiscal imbalances are treated separately. Vertical imbalance is addressed through the tax-sharing. However, if there is huge difference in the fiscal capabilities to generate revenues, even grants are extended to sub national governments. On the other hand, the horizontal fiscal imbalances are tackled through contribution from provinces with higher fiscal capacity to the less prosperous provinces. In this mechanism a combined pool of resources are created by the well off provinces which is later divided among the financially weak states. This method is nowadays in practice in Germany where the rich states provide finances to the poorer states and thus equity among the stats is tried to be achieved.

4.2. Well established equalization funds system to achieve horizontal equalization:

The second method adopted by the developed countries is that horizontal fiscal imbalances are resolved by extending equalization transfers and some special purpose grants. Under this approach vertical fiscal imbalances are not looked at because federal government finances bulk of development schemes. This system is functioning in Australia and Canada. In Australia, relativities[1] are calculated and used to advance funds to the states with the condition that all states would make efforts of the same level and would operate at the same level of efficiency. Average per capita income of all states is calculated on year to year basis and used as the bench mark to determine the financial requirements of the states. Thus, states with relativities above one require more than the Australian average per capita amounts and opposite for those whose relativities are below one. However, it is important to note that those who have relativity below one are not negatively compensated but simply are not given any equalization funds. While the others who has relativity above one, are given more funds to raise their fiscal capacity and solve cost disabilities for providing services (Australia, 2007). Similarly in Canada, a well established equalization funds system is working and horizontal imbalances of the states and territories are met through per capita equalization transfers and grants.

4.3. Vertical imbalance should be corrected ignoring horizontal imbalances:

Contrary to the above discussed approach, the third approach adopted in developed countries, is based on the competitive behaviour. Under this system, it is assumed that once vertical fiscal imbalances are resolved, the horizontal imbalances would be resolved by its own through the play of economic factors i.e. through capital and labour migration. Nevertheless, some special purpose grants are made to achieve certain goals of federal government which in turn also make some contribution in solving horizontal imbalances. Nowadays United States is practicing this approach (Ebel and Yilmaz, 2001).

After elaborating the resource distribution stance of developed countries, it is interesting to discuss the case of developing countries as well. A comparative analysis can be summarized in table II, which presents the various methods adopted in different countries to disaggregate the divisible pool and correct fiscal gaps.

Contrary to the approach adopted in developed countries, Pakistan as a developing country, tries to address both the vertical and horizontal fiscal gaps, simultaneously through its National Finance Commission (NFC) Awards. Similar is the case with India. This similarity in behaviour is also reflective of the facts that in both the developing countries there is a heavy concentration of taxes at the centre and provinces are transfer dependent. Both the countries resort to the formula transfers as well as advance grants in order to make the provinces able to work and provide basic necessities to its people (Table II).

Table II: Country Gap and Remedy

Country	Gap addressed		Remedy		
	Vertical	Horizontal	Formula	Grants	Equalization funds
Australia	-	Y	-	Y	Y
Canada	-	Y	-	Y	Y
Germany	Y	Y	-	Y	Y
India	Y	Y	Y	Y	-
Pakistan	Y	Y	Y	Y	-
Philippines	Y	Y	Y	-	-
USA	Y	-	-	Y	-

Sources: Smoke and Kim, 2003; India, 2004; Beierl, 2001; Australia, 2007; Ruggeris, 2006; Ma, 1997

Approaches addressing vertical and A fundamental dissimilarity between the developed and developing countries is that in developing countries, emphasis is mainly on the formula based transfers. To formulate an amicable resource distribution mechanism, different aspects of cost disabilities and revenue generation capabilities are taken into account. At the same time some aspects of tax efficiency are also tried to be encompassed to persuade efficient use of resources. Main focus is generally to provide sufficient funds to sub national governments, so as to make them able to provide basic services to its people which are of comparable level.

5. Defining the Volume of Divisible Pool

Another critical element in explaining the resource distribution stance of the government is the definition of the divisible pool (DP). It determines the size of the pie to be apportioned between the federal and provincial governments. DP is constituted on the basis of preferences of the government as well as the transfer systems adopted in a particular country from time to time. For example, in Pakistan, fewer taxes were shared with the provinces till 1997, however the (5th) National Finance Commission (NFC) decided to expand the divisible pool and include all the taxes in it. Currently, 43.75 percent, out of the total divisible pool, are allocated to the provinces to be distributed among them. The net proceeds plus grants to the provinces collectively makes about 47 percent in 2008-09 and will ultimately reach 50 percent of the net divisible pool by 2011, increasing at 1 percent per annum (Ahmed et al, 2007). Thus Pakistan is moving ahead towards more resource distribution which is supposed to be finally translated into financial autonomy.

Same has been witnessed in India. Till year 2000, divisible pool consisted of only two major taxes i.e. non-corporate income tax and union excise duty.

Both these taxes were distributed on tax-to-tax basis by assigning different weights to different criteria separately. But in year 2000, all taxes were included in the divisible pool through a constitutional amendment (80th amendment) and Finance Commission was authorized to decide upon the respective shares of the states. Currently around 30.5% out of the total divisible pool are allotted to the states in India (India, 2004). In Canada, major taxes like customs and excise are collected at centre and are then used to resolve vertical imbalances through the means of grants and per capita transfers.

The size of the DP holds very crucial position and has direct implications on the lower level government's budgets. In Philippines, around 40 percent of gross national revenues are allocated to local governments. This constitutes about 94 percent of transfers to local governments (Capuno, 2002). While in Indonesia, 25 percent of federal budget is directed towards provinces according to law passed in 1999. This constitutes around 75 percent of local government's revenues (Lewis, 2002). In Australia, GST revenue and Health Care Grants are distributed among the states. These transfers contribute around 42 percent to the states budgets, with highest 72 percent to the Northern Territory and lowest 32 percent to the New South Wales (Australia, 2007). The whole discussion can be summarized as in Table III.

Table III: Divisible Pool Definition and Provincial Allocation Across Countries

Country	Divisible pool	%age allotted to states
Australia	Income Tax, VAT and Health Care Grants	42
Canada	Income Tax, VAT, Customs and Excise	NA
Colombia	All taxes	45.5
India	All major taxes	30.5
Indonesia	Federal Budget	25
Japan	Income tax + Alcohol Tax	32
Pakistan	All major taxes	47*
Philippines	All taxes	40

Source: Kim & Smoke, 2003, India, 2007
* will subsequently reach to 50 percent of the net divisible pool by 2011.

In Austria, fixed percentages of the certain federal taxes are allocated to the sub national governments. The local governments get around 12 percent of income tax and value added tax. Similarly in Japan, 32 percent of income and alcohol taxes are given to the states on the basis of population and community size. In Germany, in year 2001, the central government collected around 17 percent of the total tax revenue while the states and municipalities collected about 5 and 7 percent, respectively. Moreover, 71 percent of fiscal resources went to the common divisible pool, which was redistributed among the three (Beierl, 2001).

6. Horizontal Resource Sharing

As far as the horizontal resource distribution is concerned, there are certain choices available to the policy makers and various methods can be used for funds allocation to the states i.e.:

I. The original targets of a country depend on its development status and the desire as well as ability of that particular country to achieve equity among the states. However, the most favourable method of allocating funds among the states is to derive a **formula** that accommodates all the desired criteria for equalization and efficiency. On the other hand, the formula based transfers satisfy the transparency issue of resource allocation to the sub national governments. Nevertheless, for smooth and timely allocation of funds, proper structure and in time availability of data is very crucial, which is not an easy task in the less developed countries. In addition, sometimes formula is over emphasized and too many items are included in the formula which makes the overall effect unclear. In this context, Smoke and Kim (2003) also advocated that the distribution formula needs to be clear and concise. In the case of India, the Indian finance commission is entrusted to recommend on the sharing of net proceeds of taxes between the federal and states governments. This is further subdivided into;

a) Determining the total share of the states out of the divisible pool.

b) Determine the criteria for the transfers to the states.

c) Assigning weights to the different elements in the formula.

As far as Pakistan is concerned, throughout its history, the National Finance Commission has remained consistent with the use of population as the sole resource distribution criteria. It is a very rough criterion to asses varying needs of the distinct provinces but still Pakistan[2] is stick to it. Table IV indicates the important factors that are taken into account to decide the horizontal resource allocation. Australia and Canada assess the state's fiscal needs and then extends fiscal transfers, accordingly. In addition, these countries also allot certain grants to the states to bridge for cost disabilities. Austria and Japan has adopted same type of formulae for the allocation of resources among their constituent parts. Cambodia and Philippines has adopted three elements formula for this purpose. In Philippines three different criteria are used i.e. population, area and equal share with subsequent weights of 70%, 20% and 10% respectively. The divisible pool consists of a pre-defined share of the national taxes. Out of the total allocation the local governments are subjected to spend 20% for development purposes (Bird and Smart, 2002). In this context, India has chosen five different factors for deciding provincial resource allocation while Pakistan put only population in place for deciding the shares of the provinces.

Table IV: Prominent Factors Adopted for Resource Distribution

Country	Criteria
Australia	Fiscal Gap Relativities + Grants
Austria	Population + Community size
Cambodia	Population + Poverty share + Equal share
Canada	Equalization funds + Fiscal Needs
India	Population + Distance + Area + Tax Effort + Fiscal Discipline
Japan	Population + Community size
Pakistan	Population + poverty +Revenue generation + Area
Philippines	Population + Land Area + Equal share

Source: Smoke and Kim, 2003; India, 2007; Pakistan, 2010

II. Despite the importance of formula transfers, in certain countries taxes are shared on the **basis of collection** in the respective areas. Advantage of this method is that it is elastic, has potential to grow overtime and thus provides incentives for the sub national government to have efficient collection each year. But on the other side, these types of sharing mechanism never ensure goal of equalization. Under the system, provinces that have better economic condition can collect more and in return obtain more out of the total divisible pool. Thus this method has no room for poorer states and is representative of the sub national government's fiscal capacity. However, there are countries where it is implemented as like in China, Malaysia and Indonesia, where substantial amounts are divided on the basis of tax sharing (Smoke and Kim, 2003). From the positive side, it provides an incentive to provinces to have an efficient and effective tax system and help them standing on their own feet. In Germany, sizeable amount of tax revenue is distributed in accordance with the local yield. Thus the local authority has the incentive to use what they have collected. Advocators of this measure stress that local revenues reflect the

[2] Nevertheless grants are advanced to the financially weak provinces so that to ensure the availability of basic necessities.

contributions made by its inhabitants and they should be compensated for it. In addition to that it exhibits the actual efficiency of the people living in that specific locality (Beierl, 2001).

III. Third important method for addressing horizontal fiscal disequilibrium is that of the **cost-sharing** to allocate funds to sub national governments. Here the central government provides either full or partial matching grants to the sub national governments for particular priority areas. In the total cost sharing, the sub national governments are provided with full funding in order to fulfil a specific project while in the partial cost-sharing the central government gives some predetermined proportion of funds to the lower tier if it commits to some desired project. These transfers highlight the efficiency motive of the states, however some rules must be there to ensure no misuse of this method (Smoke and Kim, 2003).

IV. In addition, there are some arbitrary transfers to deal with some special purposes like satisfying political ends or emergency situations (Smoke and Kim, 2003). For example in India ten states are given special status due to the prevailing political instability there. Similarly sometimes the bargaining potential of the provinces also counts in this connection. Thus political strength as well as political situation poses an important bearing on the allocation of funds to the sub national governments.

7. Summary

As far as the developing countries are concerned due to the complex nature of the political and economic conditions, to make transfers stable and predictable, generally all the taxes are included in the divisible pool as is the case in Pakistan and India. Due to capacity as well as efficiency issues at the sub national level, bulk of resources is collected by the central government. Once taxes are collected at the centre, next step is to define the divisible pool. When the divisible pool is defined another important step is the method adopted to disaggregate it among the member states. It again varies from country to country. In the developed countries generally equalization funds and grants are in use. With the higher level of education and established civil society it is hard to deceive the lower tier of government. Thus provinces get what they require without any fear of biasness. Developed countries generally target for more calculated disaggregation of resources to cure horizontal fiscal imbalances and thus try to achieve a comparable standard of living across the provinces. Due to timely availability of credible data it is easier to calculate the provinces fiscal capacity and fiscal needs; the remaining gap is filled by the central government.

On the other hand the developing countries lack proper facts and figures. In addition generally there is a threat of political biasness in the allocation of resources that's why they adopt the method of formula transfers. It provides the provinces with stability, predictability as well as transparency in resource allocation. However, definition of formula varies from country to country. Moreover, unlike developed countries they don't have much of reserve funds to directly cure all the deficiencies in the provinces budgets. In addition, taxes are more concentrated towards the central government due to lack of provincial autonomy and it results in inability to impose and collect taxes at provincial level. So in these circumstances, formula transfers are given more weight in the developing countries.

The two desirable characteristics of a good fiscal transfers system can be pointed out as stability and flexibility. Generally there are three ways to adopt while transferring amounts to local government i.e.

i. As a fixed proportion of the central government revenues but the problem with it is that it is not demand driven and thus lacks consideration for the absorption capacity of the concerned states into its view.

ii. Without any specialized consideration as ad hoc budgetary allocation. This hits the provinces with uncertainty and negatively affects their efficiency due to absence of competition among the states.

iii. On formula basis, giving some specified weights to distinct characteristics of different jurisdictions. In the perspective of developing countries, the formula transfers present the best solution for solving the problem of fiscal imbalances. Formula transfer ensures stability, competition, efficiency as well as has the flexibility to adjust with provincial needs.

It has been observed that in the developed economy there is more emphasis on achieving equalization in health and education due to availability of excess revenues like in Canada where the CHT, CST and Equalization transfers operate alongside one another. On the other hand definition of the divisible pool as a percentage of all taxes also prevents national tax policy from becoming biased. If some taxes are shared with the local governments and some are not, over the time the federal government would have the inclination to increase only those taxes which they do not have to share with the provinces.

Thus, in the developing countries, keeping in view their financial situation, the best way to achieve stability and flexibility characteristics is to determine a fixed percentage out of the national taxes as the divisible pool that to be apportioned among the sub national governments. This is exercised in India, Pakistan, Colombia and Argentina. This not only brings stability and predictability in local budgets but the divisible pool also grows with time to accommodate the growing needs of the jurisdictions. Hence, formula should be based on such factors which on one side represent the needs of the provinces while on the other and more important side, it should induce efficiency and stability. Nevertheless, formula should not be over emphasized, with the inclusion of so many factors, that its overall effect becomes obscured.

Case study

India

India is a developing country and it comprises of a central government, have 28 states and union territories. Out of these 28 states 10 are characterized as special category states and are given special treatment due to political reasons. For fiscal resource distribution prime role is played by two forums i.e. the Indian Finance Commission and the Indian Planning commission. The Indian Finance commission is constituted periodically after every five years and is concerned with the devolution of the central taxes and grants to the states to be given out of the divisible pool. Planning Commission is a permanent federal body and has the responsibility to assess development needs of the states. In addition to that there are other agencies like the Interstate Council, the National Development Council and the State Finance Commissions (on each for one state) (Smoke and Kim, 2003).

The history of fiscal resource distribution in India, after independence, starts at November 19, 1951. In the near past, the twelfth Finance Commission was appointed by the president to give recommendations for smooth resource distribution covering the period of five years i.e. from 2005-06 to 2009-10 (India, 2004).

In India fiscal resource transfer takes place in three parts:

1. The federal tax revenue is shared between the federal and state governments through the Finance Commission. The funds transfer accounted for 65 percent during 1969-74 but declined to 58 percent in 1992-93 and currently once again it accounts for around 65 percent (India, 2007).
2. Transfers of grants to the states are governed by the Planning Commission of India thus Federal government is responsible for the distribution of development grants. It extends the unconditional grants, special purpose grants and matching grants to the states. In 1992, funds transferred to the provinces by Planning Commission were about 38 percent of total transfers.
3. The local governments have to seek for the authority given by central government to borrow, thus it makes the third mode of transfer.

In this context, the Indian finance commission is entrusted to extend recommendation on the following issues;

1. The sharing of net proceeds of taxes between the federal and states governments. This is further subdivided into
   a. Determining the total share of the states out of the divisible pool.
   b. Determine the criteria for the transfers to the states.
   c. Assigning weights to the different elements in the formula.
2. To propose principles for extending grants in aid to the states out of the consolidate fund of India.
3. Suggest measures to enlarge the federal pool of taxes so that higher transfers are made to the lower level of governments.

Main responsibilities of federal government include civil administration, defense, internal & order security, debt-servicing and alike. An important aspect related to Finance Commission is that it takes the 1971 figure of population as a base wherever transfers are made on the basis of population.

Till 2000, only two important taxes i.e. non-corporate income tax and union excise duty were shared with the states on tax to tax basis. These taxes were distributed on the basis of only two factors of population and collection. However later on through the 80th constitutional amendment, all taxes (except few) are included in the divisible pool. After the inclusion of all taxes in the divisible pool different criteria are used to disaggregate the federal revenue and are given in table VI (India, 2004).

In this context, to address vertical fiscal imbalance, the Twelfth Finance Commission (FC) has recommended that 30.5 percent out of the net divisible pool be transferred to the states, where the divisible pool consists of all federal taxes (except few) since year 2000. As far as the horizontal distribution is concerned, different criteria were devised for resource distribution among the states, based on various aspects of cost disabilities. To ensure judicious and efficient resource allocation, the Indian FC considered the following important factors:

a. Needs: Health and education is always considered as a basic need everywhere. Therefore, deficiencies in basic needs persisting in different areas were emphasized. However, commission takes utmost care in considering these areas because any arbitrary transfers of funds will negatively affect the tax effort by the states.

b. Cost Disabilities: There are several reasons for higher than average per capita costs for same degree of public service provision in different states. There are factors which cause higher costs and are out of the states control. Causes for cost disabilities may be like excess rainfall, hilly areas, vast remote areas, adverse population density etc. So the commission has to thoroughly consider these factors while deciding the shares for different states.

c. Fiscal Efficiency: Although there is no exact measure for this criterion however in order to improve fiscal efficiency, incentives are given relating to tax effort.

Hence to capture the effects of all these requirements, different weights are assigned to various factors in order to ensure fiscal equalization. The weights given to different factors by different FC in India are shown in the table V (India, 2004). While Table VI, provides the history of resource allocation in India.

Table V: Relative Weights of Criterions under Tenth, Eleventh and Twelfth

Finance Commissions	10th FC	11th FC	12th FC
	Percentage		
1. Population	20.0	10.0	25
2. Distance[3]	60.0	62.5	50[i]
3. Area	5.0	7.5	10
4. Index of Infrastructure	5.0	7.5	-
5. Tax Effort	10.0	5.0	7.5
6. Fiscal Discipline	–	7.5	7.5

[i] income distance criteria

Source: Smoke and Kim, 2003; India, 2004

A brief justifiability of the factors adopted by the different Indian FC is given as: (India, 2004).

1. Population:

It is the representation of basic needs of an area for public goods and services. It helps in achieving equitable per capita transfers. However it is a very blunt element to represent the costs involved in providing basic needs of an area thus cannot be depended upon as a whole. That's the reason that the weight attached to it by various FCs ranges around 20 to 25 percent.

2. Per capita income distance:

It is a very good indicator of representing the fiscal capacity of different states. It represents the fiscal gap among the rich and the poor states and help in assessing the needs of the poorer states. It ensures progressive allotment of amounts to states whose per capita income is below the average per capita income. For calculating the state-wise income distance, first of all the states are arranged in accordance with their gross domestic product for the last three years. Then the average of the top three states is calculated to compute income distance and this gap from these highest ranked states is then used to assign weights to different states.

3. Area:

Area of a territory gives another insight of determining the hardships that a state faces in providing basic needs to its people. It can be taken from both the sides i.e. states with vast area and states with small areas. The states that cover huge areas needs higher funds to achieve this motive, on the other hand the states with small territory have also to incur funds to set up minimum administrative facilities. Thus it is considered in both the ways. That's why it is also called inverse population density at time. Thus Indian FC has designed the transfers in such a fashion that any jurisdiction (with varying areas) should not get less than 2 percent or greater than 10 percent. In general, in the formula definition, a 10 percent weight is allotted to the criteria of "area".

4. Tax effort:

It indicates the capacity of a state to tax the inhabitants of its area. It is measured by the ratio of per capita own tax revenue of a state and its per capita income.

5. Fiscal discipline:

It is a measure of better fiscal management and it helps in creating an incentive for better management. It is measured by calculating the improvements made in the state's revenue to its expenditures and is compared with that of the other states.

Conclusion:

From the current discussion it is obvious that there is a fundamental difference among the approach of developed and developing countries. Developed countries are more concerned about equity and equalization and the provision of same level of health and education facilities. Thus funds are generally provided through the means of grants. While the developing countries, due to lack of resources, generally are aiming at the formula transfers to ensure stability in provincial budgets. The reason is that in the developing countries taxes are structured in such a fashion that provinces are not left with sufficient opportunities to fulfil their requirements from their own revenues. Thus the formula transfers ensure the minimum level of funds that will be available to the sub national governments to fulfil

[3] This criterion has been modified a number of times by various Finance Commissions.

their current expenditures. Thus through these transfers the availability of the basic facilities is tried to be ensured throughout the country.

Table VI: Average transfers from Centre to States under various FCs

FC	Finance Commission Transfers			Other Transfers			Total Transfers
	Central Taxes Share	Grants	Total Finance Commission Transfers	Planning Commission Transfers	Non-plan Grants	Total Other Transfers	
1	2	3	4	5	6	7	8
7th FC	22.39	1.96	24.35	12.11	1.66	13.77	38.11
8th FC	20.25	2.52	22.77	13.56	1.54	15.10	37.86
9th FC	21.37	3.42	24.79	14.48	1.06	15.54	40.33
10th FC	21.40	2.34	23.75	10.57	0.63	11.19	35.79
11th FC (2 years)	20.93	5.20	26.13	10.39	0.82	11.21	37.20

Source: India, 2004

As far as development expenditures are concerned generally grants are used in various ways like conditional grants, matching grants, special-purpose grants, and sector-specific grants. Grants can be taken in two different ways i.e. according to their use and according to the amount disbursement.

Now the problem is that how can we best constitute a formula that encompass all the desirable characteristics. Too simple a formula though have some benefits of simplicity and predictability but does not ensure all other characteristics of a good transfers system like ensuring efficiency and accounting for development needs. For example in Pakistan population is used as a single criterion for resource distribution which simply is a crude representative of expenditure needs. This never ensures realization of the fiscal needs according to the varying nature of the distinct provincial circumstances. Pakistan is a large country and all its provinces have different fiscal capacities and cost disabilities. Therefore while formulating a feasible resource distribution mechanism all efforts should be made to make it reflective of the varying needs of its people living in different areas of the country.

Although different countries have adopted different formulae but one of the most important is that of India. This formula is relevant and consistent with our political economy. It is developed over a period of time and different combinations of distinctive criteria reflecting needs, fiscal capacity and tax effort are being used to determine the states shares. So this formula can provide us good base to mould our formula in such a way so that it can properly reflect people's desires and needs. Nonetheless one of the main bottlenecks in this process is the unavailability of free and transparent professional finance commission, lack of timely availability of data as well as credibility of available data. If we are able to cope with these problems then the best representative formula can be designed. But it should be kept in mind that involving too many objectives and resultantly inclusion of too many criteria would also not do the job. It makes the formula very complex making it unclear and sometimes cancels out its benefits. Thus formula should be kept simple yet comprehensive to serve most of the problems while else can be done through grants etc.

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