

FISCAL FEDERALISM AND LOCAL AUTONOMY: A COMPARATIVE STUDY OF INTERGOVERNMENTAL TRANSFERS IN INDIA AND BRAZIL

DINESH KUMAR MISHRA¹, VAIBHAV YADAV²

¹TEACHING AND RESEARCH ASSOCIATE (LAW), GUJARAT NATIONAL LAW UNIVERSITY
GANDHINAGAR.

²TEACHING AND RESEARCH ASSOCIATE (LAW), GUJARAT NATIONAL LAW UNIVERSITY
GANDHINAGAR.

ABSTRACT

This research article takes on a comparative examination of fiscal federalism and intergovernmental transfers in two giant and most varied federal democracies in the world-Brazil and India. The general aim of the study is to understand the specific constitutional and institutional arrangements; the resource allocation processes and the political economy of center-state and center-local fiscal relations. Drawing on the classic theoretical contributions of Richard Musgrave and Wallace Oates, the article describes how each country's transfer system deals with the fundamental issues of vertical and horizontal fiscal imbalances.¹

For India, the analysis is about the statutory, quasi-judicial function of the Finance Commission, the historical role of the now-defunct Planning Commission and the transformative (but contentious) introduction of the Goods and Services Tax (GST). For Brazil, we investigate its specific constitutional co-equality status of municipalities, the design of its compulsory revenue-sharing funds (FPE and FPM) and the enormous ramifications of its recent tax reform (PEC 45/2019). A key observation is the common problem of political-economy drivers of resource allocation, where discretionary transfers are used to pay for political conformity in both countries, but that is offset in the case of India's statutory transfer system. The paper concludes that despite some degree of fiscal decentralization achieved in both countries, the challenge of imbalances and centralizing tendencies (often disguised by the rhetoric of modernizing reforms) continues to haunt the ideal of true local autonomy. The article contains specific recommendations for institutional and policy reforms to make intergovernmental relations fairer, more transparent and more efficient.²

Keywords: Fiscal Federalism, Inter-sectoral Transfers, Fiscal Decentralization, Public Finances, Local Self Governance, India, Brazil, Comparative Analysis.

INTRODUCTION: SETTING THE STAGE FOR COMPARATIVE FEDERALISM

Public finance investigates fiscal relationships and the sharing of governmental functions between several levels of federal government. Public finance is focused on these issues and fiscal federalism is an integral part of public finance. It is not just a technical or administrative exercise in large and diverse federations like India's and Brazil's, but an important part of the political system which ensures a balance between the national and the regional/local, the collective and the particular.³ The problem is a familiar one: how to allocate resources appropriately and how to devolve power in a way that does not erode trust in the ability of subnational entities--which are uniquely positioned to understand and meet the needs of the local populace--to have the financial capacity and autonomy to do so. Intergovernmental transfers are procedures by which central governments share their resources with state, provincial, and municipal governments in order to compensate for fiscal imbalances and

¹ Singh Nirvikar, *Fiscal Decentralization in China and India: Competitive, Cooperative or Market Preserving Federalism?* (2009) 9(1) *Public Finance and Management* 97–136.

² K Kenneth Kletzer and Nirvikar Singh, 'Indian Fiscal Federalism: Political Economy and Issues for Reform' (Working Paper, IRIS, Stanford University, 1995).

³ Wallace E Oates, *Fiscal Federalism* (Harcourt Brace Jovanovich 1972).

implement national policy. Such transfers are one of the main instruments used in fiscal federalism.⁴

Taking this as the scope of the research work, a comparative analysis between these systems in the context of India and Brazil is undertaken. In this study, the different institutional and constitutional designs of respective transfer mechanisms are compared as well as the operating principles of resource allocation, taking into consideration the political-economic context where respective transfer mechanisms are evolving. Starting from basic concepts of public economics, the research extends thereafter to country-specific studies, and closes with a paper on efficiency, equality, and local autonomy in an international context.⁵ The aim of this research is to identify issues common between these two countries and offer lessons that may be applied to policymaking, by undertaking a comparative analysis of decentralisation and reform processes which occur in Brazil's constitutionally mandated system and in India's rules-based but politically-driven system. Its cutting-edge analysis points to the shared predicament to which both countries are subject, despite their very different trajectories, which is the historic tension pitting the central government's macroeconomic stability and hegemony against subnational units' thirst for genuine fiscal and political autonomy. This struggle has been around for a while now.⁶

This work is structured by the method of stratification and the method of integration. In the next section the theoretical underpinnings of fiscal federalism are going to be discussed. Thereafter, two parts are dedicated to a detailed analysis of the institutional set-ups in India and Brazil respectively, including the process followed for transfer. Following that, a section on comparative political economics assesses and compares the political forces behind transfers in the two countries. The paper concludes with a summary of the most relevant findings, accompanied by a set of specific policy recommendations designed to strengthen the financial bases of these two important federal democracies.⁷

THEORETICAL FOUNDATIONS OF FISCAL FEDERALISM

The literature related to fiscal federalism rests on the theories that offer clarity on the normative goals of fiscal federalism and the criteria for its success. The American economist Richard Musgrave, who was born in Germany, is credited with having been the first person to make use of the term. In 1959 he created a theory for it based on three basic functions of government including economic stabilization, redistribution of income, and redistribution of resources. Musgrave said that the most efficient level of government to execute the first two functions is the central level.⁸ As a result, from the point of view of national fiscal policies to be effectively implemented in order to control the instability of the economies, there is the need for a macro-integrated approach in order to control unemployment and inflation. Open economy subnational units are not able to successfully adopt such an approach. In a similar way, income redistribution, which aims to create an equitable distribution of income, requires intervention by the central government in order to avoid inequalities between regions as well as the migration of citizens to jurisdictions offering more generous social policies.⁹

⁴ Paul B Spahn, 'Intergovernmental Transfers: The Funding Rule and Mechanisms' in Jorge Martínez-Vázquez and Bob Searle (eds), *Fiscal Equalization* (Springer 2007) 163–204.

⁵ Teresa Ter-Minassian and Luiz R. de Mello Jr, *Intergovernmental Fiscal Cooperation: International Experiences and Possible Lessons for Brazil* (Technical Note, Inter-American Development Bank, May 2016).

⁶ The Research Department of the Inter-American Development Bank (IDB), *Intergovernmental Fiscal Cooperation: International Experiences and Possible Lessons for Brazil* (IDB Technical Note, May 2016).

⁷ Francisco Javier Romero Caro and Alice Valdesalici, eds, *Fiscal Federalism and Diversity Accommodation in Multilevel States: A Comparative Outlook* (Palgrave Macmillan 2024).

⁸ RA Musgrave, *The Theory of Public Finance: A Study in Public Economy* (McGraw-Hill 1959).

⁹ RA Musgrave, *The Theory of Public Finance: A Study in Public Economy* (McGraw-Hill 1959).

In contrast, Musgrave advocated that state and local governments should be held responsible for the provision of public goods and services and that such provision should be the major area of responsibility for government. This has been formalised by Wallace Oates with his well-known Decentralisation Theorem. In the theorem, it is said that in a system with no inter-jurisdictional spillovers and heterogeneous national preferences for public goods, local decentralised provision of services is more efficient than standardised provision of services under centralised provision. By virtue of its closeness to the citizens being served, local government will be in a better position to adequately adapt public services to the varied demands and tastes of localities.¹⁰

When discussing the concept of fiscal federalism, there are many important concepts to be aware of describing the fiscal relationships between the levels of government. The Vertical Fiscal Imbalance (VFI) is a measure of the structural imbalance between vertical revenue raising capacity and spending obligations of a level of government. In many federations the central government will generally collect the most economically valuable tax sources. This is because the central government is more efficient in collecting taxes and controlling the macroeconomic situation of the country. There is also a more sophisticated version of this, sometimes called Vertical Fiscal Asymmetry (VFA).¹¹ The word Imbalance is a judgemental one usually because it implies a deviation from the optimal state. In contrast, the term "asymmetry" recognizes both that the ideal symmetry can never be reached in practice, and that a degree of mismatch is an inexorable and realistic property of federal systems. This incongruence is captured in the fact that the term "asymmetry" has been favored over "inequality" or "federalism"-that is, a broader change in thinking is part of this institutional evolution; the imbalance between subnational revenues and spending is real and must be governed rather than eliminated. This realization in turn provides the justification for the need of intergovernmental transfers to bridge the gap.¹²

Horizontal Fiscal Imbalance (HFI) is another important concept which refers to the differences in the potential for revenue generation and the cost of public services available to subnational units operating at the same level of government. It is possible that this inequality has its own causes such as differences in levels of economic development, population density or endowment with natural resources. Since it is the Government's central objective that all citizens should receive a broadly equivalent level of public service for a broadly comparable tax payment, irrespective of their geographical location, the main aim of equalisation transfers is to reduce the emergence of these horizontal disparities.¹³

Much literature on fiscal decentralisation is organised around its four key pillars. The first pillar refers to the sharing of spending responsibilities between the different levels of government, in a way that a clear division of labour is ensured. Second, there are the revenue powers, which regulate what kind of taxes the central government and the state governments and local governments may impose. The third pillar is the design of intergovernmental transfers (including the system of grants and revenue sharing); and the fourth pillar relates to regulations and laws on public sector subnational debt, borrowing and capital finance, which are required for fiscal discipline and stability. For the purpose of understanding the kaleidoscope of the complex and dynamic fiscal regimes of India and Brazil, the four pillars

¹⁰ WE Oates, *Fiscal Federalism* (Harcourt Brace Jovanovich 1972).

¹¹ Anwar Shah, *The Practice of Fiscal Federalism: Comparative Perspectives* (McGill-Queen's University Press 2007).

¹² Robin Boadway and Anwar Shah, *Intergovernmental Fiscal Transfers: Principles and Practice* (World Bank 2007).

¹³ Robin Boadway and Anwar Shah, *Fiscal Federalism: Principles and Practice of Multiorder Governance* (Cambridge University Press 2009).

offer a nuanced analytical framework which can be used.¹⁴

THE INSTITUTIONAL ARCHITECTURE OF INDIAN FEDERALISM

While India, as a federation of states, and as a Union of States as the Constitution describes it, is a powerful centre with sharp lines of demarcation of power. The Union list, the State list, and the Concurrent list are the three lists which are mentioned in the Seventh Schedule of the Constitution. There's an important division of powers between the legislative and financial branches of government on these lists. On matters of concurrent subjects, the central government retains its superiority and is in the position of a fiscal oligarchy. This despite the fact that states are entrusted with a huge number of functions, especially in social sectors like agriculture and health care.¹⁵ Another fact that endorses the constitutional scenario is the fact that the Constitution grants the power to the Central Government to exercise control over State borrowing and even apprehension to step in and take over administration of the states if a financial emergency exists.¹⁶

The inter-governmental payment system has been a multi-channel system in India for a long period of time, but the same has changed a lot over the years. The major and the most important channel is the quasi-judicial institution and statutory authority - the Finance Commission (FC), which is set up by the President at regular intervals of five years, as per provisions of Article 280 of the Constitution. The Federal Council in particular is responsible for recommendations on the sharing of the net income of the central taxation between the Union and the State (called vertical devolution) and the sharing of the State share between these entities (called horizontal devolution). It also embraces concepts on grants-in-aid given by the Consolidated Fund of India to needy states. It is suggested that the FC be an independent and neutral player and that this FC be the vehicle for providing a rule-based rather than discretionary mechanism for a substantial portion of the fiscal transfers.¹⁷

For a number of decades the Forestry Commission (FC) worked hand in hand with a formidable organisation called the Planning Commission (PC). Pursuant to Article 282, the PC, a non-statutory body, was the main means of financing development planning through issue of grants and loans to the states. In particular, transfers from the PC tend to be ad hoc and project-specific, which is something constitutional experts have pointed out. This historical coevolution of the two bodies led to the development of a "dual channel" system of transfers between the two bodies (Boras, 1981; Kunst, 1976; Suttig-Wiese & Rother, 1981). On the one hand, this system was a system of statutes and rules; and on the other hand, it was a system of politicised discretionary transfers. This system often resulted in tensions and centralized development of the economy at Union level.¹⁸

There would be other transfers which were specific to certain central ministries and which would have other matching requirements than the states. These transfers were also made, apart from the two big channels mentioned above. The rise in cesses and surcharges is a relatively modern addition to the system of fiscal federalism introduced in India. These are not counted as part of the so-called "divisible pool" of tax proceeds paid out to the states; instead, the Union government gets to keep all of those for itself. As per the Budget 2023-24, this non-devolvable levy, as a percentage of the Union Government's total tax revenue has increased dramatically,

¹⁴ Ehtisham Ahmad and Giorgio Brosio (eds), *Handbook of Fiscal Federalism* (Edward Elgar 2006).

¹⁵ Constitution of India 1950, arts 246–254 and sch VII.

¹⁶ Constitution of India 1950, arts 293 and 360.

¹⁷ Constitution of India 1950, art 280.

¹⁸ Constitution of India 1950, art 282.

from 5.9 per cent of the total tax revenue in 2015-16 to 10.8 per cent of the total tax revenue.¹⁹ It is this that results in a contradiction to the fiscal structure. While increasing the shares of the

divisible pool is under the sole domain of the Finance Commission, a decision from the political and executive branches to increase cesses, actually raises the cost of making those pools. This decision threatens the principle of devolution and subtly redistributes a large amount of national revenue. There is an important tension to this relationship, and that tension is the potential for formal constitutional mechanisms of decentralisation to be effectively subverted by administrative and political decisions contributing to a breakdown in the fiscal foundations of subnational governments.²⁰

INTERGOVERNMENTAL TRANSFERS IN INDIA: MECHANISMS AND TRENDS

The intergovernmental transfers in India are used to address the vertical fiscal imbalance, which is a structural fact of intergovernmental fiscal arrangements in India, where the central government captures more than 60 percent of general government revenue but the states are responsible for a substantial amount of public expenditure. These transfers are also intended to cater to horizontal imbalances between states, while providing a minimum standard of public services across the country.²¹

The main mechanism for a statutory transfer is devolution of tax. Under article 270 and 280(3)(a) of the Constitution, the Finance Commission computes the vertical distribution-the share of the divisible pool of tax devolved upon the States-and the horizontal distribution-the share of that amount distributed among the states. Once the formula for FC is used, the states have an unrestricted right to these monies, which are not linked to specific programs. The horizontal distribution formula has changed over time as the relative importance attached to different policy objectives has changed.²²

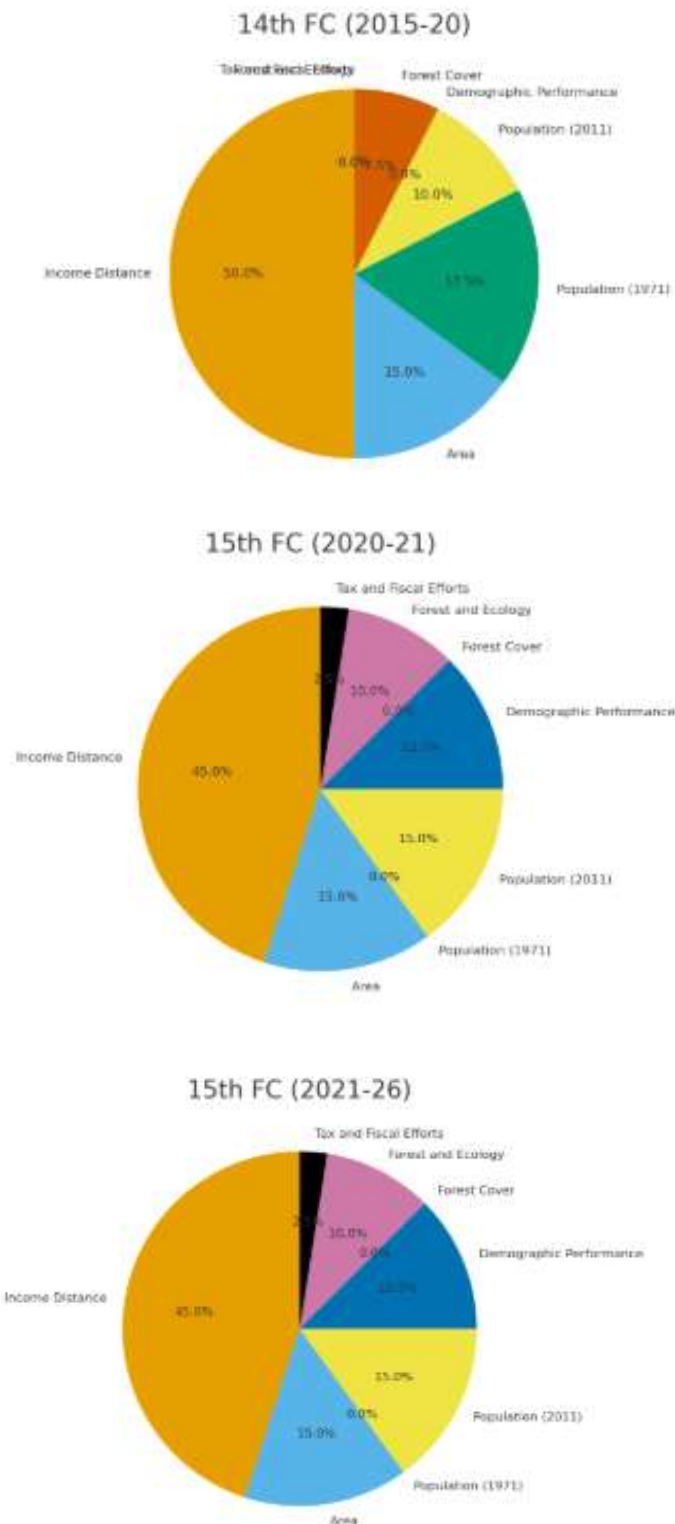
Criteria	14th FC 2015-20 (%)	15th FC 2020-21 (%)	15th FC 2021-26 (%)
Income Distance	50.0	45.0	45.0
Area	15.0	15.0	15.0
Population (1971)	17.5	-	-
Population (2011)	10.0	15.0	15.0
Demographic Performance	-	12.5	12.5
Forest Cover	7.5	-	-
Forest and Ecology	-	10.0	10.0
Tax and Fiscal Efforts	-	2.5	2.5
Total	100	100	100

¹⁹ Union Budget 2023–24, Ministry of Finance (Government of India).

²⁰ M Govinda Rao and Nirvikar Singh, *Political Economy of Federalism in India* (Oxford University Press 2005).

²¹ Raja J Chelliah, *Intergovernmental Transfers in India* (Asian Development Bank 2003).

²² Constitution of India 1950, arts 270 and 280(3)(a).



As can be seen in the table and the pie chart above, a significant change has been made to the devolution formula. The 15th Finance Commission (FC) broke away from the antiquated population data of 1971 and instead gave more weightage to the population data from the Census of 2011. In addition, the FC developed new criteria along the way. The idea behind the development of the Demographic Performance criterion is to incentivize states that have succeeded in putting a population control policy in place by rewarding them if their fertility

ratio stays below a certain threshold. This is done in order to incentivize action by states.²³ Tax and Fiscal Efforts: It is a criterion for awarding rewards to states that are more retrogressive in tax revenues and are fiscally disciplined. This criterion is defined by the ratio of tax revenue generated by the state itself to Gross Domestic Product of the state. Nonetheless, the change to the formula has been a political matter. As a consequence of the new formula, states to the south who have done well in terms of population control and various social indicators will feel that they are being penalized for their success. This is because the new formula is a bonus for the states with a large population. There are some parallels between this tension and between the equity criteria and the efficiency criteria that are applied to the design of fiscal equalisation schemes.²⁴

The second is Article 275 of the Constitution providing for grants-in-aid. These grants are proposed by the Finance Commission as a method of financial aid for the weaker states or any states that need some financial help for budgetary balance. Grants can be conditional or unconditional, and they are used for gap-filling, for supporting local bodies and for funding specific projects ensuring minimum standards in certain industries.²⁵

Also, the use of conditional transfers that are discretionary for the states has risen dramatically. In this respect Centrally Sponsored Schemes (CSS) are a good example. Such funds are welfare categorical, meaning that if states wish to receive money they must meet certain criteria. Moreover, those expenditures are often conditional in that the state must contribute matching funds. The share of money the state contributes for CSS has been steadily increasing from Rs 5.21 lakh crore to Rs 14.68 lakh crore between the year 2015-16 and 2023-24. It is also likely that the balance of powers will be fundamentally changed as a result of the increasing reliance of states upon centrally sponsored programs.²⁶ This is due to the character of the financing relations. It is the central government that is responsible and the states are the agents who are responsible for the implementation of the spending plans and national priorities as awardees from the central government. The states become even less able to control their own budgets; they no longer can fully attend to local needs; they are more able in general to spend as they please - all of which adds to the problem that the agency is having. These conditional transfers are reinforced by the fact that the Union government can actually set limits on how much money states can borrow. The trend towards the localisation of the locus of public spending in the context of statutory devolution represents an important challenge to the principle of true local autonomy.²⁷

THE GOODS AND SERVICES TAX (GST): A GAME-CHANGER IN INDIAN FISCAL FEDERALISM

The Goods and Services Tax (GST) introduced on July 1, 2017, is considered to be the most important piece of taxation reform since the country's independence. It has led to the creation of a single and unified tax market across the country and it has absorbed many indirect taxes hitherto levied by the central government and the states. The long road towards the rollout of the Goods and Services Tax (GST) is an exercise of robust cooperative federalism, involving an amendment to the Constitution and a political consensus across parties. This was agreed through the GST Council, the only federal-level negotiating body, where decisions are taken on the basis of three-fourths majority and where all states are represented and have an interest

²³ Finance Commission of India, *Report of the Fifteenth Finance Commission for 2021–26* (Government of India 2020).

²⁴ M Govinda Rao and Nirvikar Singh, *The Political Economy of Federalism in India* (Oxford University Press 2005).

²⁵ Constitution of India 1950, art 275.

²⁶ Government of India, *Union Budget 2023–24, Expenditure Profile* (Ministry of Finance 2023).

²⁷ Montek S Ahluwalia, 'Political Economy of India's Fiscal Federalism' (2019) 54(7) *Economic and Political Weekly* 41.

in the outcome of the negotiation. Even the judicial system has applauded this as an example of something called "cooperative federalism" and even held it up as exemplary.²⁸

If the introduction of the Goods and Services Tax (GST) has had important implications (and/or consequences) for fiscal federalism and local autonomy, then has it done so in controversial ways and, despite the success of the legislative process, with consequences not entirely supportive of local autonomy. Sales Tax was a significant source of revenue for the states in their own right, and till Goods and Services Tax (GST) was rolled out, there was a tremendous amount of autonomy granted to the states in formulating their sales tax policy. Because of subsumption of State Value-Added Tax (VAT) in the GST, a significant blow has been dealt to the sovereign status of States in the sphere of taxation. This has had the effect of virtually eliminating the right of the states to set a rate for their revenue sources individually.²⁹

As a consequence, a new form of vertical fiscal asymmetry has been prescribed. In this aspect of asymmetry, the state's autonomy over taxation has been sacrificed in exchange for other

elements which include resisting the new tax regime and the central government. According to one set of calculations the states are losing between 19% and 33% of their revenues. To make up for this, there has to be a compensation formula, which ensures that states will receive some form of compensation for loss of revenue due to the transition for five years.³⁰ While this proved an important safety net, the eventual failure of the compensation cess has become a source of political tension. This has led to a fundamental change in the power balance. No longer having a single indirect tax which had been largely under the control of the states, they are now completely reliant upon a centrally administrated indirect tax system and upon a central government department for the protection of their revenues. This Committee is called GST Council.³¹

The issues with the Goods and Services Tax (GST) don't stop with the issues of initial revenue shortfalls. Tendency towards centralisation: Under the pretext of making the tax system simpler and achieving a common market, the Goods and Services Tax (GST) regime has a tendency to centralising and it can lead to the jeopardy of the fiscal space for subnational governments. The reform being carried out in the name of modernisation is the most typical manifestation of centralisation.³² State-led reform planned to improve national efficiency and transparency has replaced direct state taxing power with dependence on a politically mediated scheme to compensate states for their loss of taxing power. Ways of compensating for some of the loss in fiscal revenue due to the application of GST need to be explored urgently. In order to save their revenue, opposition-ruled states have floated the new sin and luxury goods cess. Even where there is cooperation in federalism, the long-term impact of a consolidating reform may de facto result in a fundamental redistribution of fiscal power. This is due to the highly complex interplay between the two theories.³³

BRAZIL: AN UNUSUAL STORY OF DEMOCRATIC FISCAL DECENTRALIZATION

Importantly, the federal history of Brazil is clearly different from that of India or many other federal states. The Brazilian federalist system was designed in opposition to a highly centralized unitary state that remained in the country from its monarchial and authoritarian

²⁸ Constitution (One Hundred and First Amendment) Act 2016.

²⁹ M Govinda Rao, 'Goods and Services Tax in India: A Political Economy Perspective' (2019) 54(9) *Economic and Political Weekly* 47.

³⁰ Constitution of India 1950, s 18 of the Constitution (One Hundred and First Amendment) Act 2016.

³¹ Constitution of India 1950, art 279A.

³² Pinaki Chakraborty, 'GST and Federalism: Need for a Fresh Look' (2020) 55(10) *Economic and Political Weekly* 14.

³³ R Kavita Rao, 'GST and Fiscal Federalism in India' (2019) 54(17) *Economic and Political Weekly* 43.

periods. This is the only other federation in the world to have been formed in this way. Nevertheless, the period from the middle of the 1960s to the middle of the 1980s was marked by strong states ruled by a military dictatorship. This resulted in centralization of public resources and the country's economy into the federal government. Because of the promulgation of the Citizen Constitution in 1988, this long history of centralization was finally reversed back to its original state. Drawn up under the context of the country's return to democracy, the new constitution had the main purpose of decentralizing government and reinforcing the democratic process.³⁴

Of particular importance in this new compact with the federal authority was the exaltation of the municipality to the position of being one of the two members of the federation along with the Union and the States. The existence of this institutional framework, wherein municipalities are no longer considered a creation of the states but have been given separate powers, which are stipulated in the Constitution, is a significant departure from India's three vertical federal structure of asymmetric distribution of powers. Therefore, the institutional framework of Brazil's fiscal relationships is based on three levels of government which are fully equal to each other, with each level enjoying full and continuous autonomy. The constitution contains an

extensive description of the taxing and revenue sharing powers which is pertinent to each tier.³⁵

The rates of the most significant tax in absolute terms - the ICMS, a value-added tax - are raised and defined by the states. This is, even though the federal executive is endowed with all the exclusive powers of importance. The result of this constitutional change has been a substantial decentralisation of revenue, most likely through transfers, with a related increase in the share of total tax revenue raised by municipalities and states. The path to a balanced and efficient fiscal system, on the other hand, has been riddled with a series of wayward traffic islands. The results of the research indicate that the search for convergence in Brazil has been a long-term phenomenon, but one with roots not in an allocative planning process but in a process of political negotiation.³⁶ The 1988 constitution brought with it a new system for government finances, during which the municipalities and the states were granted more access to revenue, causing a shift and an increase in the amount of money spent by the government at the municipal level. As such, we have been in constant crisis in regard to the survival of the budget. In spite of the fact that the Constitution creates a nominally symmetrical federalism and the constituent units possess ostensibly equal powers, the socioeconomic realities of an asymmetrical country have made the principles of federalism difficult to implement in practice.³⁷

THE BRAZILIAN TRANSFER SYSTEM: THE EXPERIENCE OF REVENUE SHARING FUNDS

Intergovernmental transfers form an important and unavoidable part of Brazil's federal structure, and are the main source of income for most subnational governments. The 1988 constitution formalized de-centralization of revenues by establishing a system by which higher levels of government must share tax revenues with lower levels in order to redress vertical imbalances. The two most significant transfer mechanisms are unconditional and non-

³⁴ José Afonso da Silva, *Curso de Direito Constitucional Positivo* (Malheiros Editores 2019).

³⁵ José Afonso da Silva, *Curso de Direito Constitucional Positivo* (Malheiros Editores 2019).

³⁶ Fernando Rezende, 'Fiscal Federalism in Brazil: History and Current Trends' (2007) 37(4) *Revista de Economia Política* 664.

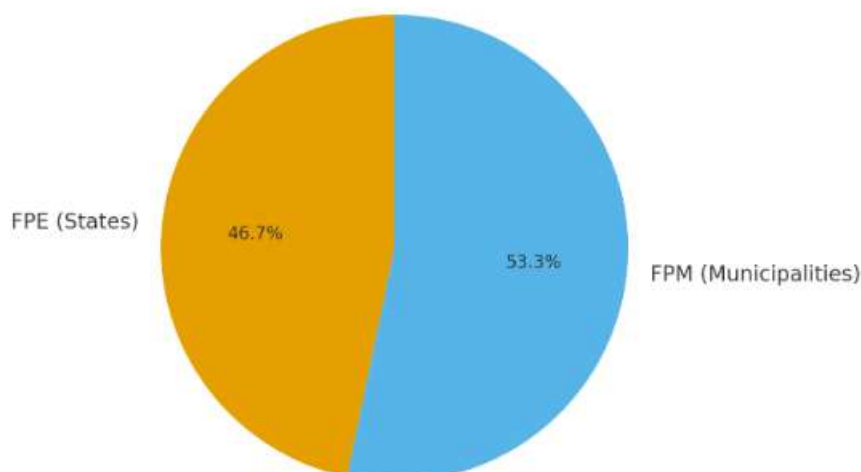
³⁷ Marcus André Melo, 'The Politics of Constitutional Change in Brazil: Political Institutions and Actors' (2002) 35(3) *World Development* 401.

matching grants and unconditional and mandatory grants, which allow a high degree of autonomy for subnational governments when it comes to spending.³⁸

Table 2: Components and Distribution Criteria for Brazil's FPE and FPM

Fund Name	Full Name (Portuguese)	Source of Revenue	Percentage of Tax Revenue	Distribution Criteria
FPE	Fundo de Participação dos Estados	Imposto de Renda (IR), Imposto sobre Produtos Industrializados (IPI)	21.5% of IR and IPI revenues	Population and inverse of per capita income of states
FPM	Fundo de Participação dos Municípios	Imposto de Renda (IR), Imposto sobre Produtos Industrializados (IPI)	24.5% of IR and IPI revenues	Population bands, with specific coefficients for different population sizes

Distribution of Brazil's FPE and FPM from IR and IPI Revenues



S

The structure of these two important funds is shown in the table and pie chart above. Fund for Transfer of Results (Fundo de Participacao dos Estados - FPE) is a mandatory and unconditional transfer and its purpose is to provide each state of Brazil a previously established amount to be used in payment of the partition of the income tax (based on federal income taxes) plus the tax on manufactured products. In parallel manner, the Fundo de Participacao dos Municípios (FPM) is the main source of revenue for most of Brazil's municipalities, with the exception of the large cities, with the smaller municipalities especially benefiting from this. In addition to being non-matching and obligatory, the FPM gives municipalities their fair share of revenues from the federal treasury while allowing a great deal of autonomy to them. Population is the main factor taken into account in the allocation formula with coefficients that vary for each population band of the 16 considered.³⁹

³⁸ Fernando Rezende and José Roberto Afonso, 'Fiscal Federalism in Brazil: An Overview' (2004) 34(2) *Revista de Economia Política* 227.

³⁹ Fernando Rezende, 'Intergovernmental Transfers and Subnational Finance in Brazil' (2007) 37(4) *Revista de Economia Política* 679.

Although these funds are regarded as a reliable and non-dependent source of revenue for subnational governments, the epidemic per capita formula used in calculating these funds has been severely criticised for not being capable of accommodating regional variations. Through research, it has been found that in reality the FPM is not as redistributive as it is in theory. This is because through its calculation procedure it puts a premium on more economically developed regions where population is relatively large.⁴⁰

On the other hand, Brazil was the first country to adopt innovative and new conditional transfer systems, even though all these methods are envisaged at the overall level of revenue sharing. A very interesting example in this regard is the Ecological Fiscal Transfer (ICMS-E), a conservation incentive that provides a share of the state's ICMS tax revenue to municipalities responsible for protecting protected areas. The ICMS-E is a sophisticated inter-jurisdictional spillover tool to make up for the lost opportunities for conservation faced by local governments.⁴¹ The empirical analysis confirms that ICMS-E did function in creating incentives for the municipalities to provide more PA. This should disprove the argument that conditional transfers are an inefficient mechanism for achieving specific policy objectives. However, the scheme also is self-limiting, meaning that the marginal financial value of establishing new protected areas actually diminishes as the protected area is expanded. This is because a larger share of the income made from the fund goes to the more land that is protected. This new approach stems from an openness to the use of budgetary instruments alongside measures at the subnational level in the context of a more comprehensive agenda for environmental policy.⁴²

FISCAL CHALLENGES AND ONGOING REFORMS IN BRAZIL

In spite of the progress that has been achieved in the process of fiscal decentralisation since the Constitution of 1988, Brazil continues to suffer from serious fiscal problems. The steadily growing national debt is a very problematic phenomenon. The cumulative effect of public sector deficits and of the continuing growth of the public sector is a debt to GDP ratio that is on par with the debt from some of the largest welfare state economies in Europe.⁴³ Due to the extremely high proportion of primary current expenditure and social security in the public budget and the lack of fiscal space for public investments, the Fiscal Responsibility Law (FRL) was passed in 2000, which brought limits and rules to fiscal management at all three levels of government. This was done in an attempt to help resolve these issues: Within the framework of the budget and debt ceilings, the FRL further increased fiscal discipline by forbidding loans for current expenses. This was done to help ensure the achievement of the above objective.⁴⁴

Another problem that persists till date is that there is a long-standing inequality between the various regions. In contrast, despite the intent of equalising resources, empirical studies have found that the theoretical goal of the Equations of FPE and FPM has not been realized. For one, the FPM will have a propensity to favour the more economically developed regions and compensation transfers are often not successful in offsetting fiscal imbalances. Seen through one lens, this suggests that a population-based formula-even when open and straightforward-

⁴⁰ José Roberto Afonso and Fernando Rezende, 'Intergovernmental Transfers and Regional Inequalities in Brazil' (2006) 36(3) *Revista de Economia Política* 467.

⁴¹ José Roberto Afonso and Fernando Rezende, 'Ecological Fiscal Transfers in Brazil: Incentives for Conservation' (2013) 43(2) *Revista de Economia Política* 239.

⁴² Leandro Castello Branco and José Roberto Afonso, 'Evaluating the Ecological Fiscal Transfer (ICMS-E) in Brazil: Incentives and Limitations' (2015) 45(3) *Revista de Economia Política* 421.

⁴³ Fernando Rezende, 'Fiscal Decentralization and Public Debt in Brazil' (2010) 40(4) *Revista de Economia Política* 513.

⁴⁴ Fernando Rezende, 'Fiscal Responsibility and Intergovernmental Fiscal Management in Brazil' (2008) 38(3) *Revista de Economia Política* 359.

could be too vulnerable to the panoply of socioeconomic conditions that engender regional inequality.⁴⁵

Perhaps the most important recent change in the context of fiscal policy has been the ongoing tax reform (PEC 45/2019), one of the biggest reform ever seen in Brazilian taxation history. The main goal of this reform is to make the extremely complex tax system that the country has created much easier. The purpose of the reform is to replace a number of indirect taxes levied by the central government, state governments and municipal governments with a system of two value-added taxes (VATs): the federal CBS and the state-municipal IBS, which would be levied jointly by the state governments and municipal governments. The new system will provide for taxation according to the port of destination and for centralization of tax administration under the authority of an independent tax committee.⁴⁶

Therefore, the tax reform, for example, is an individualised modernisation process which is driven by the central government. On closer inspection, this process of modernisation does have serious implications for fiscal federalism. The reform is, in fact, a profound recentralization of tax collection and administration, however, it is apparently a reform that will make the administration of taxes more efficient and remove burdens of bureaucracy from the system. When it comes to collecting and disbursing the revenues generated through the new levy, the states and municipalities for whom, up to now, revenue was at least partly under a more or less direct control, will be obliged to leave the task to a central committee. This is because the new levy is starting to come into operation quickly.⁴⁷ However, even though a national reform simplified the tax code, it also spelled the end for state autonomy in taxation. This problem is very much like the Goods and services tax (GST) regime, which was introduced in India. When it comes to Brazil, the reform offers yet another example of the same point: the move towards a more modern and efficient tax system doubtless was achieved at a price, most probably at the expense of effective subnational autonomy. The central states of large Federations have a propensity to employ sweeping reforms as vehicles for a gravitation of fiscal power expropriation, thereby triggering a significant re-balancing of the delicate equilibrium of federal relations. This is a topic dominating large federations now.⁴⁸

A COMPARATIVE POLITICAL ECONOMY OF TRANSFERS

By comparing the political economy of intergovernmental transfers in India and Brazil, it is possible to draw out both problems that are common to both countries, and institutional variants in how these problems are addressed in both. However, persistent VFI is a structural feature of both of the federal systems and its causes are similar. This disequilibrium is characterised by the fact that subnational governments are directly responsible for a high share of expenditures and only play a minor role in the process of revenue mobilization. In India, the central government takes in over 60% of the total revenue and spends less than 45% of the amount. On the other hand, in Brazil, there is in the constitution itself, a requirement for the federal government to transfer a share of its tax revenue to other levels, and the states and municipalities continue to receive transfers that are smaller than in India.⁴⁹

Another feature of transfer politics in both countries is the willingness of the central government to use discretionary funds to reward suitably compliant sectarian subnational governments forming part of the central government's base. Another major aspect of transfer

⁴⁵ José Roberto Afonso and Fernando Rezende, 'Regional Inequalities and Intergovernmental Transfers in Brazil' (2006) 36(4) *Revista de Economia Política* 515.

⁴⁶ Brazil, *Proposta de Emenda Constitucional 45/2019 (PEC 45/2019)*.

⁴⁷ Fernando Rezende, 'PEC 45/2019 and the Recentralization of Tax Administration in Brazil' (2020) 50(2) *Revista de Economia Política* 235.

⁴⁸ Fernando Rezende, 'Tax Reform and Subnational Autonomy in Brazil: Lessons from PEC 45/2019' (2021) 51(3) *Revista de Economia Política* 289.

⁴⁹ Anwar Shah, *The Practice of Fiscal Federalism: Comparative Perspectives* (McGill-Queen's University Press 2007) 45.

politics is the partisan transfer. As far as I am aware this is a widespread phenomenon in both countries, and embodies a serious challenge to the fair allocation of resources.⁵⁰

The treatment of political power is further complicated by the fact that the institutional arrangements of the two nations provide an important counterpoint to the question. Political scriptedness prevails in India despite the presence of the Finance Commission, which is in place with the help of statutory rules. It was concluded that the transfers are higher for politically independent state governments because they drive more transfers which are decided by an independent Finance Commission. This was determined after a study of the fiscal structure of India during the period 1972-95.⁵¹ This is a significant finding which provides support for the claims that a powerful and independent constitutional agency can effectively constrain the degree to which partisan politics can effectively decide issues related to distributive justice. This is a key difference on account of the politicisation of discretionary transfers programme, such as Centrally Sponsored Schemes (CSS), which have been demonstrated to penalise states outside of the BJP's electoral space.⁵²

Although the FPE and FPM are controlled by regulations and must be used in Brazil, for some categories of projects, most notably infrastructure, these transfers have a largely discretionary nature. They have also found that those transfers are often used as a reward system to benefit mayors with political chutzpah, and mayors that disagree with the governor of their state. The federal executive made discretionary grants a means to secure support at the local level in the power struggle waged between the national government and the state governments. This is the result of the struggle for authority between the two levels of government.⁵³

This article offers a basic analysis of the tension inherent within the institutional structure of both federations. The paper makes clear that the two individually applied mechanisms of rules-based independent transfer and discretionary executive-led transfer are in a state of constant conflict with each other. India's decentralized system with an independent role for the Finance Commission acts as a strong institutional firewall against political pressure. This is because finance commission is a body functioning without any dependence. Furthermore, Brazil's system seems to be much more vulnerable to political abuse of discretionary resources because it is constitutionally decentralised. It turns out that the most important factors in determining whether or not a federation is able to insulate its fiscal scheme from partisan politics are not constitutional provisions per se, but rather the strength and independence of the actors that have a say in its enforcement.⁵⁴

EVALUATING EFFICIENCY, EQUITY, AND AUTONOMY: A CROSS-COUNTRY ANALYSIS

An assessment of how well the Indian and Brazilian systems meet the normative objectives of fiscal federalism - efficiency and equity - and local autonomy is conducted. This can be based on comparison of key fiscal indicators.⁵⁵

⁵⁰ M Govinda Rao and Nirvikar Singh, *The Political Economy of Federalism in India* (Oxford University Press 2005) 112.

⁵¹ M Govinda Rao and Nirvikar Singh, *The Political Economy of Federalism in India* (Oxford University Press 2005) 118.

⁵² M Govinda Rao and Nirvikar Singh, *The Political Economy of Federalism in India* (Oxford University Press 2005) 121.

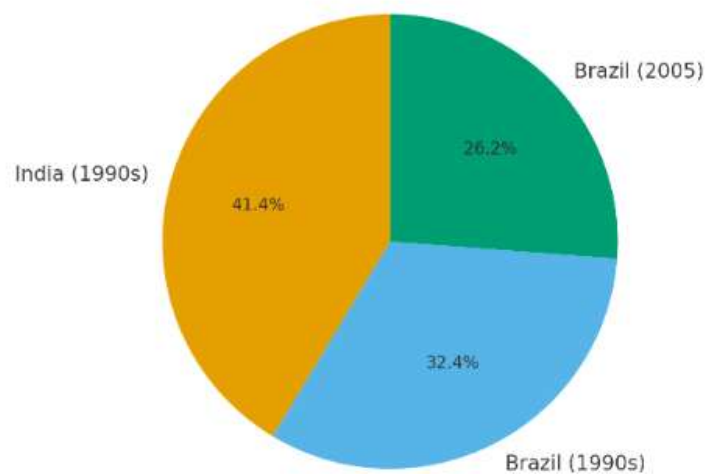
⁵³ Fernando Rezende, 'Intergovernmental Transfers and Political Incentives in Brazil' (2007) 37(4) *Revista de Economia Política* 691.

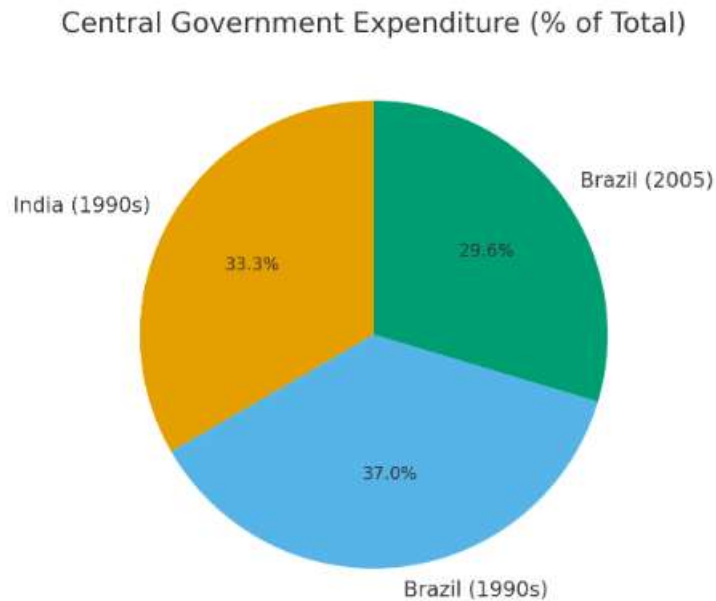
⁵⁴ M Govinda Rao and Nirvikar Singh, *The Political Economy of Federalism in India* (Oxford University Press 2005) 125.

⁵⁵ Anwar Shah, *The Practice of Fiscal Federalism: Comparative Perspectives* (McGill-Queen's University Press 2007) 78.

Indicator	India (c. 1990s)	Brazil (c. 1990s)	Brazil (2005)
Central Government Revenue (% of Total)	> 60%	~ 47% (shared)	~ 38% (tax revenue)
Central Government Expenditure (% of Total)	~ 45%	< 50%	> 40% (spending)
Fiscal Transfers (% of GDP)	N/A	~ 5%	N/A
Indicator	India (c. 1990s)	Brazil (c. 1990s)	Brazil (2005)
States' Own Revenue (% of States' Expenditure)	55-69% (1955-94)	N/A	N/A
Total Government Spending (% of GDP)	N/A	N/A	> 40%
General Government Gross Debt (% of GDP)	N/A	N/A	77.6% (July 2025)

Central Government Revenue (% of Total)





An approximate idea of the relative decentralisation of fiscal policy can also be obtained from the table and the pie chart above, which relate to different periods of time. In addition to this, India's revenue base is highly concentrated and India faces a large vertical fiscal deficit. By comparison, the level of centralisation for Brazil was lower in the latter part of the 1980s, and the decentralising constitutional changes introduced in 1988 reflect this situation to some extent. The data from Brazil, on the other hand, suggest the presence of a large public sector marked by high rates of expenditure and debt, which raises a further set of challenges.⁵⁶

When efficiency and equity are considered, there are still problems with the transfer system in both countries. The Finance Commission of India uses a formula that works on multiple parameters in an attempt to create a balance between equity and incentives for efficiency. Yet, the complexity of the situation has fostered the preconditions for a political conflict as different states feel as if they are being penalized for good governance and demographic performance.⁵⁷ The FPM simple population band adopted by Brazil has been targeted by criticisms for not sufficiently taking into account the increasing levels of regional inequality, privileging in this way municipalities with a more developed economic performance. One of the first conditional transfers that gives incentives for a specific public good is the ICMS-E ticket in Brazil. However, this transfer can never be used for other purposes than to induce incentives for a public good, and does not capture the impediments associated with horizontal inequality.⁵⁸

One of the deepest rooted and prevalent problems is the devaluation of the power of place. In Brazil and India, structural changes initiated at a central government level placed the countries in an intriguing paradox of de-facto centralisation of fiscal authority. These changes have been started by the central government. Thus, through the introduction of a new form of transfer and political council of state dependent regime, introduction of GST has led to curtailment of State autonomy in matters of taxation. Despite the billing of this GST as a revolutionary tax reform, there have been criticisms about it.⁵⁹ As an added matter of interest, the proposed tax reform in Brazil despite its aims for simplifying the tax system will place the administration

⁵⁶ Fernando Rezende, 'Fiscal Federalism in Brazil: History and Contemporary Issues' (2007) 37(4) *Revista de Economia Política* 668.

⁵⁷ M Govinda Rao, *The Political Economy of Federalism in India* (Oxford University Press 2005) 130.

⁵⁸ José Roberto Afonso and Fernando Rezende, 'Intergovernmental Transfers and Regional Inequalities in Brazil' (2006) 36(3) *Revista de Economia Política* 472.

⁵⁹ M Govinda Rao, 'Goods and Services Tax in India: A Political Economy Perspective' (2019) 54(9) *Economic and Political Weekly* 47.

and collection of related taxes under the authority of a federal board, endangering financial autonomy of states and municipalities. Based on the analysis above the only conclusion would be that even strong federal systems may pose the risk of being the mechanism for the recentralization of power. So when desire for modernisation is strong, recentralisation is bound to occur which in the end results in the adjustment of fiscal relations in favor of the central government alone.⁶⁰

Except from the construction of a transfer formula, the most important element in the issue is the political and institutional will to respect the autonomy of subnational entities. In both India and Brazil there are strong constitutional protections for federalism; there is a great deal, however, that is happening at the ground level which is challenging the reality of these strong federal constitutional safeguards in the context of the central government's political needs.⁶¹

CONCLUSION

This comparative study has led to a better insight into the nature and complexity of fiscal federalism and local autonomy in India and Brazil. While both countries are still caught in their respective institutional and historical trajectories, the analysis has shown that they struggle with many of the same, underlying problems. A long-standing vertical fiscal imbalance with a disproportionate central share of revenue, requiring complex intergovernmental transfers, exists in both countries. Further, in both federations, the challenge of horizontal imbalances must be confronted, and the challenging task of creating equitable and efficient equalization mechanisms must be undertaken.⁶²

Its most important similarity, however, is in the political economy of transfers. In India and Brazil, for example, discretionary transfers tend to be politically driven, as a device used by the central government to reward political loyalty at the subnational level. The study has also found that the statutory and quasi-judicial nature of the Finance Commission has been an important, if not the only, institutional protection against this partisan pressure in India. This stands in contrast to Brazil's system as there is not a similar adjudicator of discretionary grants and therefore the possibility of political manipulation.⁶³

Finally, the study has found a worrying trend in both countries: the centralisation of the application of fiscal power in the name of reforming tax. GST in India and the proposed tax reform in Brazil, while streamlining their respective tax regimes and favouring the country's markets, have done justice neither to the states' nor municipalities' power to tax. The question of what futures fiscal federalism holds then demands a shift from the fascination with (individual) tax autonomy to the reality of transfer dependency as necessarily recalibrating the power balance and showing that the future of fiscal federalism lies in the political will to have (functional) subnational autonomy.⁶⁴

RECOMMENDATIONS FOR ENHANCING FISCAL FEDERALISM

Based on the comparative analysis, we suggest the following recommendations to improve fiscal federalism in India and Brazil, based on critical lessons from their respective experiences: Recommendations for India:

1. Provide Fiscal Autonomy to the States: GST's loss of fiscal autonomy over time and space needs to be remedied by revisiting the GST regime and allowing states greater

⁶⁰ Fernando Rezende, 'Tax Reform and Subnational Autonomy in Brazil: Lessons from PEC 45/2019' (2021) 51(3) *Revista de Economia Política* 289.

⁶¹ Anwar Shah, *The Practice of Fiscal Federalism: Comparative Perspectives* (McGill-Queen's University Press 2007) 92.

⁶² Anwar Shah, *The Practice of Fiscal Federalism: Comparative Perspectives* (McGill-Queen's University Press 2007) 101.

⁶³ M Govinda Rao and Nirvikar Singh, *The Political Economy of Federalism in India* (Oxford University Press 2005) 128.

⁶⁴ Anwar Shah, *The Practice of Fiscal Federalism: Comparative Perspectives* (McGill-Queen's University Press 2007) 108.

discretion in taxation over sectors such as petroleum products and electricity which are at present not in its tax bracket. That would give states a more certain and independent revenue base.⁶⁵

2. Rationalize Non-Devolvable Levies: Government of India must limit its use of non-devolvable cesses and surcharges. This includes transfer tax, which takes away from the pot of revenue to be divided, which violates the state of devolution and creates fiscal opacity. In the central tax system, if the levies were to be incorporated, this would contribute to a clearer and more efficient allocation of national tax revenues, more equitably.⁶⁶
3. Transforming Conditional Transfers: The nature of Centrally-Sponsored Schemes requires review to reduce the prevalence of conditional, tied transfers. The centre should transfer larger unconditional, untied transfers to the states, giving them the flexibility to allocate its resources wherever they are needed most and to devise budgets that better suit its needs. This would be more in line with the level of autonomy that Brazil gets from its compulsory revenue-sharing mechanism.⁶⁷
4. Power to Local Governments: On the basis of 73rd and 74th constitutional amendments, the central and the state governments have to devolve specific taxation powers to the local self-governments. This would dilute the excessive reliance of local bodies on transfers from the central government, and would encourage a more substantive form of fiscal federalism by allowing them to raise their own revenues and to be accountable to the people.⁶⁸

Recommendations for Brazil:

1. Increase Equalization Efforts: The FPE and FPM rules and guidelines should be adjusted to reflect more than just population formulas. The Government needs to consider the introduction of socioeconomic indicators, fiscal effort, and the costs of delivering services to better account for the deep regional disparities which exist despite the transfer system in place. Lessons can be learned from the complexity of India's multi-criteria devolution formula but with caution so as not to fall into its own traps.⁶⁹
2. To protect Local Autonomy that is tax reform: As a new tax reform (PEC 45/2019) is introduced, institutional safeguards shall be established to ensure that the new centralized tax administration will not ruin state and municipal fiscal autonomy (LOC). Clear and predictable rules, on how revenue from the new IBS tax will be distributed, need to be put in place to avoid political manipulation and preserve the federative compact.⁷⁰
3. Strengthen Fiscal Discipline: The tenets of Fiscal Responsibility Law should be consistently implemented at all levels of government in order to achieve fiscal sustainability. This includes strengthening and implementing more robust rules-based

⁶⁵ M Govinda Rao, 'Goods and Services Tax in India: A Political Economy Perspective' (2019) 54(9) *Economic and Political Weekly* 47.

⁶⁶

⁶⁷ M Govinda Rao and Nirvikar Singh, *The Political Economy of Federalism in India* (Oxford University Press 2005) 140.

⁶⁸ Constitution of India 1950, 73rd and 74th Amendments.

⁶⁹ Fernando Rezende, 'Intergovernmental Transfers and Regional Inequalities in Brazil' (2007) 37(4) *Revista de Economia Política* 684.

⁷⁰ Fernando Rezende, 'Tax Reform and Subnational Autonomy in Brazil: Lessons from PEC 45/2019' (2021) 51(3) *Revista de Economia Política* 289.

restrictions on state and municipal debt to stave off debt accumulation and resulting fiscal crises.⁷¹

4. The future of fiscal federalism in both countries depends on their capacity to devise and deploy transparent, rules-based and institutionally independent mechanisms that are capable of withstanding political pressures; this is what makes such a form of federalism constitutional federalism. It is evident that if we are committed to this course we will have to develop the local autonomy as more than a constitutional promise, but as a living reality, so that local administration could become more efficient in the delivery of public services, promoting a more balanced development of all citizens.⁷²

⁷¹ Fernando Rezende, 'Fiscal Responsibility and Intergovernmental Fiscal Management in Brazil' (2008) 38(3) *Revista de Economia Política* 359.

⁷² Anwar Shah, *The Practice of Fiscal Federalism: Comparative Perspectives* (McGill-Queen's University Press 2007) 115.