

# Reconciling Fiscal Federalism and Accountability: Is there a Low Equilibrium Trap?

## 04 CHAPTER

*The village of which the people come together to earn for themselves their food, their health, their education, to gain for themselves the joy of so doing, shall have lighted a lamp on the way to swaraj.*

**Rabindranath Tagore**

*Long-run institutional development co-evolves with fiscal accountability involving, perhaps requiring, a low and declining dependence on devolved resources and a high and rising share of direct taxes in total taxes. India's second and third tiers of government tend to under-perform relative to these standards. The extent of tax and functional devolution to these tiers is one possible explanation. However, one key finding is that these tiers under-collect direct taxes even relative to the powers that they have. Whether this could lead to a low equilibrium trap of weak direct tax collection leading to inadequate service delivery provision, back to weak collection and accountability, needs to be actively discussed.*

### INTRODUCTION

4.1 Taxation is not just a vehicle for raising state revenue. It can also be critically important for economic and political development. As Besley and Persson (2013) note, there is a social contract between citizens and the state. “The state's role,” they write, “is to create the conditions for prosperity for all by providing essential services and protecting the less well-off via redistribution. The citizen's part of the contract is to hold the state accountable when it fails to honor that contract.”

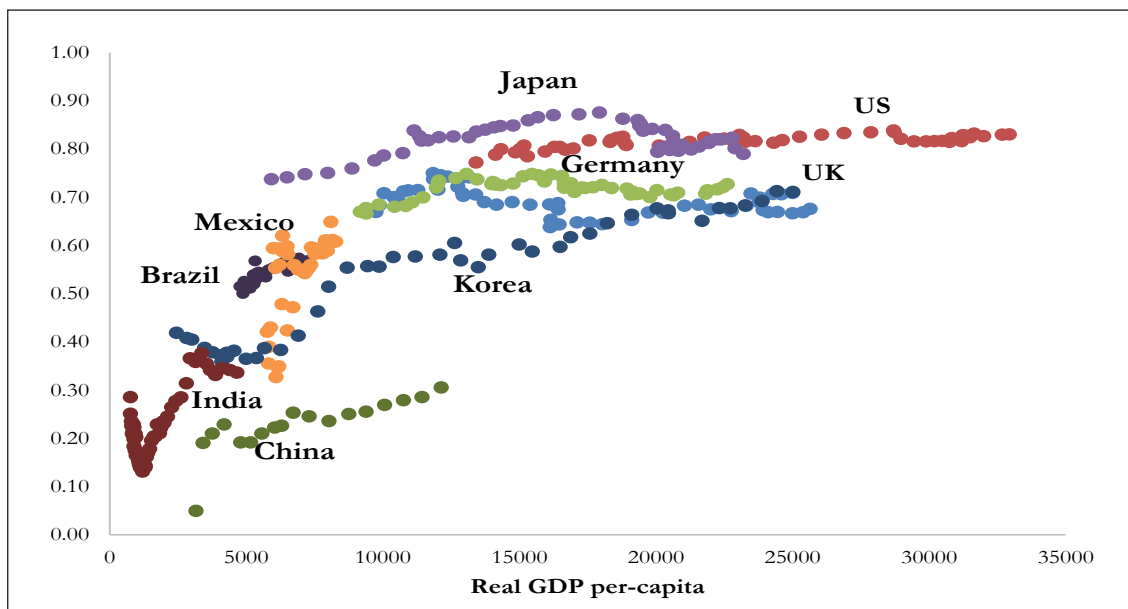
4.2 But a citizen's stake in exercising accountability diminishes if he does not pay in a visible and direct way for the services the state commits to providing. If a citizen does not pay, he becomes a free rider (using the service without

paying), and cannot complain if the state provides a poor quality service. If he exits (not using the service at all), he loses interest in holding the state accountable. Only if he pays and uses the service will he try to hold the state accountable. Hence the expression: no representation without taxation. In other words, taxation is the economic glue that binds citizens to the state in a necessary two-way relationship. (*Economic Survey* 2015-16, Chapter 7).<sup>1</sup>

4.3 The “aid” and “natural resource” curses illustrate what happens when countries rely on non-tax sources of government revenues: economic and institutional development is stunted (Easterly, 2003; Sala-i-Martin and Subramanian, 2003).

<sup>1</sup> To quote Weigel (2017), “Historically, when states began systematically taxing their populations to pay for wars, citizens protested fiercely, demanding public goods and political rights: “no taxation without representation.” This process triggered the co-evolution of tax compliance, citizen participation in politics, and accountable governance. Today, policymakers often promote taxation in developing countries to jumpstart this same virtuous cycle.”

**Figure 1a. Direct Taxes of the General Government as a ratio of its direct plus indirect taxes in “Development Time”**

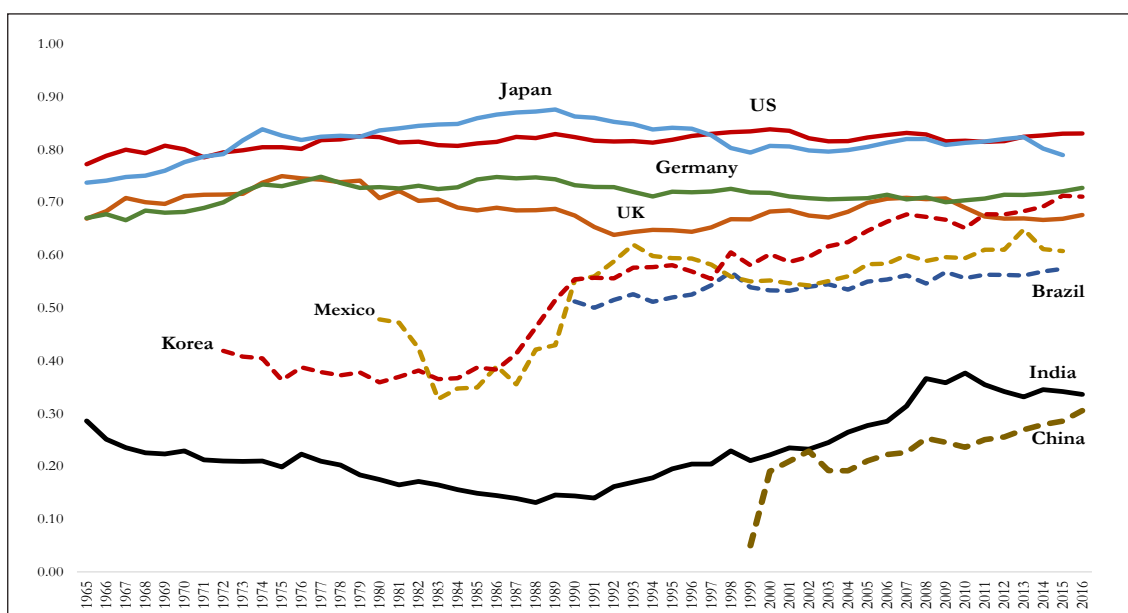


Source: OECD and Indian Public Finance Statistics (IPFS).

4.4 But does this glue rely on taxation broadly or on direct taxation in particular? It seems that a citizen's stake would be greater the more it “hurts” to pay taxes. As the name itself suggests, direct taxes are felt more by the taxpayer. Direct

taxes feel more like expropriation because they reduce citizens' disposable income, the earnings that they get to keep. With indirect taxes, citizens are burdened but that sense is leavened to the extent that citizens feel they are exercising choice.

**Figure 1b. Direct Taxes of the General Government as a ratio of its direct plus indirect taxes in “Chronological Time”**



Source: OECD and IPFS.

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

### **Direct taxation and development: General Government**

4.6 First, economic and political development has been associated with a rising share of direct taxes in total taxes. Figures 1a and 1b illustrate this association for a group of advanced and emerging market countries using data from the Organization for Economic Cooperation and Development (OECD). Both these figures pertain to the general government and are plotted between 1965 and 2016. Figure 1a is plotted in development time: it shows how the share of direct taxes in total taxes evolved over time in these countries as they developed (proxied by PPP adjusted per capita GDP from the Maddison Project database). Figure 1b plots the same in chronological time for the same group since 1965.

4.7 These graphs reveal that advanced countries collect a substantially higher proportion of their taxes as direct taxes than do emerging markets. This proportion has also risen over time. Early on in the development process, import taxes (an indirect tax) and property taxes (an income tax) were the primary sources of revenue. Later, as the welfare states expanded in Europe and the US, government collections shifted toward income taxes, so that workers could contribute to their social insurance. Against this trend, Europe in the 1970s discovered the value added tax (VAT) as an important source of revenue, which led to a renewed rise in the share of indirect taxes. But even today direct taxes account on average for about 70 percent of total taxes in Europe.

4.8 Another striking feature of the graphs relates to India. Apart from China (which is the only non-democratic country in the chart), India has the lowest share of direct taxes in total taxes.

India is not an outlier: its direct tax share is similar to other countries at a comparable stage of development. However, unlike in other countries its reliance on direct taxes seems to be declining, a trend that will be intensified if the Goods and Services Tax (GST) proves to be a buoyant source of revenue.

### **Direct taxation and development: Sub-federal levels**

4.9 A second stylized fact relates to direct tax contributions at sub-federal (state and urban/rural local bodies) levels of government.

4.10 Fiscal decentralization is often embraced as not just a desirable economic but also as a political and philosophical principle, as Tagore envisaged. This is captured in the idea that spending and tax decisions must reflect local preferences as far as possible. To what extent is this principle followed? That is, what is the share of own revenues (compared to devolved sources) in total revenues at lower levels of government, and what is the relative contribution of direct taxes?

4.11 Before considering the data, an important issue must be noted. There is an important legal argument for the case that resources received by the states as part of successive Finance Commission verdicts are not “devolved” resources but shared resources. In this view, the Center is merely collecting the taxes in the divisible pool on behalf of the states, and sharing it with them. But this position must be assessed against the following realities:

- it is difficult to dispel the association (in the eyes of taxpayers) of the Center with the income taxes and customs duties that form a major part of the divisible pool.
- if the Center were a mere collecting agency the funds would be apportioned according to states’ tax bases; they would not have sizable

**Figure 2. Own Revenue and Direct Taxes of Lower Tiers**  
(In per cent of total revenue)



Source: For India, survey calculations for Rural Local Governmes (RLGs), while the Urban Local Government (ULG) data has been sourced from the “Annual Survey of Indian City-Systems, Janaagraha”; Ministry of Finance, Govt. of Germany; World Bank for cross country data.

Note: Tier 2=state, 3=urban local bodies and rural local bodies in India; tier 2=Estados (States) and tier 3=Municípios (Municipalities which contain both urban and rural areas) in Brazil; tier 2=Länder or Bundesländer (States) and tier 3=Bezirke in Germany.

For India, the RLG plot is based on data from 4 States—Andhra Pradesh, Karnataka, Kerala, and Uttar Pradesh while the ULG plot is based on data on 19 (17 in 2013-14) major cities of India.<sup>2</sup>

<sup>2</sup> Accounting patterns across States are different; for instance, Karnataka includes salaries of line departments as part of their resources, while Kerala does not. Total revenue, in this context, is defined as the sum of own resources and devolved funds from Central and State Governments, excluding (a) schematically tied transfers and (b) funds for salaries of line departmental staff.

redistributive components, as quantified in Chapter 13 of the *Economic Survey*, Volume 1, 2016-17;

- the new GST provides a sharp contrast in that it is clearly more “shared” because decisions and tax administration are done by both.

4.12 In sum, whatever their *de jure* status, *de facto* resources from the divisible pool to the states have the strong whiff of devolution.

4.13 Figure 2 provides data on own resources and direct taxes for three countries which have three tiers of government: Germany, Brazil, and India.

4.14 At the second tier, all countries are broadly comparable in their reliance on devolved resources, but India stands out as a country where the second tier (states) generate a very low share of its revenue from direct taxes: about 6 percent in India compared to 19 percent in Brazil in 2016 and a hefty 44 percent in Germany.

4.15 At the third tier, India’s rural local governments (RLGs) stand out on both counts. RLGs’ reliance on own resources is just 6 percent compared to 40 percent for third-tier governments in Brazil and Germany. And panchayats raise about 4 percent of their overall resource envelope in the form of direct taxes, compared with about 19 and 26 percent in Brazil and Germany respectively <sup>3</sup>.

4.16 India’s urban local governments (ULGs), meanwhile, are much closer to international norms. Their own revenues as a share of total revenues are actually higher than Brazil and Germany, while their direct tax share (about 18 percent of total revenues) is only marginally lower than Brazil (19 percent) and somewhat lower

than Germany (26 percent). This is evidence that ULGs have emerged more fiscally empowered than RLGs so far in India.<sup>4</sup> However in the Indian case, we have considered only selected large cities, for which data are available, and which may have larger own resource bases than smaller ones.

4.17 These two stylized facts provoke the obvious question: is the current system in India appropriate, and if not, can it be changed? This chapter sheds light on this question. Section 2 starts with a brief overview of local governments.

## LOCAL GOVERNMENTS: WHAT DO WE KNOW?

4.18 The famous 73<sup>rd</sup> amendment to the Constitution (1992) recognized panchayats as institutions of self-government. The simultaneous 74<sup>th</sup> amendment bestowed the same status on urban local governments.

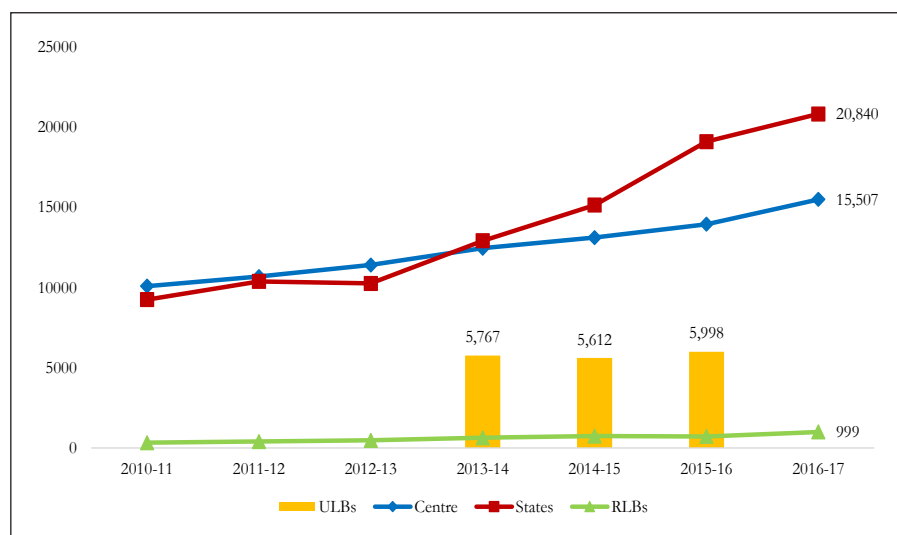
4.19 RLGs or panchayats were mandated to have three tiers (at the district, intermediate and village levels) in states with population of over 20 lakh.<sup>5</sup> States were mandated to devolve such functions and authorities to RLGs which would enable them to function as institutions of self-governance. Illustratively, the Constitution listed 29 matters which could be the focus of their governance, such as agriculture and land reforms, minor irrigation, small scale industries, rural communication, drinking water, poverty alleviation programmes.

4.20 States were also supposed to constitute a quinquennial State Finance Commission (SFC) to determine the share of their financial resources going to the local tiers, analogous to the Finance Commissions at the union level.

<sup>3</sup> Constitutionally, the third tier consists of local self-governments (LSGs), consisting of rural and urban local self- governments, which are called RLGs and ULGs respectively in this Chapter.

<sup>4</sup> Nonetheless, States generally have considerable influence over the staffing and spending of ULGs, with wide variations across States.

<sup>5</sup> This amendment is not applicable in some special areas and in the states like Nagaland, Mizoram, etc. and in areas where regional councils exist. States with lesser population may omit the intermediary tier.

**Figure 3. Per capita Expenditure at Central, State and RLG levels (In rupees)**

Source: For RLGs, Survey calculations based on data from Andhra Pradesh, Karnataka, Kerala and Uttar Pradesh.

Note: The calculations assume that expenditure of RLGs is equal to their receipts. ULG information has been sourced from the “Annual Survey of Indian City-Systems, Janaagraha”, based on 19 (18 in 2013-14) major cities of India.

4.21 Empowered in such a manner, ULGs and RLGs were mandated to prepare and implement plan(s) for economic development and social justice. Following the amendment, most states have constituted three levels of RLGs. Over the past two decades, local governments have gained prominence as institutions with substantial ‘say’ in grassroots development issues, albeit with significant spatial variations, and spaces of intense political contestability. However, the tied nature of a considerable part of resource flow constrains spending autonomy in RLGs.

4.22 Any policy prescription for the third tier must follow from an understanding of the performance of RLGs. But what do we really know about the efficacy in service delivery and accountability mechanisms in such institutions? There is an extensive and rich literature on fiscal decentralization with contributions by India’s eminent experts on fiscal federalism (Kelkar, 2016; Mathur and Peterson, 2006; Oommen, Wallace and Muwonge, 2017; Nagarajan, Mkhize and Meenakshisundaram, 2014; Pritchett and Aiyar, 2015; Rajaraman, 2003; Rajaraman and

Sinha, 2007; Rangarajan and Srivastava, 2011; Rao, 2013; Rao, Gupta, Raghunandan, Datta, Jena, and Amarnath 2011; Reddy, 2016; Vijayanand, 2009). This chapter builds on this body of work.

### **Expenditure patterns of different tiers of government**

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

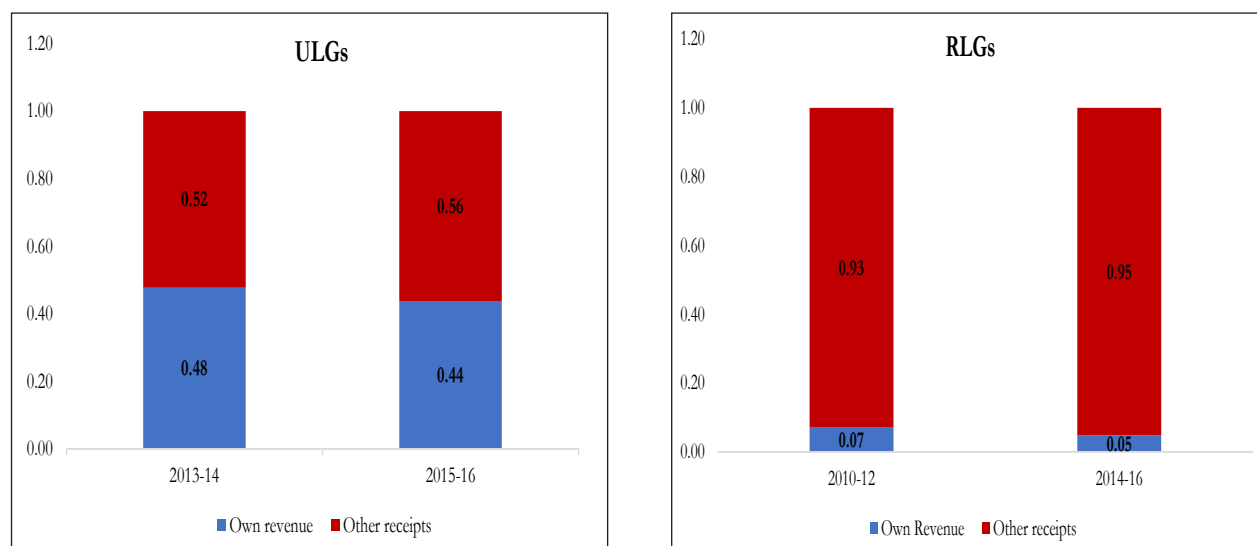
4.24 What may be the reasons underlying the spending patterns visible in Figure 3? Are they related to revenue generation performance or total resource availability, including devolution?

### **Overwhelming reliance on devolved funds**

4.25 From where do ULGs and RLGs derive their resources for spending? Analysis based on

<sup>6</sup> The time periods reported do not match for ULGs and ULGs due to data constraints.

**Figure 4. Own Revenue Generation\***  
(Share of total receipts)



Source: For RLGs, Survey calculations based on data from Andhra Pradesh, Karnataka, Kerala and Uttar Pradesh. ULG information has been sourced from the “Annual Survey of Indian City-Systems, Janaagraha”, based on 19 (17 in 2013-14) major cities of India.

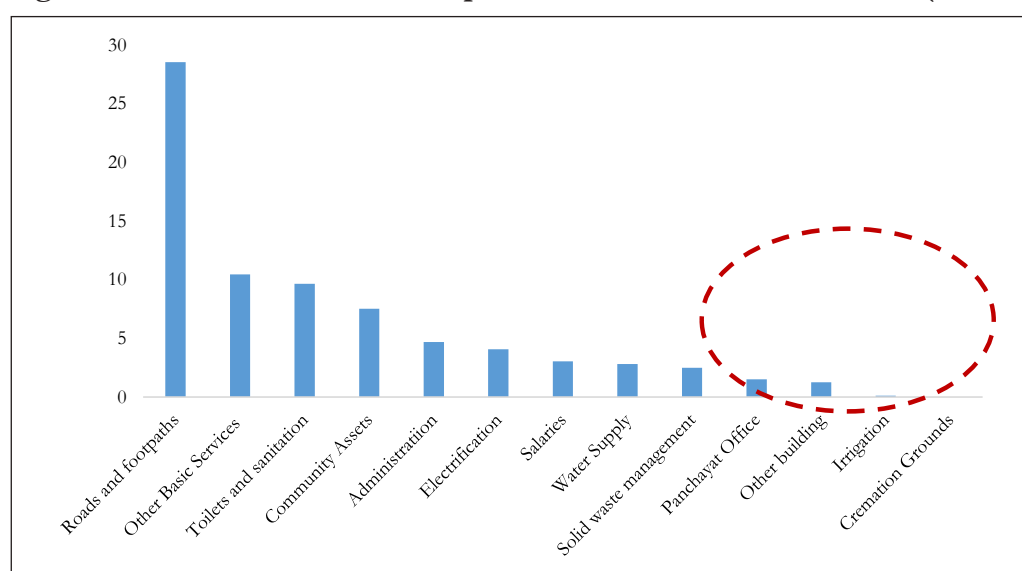
Note: \*: Other receipts include devolution from State and Central Governments, including schematically tied transfers.

available data confirms the following.<sup>6</sup>

**i. ULGs are different:** ULGs seem to be doing much better in terms of own revenue generation. They generate about 44 per cent of their total

revenue from own sources (Figure 4). RLGs, in contrast, rely overwhelmingly (about 95 percent) on devolution. Per capita own revenue collected by ULGs is about 3 per cent of the urban per

**Figure 5. Sectoral Share of GP Expenditure out of Devolved Funds (2014-16)**



Source: Survey calculations based on information furnished by Karnataka, Kerala and Uttar Pradesh.

<sup>7</sup> RLGs collect Rs. 59 per-capita as own resources. This number was about Rs. 16 around 2006 (based on Nagarajan, Mkhize & Meenakshisundaram, (2014).



capita income while the corresponding figure is only 0.1 per cent for RLGs.<sup>7</sup>

**ii. Variation across states:** Figure 4 depicts the situation on average. There is significant variation across states in the extent of own revenue generation. There are also vast differences between RLGs within each state (for instance, please refer to the data presented for Tamil Nadu GPs in Annex 5). Broadly, there are two categories—RLGs of those States that collect some direct taxes and own tax revenue (e.g. Kerala, Andhra Pradesh and Karnataka in our sample), in contrast to RLGs of states like Uttar Pradesh that almost entirely depend on transfers. This variation is much starker in case of RLGs than ULGs (more details in Annex 2).

4.26 Given the overwhelming reliance on devolved funds which, to a large extent, are tied to sectors and schemes, it is not surprising that gram panchayats (GP) spend the bulk of such funds on earmarked areas, such as roads, other basic services, sanitation and community assets.<sup>8</sup> The spending on purely local public goods like irrigation are not a priority out of such funds (Figure 5).

4.27 Institutional accountability is not readily measured. However, drawing from arguments presented in the first section, the trends in fiscal performance of local governments can broadly be considered as a proxy for local-level accountability. The better the performance in generating own revenue via taxes, the stronger accountability is expected to be.

### Other issues

4.28 Standard discourse, a quarter century after the landmark 73<sup>rd</sup> and 74<sup>th</sup> constitutional

amendments, seem to overwhelmingly focus on the extent of devolution of powers to panchayats. This has drawn attention away from the pressing questions relating the performance of RLGs in fiscal accountability and delivery of services. Discussions instead have primarily focused on the following:

- Has there been adequate tax and expenditure devolution to the RLGs by the states?
- Have State Finance Commission's recommendations been followed?

4.29 In many states, RLGs and ULGs have not been devolved enough taxation powers. Successive Devolution Reports of the Ministry of Panchayati Raj (MoPR) show that the share of revenues assigned to local governments in many states are much less vis-à-vis expenditure assignments.<sup>9</sup> From these reports, however, it is seen that several states—notably Kerala, Maharashtra, Karnataka, Gujarat and West Bengal—are consistently improving on this front.<sup>10</sup>

4.30 On the second issue, even though most states have constituted SFCs, very few seem to have accepted their recommendations in full or even to a significant extent, especially those that carry financial implications for them. As per the latest MoPR Devolution Report (2015-16) the percentage of acceptance of such recommendations varies from as low as 11 percent in Karnataka to above 50 percent in West Bengal, Andhra Pradesh and Rajasthan to full acceptance in Kerala. The differences in the devolution formulae recommended by a few SFCs are encapsulated in Annex 1.

<sup>8</sup> As per data based on the four states, 46 per cent of total resources of RLGs during 2010-12 and 35 per cent of that during 2014-16 were tied transfers.

<sup>9</sup> Devolution Report, 2015-16, MoPR.

<sup>10</sup> As captured by their rank on the 'Aggregate Index of Devolution in Practice' in which, among major states, Kerala ranks at the top followed by Maharashtra, Gujarat, Karnataka, West Bengal and Telangana (Devolution Report 2015-16), MoPR Government of India.



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

### STATE AND LOCAL GOVERNMENTS: POSING AN ENTIRELY DIFFERENT QUESTION

4.32 Especially with the formation of the Fifteenth Finance Commission, which will re-assess issues related to fiscal federalism, it is perhaps time to pose a different—and complementary—question about the functioning of second and third tier institutions. Why is their own revenue collection, especially from direct taxes, so poor? Recall that RLGs collect less than 10 percent of their total resources from own revenues and ULGs around 45 percent.

4.33 A common answer is that higher levels especially the states have not devolved enough taxation powers to the Panchayats. For example, the permissible taxes for panchayats include property and entertainment taxes but not land taxes or tolls on roads (except local panchayat roads).

4.34 But much less examined has been a different question: given their powers to tax, how have they performed and have they collected revenues close to the potential conferred by these powers? These issues are examined in this section.

4.35 The property taxes collected at the second and third tiers of government are (a) land tax assessed and collected at the state level; and

(b) building tax, including property/house tax, collected at the municipality (ULG) and grama panchayat (RLG) levels<sup>11</sup>. Property taxes are the principal sources of direct tax revenue at the third tier of government, apart from professional taxes. The collections from these potentially buoyant sources of revenue are generally stacked at very low levels because of archaic base values—far below market values—applied to properties, low rates of taxes levied, and lack of powers to local bodies in some states like Odisha and Rajasthan.

4.36 This section examines the potential for these taxes (details in Annex 3).

### Land tax vis-à-vis potential : States

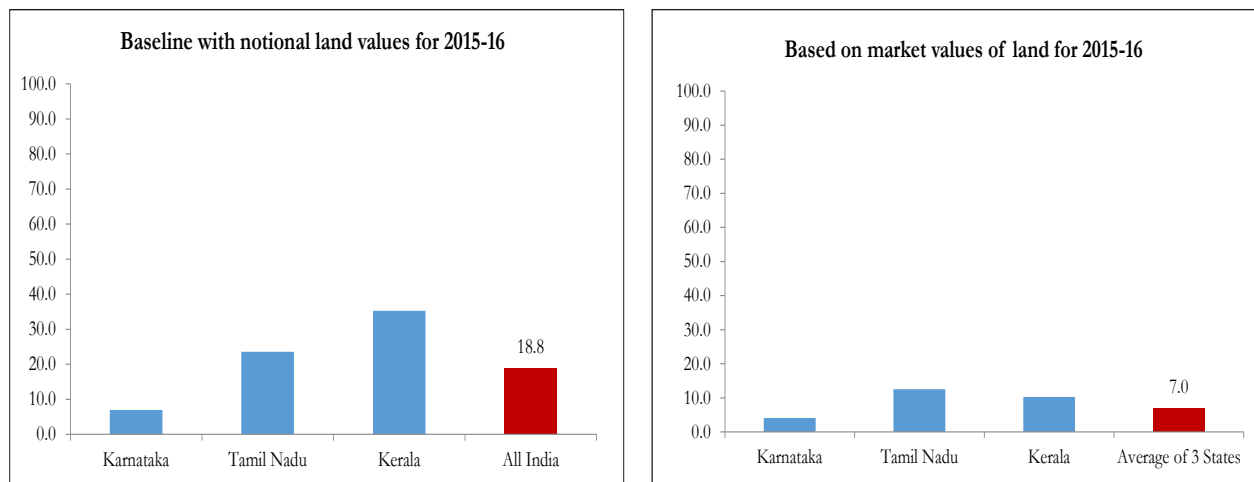
4.37 Different states follow different methodologies to assess land values and apply different rates of land tax. For estimating the potential for land revenue collections, this analysis exempts landholdings of 0.10 hectare and below from taxation and assumes rates of 0.1 per cent of land value for holdings between 0.1 and 1.0 hectare and 0.2 per cent for holdings above 1.0 hectare.<sup>12</sup> Figure 6 presents the land revenue collections as a percentage of the potential estimated separately based on notional values of land and market values of land in three states on which data on market values of land could be accessed online. The methodology employed for arriving at notional and market values of land, along with the collection of land revenue vis-à-vis potential for all States are at Annex 3.

4.38 The significant wedge between the two in Kerala is because the market values of land in the State are much higher than the underlying notional values. The all-India average is boosted by the collections in States like West Bengal and Gujarat which are doing much better in this regard.

4.39 The stark finding is that the states collect

<sup>11</sup> States derive their power to tax land from the Seventh Schedule of the Constitution. The third tier derives the power to tax properties from the respective State Panchayati Raj Act.

**Figure 6. States' Land Revenue Collection Relative to Potential  
(In per cent)**



Source: Survey calculations.

a small fraction of their potential: an all-India average of 19 per cent if unreasonably low land values are assumed, and about 7 per cent on more realistic land value assessments. Complaints about inadequate tax and revenue devolution are less persuasive under such conditions of serious under-collection.

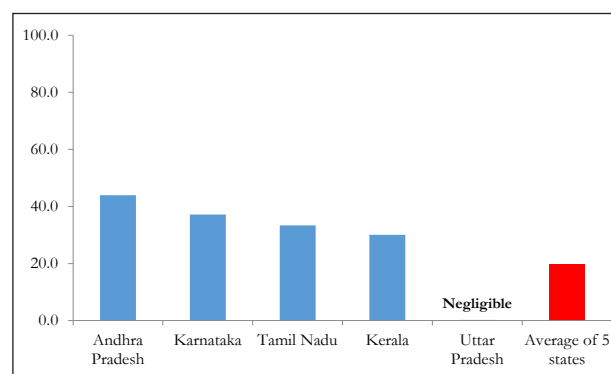
### House tax vis-à-vis potential : RLGs

4.40 RLGs are empowered to a much greater extent by states to collect taxes on house and commercial properties than land taxes of any kind. But while the population census (2011) gives an inventory of houses in the rural areas, there is no such data available for commercial properties in rural areas. Hence, in this analysis the total property tax collection of RLGs—including tax on houses and commercial properties—is set against their *house* tax potential. This procedure thereby overstates performance. The procedure for this estimation, including data sources and valuation, is outlined in Annex 4.

4.41 As with land taxation, states follow different methodologies to assess value of houses and the

land values embedded in a property; they also apply different rates of house tax. States such as Kerala apply unit rates of taxes on a given plinth area while states such as Karnataka and West Bengal apply *ad valorem* rates. For estimating the potential for land revenue collections, this analysis exempts dwelling units of no/one living room from house tax, and assumes rates of 0.1 per cent of the property value for households having 2 living rooms, 0.2 per cent for households having 3 to 5 living rooms and 0.3 per cent for households with more rooms. Figure 7 presents the house

**Figure 7. RLGs' House Tax Collection  
Relative to Potential (in per cent)**



Source: Survey calculations

Note : Figures for Tamil Nadu are for 2014-15 and only for house tax.

<sup>12</sup> These rates are progressive, with the base rate being similar to the rates presently applied in West Bengal.

tax collections of states (for which panchayat level property tax collections are available) as percentage of the estimated potential.<sup>13</sup>

4.42 Even in states viz. Kerala and Karnataka that are ahead of others in devolution of powers to RLGs, the collection vis-à-vis potential is only around one-third. And all these are upper bounds on tax collection vis-à-vis potential given the lack of data on commercial property taxes.

#### **Land tax vis-à-vis potential: Center**

4.43 It is worth asking how the Center itself has done at the third tier. There is a kind of natural experiment here because the Center does directly administer some parts of India. Of course, some Union Territories (UTs) such as NCT of Delhi and Puducherry have their own administrations, which take charge of land tax collection. But there are UTs where the central government assumes this responsibility, including Chandigarh, Dadra and Nagar Haveli, Daman and Diu, Lakshadweep, and Andaman and Nicobar Islands. In these UTs, the question can be legitimately asked about central government performance.

4.44 The previous analysis (on land tax potential estimation for the States) is extended to the UTs, recognizing that they have limited agricultural land.<sup>14</sup> The conclusions are broadly similar. Actual collection in these UTs is, on average, around 30 per cent of potential. For instance, there is no land tax realization in Chandigarh, which has about 923 hectares of some agricultural land (as per the Agricultural Census 2010-11). The collection from Dadra and Nagar Haveli was only Rs.0.19 crore as per the revised estimates for 2016-17 from its 21,856 hectares of agricultural land (the Agricultural Census 2010-11).

4.45 In sum, the under-collection of direct taxes relative to potential afflicts the Center as much as the other two tiers.

#### **CONCLUSION: A LOW EQUILIBRIUM TRAP?**

4.46 The 73<sup>rd</sup> and 74<sup>th</sup> amendments to the constitution in the early 1990s were watershed developments in India's federal structure, its governance and accountability. But twenty years on, it is necessary to realistically evaluate their performance. To do this, better data and evidence on the performance of these institutions is imperative. As discussed in Annex 2 to this chapter, severe data constraints handicap efforts to gauge the performance of RLGs and ULGs. Consequently, policy making is hampered.

4.47 That said, it is clear that state and local governments in India (federal tiers 2 and 3) do not conform to the cross-country trends discussed in the first section. In comparison with their counterparts in some other federal countries, they rely much more on devolved resources and much less on their own tax resources, and they collect less direct taxes. And the reason does not seem to be so much that they don't have enough taxation power. Rather, the bigger problem is that they are not fully utilizing the taxation powers they already possess.

4.48 But why would that be? Is under-collection a matter of capacity and resources, perhaps even related to expenditure? After all, there is little reason to collect more taxes if they cannot be spent efficiently. Or, is the problem a potential unwillingness to tax by the State, stemming possibly from the very proximity between state and citizens upon which decentralization is premised? Or, perhaps taxpayers/citizens are able but unwilling to pay more, because they are

<sup>13</sup> There is one source of significant overstatement of collection vis-à-vis potential in this analysis: inability to estimate the potential for taxes on commercial properties for lack of reliable information.

<sup>14</sup> The methodology is mainly based on the income capitalization approach detailed at Annexure 3.

dissatisfied with the quality of services they are receiving?

4.49 There is another possibility. The status quo can be an equilibrium desired by all actors with higher tiers (both Centre and states) using their devolution powers to control and influence lower levels; and the latter, unable and unwilling to tax their proximate citizens, need outside resources even if they are not always untied. But this is a low-equilibrium, perhaps even a trap.

4.50 Answers to these questions must inform future discussions of devolution and decentralization. For unless the underlying problems are identified and solved, local governments could remain stuck in a low equilibrium trap. That is, the fiscal model of the states and third tier institutions could forever be based on outside resources which—like foreign aid and natural resources or other forms of ‘redistributive resource transfers’ (*Economic Survey* 2016-17 Volume I, Chapter 13)—come with weak accountability mechanisms and weak own-resource generation capacity.<sup>15</sup>

4.51 In the context of growing decentralization of economic and political power, how to break this equilibrium could well be one of the more pressing issues confronting fiscal federalism going forward. Indian policy makers can perhaps no longer avoid this question: should vertical and horizontal resource devolution to second and third tier fiscal institutions be credibly linked to their performance in increasing reliance on own taxes, especially direct taxes?

4.52 This will, of course, raise the question of the Center’s own performance. The previous Section showed with respect to the Center’s collection of direct taxes in the UTs and the first Section highlighted on the broader performance of direct tax collections (Figures 1 and 2). So, it

is not obvious that the states and third tier fiscal institutions are the only ones unable or unwilling to collect direct taxes. To any suggestion of the Center incentivizing second and third tiers toward better direct tax performance, the natural rejoinder of these tiers could be: *Quis Custodiet Ipsos Custodes* (“who will guard the guardians themselves”)?

4.53 Perhaps there is a broader challenge—afflicting all tiers of government—in the limited ability to collect direct taxes. Given the quality of public service delivery, such taxes are often viewed as a “tribute” to a state rather than a contribution to and acknowledgement of the state in raising the quality of life (Aiyar and Pritchett, 2015). One consequence is middle-class exit to more privately-provided services (safety, health, and education) that only serves to exacerbate the problem. Breaking that self-reinforcing cycle of inadequate delivery-low direct taxes-weak accountability-inadequate delivery is perhaps the heart of the governance challenge in India.

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<sup>15</sup> Nagarajan et. al. (2014) estimate (based on survey based data of 1999 and 2006) that an increase in the proportion of devolved function by 10 per cent (approximately by 3 additional functions) raises per-capita revenue generation by about Rs. 6.

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