UNIT 20 FISCAL FEDERALISM IN INDIA

Structure

20.0 Objectives
20.1 Introduction
20.2 Principles of Federal Finance
20.3 Constitutional Provisions
  20.3.1 Allocation of Revenues between the Centre and the States
  20.3.2 Grants-in-Aid
  20.3.3 Borrowings
20.4 Finance Commission
20.5 Planning Commission
20.6 Finance Commission Versus Planning Commission
20.7 Working of Finance Commissions
20.8 Issues in Fiscal Federalism
20.9 Recommendations of Twelfth Finance Commission (TFC)
20.10 Evaluation of Recommendations
20.11 Let Us Sum Up
20.12 Exercises
20.13 Key Words
20.14 Some Useful Books
20.15 Answers or Hints to Check Your Progress Exercises

20.0 OBJECTIVES

This unit is concerned with Union-States financial relations. While going through this unit, you will be able to:

- know the principles governing fiscal federalism;
- state the provisions enshrined in Indian Constitution relating to division of financial powers between Union and States;
- appreciate the role of Finance Commission which constitutes a pillar of India's federal structure;
- appraise the role of Finance Commission versus Planning Commission;
- critically examine the various recommendations of 12th Finance Commission; and
- fathom and consider the dimension and nature of issues involved in contemporary situation prevailing in the country.

20.1 INTRODUCTION

The framers of the Indian constitution wanted to build a strong united India. India has adopted federalism to actualise and uphold the values of national unity, cultural diversity, democracy, regional autonomy and rapid socio-economic transformation through collective efforts. Any viable and durable federal polity must have its counterpart in a system of efficient and equitable federal fiscal arrangement. The diverse political, economic and juridical

aspects of federal fiscal relations have been discussed at length in the *Commission on Centre-State Relations* chaired by Justice R.S. Sarkaria which reported in 1988. The Sarkaria Report observed that from the functional standpoint, such a Constitution is not a static format, but a dynamic process. The very dynamism of the system with all its checks and balances brings in its wake problems and conflicts in the working of Union-State relations.

The country is passing through major economic and political changes and, as a reaction to over-centralisation in the past decades, the States have been asking for greater freedom in the exercise of economic powers. Besides, the current policy of decentralising economic decision-making through liberalisation can aggravate regional disparities and here the Centre has an important role to play. At the same time, the less developed States will have to make corrections in their policies to attract investment, otherwise there are going to be more disparities.

In the light of this background, it is desirable first to know the constitutional provisions and the role of Finance Commission and Planning Commission in this regard. Let us begin with discussing the principles of Federal Finance.

20.2 PRINCIPLES OF FEDERAL FINANCE

Finance is the foundation of a Government. Financial provisions of the constitution have a special significance to the federal Government and the constituent units. The Indian Union has a written constitution. The Constitution splits the powers in various fields between the Central Government and the States. In the financial field, the Indian Constitution has very elaborate provisions. Such are not found in other federal constitutions. The financial relations between the Centre and the States are among the most difficult problems in a federation. Complete separation of taxation powers appears to be more logical, but as has been remarked by K. Santhanam, it has given rise to a new set of difficult problems relating to transfer of funds from the Centre to the States. The major principles are three: *(i) the Centre as well as the States should be autonomous and neither should be unduly dependent on the other for its finances; (ii) both should be able to obtain enough funds for their legitimate expenses; and (iii) the receipts should grow with the need for expenditure. The reconciliation of these principles is never easy, but at times, it may become very difficult. It is true that in no federation have the Central and State governments seen eye to eye. That is why there is not a single democratic federation in which argument about the division of power and authority between the Union and its constituent units has come to an end. It is the scope and quality of the debate that matters. What is needed is a functional and not a political or ideological approach.*

20.3 CONSTITUTIONAL PROVISIONS

20.3.1 Allocation of Revenues between the Centre and the States

The basic point of financial relations is the division of tax-sources between the Centre and the States. There should be *no overlapping of tax jurisdiction*, otherwise, it will cause confusion and conflict. The distribution of taxes in

India is more logical and thorough than in other federations. *The Union List (List I)* contains powers and functions of the Union.

It enumerates the taxes and levies which can be imposed by the Union Government. *The State List (List II)* enumerates the taxes and levies which can be *imposed by the States*. List III, *which is the Concurrent list, does not include any sources of taxation. There is, thus, an attempt to avoid all over-lapping.*

Taxing Powers

Article 268 to 281 of the Indian Constitution deal with the distribution of revenue between the Union and the States. In the Seventh Schedule items 82 to 92(a) in the *Union List* and items 45 to 63 in the *State List* refer to sources of taxation. As regards the division of taxing power, taxes that have an inter-state base are under the legislative jurisdiction of the Union, while those having a local base came under the jurisdiction of the States. *The Union List contains 12 items of taxation. Though they are all in the Union List, it does not mean that the revenues from these accrue to the Union.*

The Constitution (Eightieth Amendment) Act, 2000 has altered the pattern of sharing of Central taxes between the Centre and the States in a fundamental way. Prior to this amendment, Taxes on Income other than agriculture income and Union duties of excise were shared with States under articles 270 and 272 respectively. The Eightieth Amendment Act has substituted a new article for article 270 and omitted the old article 272. The new article 270 provides as under:

"270(1) All taxes and duties referred to in the Union List, except the duties and taxes referred to in articles 268 and 269, respectively, surcharge on taxes and duties referred to in article 271 and any cess levied for specific purposes under any law made by Parliament shall be levied and collected by the Government of India and shall be distributed between the Union and the States."

The Finance Commission is now required to recommend such percentage of taxes or duties referred to in the new article 270 that may be assigned to the States and also recommend the manner in which these may be distributed among the States. The main changes brought about by this amendment are as follows:

a) All Central taxes and duties, except those referred in articles 268 and 269 respectively and surcharges and cesses, are to be shared between the Centre and the States.

b) Only States in which these taxes and duties are 'leviable in that year' are entitled to get a share in these taxes and duties.

c) A percentage of "net proceeds" of these taxes and duties as may be prescribed by the President by order after considering the recommendations of the Finance Commission is to be shared by States.

d) The percentage of "net proceeds" of these taxes and duties which is assigned to the States in any financial year shall not form part of the Consolidated Fund of India.

States Taxes

There are 19 items (as against 12 in the Union List) of which the most important are land revenue, duties of excise on alcoholic liquors and narcotic drugs, general sales tax and sales tax on motor spirit, stamps and registration, taxes on motor vehicles, entertainment taxes and electricity duties. Every State levies these taxes by law and collects and appropriate them. *There is no complication about States' taxes. There is no tax item in the Concurrent list, hence, no question of common source of taxation.*

Article 274 of the Constitution protects the interest of the States. The purpose of this Article is to safeguard the financial interests of the States and prevent any possible inroads by the Centre into the revenue preserves of the States, by making it obligatory for the Union Government to take consent of the States through the President.

20.3.2 Grants-in-Aid

The States' tax-heads are such that they would not make them financially independent. Accordingly, provision has been made for grants-in-aid of revenue in article 275(i) of the constitution. *Federalism is not only a unifying but also a leveling up force.* Federal grants-in-aid to the Constituent units have been necessary and this exists in all federations. The simple reason behind this is that no system of distribution of financial sources between the federation and the units can possibly meet the needs of national development and social services which are usually the responsibility of the units. *By this device financially weaker States can be assisted in bettering their economic conditions.*

Different clauses of *Article 275* make both general and specific provision for grants-in-aid to the States in need of assistance. *This is a discretionary provision.* But its inclusion in the Constitution makes it obligatory on the part of the Central Government to make grants-in-aid towards the costs of schemes undertaken by the States, with the approval of the Centre, for promoting the welfare of the Scheduled Tribes and for raising the level of administration of Scheduled areas.

Article 282 also provides for grants to the States. This article empowers the Union Government to make grants for a public purpose even though the purpose is one concerning which Parliament cannot normally legislate.

20.3.3 Borrowings

Article 292 of the Constitution empowers the Government of India to borrow upon the security of the Consolidated Fund of India, i.e., the resources of the Union, subject only to such limitations as Parliament by law may impose. The Government of India can borrow internally as well as externally. States too are empowered to borrow under *Article 293.* According to this Article, a State cannot borrow outside India. The borrowing powers of the States are limited. Furthermore, if a State is indebted to the Union (as every State is now), it may not resort to further borrowing without the prior consent of the Central Government. However, the State governments do not regard this provision as putting them unduly in the grip of the Union. It does not appear that the working of this Article has been detrimental to the interest of the State.

The scheme of distribution of resources and of functions just described makes the State governments inevitably dependent upon the Central financial transfers, for which the balancing devices have already been provided. The Constitutional provisions have avoided rigidity in these balancing devices by leaving undefined the exact quantum of devolution and its distribution among the States. *Basically, the working of Centre-State financial relations can be seen from the overall result of financial operations on State finances.* The relationship can also be seen in terms of various elements of fiscal federalism such as *sharing of taxes, statutory and discretionary grants-in-aid, Central loans to States, performance under Article 269 and so on.*

Check Your Progress 1

Note: i) Space is given below each question for your answer.

ii) Check your answer(s) with those given at the end of the unit.

1) Explain the principles of federal finance.

…………………………………………………………………………………

…………………………………………………………………………………

…………………………………………………………………………………

…………………………………………………………………………………

2) What are the constitutional provisions relating to Centre-State financial relations?

…………………………………………………………………………………

…………………………………………………………………………………

…………………………………………………………………………………

…………………………………………………………………………………

3) What changes have been brought about through the Constitution (Eightieth Amendment) Act, 2000?

…………………………………………………………………………………

…………………………………………………………………………………

…………………………………………………………………………………

…………………………………………………………………………………

20.4 FINANCE COMMISSION

A distinguishing feature of Union-State financial relationship in India is the explicit recognition in the Constitution of the varying nature of the need and the provision of a periodical review of the situation by a quasi-judicial body. Article 280 of the Constitution provides for the appointment of a Finance Commission by the President. It is with respect to the obligatory sharing of Union taxes and grants that the provision for a Finance Commission has been made in Article 280. It is appointed after every five years or earlier to make

recommendations to the President regarding the distribution of shared taxes, *grants-in-aid* and any other matter referred to the Commission. The Commission is to consist of a Chairman and four other members. Article 280(3) of the Constitution requires the Finance Commission to make recommendations: (a) as to the distribution of the net *proceeds of shareable taxes between* Union and the States, and the allocation between the States of their shares in such proceeds. Formulation of principles that should guide the assignment of share to the States and the determination of individual share of each State constitutes a central task of the Commission, (b) the principles which should govern the grants-in-aid of the revenues of the states out of the Consolidated Fund of India. In addition, the sub-sections (b)(b) and (b)(c) inserted by the 73rd and 74th amendments require it to recommend measures needed to augment the resources of panchayats and municipalities in the states. And most importantly, sub-section (b)(d) requires the commission to look into any other matter referred to it by the president 'in the interests of sound finance'.

Accordingly, it is customary that the presidential order appointing the Finance Commission contains two parts: the first part contains the substantive matters relating to the (a) and (b) above, and the second part contains certain other considerations that the commission might keep in mind while making its recommendations in the interests of sound finance. The considerations to be kept in view '*in the interests of sound finance*' have differed from commission to commission depending upon the economic exigencies prevailing at that time. A comprehensive list of the considerations included in the terms of reference given to all the finance commissions so far, are enumerated in *Vithal* and *Sastry* (2001). They include: (1) Plan requirements; (2) additional resource mobilisation efforts by states; (3) requirements of committed expenditure; (4) scope for economy consistent with efficiency; (5) central assistance to state plans; (6) emoluments of Government employees, teachers, etc; (7) maintenance of capital assets; (8) upgradation of standards of administration; (9) resources of the centre and demands thereon; (10) requirements of states to meet non-Plan liabilities; (11) debt servicing; (12) adoption of a normative approach; (13) adequate incentives for better resource mobilisation and financial discipline; (14) need for speed, efficiency and effectiveness of Government functioning and delivery systems; and (15) need for generating surpluses for capital investment.

The Finance Commission is entrusted with periodic review and resolution of Central-State fiscal problems. It was the clear intention of the fathers of the Indian Constitution that all matters pertaining to normal Central-State financial adjustments should be scrutinised by the Finance Commission, which was given a pre-eminent role in the resolution of problems in fiscal federalism. An incidental and by no means insignificant advantage of the appointment of a Finance Commission has generally been *to rekindle interest in issues pertaining to financial relations between the Centre and the States and to promote an enlightened national debate on the several facets of India's federal fiscal set-up.* The role of the Indian Finance Commission is unique in many ways. *It is one of few commissions provided in the constitution.* It has no parallel in established federal Constitutions. The First Finance Commission was appointed in 1951 and twelve Finance Commissions have reported so far. The following *Table* presents details regarding years of establishment and reporting of various Finance Commissions.

Table 20.1: Chronology of Finance Commission

Five-year Plan		Finance Commission and period of award	Year of Establishment	Year of Reporting	Name of Chairman
I.	1951-56	First: 1952-57	November, 1951	December 1952	Shri K.C. Neogi
II.	1956-61	Second: 1957-62	June, 1956	September 1957	Shri K. Santhanam
III.	1961-66	Third: 1962-66	December, 1960	December 1961	Shri A.K. Chanda
	Annual Plan: 1966-69	Fourth: 1966-69	May, 1964	August, 1965	Justice P.V. Rajamannar
IV.	1969-74	Fifth: 1969-74	February, 1968	July, 1969	Shri Mahavir Tyagi
V.	1974-79	Sixth: 1974-79	June, 1972	October, 1973	Shri K. Brahmananda Reddi
VI.	Annual Plan: 1979-80 1980-85	Seventh: 1979-84	June, 1977	October, 1978	Justice J.M. Shelat
VII.	1985-90 Annual Plan: 1989-90	Eighth: 1984-89	June, 1982 First Report for 1989-90	April, 1984	Shri Y.B. Chavan
VIII.	Annual Plan: 1990-92	Ninth: 1990-95 (Second Report)	June, 1987	July, 1988 December 1989	Shri N.K.P. Salve
	1992-97	Tenth: 1995-2000	June, 1992	December 1994	Shri K.C. Pant
IX.	1997-2002	Eleventh: 2000-2005	July, 1998	June, 2000	Dr. A.M. Khusro
X.	2002-2007	Twelfth: 2005-2010	November, 2002	November 2004	Dr. C. Rangarajan

20.5 PLANNING COMMISSION

The Planning Commission is another important body which has an important place in Centre- State financial relations. The genesis of economic planning in India necessitated the introduction of plan assistance to states to enable them to undertake various developmental programmes envisaged in the five year plans. The responsibility for taking decisions and implementing them rests with the Union and the State governments. The resolution emphasised the need for "*adequate coordination*" between the development schemes initiated by the union and the states and for comprehensive planning based on a careful appraisal of resources and essential conditions of progress.

20.6 FINANCE COMMISSION VERSUS PLANNING COMMISSION

The inauguration of the Five Year Plans in 1951-52 and the setting up of the Planning Commission brought about a new development in federal financial relations which were not regulated by any financial rules and became, therefore, a source of great uncertainty in such relation. Plan grants are given under various developmental heads. Most of the grants are *matching grants*. That is to say, the states have to find a share of the expenses before they become entitled to the central share. It will, thus, be found that the *discretionary grants* made under the recommendations of the Planning Commission have been much greater than the grants given under Article 275(1). As the settlement of the amounts of these grants and later their actual issue depended upon detailed discussions between the State governments, the Planning Commission and the Central departments concerned, *the financial autonomy of the State was being steadily encroached*. Another feature of these grants is that they are available only for the plan period at the end of which they become committed expenditure for which the States are exclusively responsible. Naturally, they approach the Finance Commission and try to get a greater share of revenue and larger grants. This constitutes a vicious circle.

This process was greatly intensified by the *loans* issued by the Centre. But, as a matter of fact, a considerable portion of these loans have been spent for purposes which do not yield any income, and their burden of interest and repayment fall on the State revenues. From this, it will be clear that *as a result of planning the federal financial relations have become seriously distorted*. Dr. P.V. Rajamanner, Chairman of the Fourth FC, pointed out that *the setting up of the Planning Commission has in practice restricted the scope and functions of the Finance Commission.*

20.7 WORKING OF FINANCE COMMISSIONS

As for the basis of distribution of shareable taxes amongst the States, *population* has been given greater weightage over the years. The consensus that has emerged is that, in the absence of scientifically constructed indices of eligibility, population is the most reliable basis for tax-sharing. It also has the additional advantage of mild *equalisation* in so far as the population criterion favours the poorer States.

The growing importance of Union excise amongst the shared taxes and the ascendancy of population as the principal basis of distribution are the two salient features of tax-sharing determined by the Finance Commissions. The Finance Commission is called upon to determine the States that would be in need of *grant-assistance* for the quinquennium under reference and the amount of such assistance in each case. The First Finance Commission laid down some important principles governing the determination *of grants-in-aid for States*. These principles have been generally, endorsed by all the subsequent Commissions. In the case of statutory grants-in-aid (under Article 275(i), *'budgetary gap' 'financial need', 'revenue gap', 'fiscal need'*, etc. are some of the expressions used to indicate the guiding principles governing the underlying transfers made through the Finance Commission. The scope of statutory grants-in-aid has been a subject of serious controversy amongst

fiscal pundits and constitutional luminaries. Differences have arisen regarding the interpretation of the scope of Article 275(i) and 282.

Grants may be broadly classified as '*plan*' and '*non-plan*' grants. Except for grants given on *ad-hoc* basis for unforeseen situations (upto 1973-74), *non-plan grants are determined by the Finance Commission*. Such non-plan grants are recommended by Finance Commission under Article 275(i) of the Constitution. The increasing outlays on plans have necessarily meant substantial increase in Plan grants which are determined by the Planning Commission. Such discretionary grants (under Article 282) have dominated grants-in-aid [under Article 275(i)].

Article 282 has been over-worked to a point where it has over-shadowed its substantive brother, Article 275(i). We must also remember the *basic fact that the non-plan grants under Article 275(i) are virtually unconditional whereas the plan grants are discretionary and conditional, varying from year to year and depending on the plan performance of the states. Article 282 has become the haven of discretionary plan grants.*

The Article 282 was intended to give power to the Union and the States to make grants for special bodies and purposes like the U.N. and other international bodies and to any States in case of natural calamities like famine, flood or earthquake. *Shri A.K. Chanda*, Chairman, Third Finance Commission, has remarked that Article 282 "is being extensively used to regulate financial relations between the Union and the States". Experts are of the opinion that this appears to be misuse of the Article's provision. *Justice P.V. Rajamannar*, Chairman, Fourth Finance Commission, has observed: "In my opinion Article 282 was never intended for the purpose for which it is now being used". The grants-in-aid under Article 282 were intended to be resorted to only in emergencies. Since such grants are not envisaged as part of normal federal state financial adjustments, they are kept outside the purview of the Finance Commission. The rise of the Planning Commission with wide powers over the allocation of resources between the federal and State governments have resulted in a progressive downgrading of the role of the Finance Commission.

Central Loans to the States

Bulk of the outstanding debt of the State governments is accounted for by the loans obtained by the States from the Central Government. In absolute terms, the outstanding loans from the Central Government have gone up. Figures testify the phenomenal increase in the States' debt to the Centre. *Dr. D.T. Lakdawala* has opined that the picture of *loans* from the Centre conceals many characteristics of the system which can only be seen if a detailed picture of the type and purposes of loans is obtained. A substantial portion of the Central loans hitherto had been on Plan account. The essential fact that it is the *unmanageable magnitude of the debt to the States.* The repayment of loans constitute a major neglected problem. It is this repayment problem that has led to difficulties for the States, which have little of free funds to meet these needs. Most of them have no surpluses on revenue account and most of the new Central loans are earmarked.

The Twelve Finance Commissions, cover a span of more than 55 years during which many conditions have changed. Correspondingly, the approach of the latter Commissions may be expected to be different in several respects from

that of the earlier ones. Nevertheless, it is possible to discern certain common elements in the thinking of the successive Finance Commissions which have come to evolve gradually what may be called '*the Indian Finance Commissions' approach to federal finance*'.

The transfers recommended by the Finance Commissions are meant for filling up the non-correspondence gap in the current revenues of the States. Thus, the transfers are, as they should be general and unconditional revenue reinforcements. This approach is characterised as the '*gap-filling*' approach. To some extent, the terms of reference issued to the successive Commissions are responsible for this '*gap-filling*' approach.

However, there are several inadequacies in the approach of the Finance Commissions. According to this approach, the States' share of Central taxes is *not allocated strictly on the basis of need*. On the other hand, the respective shares of individual States are determined by different formulae. Consequently some States receive, out of shareable taxes, much more than is needed to meet their projected non-plan expenditure while some other States receive much less than their revenue requirements. The budgetary gaps of the latter States are met by the Finance Commission through grants-in-aid. *The grants-in-aid are by and large determined on the basis of budgetary deficits.*

It is also suggested that a *permanent Finance Commission is necessary* condition for a satisfactory arrangement, for general transfers to the States. *The scope for discretionary transfers could be minimised if the states are left by the Commissions in a position where they do not have to look to the Centre for help even in trifling matters.* Further, the purview of the Finance Commission should be enlarged to include *all non-Plan financial transfers both on revenue and capital accounts.* By implication, there will be little room for discretionary transfers on non-Plan account. The Planning Commission should continue to make recommendations regarding the allocation of Central assistance for Plan purposes. However, the need for *greater coordination between the two commissions is also emphasised.*

Devolution of Resources

Devolution of resources from the union to the states may be placed under *three* categories: (i) transfers based on the recommendations of the *Finance Commission*; (ii) transfers by way of assistance for execution of the plans recommended by the *Planning Commission*, including centrally sponsored schemes; and (iii) others consisting of small savings, loans, assistance for natural calamities, etc., canalised through the *Union Finance Ministry.* The transfers effected on the recommendations of the Finance Commission (also called statutory transfers) are normally determined for a period of five years. Bulk of these transfers are unconditional and have *a built-in buoyancy* with respect to the growth of the concerned tax receipts. Resources flowing from the Union Government to the states through other channels, principally the Planning Commission, over two-thirds of the revenue received by the states from the centre is still governed by the dispensation of the FC.

A substantial part of the transfers in the *second* category are by say of assistance for the execution of the state plans. If to these transfers are added those on account of central and centrally sponsored plan-scheme, the totality of the plan transfers works out to about 40 per cent of the total transfers. The central assistance for the plans is based on the recommendations of the Planning Commission. It includes loans and grants.

The *third* category of transfers are given for various purposes by the Union Government. These are in the form of grants and loans for relief of natural calamities, improvement of roads, upgrading salaries of teachers. Central assistance is an important instrument for reducing regional inequalities and augmenting finances particularly of less developed states for meeting their developmental needs. Plan assistance has always been crucially important for state plans. The amounts given as plan assistance in the form of *grants* (30 per cent) and *loans* (70 per cent) has always been determined on the basis of prescribed criteria. Nevertheless, in actual practice stronger states could get away with a larger slice than what was their due.

Bulk of central assistance (grants and loans) is decided according to prescribed criteria, *population being a major criterion, backwardness of the states, other special problems* also being other important criteria. This is done under what is known as the *Gadgil Formula or modified Gadgil Formula.* As *Sarkaria Commission* has observed: "It is not humanly possible to derive foolproof formula which would make the totality of central transfers confirm fully to the ideal of automatic and free-from interference devolution. Some amount of flexibility and room for subjective judgement will have to be left to the concerned institutions to deal with the specific situations as they arise. *What is really important is that the institutions involved should function in a fair and non-partisan manner and take decision with due discernment and expertise which are implicitly acceptable to the states"*.

Check Your Progress 2

Note: i) Space is given below each question for your answer.

ii) Check your answer(s) with those given at the end of the unit.

1) What is Finance Commission?

……………………………………………………………………………………

……………………………………………………………………………………

……………………………………………………………………………………

……………………………………………………………………………………

2) What is the need for a Finance Commission?

……………………………………………………………………………………

……………………………………………………………………………………

……………………………………………………………………………………

……………………………………………………………………………………

3) What is the basis for recommendation of the Finance Commissions on transfers?

……………………………………………………………………………………

……………………………………………………………………………………

……………………………………………………………………………………

……………………………………………………………………………………

4) Why is Planning Commission considered a distortion in Fiscal Federalism?

……………………………………………………………………………

……………………………………………………………………………

……………………………………………………………………………

……………………………………………………………………………

20.8 ISSUES IN FISCAL FEDERALISM

The Indian Union has had more than 55 years of experience with fiscal federalism operating within the framework of parliamentary democracy and planned economic development. A comprehensive review of fiscal federalism in independent India is, therefore, overdue. There have been feeble protests from time to time about the sprawling powers of the Central Government eroding the foundations of fiscal federalism. But these voices were drowned by the overwhelming influence of the same Party at the Centre and the States. Now that the Congress Party has been dislodged from power in some of the States and parties of different hues and colours are holding office, a candid and comprehensive review of all the aspects of Centre-State relations and the working of fiscal federalism in particular is important and necessary.

Under the changed circumstances, there is need for change in the outlook of the Union towards the States and of the States towards the Union. Now it is difficult, if not impossible, for the Central Government to impose its will or decision on the States. *"What is needed is an atmosphere of trust and confidence. For establishing an atmosphere of trust the method of 'decision-making by consensus' should replace the imposition of a decision taken on the basis of majority. The essential principles upon which Union-State financial relationship should be based in the changed atmosphere should be of accommodation, co-operation, empiricism and balance. In the absence of an approach based on these principles, Union-State relationship will be subject to undue strain".*

The root cause of States' chorus of more and more demands is too much financial dependence on the Centre due to the latter's possession of more elastic and larger resources of revenues while States have to shoulder responsibility of meeting growing expenditure on various heads of expenditure. This has caused demand for more financial powers.

Dr. D.T. Lakdawala has observed that there are buoyant tax sources both with the Central and State governments and there are also slow growers. A rise in land revenue rates and extension of agricultural income are urgently called for. Further, States' revenues would have grown at a faster rate if they had secured reasonable returns on investments in irrigation and power projects.

A satisfactory and enduring solution to the problem of Centre-State relations cannot be found except through a rigorous and concerted drive against tax evasion, tax avoidance and waste and extravagance in public expenditure. It is equally important to ensure all round efficiency in the deployment of public funds in particular, investments in productive enterprises in the public sector. In other words, sound fiscal management holds the key to the evolution of

harmonious and fruitful fiscal relations between the Centre and the States. One must agree to the view that in the scheme of devolution of resources to the States, *we must keep in mind that the resources belong to the nation and they should be applied at points where they are most needed.*

The question of Centre-State relations has become the focal point of discussion for a number of reasons. The appointment of the *Sarkaria Commission* by the Centre reflected its recognition of the seriousness of the issue. The Centre-State economic relations have assumed special significance in the context of the states asking for greater decentralisation of powers to manage their economies. The economic reforms programme, emergence of strong regional parties, the governance through political coalitions, and the constitutional amendments to empower the local bodies, have raised many economic and political issues regarding the Centre-State relations. The resources are short and the pattern of expenditure of the Centre and the states is such that there is not enough left for the needed investment in social and physical infrastructure. There are wide disparities as between the states and even within the states and also conflicting interests between the regions and the social problems of the low-income states. There is need for augmenting the resources both of the Centre and the States and the cake has to grow before the slices can become bigger. This requires faster growth of the economy and restructuring the expenditure of the Centre and the States, which is hampered largely by the pulls and pressures in the political arena. It is time that the major political parties develop a broad consensus at the centre and the states and blend good economics with politics. This is the background in which the centre-state relations are to be considered.

To be fair to the Finance Commission, it must be noted that they have tried to be responsive to the criticisms of the states to the extent it lay within their domain. However, it must be noted that the Finance Commission alone cannot solve the difficult problems faced by it. In particular, *a harmonious, equitable and efficient delegation of financial powers between Centre and States must be an integral part of the overall investment and planning objectives of the economy. While the Finance Commission looks after the revenue deficits of the states, and the Planning Commission takes care of plan needs, revenue and capital, there is no mechanism to look after the non-plan capital requirements of the states.* Large sums are needed to repay the plan loans taken earlier from the centre, but apart from the share in small savings there is no regular major source of non-plan capital receipts which can provide for repayment. The '*gap filling approach*' which had dominated the Finance Commission's perception of their task in the past had come in for criticism from almost all quarters as it tended to undermine the incentives for efficient fiscal management.

While these arrangements have provided a flexible mechanism for the operation of fiscal federalism, there is a widespread feeling that they have proved inadequate and what is more, there has been a trend towards greater centralisation and dependence of the states on the centre than is conducive to the good federal governance in a country like India. Thus, the issues in Union-States financial relations are:

i) The unitary elements already embedded in the Indian Constitution have gained further strength over the years with concentration of fiscal powers in the Centre and growing dependence of the States on transfers from the Centre.

ii) The institutions contemplated in the Constitution to safeguard the fiscal autonomy of the States have not helped to correct the vertical imbalance.

iii) In the distribution of responsibilities and powers delineated in the Indian Constitution, there is a chronic imbalance with concentration of fiscal powers in the Centre. This is not uncommon in fiscal federalism.

iv) The fact that the Planning Commission was a creature of the Centre and not a statutory body continued to be a point of discord.

v) About one-fifth of the total transfers takes place at the discretion of the Centre.

Union-State differences become sharp and cause anxiety in different ways and under different conditions. The unmistakable trend is that larger amounts are being channeled to the States from the Central pool. However, the two important socio-economic problems which must be tackled are the *general backwardness of the people and the wide inter-State disparities in the Union.* That is how the case of poorer Stats has been highlighted in all the deliberations.

Now a few suggestions may be attempted. The objective is three-fold: (a) *The Centre has to discharge its coordinating, corrective and lead functions in a truly federal set-up*; (b) *The States should have their due share in responsibilities as well as rights*; and (c) *A continuing system of communication and clearing should be available.*

The upshot of the argument is that in recommending resources transfer to states a Finance Commission ought to take into account *three* different considerations: (i) it must be ensured that states are not starved of funds required to meet legitimate expenditures on an adequate scale; (ii) since one of the primary reasons for centralising major powers of taxation is the need to promote fiscal efficiency, a state should rightfully expect a share which bears some relationship to what it could have secured on its own if it possessed the relevant powers of taxation; and (iii) the special needs of the less-developed states have also to be given due weight in any worthwhile scheme of devolution. The first consideration relates to the magnitude of resources transfer from the Centre to the states, whereas the remaining two considerations indicate guidelines for inter-state distribution of the aggregate share assigned to states taken as a group.

20.9 RECOMMENDATIONS OF THE TWELFTH FINANCE COMMISSION (TFC)

The Twelfth Finance Commission (TFC) recommendations under Dr. C. Rangarajan, has chalked out a unique programme of fiscal reconstruction, both for the Centre and the States. The Twelfth Finance Commission has also adopted principles of distribution of Central revenues, almost similar to those adopted by the Eleventh Finance Commission. The Report of the Twelfth Finance Commission (TFC) has been remarkably free from controversy of the type that accompanied the reports of some of its predecessors. Most of its major recommendations have found ready acceptance at the Centre and in the States. The implementation of the award should improve state finances and usher in structural changes in their fiscal position. The TFC has recommended about 74 per cent step up in transfer of resources – states share in divisible pool of Centre’s taxes and duties and grants-in-aid – to Rs. 7,55,751 crore

during 2005-10. This is up from Rs. 4,34,905 crore recommended by the Eleventh Finance Commission (EFC) for 2000-2005. The grant portion has seen a steep hike of 143 per cent from Rs. 58,587 crore awarded by the EFC while taxes portion has gone up by 63 per cent from Rs. 3,76,318 crore. The share of states' in Centre's divisible pool of tax and duties has been enhanced to 30.5 per cent. An estimated Rs. 6,13,112 crore is to be devolved to the states as their share in Centre's tax and duties and Rs. 1,42,639 crore as grants-in-aid. States would also get relief in terms of interest payment on loans outstanding as of March 31, 2004 and on repayment of the principal component.

Restructuring Public Finances

i) Centre and States to improve the combined tax-GDP ratio to 17.6 per cent by 2009-10.

ii) Combined debt-GDP ratio, with external debt measured at historical exchange rates, to be brought down to 75 per cent by 2009-10.

iii) Fiscal deficit to GDP targets for the Centre and States to be fixed at 3 per cent.

iv) Revenue deficit of the Centre and States to be brought down to zero by 2009-10.

v) Interest payments relative to revenue receipts to be brought down to 28 per cent and 15 per cent in the case of the Centre and States, respectively.

vi) States to follow a recruitment policy in a manner so that the total salary bill, relative to revenue expenditure, net of interest payments, does not exceed 35 per cent.

vii) Each State to enact a fiscal responsibility legislation providing for elimination of revenue deficit by 2008-09 and reducing fiscal deficit to 3 per cent of State Domestic Product.

viii) The system of on-lending to be brought to an end over time. The long-term goal should be to bring down debt-GDP ratio to 28 per cent each for the Centre and the States.

Sharing of Union Tax Revenues

i) The share of States in the net proceeds of shareable Central taxes fixed at 30.5 per cent, treating additional excise duties in lieu of sales tax as part of the general pool of Central taxes. Share of States to come down to 29.5 per cent, when States are allowed to levy sales tax on sugar, textiles and tobacco.

ii) In case of any legislation enacted in respect of service tax, after the notification of the eighty eighth amendment to the Constitution, revenue accruing to a State should not be less than the share that would accrue to it, had the entire service tax proceeds been part of the shareable pool.

iii) The indicative amount of overall transfers to States to be fixed at 38 per cent of the Centre's gross revenue receipts.

Local Bodies

i) A grant of Rs. 20,000 crore for the Panchayati Raj institutions and Rs. 5,000 crore for urban local bodies to be given to States for the period 2005-10.

ii) Priority to be given to expenditure on Operation and Maintenance (O&M) costs of water supply and sanitation, while utilising the grants for the Panchayats. At least 50 per cent of the grants recommended for urban local bodies to be earmarked for the scheme of solid waste management through public-private partnership.

Calamity Relief

i) The scheme of Calamity Relief Fund (CRF) to continue in its present form with contributions from the Centre and States in the ratio of 75:25. The size of the Fund worked out at Rs. 21,333 crore for the period 2005-10.

ii) The outgo from the Fund to be replenished by way of collection of National Calamity Contingent Duty and levy of special surcharges.

iii) The definition of natural calamity to include landslides, avalanches, cloud burst and pest attacks.

iv) Provision for disaster preparedness and mitigation to be part of State Plans and not calamity relief.

Grants-in-aid to States

i) The present system of Central assistance for State Plans, comprising grant and loan components, to be done away with. The Centre should confine itself to extending plan grants and leaving it to States to decide their borrowings.

ii) Non-plan revenue deficit grant of Rs. 56,856 crore recommended to 15 States for the period 2005-10. Grants amounting to Rs. 10,172 crore recommended for the education sector to eight States. Grants amounting to Rs. 5,887 crore recommended for the health sector for seven States. Grants to education and health sectors are additionalities over and above the normal expenditure to be incurred by States.

iii) A grant of Rs. 15,000 crore recommended for roads and bridges, which is in addition to the normal expenditure of States.

iv) Grants recommended for maintenance of public buildings, forests, heritage conservation and specific needs of States are Rs. 500 crore, Rs. 1,000 crore, Rs. 625, and Rs. 7,100 crore, respectively.

Fiscal Reform Facility

With the recommended scheme of debt relief in place, fiscal reform facility not to continue over the period 2005-10.

Debt Relief and Corrective Measures

i) Central loans to States contracted till March, 2004 and outstanding on March 31, 2005 amounting to Rs. 1,28,795 crore to be consolidated and rescheduled for a fresh term of 20 years, and an interest rate of 7.5 per cent to be charged on them. This is subject to enactment of fiscal responsibility legislation by a State.

ii) A debt write-off scheme linked to reduction of revenue deficit of States to be introduced. Under this scheme, repayments due from 2005-06 to 2009-10 on Central loans contracted up to March 31, 2004 will be eligible for write-off.

iii) Central Government not to act as an intermediary for future lending to States, except in the case of weak States, which are unable to raise funds from the market.

iv) External assistance to be transferred to States on the same terms and conditions as attached to such assistance by external funding agencies.

v) All the States to set up sinking funds for amortisation of all loans.

vi) States to set up guarantee redemption funds through earmarked guarantee fees.

Others

i) The Centre should share 'profit petroleum' from New Exploration and Licensing Policy (NELP) areas in the ratio of 50:50 with States where mineral oil and natural gas are produced. No sharing of profits in respect of nomination fields and non-NELP blocks.

ii) Every State to set up a high level committee to monitor the utilisation of grants recommended by the TFC.

iii) Centre to gradually move towards accrual basis of accounting.

20.10 EVALUATION OF RECOMMENDATIONS

The total transfers recommended by the TFC are 73.8 per cent more than what its predecessor allowed with both the share in Central taxes and grants-in-aid being higher. Obviously, the States have scant cause for complaint over the TFC report. While enlarging substantially the transfers to the States it sought to end the practice of Central assistance for State Plans (comprising grants and loans). Eligible only for Plan grants, States will have to do their own borrowing to fund their Plans. Surely, the TFC asking *the States to borrow directly is a prescription to tread the path of prudence instead of looking constantly to the Centre for bail-outs. However, the TFC has directed the Centre to continue loan intermediation on behalf of States that may not be able to tap the market.* On the constant refrain by States of debt relief, the TFC has broken fresh ground. Henceforth, all Central loans to States contracted till March 2004 and outstanding on March 31, 2005, amounting to Rs. 1,28,795 crore would be consolidated and rescheduled for a fresh tenure of 20 years at 7.5 per cent. A debt write-off scheme aligned to the absolute amount by which the revenue deficit is whittled down is a salutary step, and should goad the State governments to be both efficacious and judicious in

their expenditure programmes. The TFC has also recommended that debt relief could be given in form of write-off to states that enact a *Fiscal Responsibility Act* and adhere to prescribed fiscal parameters. The TFC has fixed proportion of write-off to each measure of fiscal discipline effected. The entire amount of outstanding debt of a state could get written off if it adhered to all the fiscal parameters laid out. *The scheme of debt relief outlined by the TFC is well-crafted and comprehensively linked to specific reform milestones.*

Decentralisation in administration is the new *mantra*, and the TFC has rightly plumped for a total grant of Rs. 20,000 crore to *Panchayati Raj* institutions and Rs. 5,000 crore to the urban local bodies for 2005-10. This should help rejuvenate grassroots involvement in the development process. The proposal to make project assistance to States only on terms similar to that set by external funding agencies should make a qualitative difference to the commissioning, operation and maintenance. This could set the States on a higher growth path, while simultaneously addressing the twin scourges of development deficit and lop-sided regional development.

It has recommended a total devolution of Central divisible taxes at 30.5 per cent as against 29.5 per cent in the earlier Commission. So far as the *inter se* distribution between States is concerned, the TFC has followed the principle of *assigning weights to area population, income distance, tax effort and fiscal discipline*. It will be seen that the TFC has blunted the edge of richer States' potential criticism by moderating the role of the distance criterion. Backwardness does not have *per se* as high a weight as in the earlier Commission. It has also discarded the *weight for infrastructure*. The emphasis laid by the TFC on fiscal prudence shines through all its recommendations. In particular, in its recommendations on debt relief – on which it has been quite liberal – it has linked the write-off of debt to the performance of States in respect of reduction of *revenue deficit and fiscal deficit*. This is a tough requirement, but the logic of the TFC is impeccable (*S. Venkitaramanan, 2005*). If the States do not have such incentives, it is difficult to keep them on the straight and narrow path of fiscal rectitude. The TFC has made a far-reaching proposal that will affect the Centre and the States – in respect of Plan financing. So far, State plans used to be financed by a *mixture of grants and loans* – loans partly from the Centre and the rest from the market. In its recommendation, the Central assistance has been radically recognised to be grants only. The Centre, so to say, saves the loan component of the Central assistance for States, and the States are expected to go to the market for the same. This recommendation has two benefits. One is that it imposes a market discipline on the States. The States can borrow from the market at lower rates than the Centre used to charge, provided their credit rating is good. Fiscal balance feeds into credit rating. This is an additional bonus to fiscally prudent States. There is also an advantage to the Centre from the deficit point of view. To the extent, it borrowed the money which it on-lent to States, its fiscal deficit was higher. The States borrowing directly means the Central fiscal deficit goes down.

The TFC has also recommended sizeable grants to *backward States* to upgrade their *health and education services* – these are, of course, related to their performance levels. The State governments have been used to dealing with the Planning Commission for approval of their annual Plans. They will have to negotiate with the banks, insurance companies and other investors for their market loans. The report has an elaborately argued segment defending the Government's current stance in favour of *fiscal deficit* reduction in terms

of specific targets. The key to good fiscal management is to ensure not only the trimming of fiscal deficits but if deficits are incurred they should be only for investment in projects of remunerative nature. While it is true that fiscal deficit targeting by States is desirable, it has to be ensured that it does not rule out essential infrastructural funding, if need be, by borrowing in the market, provided the projects price the services rightly. Ultimately, the secret of successful economic management lies not in the *mantra of fiscal deficit being zero*, but in achieving economic growth with enhancement of job opportunities and alleviation of poverty (S. Venkitaramanan, 2005).

The recommendations of the 12th Finance Commission mark a departure from the past, in several significant ways. A major theme of the report is *graduation of the states to accepting full responsibility for their fiscal performance*. The recommendation for debt relief and write-off, conditional respectively on states legislating fiscal responsibility and achieving revenue deficit reductions, is welcome. The allocation of grants for specific purposes and for local bodies are significant features that whittle down state level autonomy and strengthen the local bodies as a third tier (*The Economic Times*, February 28, 2005).

While the TFC attempts to set its own rules in the matter of deciding the fair share of the states in the central revenues, what distinguishes its recommendations from those of its predecessors is the thrust in four directions: (i) *redefining the respective roles of tax devolution and grants*; (ii) *anointing the principle of 'equalisation' of some basic services across the country as a guiding rule in the distribution of revenues among the states*; (iii) *discontinuing the practice of the centre giving loans to the states and requiring all plan assistance from the centre to flow as grants*; and (iv) *a new scheme of debt relief to the states designed to make a paradigm shift in the system of borrowing by the states.* Overarching these thrusts is a restructuring plan for the finances of the two levels of Government that should help to fulfill the targets of fiscal and revenue deficits laid down in the Fiscal Responsibility and Budget Management Act.

Contrary to what might be expected in a system of federal transfers that addresses *vertical and horizontal* imbalances in an equitable and efficient manner, over the years the proportion of grants in the total transfers arbitrated by the FC has dwindled from over 40 per cent to barely 10 per cent while that of tax share has expanded. The TFC has made a valiant effort to reverse this trend, but has been able to enlarge the share of grants to no more than 19 per cent of transfers. *A major contribution of the TFC in India's federal transfer system is the emphasis on equalisation of two basic services, education and health, across the country.* Then, there are grants for maintenance of roads and bridges, heritage projects and forests. *Balancing the objectives of equity, efficiency and autonomy in federal transfers is a tricky job.* As *Robin Broadway*, the noted federalist economist, puts it, "*…the role and design of inter Governmental transfers is as much an art as a science*". Also, ultimately, a system is as good as it operates and not as it is conceived. So the ultimate responsibility for seeing that the vision of the TFC materialises, rests on those who implement the scheme of transfers laid down by it (*Economic and Political Weekly*, March 12, 2005).

However, the overall effect of the report is likely to be a reduction in the dependence of the States on Central transfers. Looking beyond numbers, the TFC seems to have contributed to a healthier fiscal federalism. The TFC has

done a great job of highlighting some tough areas for reform. The continuing reform of India's indirect tax system gets considerable attention, and the fact that central service taxes, being introduced by the 88th Amendment, are not part of the shareable pool, is rightly highlighted as a retrograde feature of the new law (*The Hindu*, March 17, 2005).

Check Your Progress 3

Note: i) Space is given below each question for your answer.

ii) Check your answer(s) with those given at the end of the unit.

1) Identify the major issues in union-state financial relations.

…………………………………………………………………………………

…………………………………………………………………………………

…………………………………………………………………………………

…………………………………………………………………………………

…………………………………………………………………………………

2) How are the recommendations of Twelfth Finance Commission different from the previous one?

…………………………………………………………………………………

…………………………………………………………………………………

…………………………………………………………………………………

…………………………………………………………………………………

20.11 LET US SUM UP

In conclusion, it needs to be added that for evolving a satisfactory institutional arrangement to take care of the problem in Centre-State financial relations, and correcting the deficiencies which have come to notice, one has to look beyond the constitutional provisions as they exist at the moment. For it should be kept in mind that after all the basic framework of financial relations between the Centre and the States was drawn up largely on the pattern on the Government of India Act, 1935, and our constitution-makers probably had not anticipated the demand on the public sector which planning and development effort might entail (*Bhabatosh Datta*). Therefore, if the institutions which have evolved over the years and come to play an important role in the nation's economic development (like the Planning Commission and the NDC) are found lacking in constitutional sanction, it may not be right to reject all that has been done by them as illegal but to find ways in which their role can be defined with some clarity and regulated by law.

The Presidential notification formally constituting an *Inter-State Council* under *Article 263 of the Constitution* fulfils a long standing demand of State governments for a body to resolve differences or disputes among the States or between them and the Centre. Though the *Sarkaria Commission* is the latest to support the demand, the Administrative Reforms Commission had strongly favoured the setting up of such a body as early as 1969. In substance, the

States' case was based on their grievances against the Centre's arbitrary ways of dealing with them for which the Centre has the ultimate authority, although this authority was not intended to override the federal character of the Constitution.

The Finance Commission (FC) constitutes a pillar of India's federal structure, mediating in the sharing of central revenues with the states and the *inter se* distribution among the constituents of the union. Moreover, the TFC has sought to define the approach needed to address the issues that would help to correct aberrations that have set in the course of time. Though its efforts do not go very far in charting a new path, the report tries to break away from the past in important ways, which may have a profound impact on the finances of the Government at all levels in the coming years. States are set to get Rs. 23,000 crore every year as additional transfers from the Centre. The states will also benefit to the extent of Rs. 14,000 crore per annum from debt relief measures such as reduced interest on consolidated outstanding amount, reschedulement of repayment and write-off. Of the resource transfers, about Rs. 20,000 crore would flow in the form of grants-in-aid, a large chunk of it being untied. The balance Rs. 3,000 crore of the additional transfer would be on account of 1 per cent increase in states' share in Centre's divisible pool of taxes and duties from the existing 29.5 per cent. Bihar, Uttar Pradesh, Tamil Nadu, Karnataka, Maharashtra and West Bengal are set to be key beneficiaries of the TFC awards.

20.12 EXERCISES

1) State in brief the principles of federal finance. How far the Centre-State financial relations in India adhere to these?

2) What is Finance Commission? How is it different from the Planning Commission? Make an evaluation of the recommendations of the Twelfth Finance Commission.

3) "States should have their due share in responsibilities as well as rights." In the light of this statement, bring out the important issues in Centre-State relations in India.

4) "The question of Centre-State relations has become the focal point of discussion for a number of reasons." Comment on this statement and point out the reasons for conflict between Centre and States.

20.13 KEY WORDS

Centrally Sponsored Schemes: Schemes initiated by the Centre but implemented by the States. The extent of Central Assistance to such schemes is normally around 50 per cent of the total outlay. The expenditure on these schemes, in the nature of conditional grants by the Centre to the States, has assumed a dimension much beyond that sanctioned by the 1969 National Development Council (NDC) resolution which laid down a ceiling on them of 1/6th or 1/7th (i.e. 14.17 per cent) of total plan assistance to the States.

Gadgil Formula: A formula of plan assistance to States adopted since the Fourth Plan (1969-74) which provided that distribution of plan assistance to the States should take five elements into account. This is named after Professor D.R. Gadgil, the then Vice-Chairman of the Planning Commission.

Gap-filling Approach: Assistance to States for rectifying imbalances – vertical or horizontal – is essentially in the nature of a device to bridge a budgetary gap. However, the phrase 'gap-filling approach' epitomises the practice of Finance Commissions of recommending grants-in-aid to States on the basis of estimated gap between forecasted expenditure and receipts (inclusive of tax shares) on revenue account.

Horizontal Imbalance, i.e., Horizontal Federal Fiscal Imbalance: The imbalance between the expenditure requirements and own revenues of different constituent units of a federation mainly on account of differences in fiscal capacities arising out of regional economic disparities. Rectifying horizontal imbalance means promoting regional equalisation.

Inter-State Council: In 1990, the Government took the step of invoking the constitutional provision (Article 263) and forming an Inter-State Council charged with the duty of: "(a) inquiring into and advising upon disputes which may have arisen between States; (b) investigating and discussing subjects in which some or all of the States or the Union and one or more of the States, have a common interest; or (c) making recommendations upon any such subject." The idea is to provide an institutional mechanism through which a more integrated approach to Centre-State relations could emerge. There would be three meetings of council on a regular basis every year, and that all questions coming up for discussion will be decided by consensus. The council will be a recommendatory body.

Statutory Transfer: Transfer of resources from Centre to States under tax devolution and Article 275 grants-in-aid at the recommendations of the Finance Commission.

Tax Effort: Judged from ratio of tax revenue to State income.

Vertical Imbalance, i.e., Vertical Federal Fiscal Imbalance: The non-correspondence between the expenditure requirements of the functions and the extent of revenue raised from the sources assigned to the unit governments as compared to the National Government in a federation.

20.14 SOME USEFUL BOOKS

Chelliah, R.J. & Associates (1981); *Trends and Issues in Federal Finance in India*, Allied Publishers, New Delhi.

——————, (2005); Realigning Central Transfers, *Economic and Political Weekly,* March 12.

Government of India (2004); *Report of the Twelfth Finance Commission*, Ministry of Finance, New Delhi.

Gulati, I.S. (edited) (1987); *Centre-State Budgetary Transfers*, Oxford University Press, New Delhi.

Gupta, B.N. (1970); *Indian Federal Finance and Budgetary Policy*, Chapters 3 and 4, Chaitanya Publishing House, Allahabad.

Jafa, V.S. (ed.) (1999); *Federal India: Emerging Economic Issues*, Indian Tax Institute, Delhi.

Lakdawala, D.T. (1967); *Union-State Financial Relations*, Lalwani Publishing House, Bombay.

Rao, C.H.H. (2005); *Essays on Development Strategy, Regional Disparities and Centre-State Financial Relations in India*, Academic Foundation, New Delhi.

Rao, M. Govind & Sen, Tapas (1996); *Fiscal Federalism in India: Theory & Practice*, Macmillan, New Delhi.

Santhanam, K. (1967); *Federal Financial Relations in India*, Lalvani Publishing House, Bombay.

Thimmaiah, G. (1981); *A Critique of the Finance Commission*, Wheeler Publishing, Allahabad.

Venkitaramanan, S. (2005); 'TFC's Report: Right Emphasis on Fiscal Deficit and Growth, *The Hindu Business Line*, March 7.

Vithal, B.P.R. and Sastry, M.L. (2001); *Fiscal Federalism in India*, Oxford University Press, New Delhi.

20.15 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) See Section 20.2

2) See Sub-section 20.3.1 to 20.3.3

3) See Sub-section 20.3.1

Check Your Progress 2

1) See Section 20.4

2) See Section 20.4 relevant portions.

3) The Finance Commission takes into account various parameters for deciding its awards. The Twelfth Finance Commission (TFC), for instance, assigned specific weights to population, income distance, poverty, geographic area and tax efforts of the states to decide the quantum of taxes that should be transferred to the states. The previous panel had considered infrastructure development also as one of the parameters. New panels can change the weight assigned to each of the parameter given changes that take place during a five year period of the award. For instance, TFC has increased the weight assigned to population size and reduced it for income distance (how much the per capita income of a state lags the highest per capita income among states).

4) See Section 20.6 relevant portions.

Check Your Progress 3

1) See Section 20.8

2) A significant change is in the quantum of resources sought to be transferred as grants-in-aid of revenues. The TFC has proposed 18.9 per cent of the transfer be in form of grants as against 13.5 per cent recommended by the Eleventh Finance Commission (EFC). This has

been done to somewhat cushion the states' fisc from the volatilities in growth of Central tax revenues. The EFC had recommended devolution of Rs. 3,76,318.01 crore as 29.5 per cent share in central taxes and duties to the states. Actual transfer fell short of this figures as the Centre's tax revenues did not grow as projected during 2000-05. Lower transfer contributed to worsening of state finances during this period. The TFC has recommended a total devolution of Central divisible taxes at 30.5 per cent as against 29.5 per cent in the earlier commission. The TFC has made a significant departure in empowering the states to borrow from the market on their own rather than have the Centre first borrow and then lend to the states. It has also recommended significant debt relief to the states, conditional on their subjecting themselves to fiscal discipline.

Table 20.1: Total Twelfth Finance Commission Transfers to States

													Grands-in-aid
States	**Share in Central Taxes & Duties (2005-10)**	**Non-Plan Revenue Deficit (2005-10)**	**Health Sector (2005-10)**	**Education (2005-10)**	**Maintenance of Roads & Bridges (2006-10)**	**Maintenance of Buildings (2006-10)**	**Maintenance of Forests (2005-10)**	**Heritage Conservation (2006-10)**	**State Specific Needs (2006-10)**	**Local Bodies (2005-10)**	**Calamity Relief (2005-10)**	**Total (Col. 3-12)**	**Total Transfers (Col. 2 + 13)**
1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**
Andhra Pradesh	45138.68				980.12	242.53	65.00	40.00	500.00	1961.00	1425.93	5214.58	50353.26
Arunachal Pra.	1767.34	1357.88			44.36	57.42	100.00	5.00	10.00	71.00	112.56	1758.22	3525.56
Assam	19850.69	305.67	966.02	1107.37	330.12	230.64	40.00	20.00	130.00	581.00	767.89	4478.71	24329.40
Bihar	67671.04		1819.69	2683.76	309.36	359.61	5.00	40.00	400.00	1766.00	592.37	7975.79	75646.83
Chhattisgarh	16285.76				262.40	183.09	85.00	10.00	300.00	703.00	444.45	1987.94	18273.70
Goa	1589.14				39.48	24.18	3.00	20.00	10.00	30.00	8.73	135.39	1724.53
Gujarat	21900.47				895.20	203.61	20.00	25.00	200.00	1345.00	1019.47	3708.28	25608.75
Haryana	6596.46				182.72	151.80	2.00	15.00	100.00	479.00	515.46	1445.98	8042.44
Himachal Pra.	3203.22	10202.38			261.64	147.60	20.00	10.00	50.00	155.00	400.52	11247.14	14450.36
Jammu & Kash.	7441.71	12353.46			117.68	164.54	30.00	10.00	100.00	319.00	343.89	13438.57	20880.28
Jharkhand	20624.02		360.98	651.73	409.04	159.61	30.00	10.00	330.00	580.00	501.46	3032.82	23656.84
Karnataka	27361.88				1458.12	205.12	55.00	50.00	600.00	1211.00	475.16	4054.40	31416.28
Kerala	16353.21	470.37			642.32	103.50	25.00	25.00	500.00	1134.00	354.32	3254.51	19607.72
Madhya Pra.	41180.59		181.64	459.56	586.88	443.02	115.00	20.00	300.00	2024.00	1011.27	5141.37	46321.96
Maharashtra	30663.19				1189.68	223.61	70.00	50.00	300.00	2774.00	923.77	5531.06	36194.25
Manipur	2221.44	4391.98			76.96	37.71	30.00	5.00	30.00	55.00	22.11	4648.76	6870.20
Meghalaya	2276.61	1796.86			86.40	35.02	30.00	5.00	35.00	58.00	44.88	2091.16	4367.77
Mizoram	1466.52	2977.79			42.12	23.29	25.00	5.00	65.00	30.00	26.19	3194.39	4660.91
Nagaland	1613.67	5536.50			120.88	46.17	25.00	5.00	45.00	46.00	15.19	5839.74	7453.41
Orissa	31669.47	488.04	196.37	323.30	1475.08	389.14	75.00	50.00	170.00	907.00	1199.37	5273.30	36942.77
Punjab	7971.00	3132.67			420.96	151.80	2.00	10.00	96.00	495.00	605.16	4913.59	12884.59
Rajasthan	34418.56			100.00	633.32	213.09	25.00	50.00	450.00	1450.00	1722.50	4643.91	39062.47
Sikkim	1392.94	188.67			18.64	32.15	8.00	5.00	100.00	14.00	69.74	436.20	1829.14
Tamil Nadu	32552.74				1214.40	242.53	30.00	40.00	300.00	1442.00	866.46	4135.39	36688.13
Tripura	2626.09	5494.20			61.48	50.11	15.00	5.00	49.00	65.00	51.12	5790.91	8417.00
Uttar Pradesh	118209.45		2312.38	4454.07	2403.16	600.28	20.00	50.00	800.00	3445.00	1177.11	15262.00	133471.45
Uttaranchal	5762.22	5114.68	50.00		324.56	97.60	35.00	5.00	240.00	196.00	369.28	6432.12	12194.34
West Bengal	43303.91	3044.72		391.86	412.92	181.23	15.00	40.00	890.00	1664.00	933.64	7573.37	50877.28
Total States	**613112.02**	**56855.87**	**5887.08**	**10171.65**	**15000.00**	**5000.00**	**1000.00**	**625.00**	**7100.00**	**25000.00**	**16000.00**	**142639.60**	**755751.62**