Karnataka State Open University
Manasagangothri, Mysore- 570 006

ಕರ್ನಾಟಕ ರಾಜ್ಯ ಮುಕ್ತ ವಿಶ್ವವಿದ್ಯಾನಿಲಯ
ಮಾನಸಗಂಗೋತ್ರಿ, ಮೈಸೂರು ೫೭೦ ೦೦೬

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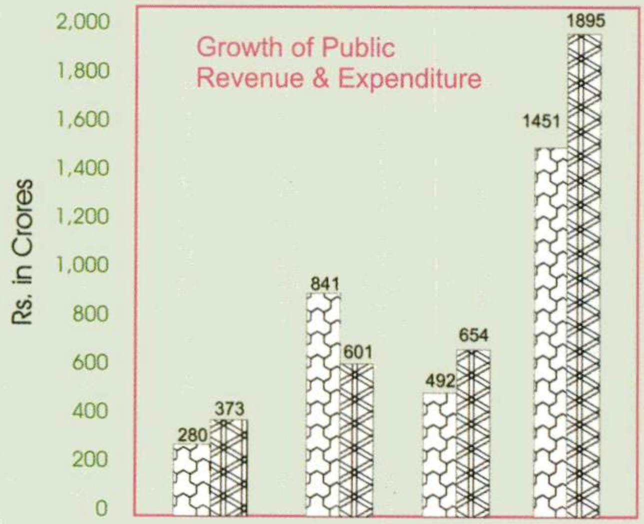
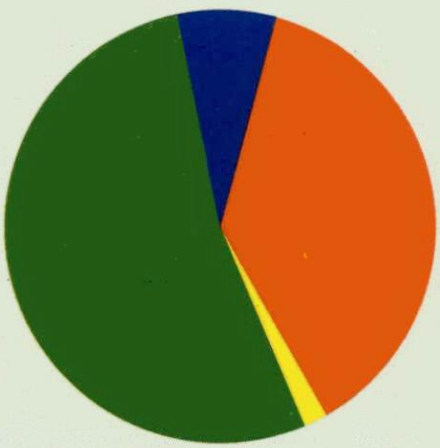
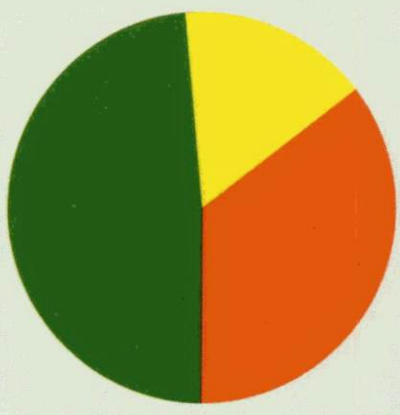
**COURSE : 4**

# M.A. (PREVIOUS)
# PUBLIC ECONOMICS




**Karnataka State Open University**

Course 4
Block 7

ಉನ್ನತ ಶಿಕ್ಷಣಕ್ಕಾಗಿ ಇರುವ ಅವಕಾಶಗಳನ್ನು ಹೆಚ್ಚಿಸುವುದಕ್ಕೆ ಮತ್ತು ಶಿಕ್ಷಣವನ್ನು ಪ್ರಜಾತಂತ್ರೀಕರಿಸುವುದಕ್ಕೆ ಮುಕ್ತ ವಿಶ್ವವಿದ್ಯಾನಿಲಯ ವ್ಯವಸ್ಥೆಯನ್ನು ಆರಂಭಿಸಲಾಗಿದೆ.

ರಾಷ್ಟ್ರೀಯ ಶಿಕ್ಷಣ ನೀತಿ 1986

*'The Open University system has been initiated in order to augment opportunities for higher education and as instrument of democrating education.*

***National Education Policy 1986***

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ಮುಕ್ತ ವಿಶ್ವವಿದ್ಯಾನಿಲಯವು ದೂರಶಿಕ್ಷಣ ಪದ್ಧತಿಯಲ್ಲಿ ಬಹುಮಾಧ್ಯಮಗಳನ್ನು ಉಪಯೋಗಿಸುತ್ತದೆ. ............................ವಿದ್ಯಾಕಾಂಕ್ಷಿಗಳನ್ನು ಜ್ಞಾನ ಸಂಪಾದನೆಗಾಗಿ ಕಲಿಕಾ ಕೇಂದ್ರಕ್ಕೆ ಕೊಂಡೊಯ್ಯುವ ಬದಲು, ಜ್ಞಾನ ಸಂಪತ್ತನ್ನು ವಿದ್ಯೆ ಕಲಿಯುವವರ ಬಳಿ ಕೊಂಡೊಯ್ಯುವ ವಾಹಕವಾಗಿದೆ.

ಡಾ. ಕುಳಂದೈಸ್ವಾಮಿ

*'The Open University system makes use of Multimedia in distance education system. .............................. it is vehicle which transports knowledge to the place of learners rather than transport to the place of learning.*

***Dr. Kulandai Swamy***

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# ಸುವರ್ಣ ಕರ್ನಾಟಕ ವರ್ಷ 2006

## ವಿಶ್ವ ಮಾನವ ಸಂದೇಶ

ಪ್ರತಿಯೊಂದು ಮಗುವು ಹುಟ್ಟುತ್ತಲೇ - ವಿಶ್ವಮಾನವ. ಬೆಳೆಯುತ್ತಾ ನಾವು ಅದನ್ನು 'ಅಲ್ಪ ಮಾನವ'ನನ್ನಾಗಿ ಮಾಡುತ್ತೇವೆ. ಮತ್ತೆ ಅದನ್ನು 'ವಿಶ್ವಮಾನವ'ನನ್ನಾಗಿ ಮಾಡುವುದೇ ವಿದ್ಯೆಯ ಕರ್ತವ್ಯವಾಗಬೇಕು.

ಮನುಜ ಮತ, ವಿಶ್ವ ಪಥ, ಸರ್ವೋದಯ, ಸಮನ್ವಯ, ಪೂರ್ಣದೃಷ್ಟಿ **ಈ** ಪಂಚಮಂತ್ರ ಇನ್ನು ಮುಂದಿನ ದೃಷ್ಟಿಯಾಗಬೇಕಾಗಿದೆ. ಅಂದರೆ, ನಮಗೆ ಇನ್ನು ಬೇಕಾದುದು ಆ ಮತ **ಈ** ಮತ ಅಲ್ಲ; **ಮನುಜ ಮತ.** ಆ ಪಥ **ಈ** ಪಥ ಅಲ್ಲ; **ವಿಶ್ವ ಪಥ.** ಆ ಒಬ್ಬರ ಉದಯ ಮಾತ್ರವಲ್ಲ; **ಸರ್ವರ** ಸರ್ವಸ್ತರದ ಉದಯ. ಪರಸ್ಪರ ವಿಮುಖವಾಗಿ ಸಿಡಿದು ಹೋಗುವುದಲ್ಲ; ಸಮನ್ವಯಗೊಳ್ಳುವುದು. ಸಂಕುಚಿತ ಮತದ ಆಂಶಿಕ ದೃಷ್ಟಿ ಅಲ್ಲ; ಭೌತಿಕ ಪಾರಮಾರ್ಥಿಕ ಎಂಬ ಭಿನ್ನದೃಷ್ಟಿ ಅಲ್ಲ; ಎಲ್ಲವನ್ನು ಭಗವದ್ ದೃಷ್ಟಿಯಿಂದ ಕಾಣುವ **ಪೂರ್ಣದೃಷ್ಟಿ.**

ಕುವೆಂಪು

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# *Gospel of Universal Man*

Every Child, at birth, is the universal man. But, as it grows, we turn it into "a petty man". It should be the function of education to turn it again into the enlightened "universal man".

The Religion of Humanity, the Universal Path, the Welfare of All, Reconciliation, the Integral Vision- these ***five mantras*** should become View of the Future. In other words, what we want henceforth is not this religion or that religion, but the Religion of Humanity ; not this path or that path, but the Universal Path ; not the well-being of this individual or that individual, but the Welfare of All ; not turning away and breaking off from one another, but reconciling and uniting in concord and harmony ; and, above all, not the partial view of a narrow creed, not the dual outlook of the material and the spiritual, but the Integral Vision of seeing all things with the eye of the Divine.

***Kuvempu***

Karnataka State
Open University

Economics
Course 4

# Block 7

Introduction

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## BLOCK INTRODUCTION

**Course : 4**
**Block : VII**
**Unit : 25,26,27,28,29,30**

The Financial problems, facing the different layers of government like the Federal, State and local Governments in a federation are referred to as the problems of Federal Finance. In any country where there is some decentralization of decision making in the public sector viz., the decision making at different layers of government the problems of federal finance do necessarily arise. These problems are often called the problems of intergovernmental fiscal and financial relations. India, as a federal country is no exception to this. In a country like India where there is strong tradition of budgetary freedom and decentralized decision making at different layers of Government, like the Union, State and local government each with a range of powers and functions within its limited jurisdiction the problem of federal finance are not only complex but complicated too.

According to the Article 280 of the constitution, the President shall appoint a Finance Commission at an interval of every five years. Besides its structural independence there are statutory provisions for its functional independence. Therefore there are specific terms of reference entrusted to the finance commissions.

Block VII has 6 Units, Unit 25 throws light on principles of multi unit finance, Unit 26 discuss Fiscal – Federalism in India. Unit 27 deals with Finance Commissions, Unit 28 studies about Resources transfer Unit 29 will concentrate on Centre – State Financial relations and Unit 30 throws light on Transfer of resources from union and state to local bodies.

**BLOCK 7 FISCAL FEDERALISM**

**UNIT 25 Principles Of Multi – Unit Finance (Federal)**

**Structure :**

## 25.0 Objectives

Our main objectives in this block is to make an enquiry into the allocation, distribution, distribution and stabilization functions of budget policy divided among units of government. The decentralized fiscal system or fiscal federalism has acquired significance both in theory and practice in the developed as well as developing countries. In a federal system, powers and functions are bifurcated between the two layers of the government and resources are placed at the disposal of the center and the units. In general, the more decentralized the government, the greater is the opportunity for expressing the desire for various kinds of government services and for obtaining the means to finance those services. In addition, government provision of services on a small scale often results in higher average costs because all economics of scale cannot be realized.

## 25.1 Introduction

Fiscal federalism is the division of taxing and expenditure functions among levels of government. Economic theory offers some insights into the consequences of alternative arrangements for supplying public goods and services and for financing them among the various levels of government. A federal system of government allows both centralized and decentralized collective choices. The more decentralized the government, the greater the opportunity to supply diverse levels and kinds of government provided services. The existence of many governmental units improves our ability to tailor the supply of public services to the wants of people. However, many public goods have only regional or local benefits and these are possible to supply in a decentralized fashion, through local government and local political institutions.

## 25.2 Principles of multi-unit finance (federal)

We must allow for the fact that fiscal operations are typically carried out by many units of government or jurisdictions. The multi unit fiscal structure as it prevails in any particular country, reflects the historical forces of nation-making, wars and geography. Typically modern nations have not been formed as a free association of individuals but have formed as a free association of individuals but have emerged by a combination of preexisting sovereign jurisdictions which then join into national units. Political history thus tells much in explaining the structure of fiscal arrangements in any one country, but not all. There are also good economic reasons why certain fiscal functions should be operated on a more centralized level while others should be decentralized. Historical influences aside, we may consider what spatial fiscal structuring would be desirable if the arrangement could be determined on the grounds of economic considerations only. Taking each of the three major functions-allocation, distribution and stabilization we will begin with this efficient setting as our basic model.

To focus on economic efficiency in the provision of public services, we assume that a group of people, having landed on a new planet, consider what spatial fiscal arrangements should be made. We also suppose that individuals will permit their location choices to be determined by fiscal considerations. The question is whether social goods and services should be provided on a centralized or a decentralized basis. To simplify the analysis, let us assume that the governmental structure of the nation consists of both a central government, whose jurisdiction covers the entire nation, and a services of smaller (both in terms of population and area) units contained therein, our problem is to assign the jobs of government to either the central government or the local governments.

The crucial features which was noted already in our discussion of social goods is that of spatial limitation of benefit incidence. Some social goods are such that the incidence of their benefits is nationwide. While others are geographically limited. Even though some services call for nationwide, others for statewide and still others for metropolitan-area-wide or local units, the arrangement so far does not call for an ordering of higher - level and lower-level governments. Rather we are faced with co ordinate units covering regions of different sizes. The theory of multiunit finance must provide an answer to the question of what constitutes the optimum number of fiscal communities and the number of people within each community. The first step, involving the choice of optimum size for a given service level and we assume that a given level of social goods is provided at a given cost. The second step is to determine the optimal service level for any given group size. The model of efficient design thus calls for multiple fiscal units differing in size and regional scope. Some will be nationwide while others will be quite local.

If we assume all tastes to be the same, local fiscal units will be similar but tastes differ. The resulting structures of fiscal units will differ also because people have different incomes. We must allow for the important fact that local goods are frequently or even typically goods provided by the muncipal government yet they do not meet the precise criterion of non rival consumption. But provision of public services may also be subject to technical economics of scale. Actually, benefits may not be uniformly distributed within any one space, and benefits from services provided by one particular jurisdiction may spill over into another jurisdiction. We now find that there may be another way, namely, voting by feet. If we stipulate that each community is to depray its own cost of public services, individuals will find it in their interest to choose such communities s will suit their particular preferences.

The central or national jurisdiction may conveniently use a broad-based income tax service all people benefit and hence should contribute. The choice of tax instruments to be used by local jurisdiction in turn should conform to the rule that each jurisdiction pay for it, own benefits. Many governmental programmes are specifically designed to redistribute income from people who are considered well off to those who are less fortunate. If redistribution were made a local function, each locality could establish a redistribution programme most in harmony with its own wishes can a similar multi unit case be made for the distribution fuction? Those favouring a high degree of redistribution might favour imposing a progressive income tax and transfer system for the finance of public services.

It remains to note that responsibility for stabilization policy cannot be left to local or regional fiscal units but must conducted in a central position. Local fiscal units will be ineffective in dealing with unemployment or inflation, because markets are interrelated so that leakages result, counter cyclical economic policy would also appear a function better left to the central government. Local governmental units are most important in helping provide an efficient allocation of resources. The decentralization theorem establishes a presumption in favour of a system of local choice. However, modrilidy and migration can also result in crowding are necessary in a federálism. Conditional grants-in-aid from the central government to state and local governments and from the state to local governments are needed to finance the external or spill over effects of locally run programmes. Unconditional grants-in-aid also have their place in the system. Empirical evidence suggests that conditional grants will indue more local spending than will unconditional grants.

**UNIT 26 : Fiscal Federalism in India – Vertical and horizontal imbalances – Assignments of function and sources of revenue – Constitutional provisions**

**Structure :**

## 26.0 Fiscal Federalism in India

According to the federal principle the powers are divided between the federal government and the federating units in such a way that the central and state governments are within one's sphere, co-ordinate and independent. Ours is a system of federal finance, with center and states sharing responsibilities and resources. The areas of the governments budgetary operation (i.e. receipts and expenditures) between the center and the states are demarcated. In addition there take place financial transfers from the center to the states. Federalism in India has evolved over the years in two ways (i) by aggregation and (ii) by devolution. A federal state may be constituted by aggregation or linking together of several sovereign states, through a treaty, for achieving certain common economic and/or political objectives.

The fundamental principle underlying a federation is that it envisages a fair distribution of powers between the central and the state governments. The functions which are of national importance or of general interest such as foreign affairs, defence, transport and communications and currency regulation, are normally retained by the central government and those subjects like education, public health, maintenance of internal law and order are left to the state governments. India has chosen a federal structure in which a clear distinction is made between the union and state functions and sources of revenue, but the residential powers belong to the center. Although the states have been assigned certain taxes which are levied and collected by them; they also share in the revenue of certain union taxes, and there are certain other taxes which are levied and collected by the union but the proceeds of which wholly go to the states.

In practice, Indian federation is a co-operative federalism, where the two layers of government do not have completely exclusive functions. Quite often, certain subjects of state jurisdiction are co-ordinational on a national level like that of labour legislation and flood control measures, and the power of co-ordination is vested in the central government. A federal constitution defines functions and authorities of the two governments. As a result there is decentralization of power followed by decentralization of finance and resources. The study of federal finance, thus relates to the principles and problems of finance – the division of resources in a federal system of government. Amongst the important functions assigned to the union government in India aredefence, foreign affairs, shipping navigation and aviation, national highways, posts and telegraphs, telephones, broadcasting etc means of communications, currency and coinage, banking and insurance, foreign trade, inter-state trade and commerce, etc. The states have been assigned police, public order, public health, sanitation, hospitals, education, irrigation, forests inter-state trade and commerce etc. The spheres of concurrent jurisdiction are criminal law, bankruptcy and insolvency, economic and social planning, industrial and labour disputes, labour welfare, social security and social insurance, price control, etc.

Since India has a federal constitution, inter-governmental financial problems are fundamental to

Indian Public finance. The constitution of India specifies the following allocation of resources between the union and state governments. Union sources of revenue such as taxes on income, corporation tax, custom duties, estate and custom duties, taxes on the capital value of assets and sources of state governments such as land revenue, taxes on the sale and purchase of goods, taxes on agricultural income, excise duties, taxes on land and buildings, irrigation duties, taxes on road vehicles etc. There are however duties levied by the union but collected and appropriated by the states eg. Stamp duties, duties or excise on medical and toilet preparations. Likewise there are taxes which are levied and collected by the union but which are assigned to the states within which they are levied eg. Succession and estate duties in respect of other than agricultural land, terminal taxes, taxes on railway fares etc.

Division of sources of revenue between the federal and state governments are generally based on the functions of the two authorities and the expenditure required to be incurred by then in discharging these functions. The underlying principle is that such taxes which affect the economic life of the entire nation should be levied by the federal government. Thus, custom duties, taxes on business incomes and corporations etc are levied by the center. This prevents the chances of double taxation and tax evasion. Taxes which have no effect on other states, such as land revenue, are assigned to the state governments. Now let us critically examine how far the distribution of resources between the center and the states, as has been laid down, is in confirmity with the principles of federal finance. The basic criteria of a sound federal finance are fiscal self-reliance, obsticity, operational efficiency and administrative responsibility. The above allocation is defective is so far as fiscal self-reliance is concerned, because the state resources are inadequate. Likewise state resources are relatively stationary too. But from efficiency and responsibility points of view, the allocation seems to be satisfactory, It is however obvious that the allocation seems to be satisfactory. It is however, obvious that the allocation exposes central domination. The states are financially weak and have to rely on central assistance and aid to balance their budgets.

In India, the constitution provides for division of financial powers between the center and the states. However the revenue – raising capacity of the states is restricted because of the nature of taxes assigned to them. The strong center and the weak states arrangement was introduced intentionally by the frames of the constitution in a bed to stall the devisee forces operating in the economy. The partition and its after effects created a strong public union in favour of such an arrangement. All these processes in the political field have considerably eroded independence of the states and their political and economic powers. Therefore, quite recently in the Indian fiscal federalism, demands for increase in state autonomy have been raised by various quarters.

We have noted earlier that transfer through the finance commission contribute only about one-third of total transfer from the center to the states. Since the center discretionary grants to the states, it acquired considerable powers to affect the decision making processes at the state level. This led to a further erosion of processes at the state level. The process of resource transfers through the Planning Commission and the Finance Commission has failed in correcting the horizontal imbalance among the federating units and disparities in their per-capita incomes are growing. As far as transfer through Finance Commissions are concerned, all Finance Commissions sought to give due importance to backward states. However, there was not a clear cut bias in favour of backward states. The ultimate result was that advanced states concerned a major share of the actual devolution of resources from the center to the states in the awards of many Finance Commissions. All Finance Commissions gave undue importance to budgetary needs while deciding the allocation of grants-in-aid.

## 26.1 Vertical and Horizontal imbalances

The decentralized fiscal federalism or fiscal system has acquired significance both in theory and practice in the developed as well as developing countries. Not withstanding some trends in a federal system, powers and functions are bifurcated between the two layers of the government and resources are placed at the disposal of the centre and the units on the basis of principle of efficiency, suitability, adequacy, integrity, administration, economy, independence, responsibility, uniformity or non-discrimination, elasticity, minimum tax competition or tax conflicts and counter cyclical or stabilization adjustments. In the background of assignment of functions and sources or revenues, it results in the vertical and horizontal imbalances of Indian fiscal federation.

There has been an ever expanding gap between the center and states due to the financial centralism and states dependence on the center has also increased. The revenue raising capacity of the states is restricted because of the nature of taxes assigned to them. Because of the economic progress registered by the country in the last three decades, the base of income tax, union excise duties, customs duties and other important central taxes has expanded considerably. This has given immense powers to the central government to increase its resources with the passage of time. This structure of financial relations between the center and the state government – less elastic sources of revenue for the states and more elastic sources of revenue for the center – places the states at a distinct disadvantage. While demands on the states resources are increasing rapidly because of the pressure of development services, especially in the field of social welfare, their income has failed to increase correspondingly. Accordingly vertical imbalances have accentuated over the years and the dependence of the state governments on the center has considerably increased.

This has made them vulnerable to increasing pressures from the central government to low its lines. Where the state government belongs to a different political party these pressures give rise to open conflict seriously jeopardizing the effectiveness of the policy measures introduced by the concerned state government.

Under fiscal federal scheme of the Indian constitution, there is a gawning gap between fiscal needs of the states and their revenue thereby, placing them under continuous subservience to the center on whom they chronically rely for covering their deflects. The existing financial arrangements have produced constant surpluses for the center and persistent deficit for states. The basic criteria of a sound federal finance are fiscal self-reliance, elasticity, operational efficiency and administrative responsibility. The above allocation is defective is so far as fiscal self-reliance is concerned, because the state resources are inadequate. The states are financially weak and have to rely on central assistance to balance their budgets. Very often it is argued that the financial provisions of the constitution have put all taxation except land revenue and one or two diminishing items like excise on intoxicating liquors in federal list. While no one denies the importance of a strong center for preserving the integrity of the nation, it is necessary certain amount of autonomy, at least in the sphere originally contemplated by the constitution, is necessary to fulfil the democratic ambitions of the people. A strong center without strong states is not conceivable. Because of the vertical imbalance the states have been demanding autonomy in the fiscal federalism of India.

The flow of discretionary grants under article 282 induce the states to voluntarily complete complete the vicious circle. For eg. these are at the instance of the planning commission, issued by different ministers, matching type, control inspection, supervision for the plan period at the end of which become committed expenditure for which states are responsible and they approach for finance. The vertical fiscal imbalances for the Indian type expands rather than contracts due to the constitutional scheme. The so-called deficit-financing and external assistance are the exclusive rights of the center.

Besides the vertical imbalances, there are also horizontal imbalances in the Indian fiscal federalism which may be attributed to the nature of distribution, the nature of attributed to the nature of distribution, the nature of the formulae adopted for the inter-redistribution, irresponsibility of the states themselves and the unproductive use of resources which describe the growing gap between the poor and rich states. The process of resources transfer through the Planning Commission and the Finance Commission has failed in correcting the horizontal imbalance among the federating units and disparities in their per-capita incomes are growing. We have already noted that plan assistance is provided 70 percent in the form of loans and 30 percent in the form of grants. Since the ratio is a fixed one and does not discriminate between advanced and backward states, it amounts to discrimination against backward states. Since advanced states have a relatively better economic position they should be granted a greater percentage of resources in the form of loans while backward states should receive a larger percentage in the form of grants. Non-compliance to this common sense logic has resulted in a paradoxical situation where the comparatively richer states received a higher per-capita grant than poorer states. For eg. during 1969-70, rich states like Punjab and Haryana received a higher per capita grant than the poor states like Uttar Pradesh, M.P, Bihar, and Andhra Pradesh with lowest percapita income also received the lowest percapita grant.

The four advanced industrial states Maharastra, Gujarat, Tamilnadu and West Bengal obtained more than one-third of total, income transfer in the awards of many Finance Commissions. All Finance Commissions gave undue importance to budgetary needs while deciding the allocation of grants –in- aid. They did not realize that advanced states could also incur large budgetary deflects (even deliberately at times) and qualify for larger grants-in-aid. This led to a paradoxical situation in some instances as richer states got more grants –in – aid as compared to poorer states. Another constitution of resource transfer namely discretionary grants is not guided by any district philosophy of helping the poorer states to a greater extent. It is guided more by political considerations than by anything else. In any case, discretionary grants also did not seem to have helped the backward states more vis – a – vis the advanced states.

There are also imbalances associated with the very formulae of distribution. For eg. under the existing criteria, during the period of more than 40 years of fiscal federalism, quite strangely, the tax devolutions have been only 30 percent and grants have been about 28 percent while the loans taking a lion share of more than 40 percent. A closer look at the past would only reveal that there were more loans than other transfer from the centre. It should also be noted that the population and level of development are adopted for the distribution of resources. This has been good in theory but has worked against the poor states in reality. The existing horizontal imbalances may also be attributed to the irresponsibility of states themselves. Poor states which suffer from poverty lethargy in resource mobilization, poor services to the people, inefficient administration etc. The rich states manage to repay the loans and become eligible for more loans whereas poor states are denied of this.

## 26.2 Assignment of function and sources of revenue – constitutional provisons

The centre – state relations in general are governed by the Government of India Act 1935. According to this Act, the functions are divided into the central list, the state list and the concurrent list. India has chosen a federal structure in which a clear distinction is made between the union and state functions and sources of revenue but the residual powers belong to the centre. In addition, the states receive grants –in – aid of their revenue from the union which further increase the amount of transfers between the two levels of governments. The transfer of resources from the central government to the states is an essential feature of the present financial system. Besides, the centre enjoys all the residuary powers indeed unaccountable. Therefore, it is argued that it is a cold blood attempt of the fathers of constitution in a bid to stall the division forces operating in the economy.

The constitution of India makes a clear division of fiscal powers between the union and the state governments. The principles adopted for this classification is that taxes which have an interstate base are levied by the union, while those with a local base are levied by the states. The residuary powers belong to the union. Thus the Indian constitution, being federal in character, has indicated the nature and scope of functions of the Union and State governments and also the taxes allocated to them. At the same time, the frames of the constitution were aware that the allocation of financial resources did not correspond with the assigned functions and that the resources from the centre to the states. It was specifically for this purpose that Article 280 provides for the setting up of a Finance Commission by the president every five years or earlier.

The partition and aftermath effects further re-iterated the trend of strong centre and weak states. The one party rule at the centre and the other at states too has cemented this trend in India. With its strong base, unlimited powers of centre has been interfering in the governments of the states. The encroachment has been practically the order of the day. There is a widespread demand for autonomy at least to satisfy the democratic ambitions of the people.

Apart from the taxes levied and collected by the states, the constitution has provided for the revenues for certain taxes on the union list to be allocated, partly or wholly, to the states. These provisions fall into various categories. There are, in the first place, certain duties which are levied by the union but are collected and appropriated by the states. Secondly there are certain taxes which are levied and collected by the union but the entire proceeds of which are assigned to the states, in proportion determined by the parliament: Thirdly central tax on income and union excise duties are levied and collected by the union but are shared by it with the states in a prescribed manner. Finally, the proceeds of additional excise duties are wholly distributed among the states in a manner as to guarantee their former incomes from the displaced sales taxes. The Article 268 refers to the duties levied by the union, but collected and appropriated by the states. Article 269 refers to the list of taxes levied and collected by the union but assigned to the states. Article 270 refers to income taxes that are levied and collected by the union and mandatorily shared with the states. Article 272 provides a permissive provisions for the sharing of union excise duties with the states. Article 275 has indicated grants – in – aid revenues of states (or known as gapfilling approach). Articles 280 and 282 are plan and discretionary grants. Article 292 provides for loans from centre to the states Article 293(1) empowers the states to borrow on security of their consolidated fund and it also contains the provisions that the centre can stand guarantee to the state loans. This is a unique feature Indian fiscal federalism.

An important welfare and development functions are entrusted to the states gaps between their revenues and expenditure have to be corrected through transference of resources from centre. This is done partly by arrangements for tax sharing. But grants-in-aid by the union for specific purposes or general aid have come to occupy an important place in Union – state financial relations in India. The grants also serve the purpose of correcting inter-state disparities in resources. They also help in the exercise of a certain measure of central control and co-ordination over essential welfare services and development programmes in different states. The states are authorized to raise loans in the market but they also borrow from the union government which gives the latter considerable control over state borrowing and expenditure. The rate of annual borrowing by the states from the union has considerably increased during recent years. Borrowing is made among other purposes for irrigation and river programmes, agricultural development rehabilitation, community development and industrial housing. The states also deposit with the union government certain state and local funds which are in effect loans by the centre and used for general purposes.

Financial resources transferred from the centre to the states are of three types : taxes, grants and loans. Resources transferred from the centre to the states have increased continuously during the planning period. In fact resources transferred during each plan in nominal terms were twice or more as compared to the previous plan. The share of these transfers in aggregate expenditure of the state governments has varied between 35 percent and 45 percent. This clearly brings out the heavy dependence of the state governments on the centre.

Before the question of division of taxes and duties arises, it is necessary to determine the basis of division and the amount that should be divided. The Indian constitution recognised that due to changing needs and circumstances it might become necessary to change the criteria and amount of division between the two levels of government (centre and state) from time to time. Hence it did not lay down any hard and fast rules in this regard. Instead it provided for the appointment of a Finance Commission at the expiry of every fifty year or earlier, if necessary, to investigate these questions. The commission is appointed under Article 280 of the constitution and is entrusted with the task of recommending the distribution between the union and the states the net proceeds of taxes, the principles which should govern the grants-in-aid of the revenue of the states out of the consolidated fund in India, any other matter referred to the commission by the President in the interests of sound finance. Thus broadly there have been principles which have influenced the sharing of resources between the centre and the states on the one hand and among the states on the other. With regard to the first aspect it is largely the fiscal needs of the states as indicated by the revenue gaps of their budgets. An insofar as the distribution among states influencing factors are population, poverty backwardness contributions and residual gap.

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# Unit 27 : Finance Commission

**Structure :**

27.0 Finance Commission

27.1 Devolution & grants -in-aid

## 27.0 Finance Commissions

Under the provision of Article 280 of the constitution, the president is required to appoint a Finance Commission for the specific purpose the devolution of non-plan revenue resources at an interval of every five years. Besides the structural independence, there are statutory provisions for its functional independence. Therefore there are specific terons of reference entrusted to the Finance Commissions. As per these provisions, the commission joys a greater independence and has very dynamic role to play in the Indian fiscal federalism. The function's of the commission are to make recommendations to the President in respect of (i) the distribution of net proceeds of tax , to be shared between the union and the states and the allocation of share of such proceeds among the states,

(ii) the principles which should govern the payment by the union of grants-in-aid to the revenues of the states and (iii) any other matter concerning financial relations between the union and the states. The appointment of the Finance Commission is of great importance, for it enables the financial relation between the centre and the units to be altered in accordance with changes in need and circumstances. The elasticity in relationship introduced by this provision has great advantage.

It is noted in the provisions further that the commission itself will decide the share between the centre and the states. So far eleven finance commissions have concluded their tasks. In fairness, it may be said that each commission has had a unique role. However if one goes by the actual magnitudes of distributions, quite a few undesirable facts emerge. In particular (i) there have been more grants than the statutory or tax devolutions, (ii) if compared between taxes/duties/devolutions, grants and loans, it appears that there are more loans than grants or taxes and (iii) the devolutions have not only been of lower magnitude, they are almost constant at 30 percent (iv) the criteria of distribution on the other hand has been to the disadvantage of poor states (v) the discretionary grants have further widened the gap. Therefore it has been realized by now that the role of finance commission should be enhanced at the same time reducing the role of planning commission. Some have also felt that there should not be a permanent finance commission to assist the states and the changes in the criteria of distribution are also considered as essential to reduce regional imbalances.

Eleven Finance Commissions have so far been appointed by the Government since the inauguration of the constitution in 1951. The recommendations of the Finance Commissions can be grouped under three heads – Division and Distribution of income tax and other taxes, Grants – in – aid and centers loans to states. The personal income tax is imposed and collected by the Union Government but the net proceeds are shared between the centre and the states under Article 270 of the Indian constituion. The Finance Commissions have to give their award on two points (a) the share of the states in the total collection of income tax and (b) the principle/principals which should govern the share of each state in the divisible pool. The First Finance Commission recommended that the states should share 55 percent of the proceeds of the income tax. But the successive Finance Commissions had raised the states share in income tax to the level of 85 percent (7th, 8th and 9th). However the Tenth Finance Commission recommended 77.5 percent of the net proceeds of taxes on income should be assigned to states.

**Table . 1 Recommendations of Finance Commissions on Income Tax**

| Finance Commission | State Share of income tax | Distribution of Income tax to the states on the basis of Population and other criteria | Tax Contribution |
|---|---|---|---|
| First | 55 | 80 | 20 |
| Second | 60 | 90 | 10 |
| Third | 65 | 80 | 20 |
| Fourth | 75 | 80 | 20 |
| Fifth | 75 | 90 | 10 |
| Sixth | 80 | 90 | 10 |
| Seventh to Ninth | 85 | 90 | 10 |
| Tenth | 77.5 | 90 | 10 |

**Source : Finance Commission Reports.**

The Tenth and Eleventh Finance Commissions evaluated the formulated of earlier Finance Commissions and introduced the following formulae/criteria to determine the shares of the different states in the shareable proceeds of income tax.

| X Finance Commission | XI Finance Commission |
|---|---|
| a) 20 percent on the basis of population of 1971 | a) 10 percent on the basis of population |
| b) 60 percent on the basis of distance of per-capita income of a state from that of the state having the highest income | b) 62.5 percent on the basis of distance of per-capita income of a state |
| c) 5 percent on the basis of area adjusted | c) 7.5% on the basis of area |
| d) 5 percent on the basis of index of infrastructure | d) 7.5% on the basis of index of infrastructure |
| e) 10 percent on the basis of tax effort | e) 5% on the basis of index of tax effort |
| | f) 7.5% on the basis of fiscal discipline. |

It is necessary to emphasize here that all Finance Commission kept one basic objective, that is to increase the share of the states in the proceeds of central excise duties. The first few commissions brought in more and more central excise duties under the divisible pool but reduced the percentage share of the states. The seventh and subsequent Finance Commissions however have (a) brought all the central excise duties under the divisible pool and (b) raised the share of the states from 20 percent to 40 percent and then finally to 47.5 percent.

**Table 2. Recommendation of Finance Commissions on Excise Duty**

| Finance Commission | States share of Excise duty | Distribution of Excise duty on the basis of population | on the basis of backwardness of the states |
|---|---|---|---|
| First | 40% of 3 duties | 40 | 60 |
| Second | 25% of 8 duties | 40 | 60 |
| Third | 20% of 35 duties | 40 | 60 |
| Fourth | 20% of 45 duties | 80 | 20 |
| Fifth | - Do - | 80 | 20 |
| Sixth | - Do - | 80 | 20 |
| Seventh | 40% of all duties | 25 | 75 |
| Eight | 40% of all duties | 25 | 75 |
| Ninth | 45% of all duties | 25 | 75 |
| Tenth | 45% of all duties | 20 | 80 |

**Source : Finance Commission Reports**

As regard the distribution of the proceeds of central Excise duties among states, the Finance Commissions had initially adopted two criteria namely the population of the state and the backwardness of the states. After seventh Finance Commission, later Finance Commissions introduced new formulae including per-capita income of the state, and income equalization. Other states being shared are additional excise duties, grant in lieu of tax on passenger fares.

## 27.1 Two devolution and Grants – in – aid

As regards the basis for the distribution of the states pool of income tax proceeds among the states, the first few commissions had used the double criteria of population and tax collection. The first Finance Commission, for instance, recommended the allocation of income tax proceeds on the basis of 80 percent and 20 percent for population and tax collection. This criterion benefited populous states as well as those richer states which contributed more income tax revenue. The Second Finance Commission regarded population of a state as a more important basis for distribution and accordingly awarded that 90 percent of the states divisible pool of income tax should be distributed on the basis of population.

This criterion naturally favoured populous states like U.P and Bihar which were the poorest states in India. This was reversed by the Third and Fourth Finance Commissions which raised the share of collection to 20 percent and thus gave greater share to states like Maharastra and West Bengal which contributed most of the collection of income tax. From the Fifth Commission onwards, population had gain become the major criterion for distribution of income tax proceeds among the states.

List II of the seventh schedule of the Indian constitution has entrusted important welfare and development functions to the states but the various tax resources provided to the states in the constitution were found to be inelastic and wholly inadequate. It was to overcome this problem that the constitution provided for a mechanism of grants from the centre to the states. Grants-in-aid may take the general form of aid to overcome current revenue deficits or to correct inter-state disparities in resources. Grants – in – aid may be for specific purposes such as the promotion of education in a backward state or for toning up of administration, and so on. Articles 275 and 282 of the constitution deal with the question of grants – in – aid. Grants under Article 275 are given to the states in need of assistance and their quantum is decided by the Finance Commissions. As against this, grants under Article 282 can be given for any public purpose and their quantum is fixed by the Union Government on its own discretion. A summary of the recommendations of the Finance Commissions on the grants-in-aid is given below.

| **Finance Commission** | **Grants-in-aid** |
|---|---|
| First | (i) for 7 States to cover their deficits. |
| | (ii) for 8 states to improve premier education. |
| Second | larger grants – in –aid for meeting developmental needs of states. |
| Third | (i) Rs. 550 crores to cover revenue expenditure. |
| | (ii) Rs. 45 Crores for communication. |
| Fourth | Rs. 610 crores to cover deficits. |
| Fifth | Rs. 638 Crores to cover deficits. |
| Sixth | Rs. 2510 crores to cover non-plan deficits of 14 states. |
| Seventh | Rs. 1600 crores to cover deficits and upgrade the standard of administration. |
| Eight | (i) Rs. 1556 crores to cover deficits |
| | (ii) Rs. 915 crores to upgrade administration. |
| Ninth | (i) Rs. 15,017 crores to cover deficits. |
| | (ii) Rs. 603 crores towards calamity relief fund |
| | (iii) Rs. 122 crores victims of Bhopal gas leak |

| | | |
|---|---|---|
| Tenth | (i) Rs. 7580 crores to cover deficits | |
| | (ii) Rs. 1360 crores towards social services | |
| | (iii) Rs. 1250 crores special problems of states. | |
| | (iv) Rs. 4730 crores for calamity relief | |
| | (v) Rs. 5380 crores to local bodies. | |
| Eleventh | (i) Rs. 35,359 crores to cover deficits. | |
| | (ii) Rs. 4,793 crores to upgrade administration | |
| | (iii) Rs. 10,000 crores to local bodies | |
| | (iv) Rs. 4730 crores for calamity relief. | |
| | (v) Rs. 5380 crores to local bodies. | |

It will be observed from the above summary of recommendations regarding grants-in-aid, that every finance commission till the sixth Finance Commission-increased the amount of grants-in-aid to the states. There were two basic reasons for this (a) the finance commissions realized that the states required increasingly larger resources to meet their evergrowing public expenditure on law and order, welfare and development. (b) despite larger transfer of the resources to the states, the latter were incurring huge revenue deflicits. Accordingly, the successive finance commissions awarded larger grants by way of centre's contribution to the calamity relief fund, upgraded of certain services, special problems and local bodies.

With regard to the loans by the centre to the states the Second Finance Commission was asked to go into the question of centre's loans to states which were mount rig as for instance from Rs. 195 crores in March 1951 to Rs.900 crores by March 1955. The Second Finance Commission recommended that the states should be entitled to only two loans a year, a long-term loan and a medium term loan at a rate of interest approximately equal to the rate of interest at which the central government was borrowing from the market. The Fourth Finance Commission suggested the formation of a competent body of study in detail the entire problem of indebtedness of states but nothing come out of this suggestion. The Fifth Finance Commission strongly recommended that the states should as a matter of necessary fiscal discipline, balance their budgets and manage their affairs within the resources available to them. The commission was of the view that overdrafts were untenable in principle and undesirable in practice, that the states should not indulge in deficit financing and that balanced budgets and expenditure control must be the sheet anchor of their fiscal policy. The sixth Finance Commission made a detailed study of debt position of the states and recommended the consolidation and spreading out of repayment over 15 to 30 years. The finance commissions only recommended writing – off of some loans and rescheduling some portion of them. The Ninth Finance Commission was against such steps and asked states to be careful and exercise restraint in incurring additional debt.

**Table 3 : Resources transferred from the centre to the states through Finance Commissions.**

| Finance Commission | Tax Devolution | Grants – in-aid | Total |
|---|---|---|---|
| First | 371.3 | 50.0 | 421.3 |
| Second | 822.4 | 197.2 | 1019.6 |
| Third | 1067.5 | 250.4 | 1317.9 |
| Fourth | 1328.0 | 421.8 | 1749.9 |
| Fifth | 4643.0 | 710.7 | 5353.7 |
| Sixth | 8250.6 | 2509.6 | 10760.2 |
| Seventh | 19297.06 | 1609.91 | 20906.97 |
| Eight | 35683.00 | 3769.00 | 39452.00 |
| Ninth (1989-90) | 11785.64 | 1876.78 | 13662.42 |
| (1990-95) | 87882.00 | 18154.43 | 106036.43 |
| Tenth | 206343.00 | 20300.30 | 226643.30 |
| Eleventh | 376318.01 | 58587.39 | 434905.40 |

**Source : Finance Commission Reports**

Table 3 gives the magnitude of transfer of resources through the various finance commissions. This table reveals the substantial increase in resources transferred from the centre to the states. In addition transfer of resources from the centre to the states. In addition transfer of resources from the centre to the states according to the recommendations of the Finance Commission, there are two other sources of transfer (a) assistance for plan purposes from the planning commission and (b) discretionary grants from the centre to the states which reflect considerable power of the Central Government in decision making process at the state level.

## Unit 28 : Resource transfer from Union to States – criteria of transfer of resources.

**Structrue :**

28.0 Resource transfer from Union to State.

28.1 Criteria of transfer of resources

## 28.0 Resource transfer from Union to state

India has chasere a federal structure in which a clear distinction is made between in the Union and State functions and sources of revenue, but the residual powers belong to the center. Although the states have been assigned certain taxes which are levied and collected by them, they also share in the revenue of certain union taxes , and there are certain other taxes which are levied and collected by the Union but the proceeds of which wholly go to the states. In addition, the states receive grant-in-aid of their revene from the union which further increase the amount of transfers between the two levels of governments. The transfer of resources from the contral Government to the states is an essential feature of the present financial system. Since finance is the life blood of a government, some of the most important problems arise in that sphere are the division of tax powers and the evolving of the modes of adjustment of finances between center and the states to keep there is equilibrium. Whereas the finances of a unitary state are integrated and can therefore be regulated and conducted on a set of consistent principles those of a federation are subject of decision making at two or more levels and thus the need for co-ordination and central intervention to bring about efficient rdutions.

Resources transferred from the center to the statges have cricreased continuqusly during the planning period, In fact, resources transferred during each plan in nominal terms were twice of these transfers in aggregate expenditure of the state governments has varied between 35 percent and 45 percent. This clearly brings out the heavy dependence of the state governments on the center.

**Table:1. Financial Resources transferred by the center to the states**

| Period | shared Taxes | Grants | Loans | total | Transferred resources as % of states total Expenditure |
|---|---|---|---|---|---|
| 1951-51 | 50 | 30 | 70 | 150 | 25 |
| First Plan | 340 | 290 | 800 | 1430 | 36 |
| Second plan | 670 | 790 | 1430 | 2870 | 42 |
| Third Plan | 1200 | 1300 | 3100 | 5650 | 43 |
| Fourth plan | 4560 | 3830 | 6710 | 15,100 | 37 |

| | | | | | |
|---|---|---|---|---|---|
| Sixth plan | 23730 | 15670 | 14120 | 53320 | 64 |
| Seventh | 49460 | 42810 | 31260 | 123530 | 43 |
| For the period 1990-95 | 98?90 | 90720 | 54650 | 244260 | 43 |

**Source: Finance commission Reports.**

The importance of central contributions to state resources becomes clear from table 1 showing the transf[illegible] in broad categories since the inception on economic planning. The figures indicate the rising contribution of the cdentre to state resourcer. On an average, the states received Rs.280 crores per year from the center during the first plan, Rs.570 crores per year from the center during the first plan, Rs.570 croerres per year during the second pland,Rs.1130 crores per year during the Third plan, Rs.3020 crores per year during the fourth plan, over Rs.10,000 crores per year during the sixth plan period and Rs. 21,000 crores per year duering the seventh plan. For the period 1990-95 the states received on an average Rs.55,000 crores per year from the center as a part of resource transfer.

In 1951-52, 25 percent of the state expenditure was met by resources transferred by the center. During second and Third plans 42to 43 percent of the expenditure of states was met out of the resources transferred from the union to the states, currently transferred resources from the center pay for 46 percent of the total expenditure of the states. The growing transference of resources from the center to the states is evidence of (a)increasing integration between the central and state finance (b) helpless dependence of states on the center and (c) growing power and interface of the center in the affairs center to the states are of three types: taxes, grants and loans. Among the taxes, the states share of union excise duties has been showing the largest rise. This is due to the increase in the number of items in the list of divisible excise duties. The states' share of taxes and duties as a whole has been expanding due to the increasing yields of various taxes also. The large increase in grants from the center indicates the growing revenue requirements of states. Loans have registered only a modest increase.

**Table.2 Relative contribution of different sources of transfer of resources from the union to the state**

| Period | Taxes and duties | Grants | Loans | Total |
|---|---|---|---|---|
| First plan | 24.0 | 20.1 | 55.9 | 100.00 |
| Second Plan | 23.2 | 27.5 | 49.2 | 100.00 |
| Third plan | 21.4 | 23.3 | 55.3 | 100.00 |
| Three annual plans | 24.0 | 26.0 | 50.0 | 100.00 |
| Fourth Plan | 30.2 | 25.4 | 44.4 | 100.00 |
| Fifth plan | 32.5 | 32.2 | 35.3 | 100.00 |
| Annual Plan(79-80) | 40.6 | 27.3 | 32.1 | 100.00 |
| Sixth plan | 36.3 | 27.4 | 36.3 | 100.00 |
| Seventh Plan | 35.2 | 29.9 | 34.9 | 100.00 |
| 1990-91 | 34.4 | 31.3 | 34.3 | 100.00 |
| 1991-92 | 37.3 | 34.1 | 28.6 | 100.00 |
| 1992-93 | 40.0 | 34.5 | 25.5 | 100.00 |
| 1993-94 | 38.6 | 36.5 | 24.9 | 100.00 |
| 1994-95 | 39.4 | 31.8 | 28.8 | 100.00 |
| 1995-96 | 42.2 | 30.7 | 27.1 | 100.00 |
| 1996.97 | 43.1 | 28.5 | 28.4 | 100.00 |
| 1997-98 | 42.4 | 28.9 | 28.7 | 100.00 |
| 1998-99 | 37.7 | 24.6 | 37.7 | 100.00 |
| 1999-2000 | 46.5 | 31.0 | 22.5 | 100.00 |
| 2000-2001(RE) | 46.5 | 34.5 | 19.0 | 100.00 |

**Source: Government of India. India – 2002**

The relative contribution of the three sources of transfer as given in table 2 over the years the largest transfer has been via taxes and duties followed by loans and grants.

There are some irking problems in the centra state financial distribution of resources even offer the award of eleven successive finance commission. These problems relate to overdrafts, loans, deficit, less tax effort and the transfers from planning commission. There are also inter-state problem of distribution as well. The most crucial problem of the center-state relations is the debt burden and the debt servicing liability of the states. An additional problem in the center-state financial distribution of resources is overdrafts by the states. This problem of unauthorized overdrafts has assumed alarming proportions during recent years, Unauthorised overdrafts also became a recurring during the decade because of the state governments very often were unable to blance their budgets. The deficits, by and large, were due to the uriability of the states to mobilize additional resources, to match the rising expenditure and quite often unforeseen events like natural calamities pushed up expediture without an increase in the revenues. The constitution visualised the transfer of finance through finance commission and planning commission, the central government transfers funder to the states under discretionary grants to meet contingencies.

## 28.1 Criteria of transfer of resources

Ours is a system of federal finance, with center and states sharing responsibilities and resources. The areas of the government's budgetary operation (i.e receipts and expenditures) Between the center and the states are demarcated. In addition there take place financial transfers from the center to the states. The sharing implied in the system has contributed a lot to the country's progress. In this analysis, we discuss the criteria underlying these transfer of resources.

The share of states depends upon two things. One is the amount that is transferred from the center though should taxes and grants-in-aid. Secondly and equally important, however, are the principles that have governed the distribution of the allocated funds among the states this determines the actual share that goes to each state. As stated earlier, the states besides receipts from their own resources, get resources from the center, these resources constitute a substantial proportion of the receipts of the states. There are three types of transfers and these take place through three channels. One as the transfer after by a finance commission appointed at least every five years. Two the Government of India, gives additional grants and loans to states to deal with problems which could not be anticipated by the finance commission and which would not fall within the purview of the planning commission, being non-plan expenditure. These are called discretionary transfers. The third type of transfers take place via the planning commission as plan assistance for plan projects.

There are two aspects of sharing, namely (a) determination of the divisible pool through the allocation of the center's funds to this pool and (b) the distribution of the divisible pool among the states. As far the transfer of resources from the center to the states is concerned, the underlying principle to determine the divisible pool or the magnitude of transfer has been that the state's fiscal requirements have been much more than their capacity to raise funds. The fiscal requirements as measured by the finance commissions, generally related to their assessment of the revenue budgetary gaps. Hence an overall estimate of these gaps generally become the basis for deciding as to how much of the total resources should be transferred from the center. Besides the resources available under taxes the grants-in-aid is made use of to till the gap. The recommendations of the finance commission, together with obany explanatory memorandum, as to the action taken thereon, are laid before each House of Parliament.

In addition to the sharing of central taxes, transfer of resources from the center to the states takes place through grants-in-aid. Faced with large obligations an account of welfare and development functions, states after peid their own revenue grossly insufficient for these purposes. Such revenue gaps are sought to be filled through the aid provided by the center in the from of grants for meeting specific or general purposes. Ober time these grants have become quite an important part of the states revenues, in fact almost as much as that of the revenue from the shared taxes.

Taking now the next aspect namely, the distribution of the divisible pool among the states, several considerations have been given weightage in determining to show of each state. These are, for eg, population of each state, incidence of poverty or percentage of the poor below the poverty line in each state, backwardness Of the state as indicated by the per capita income in a state, contributions of each state to the tax-receipts of the centre, tax effort and fiscal discipline etc. The emphasis on these considerations have varied from one finance commission to another. Overall, however the principal factors that dominated the criteria of distribution has been population, poverty and backwardness. Since in the past, receipts from personal income tax and control excise dutces were distributed, the above-mentioned considerations have been combined in varying digress to each one of the two sources of funds to determine the share of each state. From now on, with all the control taxes having been combined, a uniform criteria will be needed to determine the share of each state.

Prior to the 1997-93 financial year, the sharing in respect of vertical transfers (or transfer from the centre to the states) was confined to the proceeds of the personal income tax and the union/ central excise duties. With effect from April 1997, the sharing covers the receipts of all the taxes levied by the centre. This change has been affected following the recommendations of the tenth finance commission. Periodical examination of the division of resources and suitable modifications by the finance commission imparts a degree of flexibility to the finance of both the centre and the units. The flexibility is the great value in these days of changing needs and resources. The planned development of the country involves growing expenditure and therefore, larger revenues and on elastic system of finance is a great necessity. Through the transfer of resources from the centre to the states, the elasticity of the Union sources of revenue is transmitted to the state finances also. The finance commissions help in this process by making suitable suggestions.

Another factor that has been very much in evidence for most of the time, is the residual gap after tax devolution (i.e. sharing of income tax and excise duties on terms of population, contributions and backwardness). The residual gap of the states is made the basis of determining the share out of the grants-in-aid. Thus in the case of states which are not able to meet their budgetary deficits with tax devolution, grants-in-aid are given. Thus broadly there have been five major principles which have influenced the sharing of resources between the centre and the states on the one hand and among the states on the other. With regard to the first aspect, it is largely the fiscal needs of the states as indicated by the revenue gaps of their budgets. And insofar as the distribution of the divisible pool among the states is concerned, the influencing factors are population, poverty, backwardness, contributions and residual gaps.

Anther long standing matter which needs to be looked into is that of devising a system whereby the various financial flows from the centre to the states, and the distribution of these among the states are treated together and their consequences for the economy examined as a whole. This is necessary to get over the present compartmentalized or fragmented way of treating the subject, wherein separate agencies look after different components of the total flow. In fact this conception can be fully realized if the range of federal finances are widened to include local finances in it. Lack of an integrated view courses much avoidable controversies and dissatisfaction among the concerned parties. In brief, it is necessary to impart strength to the federal character of the Indian state, something that will be shared both by the union and the states.

## Unit 29 : Centre and State Financial relations in India – problems of states resources indebtedness.

**Structure :**

## 29.0 Centre and State Financial relations in India

Governments may be classified into unitary and federal depending upon the concentration and distribution of power and the relation between the central and local authorities. Under the unitary system, whole power of government is conferred by the constitution upon a single central organ and local governments derive whatever authority they possess from this central organ. As against the unitary system, federal system provides for a distribution and division of governments of the individual states of which the federation is composed. The general principle of division of power is such that affairs of common interest to the federation as a whole and thus requiring uniformity of regulation are placed under the central government, while all local affairs are left of the state governments. After independence, India also opted for a federal system of government.

The distribution of powers in countries adopting the federal system of government defines the financial relations between the central and the state governments. However, there are some special problems that have to be grappled within federal financial system. These are (i) the sources of revenue assigned to the centre and the states should be adequate to enable the centre and the states should be adequate to enable them to fulfil the functions allotted to them. However in modern states, it is frequently not possible to ensure this and it is highly unlikely that the needs and resources of each government will be exactly balanced. Therefore, it becomes necessary to evolve a mechanism of adjustments so that shortages and surplus are evened out (ii) each government should have independent financial authority i.e. each government should have separate sources of revenue, powers to levy taxes and borrow and to incur expenditure to carry out its functions effectively and (iii) a certain uniformity should be ensured in all areas of the federation so that no preference is given to one state over the other as regards payment of federal taxes.

The constitution of India makes a clear division of fiscal powers between the centre and the states governments. The principle adopted for this classification is that taxes which have an interstate base are levied by the states. The residuary powers belong to the centre. In the Indian federation, the centre – state fiscal relationship is largely governed by the Articles 268 to 281. Article 280 is of crucial importance because it provides for the constitutionality of the Finance Commission which makes financial transfers under the relevant provisions operative on a non-partisan basis. The main provisions under the constitution which largely govern the fiscal relationship between the centre and states are as follows. Article 268 refers to the duties levied by the centre, but collected and appropriated by the states. Here the centre discharges only agency service. Article 269 refers to the list of taxes levied and collected by the centre but assigned to the states. Article 270 refers to income taxes that are levied, collected and mandatorily shared with the states. Articld 272 provided a permissive provision for the sharing of central excise duties with the states, if the parliament so desires. Article 275 refers to grants-in-aid revenue of the state may be capital grants as well.

The central taxes as laid down in list I, Seventh schedule of the constitution, are as under taxes on income other than agricultural income, corporation tax, customs duties, excise duties, estate and succession duties, taxes on the capital value of assets etc. Taxes within the jurisdiction of the states is given in list II of the Seventh schedule are as follows, land revenue, taxes on the sale and purchase of goods, taxes on agricultural income, taxes on land and buildings, succession and estate duties. Excise on alcoholic liquors and narcotics etc. The Central Government has exclusive power to impose taxes which are not specifically mentioned in the state or concurrent lists. The centre an the state Governments have concurrent powers to fix the principles on which taxes on motor vehicles shall be levied and to impose stamp duties on non-judicial stamps. Thus, the Indian constitution, being federal in character, has indicated the nature and scope of functions of the central and state governments and also the taxes allocated to them.

Apart from the taxes levied and collected by the states, the constitution has provided for the revenues for certain taxes on the union list to be allocated, partly or wholly, to the states. These provisions fall into various categories. Firstly certain duties which are levied by the centre but are allocated and appropriated by the states. Secondly, there are certain taxes which are levied and collected by the centre, but the entire proceeds of which are assigned to the states, in proportion determined by the centre, but the entire proceeds of which are assigned to the states, in proportion determined by the parliament. Thirdly central tax on income and central excise duties are levied and collected by the centre but are shared by it with the states in a prescribed manner.. Fourthly, the proceeds of additional excise duties in replacement of states sales taxes on these commodities, are wholly distributed among the states in a manner as to guarantee their former incomes from the displaced sales taxes.

An important welfare and development functions are entrusted to the states gaps between their revenues and expenditure have to be corrected through transference of resources from centre. This is done partly by arrangements for tax sharing. But grants-in-aid bAn important welfare and development functions are entrusted to the states gaps between their revenues and expenditure have to be corrected through transference of resources from centre. This is done partly by arrangements for tax sharing. But grants-in-aid by the centre for specific purposes or general aid have come to occupy an important place in centre-state financial relations in India.

The states are authorized to raise loans in the market but they also borrow from the central government which gives the latter considerable control over state borrowing by the states from the centre has considerably increased during recent years. The states also deposit with the central Government certain state and local funds which are in effect loans by the centre and used for general purposes.

Financial resources transferred from the centre to the states are of three types: taxes, grants and loans. Among the taxes the states share of central excise duties has been showing the largest rise. This is due to the increase in the number of items in the list of divisible excise duties. The states' share of taxes and duties as a whole has been expanding due to the increasing yields of various taxes also. The large increase in-grants from the centre indicates the growing requirements of states. There were two basic reasons for this 1) the finance commissions realized that the states required increasingly larger resources to meet their evergrowing public expenditure on low and order, welfare and development (2) despite larger transfer of tax resources to the states, the latter are incurring huge revenue deficits. Loans have registered only a modest increase. Borrowing is made among other purposes for irrigation and river programmes, agricultural development and industrial housing. Apart from Finance Commission and Planning Commission the Central Government is giving discretionary grants to the states to meet contingencies.

## 29.1 Problem of States resources indebtedness

In the last few years, there has been growing conflict and tension between the Indian Union and the States in the matter of finance. This conflict has often been aggravated by political and ideological differences between the different parties governing the centre and the states. The frames of the Indian constitution provided for grants and loans so that the centre might come to the helps of those states which were in difficulty and also to bring about balanced development of the different regions. The use of grants and loans in the last 30 years or so, however has resulted in the complete domination and control of the states by the centre and to a certain extent, even financial irresponsibility and indiscipline on the part of the states. The enormous increase in transferred resources from the centre to the states, the phenomenal growth in loan assistance to the states and the political pressure amounting to blackmail by the centre through the instrument of grants have frightened the states. Hence there has been an insistent demand for a comprehensive review of centre state relations in general and centr-state financial relations in particular.

According to the constitution, the centre has to concern itself with the most generalized features of the Indian economy. On the other hand, the states are concerned with important aspects of the life of the people. In order to carry out these responsibilities the constitution provided for different types of financial resources. The union is entrusted with taxes on personal incomes and profits of companies, excise duties and customs duties. In a rapidly developing economy, these are precisely the most productive taxes in the country. In the case of the states, land constitutes an important base of taxation. In a densely populated country like India, the volume of land coming under tax remains almost stationary. Therefore, land as a source of revenue has been responsible for the inelastic nature of state revenues to a considerable extent. Similarly, taxes on agricultural income, excise duties on intoxicants, taxes on motor vehicles, entertainments etc are also comparatively less elastic than the taxes assigned to the centre. Sales tax is the only tax levied by the states which has substantial elasticity.

Because of the economic progress registered by the country in the last three decades, the base of income tax, union excise duties, customs duties and other important central taxes has expanded considerably. This has given immense powers to the central government to increase its resources with the passage of time. This structure of financial relations between the centre and the state governments – less elastic sources of revenue for the states and more elastic sources of revenue for the centre – places the states at a distinct disadvantage. While demands on the states resources are increasing rapidly because of the pressure of development services, especially in the field of social welfare, their income has failed to increase correspondingly. According vertical imbalance have accentuated over the years and the dependence of the state governments on the centre has considerably increased. This has made them vulnerable to increasing pressures from the central government to low its lines. Where the State Government belongs to a different political party these pressures give rise to open conflict seriously jeopardizing the effectiveness of the policy measures introduced by the concerned state government.

The period since 1951 has witnessed an enormous expansion of financial powers of the central government whose dimensions have progressively increases in relation to the combined resources of all states governments put together. The rate of growth of revenues of the centre is much faster as compared to that to the state. But then, the centre has limited functions to perform while the functions of the states are almost unlimited.

The centre – state conflict on financial relations is only a part of the overall centre-state relations and the demand for political and fiscal autonomy. The basic assumption for political and fiscal autonomy. The basic assumption of the constitution in favour of a strong centre and weak and dependent states is no longer acceptable. The centre, with too little to do, is entrusted with too much financial resources while the state governments with so many vital functions to perform are starved of financial resources. As the share of taxes and duties was inadequate to meet the growing revenue and capital expenditure the states had to resort more and more to grants-in-aid and loans from the centre. The centre has not taken sufficient initiative to impose all the taxes under Article 269 whose proceeds would go to the states. The corporation tax was excluded from the scope of sharing with the states from the very beginning. The states feel sore because their contribution to the development of the corporate sector is quite large. It is, therefore, fair and appropriate that the states should have a share in the proceeds of the corporation tax as well. The central excise duties have been expanding by including under it a growing number of items previous by taxed by the states. The surcharges on income tax were imposed by the central government but the proceeds were not shared with the states. The main source of revenue of the states is the sales tax which accounts for 60 percent of the states own tax revenue. The centre wants to abolish the sales tax also. There are also proposals to abolish octroi duties and state excises.

**Unit: 30** **Transfer Of Resources From Union And States To Local Bodies**

**Structure :**

## 30.0 Transfer Of Resources From Union And States To Local Bodies

The directive principles of our constitution paid down. "The state shall, in particular direct its policy towards securing-(a) that citizens, men and woman equally, have the right to an adequate means of livelihood,(b) that the ownership and control of the resources of the community are so distributed as best to suhserve the common good, (c) that the operation of the economic system does not result in the concentration of wealth and means of production to the common detriment "In India the decentralized planning is being thought of at two planes. At one plane the method of planning, largely centralized at the level of control Government, and to an extent also at the level of state Government, is sought to be changed by passing on to the governments at the district/block/village levels a part of the tasks of plan making and plan implementation. At another plane the case is being made for the use of market and market related prices and incentives for purposed of planning.

The Panchayat Raj and Community Development was launched under the Nehru Saga, the matter put under the directive principles of state policy, received varying attention among the states. The village panchayats and taluk boards were introduced in large many states in the country. These have come to occupy as yet the experimental value, whenever they have been in existence, have enjoyed wide ranging taxing powers and also can undertake the developmental works. However, they have been quite subservient to the state authorities. The major source of revenues have been grants and justifying thereby, the rule of state than the panchayat raj institutions. They are the true representatives of the people. But there are recent moves to have direct controls on them by the control and the states alike. The Muncipal councils, Palikas corporations, cantonment Boards etc have been the local-self governments existing in India even before the independence. However akin to the village pancnhayat and zilla punchayat, their dependence on the states has increased. They have taxing powers but lack skill and they are often encroached or superseded by the states. The grants play a very important role. Besides, they have substantial gaps in revenue and expenditures and the capital lgaps place them in complete disadvantage. Their autonomy is a subject of current interest.

The basic philosophy of decentralized planning involves the dispersal of planning both in respect of the formulation of plans and their implementation. The contents of this philosophy in the Indian context encompass two types of dispersal. One is that the central Government, and to an extent the state Governments should shed off a part of their planning responsibilities and pass on the same to the lower level governments of districts, blocks and villages or to the panchayati raj institutions, which enjoy financial adequacy and independence.

Hence, development charges, cars, land tax, property tax authorities to issue licenses, permission etc. Accordingly they can levy fees, charges rates on the services rendered by them. Moreover they also enjoy subsidies from the centre on certain schemes and programmes, while the state governments also have been accorded (a) assigned revenue shares and (b) grants-in-aid. All these measures have been direct contact with tax paying individuals or entities, enforce compliance required to finance the local projects and programmes. These undertakings by the local bodies ensure direct participation of the people resulting in equilibrium and improvement in welfare of the people at the gross-root level of the society.

Municipalities are considered as the local-self-governments and their financial operations, public expenditure benefits and taxburdens may be equalized in practice only in The contest of local finance, therefore they have been outhorizal to unpose various taxes such as property tax, the octrai or entry tax etc, They are treated as the third layer of the government, are empowered to levy various kinds of fees, user charges, prices to merit goods, social goods supplied. These can also undertake various entrepreneurial activitutions are best with the following problems (a) these are very poor revenues assigned by the states diretly, (b) they do not have serious tax base to exploit.All the secondary and sundry taxes are assigned to these institutions (c) They depend greatly upon the grants from the state governments, (d) they do not have trained/skilled manpower to administer the taxes assigned to them, (e) They have no permanent or even in many cases, supporting staff, (f) no less serious are the local inertia/the problems of lack of political will in the context of resource mobilization.

Similarly these are also serious problems with the finances of the municipalities. (a) no initiative/ will to revise the property tax rates, poor collections and huge arrears. (b) the entertainment tax is partly taken over by the state and partly very poor states and has termed out to be specific tax unable to increase revenues, (c) the states have forced the municipalities to abolish octroi and introduce entry tax (d) poor quantum of grants do not help them substantially, (e) the state control has been exforce on them, (f) the urban local bodies in majority of the states were in grave financial grips as their expenditure outplayed the revenues, (g) financial indiscipline, inefficiency, stalling development works and crippled financial positions.

List II of the Seventh schedule of the Indian constitution has entrusted important welfare and development functions to the states but the various tax resources provided to the states in the constitution were found to be inelastic and wholly inadequate, Under article 275 of the constitution, the Finance Commissions have to decide about the grants-in-aid to states corresponding to each five year plan. Eleventh Finance Commission recommended grants of Rs. 10,000 crores for the 5 year period to provide support to local bodies- at the panchayat level and municipalities at the urban level. Out of this, panchayats will receive annually Rs.1600 crores per annum and municipalities will receive Rs.400 crores per annum. Tenth Finance Commission provided total grants of Rs.5380 crores to local bodies namely Panchayat and Municipalities. The Eleventh Finance Commission recommendations have been accepted subject to the following conditions (a) the local bodies should required to raise suitable matching resources (b) in cases where elected local bodies are not in place, the Central Government shall hold the share of such bodies in trust on a non – lapsable basis during 2000-05. Central Government may also similarly hold back a part of the recommended share in case of such bodies to whom functions are addressed.

The local bodies at the rural and urban areas in some of the states have a huge seem of deficit in their capital budgets. Are they in a position to cope with serious developmental works is an issue recalling the situation all over the country – Their financial management is not sound. It has been felt by the government that Zilla -Panchayat have not been living upto the expectations. The Municipalities on the other hand also need a better deal. There is a plea that their autonomy should be ensured then only they discharge their functions effectively.

## 30.1 Let us sum up

A federal system of government allows both centralized and decentralized collective choices. The more decentralized the government the greater the opportunity to supply diverse levels and kinds of government – provided services. The fundamental principle underlying a federation is that it envisages a fair distribution of powers between the control and state governments. The constitution of India makes a clear division of fiscal powers between the union and the state governments. The appointment of the finance commission is of great importance, for it enables the financial relation between the control and the units to be altered in accordance with changes in need and circumstances. The contribution of the source of transfer from the union to the states has increased and the largest transfer has been via taxes and duties, followed by loans and grants . the distribution of power in countries adopting the federal system of government defines the financial relations between the center and the states. The panchayat raj and community development was punched under the Nehru saga, the village panchayats and taluk boards were introduced in large many states in the country.

## 30.2 Key concepts

| | |
|---|---|
| Fiscal Federalism | Centre state relations |
| Multi –Union Finance | The Residual gap |
| Vertical and horizontal imbalances | Fiscal autonomy |
| Inter governmental fiscal transfer | Resource Transfer |
| Tax devolution | Panchayat raj system |

| | |
|---|---|
| Grants –in- aid | community development |
| Deficit Financing | Decentralised planning |
| Fiscal discipline | Local Self government |
| Revenue Deficit | unauthorized overdrafts |
| Revenue expenditure | states resources indebtedness |

## 30.3 Typical Questions

1. Examine critically the principles of Multi-unit finance.
2. Discuss the vertical and horizontal imbalances under Indian fiscal federalism.
3. Explain the constitutional provisions relating to assignment of functions and sources of revenue in Indian federation.
4. Describe the role of Finance Commission in India by resource transfer through tax devolution and grants-in-aid.
5. Evaluate the criteria of resource transfer from union to states.
6. Outline the major highlights of center-state financial relations in India.
7. Analyse the problem of states resources indebtedness in India.
8. Comment on the resource transfer from union and states to local bodies in India.

## 30.4 Suggested Readings


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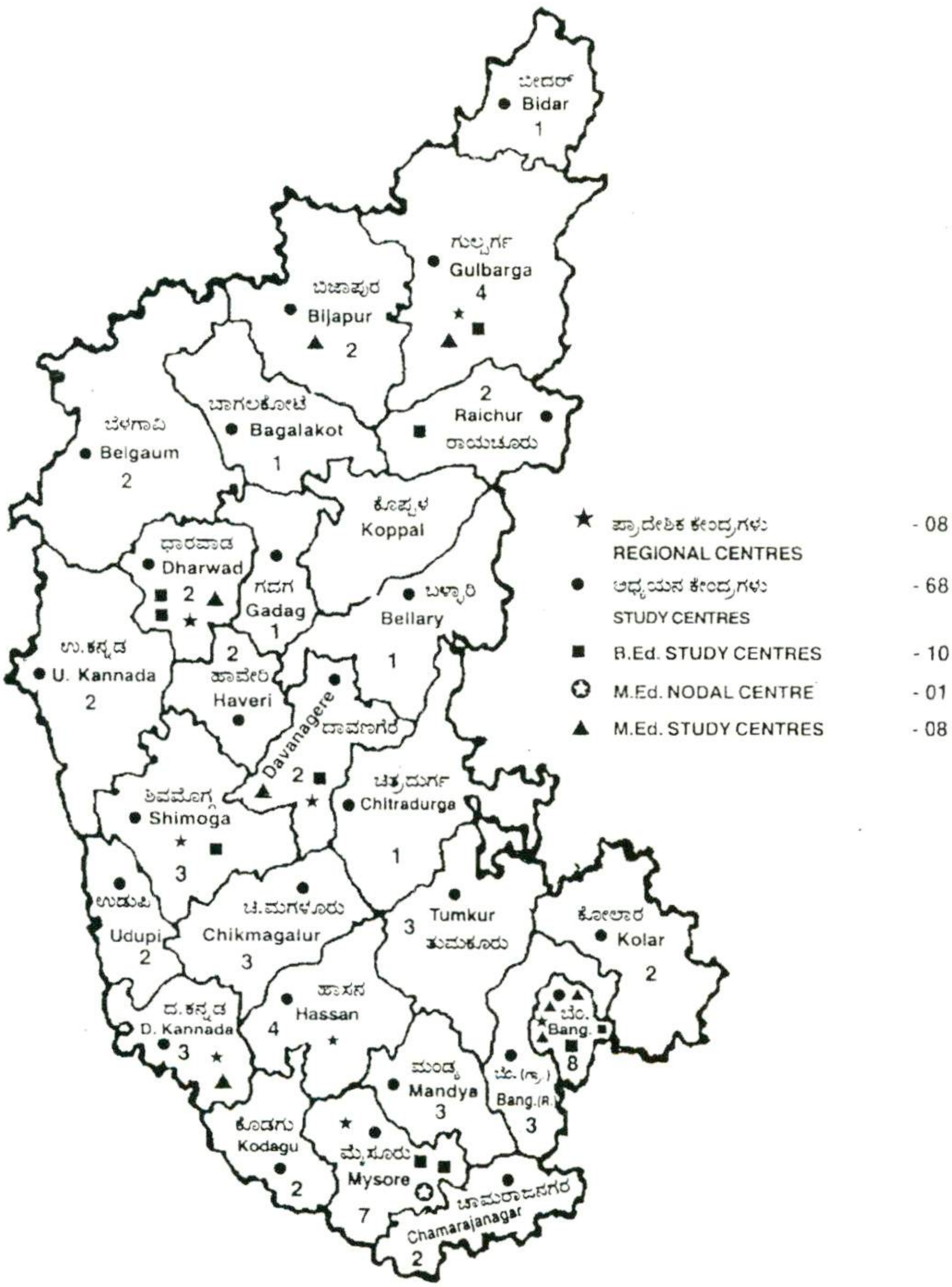


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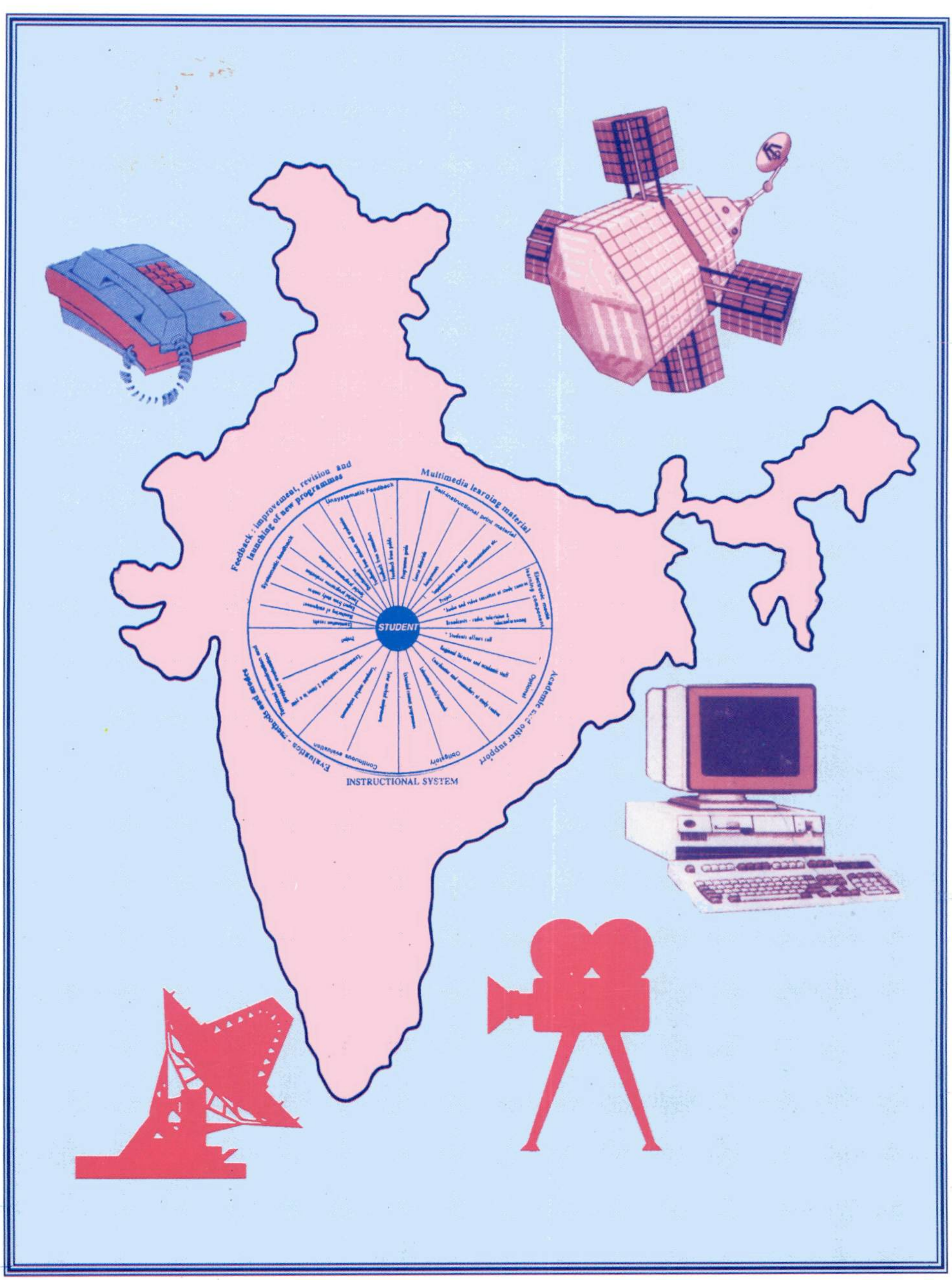
Feedback : improvement, revision and launching of new programmes
Multimedia learning material
Unsystematic Feedback
Self-instructional print material
Electronic media learning component
STUDENT
Optional
Academic and other support
Obligatory
Continuous evaluation
Evaluation - methods and system
INSTRUCTIONAL SYSTEM