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A Survey on Center-State Finance Relation in India

Dr. Manju Dalal[1]

Abstract

Present study discuss about the basic center state finance relation in India. How resources and responsibilities are distributed among government of various levels?, and How finances transfers from centere to the states to remove horizontal and vertical financial imbalances?

Introduction

A federal structure of government implies multiple autonomous tiers of government, as different from a unitary form with one effective level of government. In practice, a fully unitary or fully federal (in the sense of complete independence of one tier from another) structure is rare; most extant systems fall somewhere between the two extremes. Thus, the difference between the two forms is more of degree than of kind, particularly with respect to fiscal matters and economic decision-making.

Thus, federalism is a form of government in which sovereignty of political power and that of making economic decisions is divided between the central and the sub-national governments. The duties and rights of different units are determined in accordance with the constitution of country.

Powers and functions of the centre and the state governments have been assigned in the Seventh Schedule of the Constitution of India. The schedule specifies the exclusive powers of the centre and states in the Union list and the State list respectively, and those falling under their

[1] Dr. Manju Dalal, Assistant Professor (Economics), B.P.S. Institute of Higher Learning, B.P.S.Mahila Vishwavidalaya, Khanpur Kalan, Sonepat, Haryana- 131305, email: manjudalal2007@gmail.com

joint jurisdiction are specified in the Concurrent list. All residuary powers are assigned to the centre. The nature of the assignments is fairly typical of federal nations. The functions of the central government are those required to maintain macroeconomic stability, international trade and relations and those having implications for more than one state. The major subjects assigned to the states comprise public order, public health, agriculture, irrigation, land rights, fisheries and industries and minor minerals. The states also assume a significant role for subjects in the concurrent list such as education and transportation, social security and social insurances. In this scheme, the states have been entrusted with a crucial role in the growth process and most of the developmental functions have been assigned to them.

The assignment of tax powers in India is based on a principle of separation, i.e., tax categories are exclusively assigned either to the centre or to the states. Most broad-based taxes have been assigned to the centre, including taxes on income and wealth from non-agricultural sources, corporation tax, taxes on production (excluding those on alcoholic liquor) and custom duty. A long list of taxes is assigned to the states, but only the tax on the sale and purchase of goods has been significant for state revenues. This narrow effective tax base is largely a result of political economy factors that have eroded or prevented the use of taxes on agricultural land or incomes by state governments. The centre has also been assigned all residual powers, which implies that taxes not mentioned in any of the lists automatically fall into its domain.[2]

Both the centre and the state governments exercise their powers to raise revenues and determine the expenditure pattern based on the constitutional classification but it has been observed that the Constitutional assignment of expenditure responsibilities and taxation powers to the states does not give them resources sufficient to meet the responsibilities bestowed upon them.[3] As a result, the revenue expenditure of the state governments grew faster than their revenue receipts and the gap between the revenue receipts and revenue expenditure has

[2] Nirvikar Singh and T.N. Srinivasan (2002).
[3] Bagchi, Amresh *et al.* (1992).

continued to enlarge. Such a situation has resulted into growing revenue deficit of the state governments.

Review of Literature

Several studies on State finances in India have observed that over a long period of time, revenue receipts of the States have generally been lower than their expenditures, leading to high levels of revenue and fiscal deficits. Decline in non tax revenues was primarily responsible for relative inadequacy of total revenue receipts of the States, and not the tax revenue component of revenue receipts. For example, **M.G. Rao (1992)** found in his study of States as a whole that during the 70s and 80s tax revenue receipts of the States increased at reasonably high rates and the growth of central transfers to the States also was higher than that of both central revenues and States' own revenues. But non tax revenue receipts, due to reluctance to levy proper user charges on social and economic services, and declining return from departmental and non departmental commercial enterprises, followed a low and declining trend. This in turn adversely affected the overall growth of total revenues relative to the growth of revenue expenditure.

On the same lines, **I.C. Arya (2004)** also highlighted the decelerating growth after mid-1980s in revenue receipts of the States. Own tax revenues registered low growth rates because of tax evasion, undervaluation of property during registration, complicated tax structure, weak administrative machinery, exemption of tax on agriculture income, very low profession tax and too many exemptions. Non-tax revenues were also lower, for which the responsible factors were lower recoveries from public services, *viz.* low irrigation charges, high level of subsidies, free availability of electricity to the agricultural sector and various exemptions to the industries to promote them. Transfers from the center were also lower because financial condition of central government also deteriorated during the study period (from 1980s to 2001).

The positive role played by healthy growth in tax revenues is also emphasized by **R. K. Mishra (2000)** in his assessment of State finances in Andhra Pradesh. He shows that during

1974-82, fiscal position of Andhra Pradesh was sound because during this period, revenue receipts increased by 16 percent p.a. whereas revenue expenditure increased by a considerably lower rate of 3 percent p.a. But after that, revenue receipts declined from 17.8 percent of GSDP in 1986-87 to 13.3 percent in 1997-98. This decline was contributed by low tax buoyancies in comparison to other 14 major States especially in case of excise duties due to which tax revenue receipts declined continuously. This decline to some extent was caused by smaller non tax revenues, which declined due to sickness in and losses of large, medium and small industries in public sector, lower user charges of services provided by government, and lower recovery of cost especially in irrigation and power sector.

Dholakia (2000) singled out low user charges and poor recovery of costs as the factors responsible for the low proportion of non tax revenue in total receipts of Gujarat. She felt that the widening gap between effective prices (effective prices include actually announced price and cost of other services like transport etc. at which public goods/services reached to the people for consumption) and announced (by government) retail prices due to inefficiency was responsible for increase in implicit subsidies. During the study period, total subsidies doubled and out of these the proportion of targeted and merit subsidies were quite small as compared to non merit and non targeted subsidies. Due to already high tax burden and declining financial position of the State, the only option it had was to raise its non tax revenue and reduce, especially (or at least), implicit subsidies. User charges of many social and economic services were untouched for more than a decade. Government of Gujarat took some measures at the end of 1990s to raise recovery rates but these measures were not very successful whereas performance of non departmental undertakings improved significantly and their recovery rates were considerably higher than the national average.

She suggested that the State government should revise user charges on the basis of cost recovery criterion and privatize those sectors which produce non merit goods, by which on the one hand, government's subsidies (implicit) will decrease and on the other hand, due to activation of market mechanism, efficient prices will be determined and quality of such goods

and services will also improve. Last but not the least, the government should reduce political interventions in departmental undertakings.

Mishra (2000) felt that in the case of the SEB, the State government (of Andhra Pradesh) should try to minimize transmission and distribution loss. The government should invite private parties for the generation of electricity and to facilitate private generation, the government should ensure supply of fuel to them which was a major problem in the generation of electricity in the State. In the case of health, education, welfare programme and irrigation government should raise user charges on the basis of capacity to pay and affordability.

Zaidi (2002), apart from advocating increase in tax buoyancies by withdrawing the plethora of exemptions and by adopting uniform floor rates adopted in different States and union territories, also suggested curbing the growth of revenue expenditure by cutting non essential subsidies especially from power and agriculture sector. He felt that a policy of privatization should be adopted for power, road transport, irrigation sector and other sick PSUs to provide relief to the State finances. A Fiscal Responsibility and Budget Management Act (FRBMA) on the line of the one adopted by the Union Government could provide some legally binding impetus to the State for containing fiscal and revenue deficits.

R. Kavita Rao (2004) concluded in her study on estimation of the impact of introduction of VAT that the impact varied considerably across States; while some States seemed to gain consistently with such a transition, in some other States the gains converted into losses depending on the assumptions on increments to value added. The estimates were based on the assumption of adopting uniform VAT design in all the States. The author suggested that one way for the States to avoid incurring losses with introduction of VAT would be through appropriate variations in the rates and/or structure of tax. Variations in the tax structure, however, were being perceived as hindrances to the formation of a common national market. Clearly, the cost of imposing/assuring such uniformity would need to be borne by the Union Government. The

central government's assurance of compensation could, however, trigger off a negative response from the States when poor collection was rewarded.

Some Economists feel that to make the revenue and expenditure reforms more effective amendment of the constitution was needed. **M. G. Rao (2002)** highlighted in his study that inefficiency and distortion in the sub national fiscal policy were due to (i) complicated tax structure which was in turn due to multiple objectives of tax policy, weak governance, poor information system, weak administration and ineffective enforcement mechanism, on the revenue side, and (ii) (a) proliferation of expenditure in salaries, pensions, interest payments and subsidies which crowded out outlays on creation and maintenance of physical infrastructure, artificial distinction between plan and non plan expenditure has caused expenditure profligacy, (b) low productivity of public expenditure, and (c) proliferation of central sector and centrally sponsored schemes which distorted the priorities of expenditure with respect to the physical infrastructure requirement of the States, on the expenditure side.

Due to deteriorating financial condition of States, inefficiency and distortion in fiscal policy, not only achievement of fiscal consolidation but also restructuring the administrative machinery, downsizing of bureaucracy, prioritizing expenditure allocation to provide quality infrastructure, increasing allocation to human development and creation of business friendly environment were some critical challenges which State governments had to face. In an era of fragmented polity and coalition politics, the challenges were even more serious in the task of improving non tax revenue by increasing user charges and fees. These challenges required reforms in expenditure and tax systems, power sector and restructuring State enterprises, administrative re-engineering, building up a proper information system and computerization of tax administration. Although State governments took several measures to raise tax revenue, for success of these reforms it was necessary to enable the States to levy taxes on services. Therefore, the Constitution needed to be amended to provide concurrent power to taxing services to the States.

To Sum up, it is observed from the above review of literature that after the mid 1980s and during the decade of 1990s, tax and non tax revenue receipts have been lower which called for reforms to raise revenue receipts from the available tax and non tax revenue sources. Tax revenue receipts have been lower due to complicated tax structure, rate war (of reduction) in sales tax among States to wean business away from their neighbours, tax concession to the new industrial undertakings etc. Non tax revenue receipts have been lower due to lower user charges, lower contribution and losses of PSUs & SEBs, high cost production and irrational tariff structure etc. Although some measures have been adopted by the States and central government to raise revenue receipts of the States, these measures have been controversial. Adopting the suggestions made by various economists/authors in the literature discussed above may not be easy; impact of these suggested measures will vary State to State. Therefore, before adopting any suggestion there is need to have correct estimates of the impacts of the concerned suggestions, which requires improvements in the methodologies adopted to estimate such impact; further, the adoption of some measures would require some amendments in the Constitution also.

Most of the above studies were based on all general category States or at aggregate level of States of India.

Constitutional Remedies to Remove Fiscal Imbalances

The framers of the Constitution well understood the fact that the prescribed federal system will create problems of vertical and horizontal imbalances, both due to the assignment of inelastic and inadequate sources of revenue to the States in comparison to their expenditure needs and the converse for the central government. Therefore, they introduced provisions for the transfer of resources from the centre to the States.

"In a federal fiscal system, on grounds both of equity and efficiency, resources are generally assigned more to the central government whereas States together with the local government have bigger responsibilities. The resultant vertical imbalances require transfer of

resources from the centre to the States. States also have different capacities and needs, and this lends a horizontal dimension to the issue of resource sharing".[4]

To remove these vertical and horizontal imbalances in India, there are three ways in which the transfer of resources takes place from the centre to the States,[5] namely,

1. Statutory transfers through Finance Commission.
2. Plan transfers through the Planning Commission.
3. Discretionary transfers for Centrally Sponsored Schemes and for different non plan purposes by various ministries, especially the Ministry of Finance.

Transfers through Finance Commission (FC)

Although the Constitution provides for central transfers, it neither indicates the size of the share of the States in the divisible taxes nor prescribes any principle for its distribution among the States. Framers of the Constitution consciously avoided a permanent formula in this regard in view of expected changes in the spheres of taxation and public expenditure. "Thus, the precise manner of sharing taxes and the actual determination of grants is left to the deliberations of the Finance Commission which is appointed by the President (under Article 280) every quinquennium, or earlier if necessary".[6] The Commission is required to make recommendations on the following:

(a) The distribution between the Union and the States of the net proceeds of shareable taxes and allocation between the States of the States' share of divisible taxes;

[4] Rangarajan, C (2004), "Issues before the Twelfth Finance Commission", *Economic and Political Weekly*, Vol-XXXIX, No-26, p.2707, June.
[5] The regional pattern of central expenditure also could be considered as resource transfer, but in a less formal manner. In any case, it would be a major task by itself to allocate central expenditures across States.
[6] Sury, M.M (2005), "Finance Commissions of India", Indian Tax Foundation, New Delhi-07, First Publication, p.33.

(b) The principles that should govern grants-in-aid of revenues of the States out of the Consolidated Fund of India and the amount to be paid to the States in need of assistance;

(c) The measures needed to augment the Consolidated Fund of a State to supplement the resources of Panchayats (rural local governments) in the State on the basis of recommendations made by the State Finance Commissions;

(d) The measures needed to augment the Consolidated Fund of a State to supplement the resources of municipalities on the basis of recommendations by the State Finance Commissions;

(e) Any other matter referred to the commission in the interest of sound finance.

The approach of the FCs to determine transfers essentially consists of (i) assessing the overall budgetary requirements of the Centre and States to determine the volume of resources that can be transferred during the period of their recommendation; (ii) forecasting States' own current revenues and non-Plan current expenditures; (iii) determining the States' share in central tax revenues and distributing them between the States based on a formula; (iv) filling the post devolution projected gaps between non plan current expenditures and revenues with the grants-in-aid. This is known as the "gap-filling" approach.

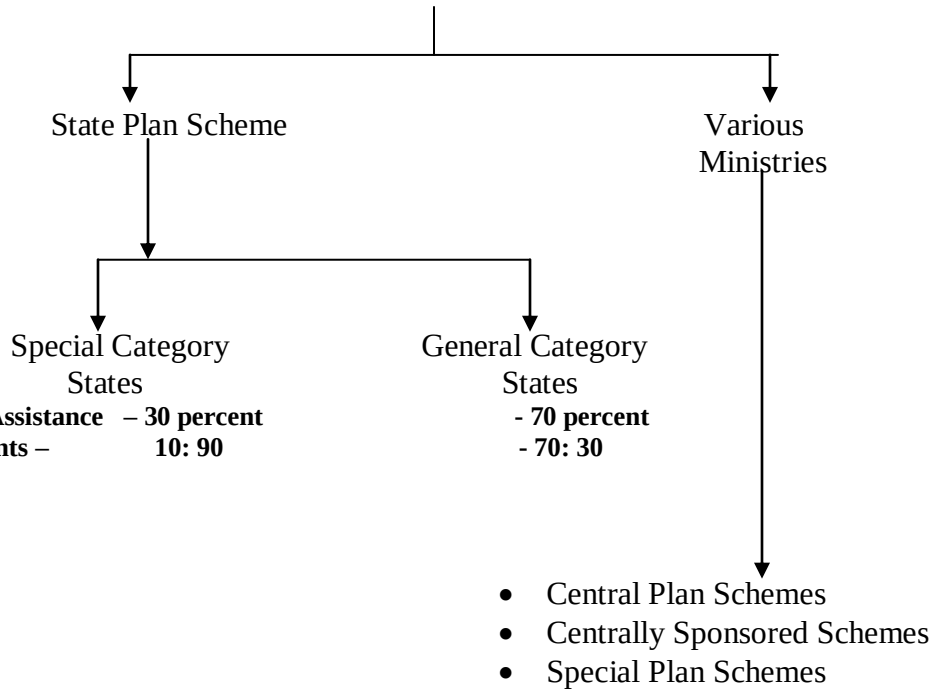
Tax devolution is a statutory transfer and every State gets a share in central taxes according to the distribution criteria determined by the Finance Commission. The main purpose of tax devolution is to supplement the resources of the States according to their expenditure requirements. But if even after tax devolution any State still needs financial assistance, Finance Commission recommends transfer in the form of grants, only to those States that have non-Plan revenue deficit.[7]

[7] Finance Commissions have confined their attention to the non-Plan account only and grants are recommended only for those States that have post-devolution non-Plan revenue deficit. If there is no non-Plan revenue deficit, no amount is transferred under the deficit grants. However, such States remain eligible for *ad hoc* grants for specific projects/programmes.

Transfers through Planning Commission (PC)

With the establishment of the Planning Commission in 1950, the Central Government has been using Article 282 of the Constitution for making grants to the States for Plan projects. Ever since the launching of the First Five Year Plan, these grants have occupied an important place in central financial transfers to the States. The Planning Commission, which for all practical purposes is a political body, makes an assessment of the existing resources of the individual States and the country as a whole and sets objectives in various fields and formulates Plans for economic development in the light of requirements of each State. The details of the Plan Assistance are schematically presented in the diagram below.

Planning Commission (Plan Assistance)



Transfers through various Ministries

In addition to the assistance to the States through the Finance Commission and the Planning Commission, various Ministries also transfer resources to the States under various schemes of national importance. These schemes are launched by the Central Ministries and implemented by the State governments with central assistance. The central ministries concerned propose and formulate these schemes which are approved by the Planning Commission and the Central Cabinet. The States execute these schemes under the technical guidance and supervision of the centre which also issues guidelines regarding the contents, coverage, and expenditure pattern and staffing of such schemes. The assistance given for these schemes is often on a matching basis and is over and above the assistance given for State plans; provision for these is made in the budgets of the central Ministries.

Although there is also some loopholes in this system of centeral transfers, not a part of discussion of the present study.

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