Chapter 7

Sharing of Union Tax Revenues

7.1 In accordance with article 280 (3) (a) of the Constitution and para 4(i) of the TOR, the Twelfth Finance Commission is required to make recommendations as to the distribution between the Union and the states of the net proceeds of taxes which are to be, or may be, divided between them under chapter I of part XII of the Constitution and the allocation between the states of the respective share of such proceeds.

Constitutional Provisions

7.2 Prior to the enactment of the Constitution (Eightieth Amendment) Act, 2000, the sharing of the Union tax revenues with the states was in accordance with the provisions of articles 270 and 272, as these stood then. While article 270 provided for the compulsory sharing of the net proceeds of the income tax (excluding corporation tax), article 272 permitted for sharing of the net proceeds of Union duties of excise (excluding duties of excise on medicinal and toilet preparations), if Parliament by law so provided. Consequently, the principles adopted for revenue sharing differed between the two taxes significantly.

7.3 The eightieth amendment of the Constitution altered the pattern of sharing of Union taxes in a fundamental way. Under this amendment, article 272 was dropped and article 270 was substantially changed. The new article 270 provides for sharing of all the taxes and duties referred to in the Union list, except the taxes and duties referred to in articles 268 and 269, respectively, surcharges on taxes and duties referred to in article 271 and any cess levied for specific purposes. The basis for this change was the alternative scheme of devolution recommended by the Tenth Finance Commission. There is considerable merit in the change, as it gives greater freedom and flexibility to the centre in pursuing the tax reforms in an integrated manner and enables the states to share the aggregate buoyancy of central taxes. The Eleventh Finance Commission was the first to take these changes into account, while recommending the share of the states in the divisible pool.

7.4 Another Constitutional amendment that is of relevance to Centre-State fiscal relations is the eighty eighth amendment, enacted in January, 2004 through the Constitution (Eighty Eighth Amendment) Act, 2003. This is relating to service tax and will come into effect from a date, which is yet to be notified. This amendment provides for a specific entry in the Constitution to authorize levy of service tax. The central

government has been imposing and collecting this tax as a residual item under entry no. 97 in the Union list and the net proceeds thereof are distributed between the centre and the states as per article 270 of the Constitution on the recommendations of the finance commission. As per the eighty eighth amendment (annexure 7.1), taxes on services are to be levied by the central government and the net proceeds of such taxes are to be collected and appropriated by the centre and the states in accordance with such principles of collection and appropriation as may be formulated by Parliament, by law. Further, in the Seventh Schedule to the Constitution, an item, 'Taxes on services' is to be inserted in the Union list under entry no. 92C, thereby assigning the power to tax services clearly to the central government. A new article 268A, has been inserted, whereby service tax is to be taken out of the divisible pool of central taxes and consequently out of the jurisdiction of the finance commission.

Evolution of the Sharing Process

7.5 As noted above, prior to the eightieth amendment of the Constitution, only two central taxes were shareable, non-corporate income tax and Union excise duties. In addition, there is a tax rental arrangement between centre and states with respect to additional excise duties *in lieu* of sales tax on three commodities. A brief review of sharing of the two taxes is given below.

Income Tax

7.6 By the time the First Finance Commission was constituted, the share of states in the 'net proceeds' of income tax had already been fixed at 50 per cent. The First Finance Commission raised the share to 55 per cent owing to increase in the number of states. The second, third and fourth finance commissions raised the share gradually to 60, 66.67, and 75 per cent respectively, to compensate for the non-inclusion of corporate income tax and surcharge (annexure7.2). The Fifth Finance Commission did not raise the share, but recommended inclusion of advance tax collections and arrears thereof in determining the proceeds of income tax during a financial year. The Sixth Commission raised it to 80 per cent, as the arrears of advance collections were not available any more. The Seventh Commission further increased the share to 85 per cent in response to the grievance of the states that the centre had raised the Union surcharge as a revenue measure rather than for meeting any specific Union purposes, thus depriving the states of a share in the increased revenue[1]. While the eighth and ninth commissions did not alter the position, the Tenth Finance Commission felt that the authority that levies and administers a tax should have a significant and tangible interest in its yield and accordingly revised the share of the states in the proceeds of income tax downward to 77.5 per cent, but increased the share in the net proceeds of the Union excise duties to protect the level of overall devolution to the states.

Union Excise Duties

7.7 At the time of the First Finance Commission, there were 12 important commodities subject to Union excise duties in 1951-52. The First Finance Commission felt that it was advisable to share the excise revenue from a select number of commodities of common consumption that yielded sizeable revenue for distribution.

Accordingly, the Commission recommended sharing of the excise on three commodities – tobacco (including tobacco products), matches and vegetable products and the share was fixed at 40 per cent[2]. The Second Finance Commission increased the number of commodities for sharing the excise duty revenue to 8 but reduced the share to 25 per cent. While the coverage of commodities was expanded by the third and fourth commissions, the share was reduced to 20 per cent. The fifth and sixth commissions, while keeping the share at 20 per cent, extended the shareable excise duties to special and auxiliary duties as well. The Seventh Finance Commission doubled the share with a view to reducing the elements of grants-in-aid[3]. The Eighth Commission increased the share by adding additional 5 per cent, which was to be distributed among the deficit states. The Ninth Commission, in its second report, retained the share at 45 per cent for distribution among the deficit states. The Tenth Commission further raised the share of the states to be 47.5 per cent with 7.5 per cent distributed among the deficit states.

Sharing in Aggregate Central Taxes

7.8 The Tenth Finance Commission in its alternative scheme of tax devolution suggested that instead of sharing of individual taxes, the states may have a share in the total net proceeds of all central taxes excluding surcharges and cesses. In determining the share of the states in the total net proceeds of the central tax revenues, the Commission distinguished between shares in income tax, basic excise duties and grants *in lieu* of tax on railway passenger fares as a proportion of central tax revenues (S1) on the one hand, and the share of additional excise duties *in lieu* of sales tax in respect of items covered by tax rental arrangement on the other (S2)[4]. The Commission observed that the average value of S1 had been 24.32, 22.22 and 24.3 per cent during the five-year-periods 1979-84, 1984-89 and 1990-95 respectively, and that of S2 at 2.96, 3.22 and 2.95 per cent. Having regard to these values, the commission recommended that the share of states in the gross receipts of central taxes should be 26 per cent, and until the tax rental arrangement is terminated, a further share of three per cent in the gross tax receipts of the centre to compensate for the additional excise duties *in lieu* of sale tax.

7.9 The Eleventh Finance Commission, while considering the issue of vertical devolution of the central tax revenues, reviewed the past trends in the aggregate share of states in the net proceeds of all Union taxes and duties, excluding surcharge and cesses during the last two decades[5]. It was observed that the share of the states in all Union taxes and duties (worked out on the basis of share of all states in the Union excise duties and income tax recommended by successive finance commissions) fluctuated between 26.17 per cent (in 1988-89) and 31.79 per cent (in 1993-94). The year-to-year fluctuations had been significant even within the devolution period covered by the same finance commission, largely due to fluctuations in the rates of growth of income tax and Union excise duties, the only taxes shared with the states before the eightieth amendment to the Constitution.

7.10 After completing the assessment of the central resources and state finances for the period, from 2000-01 to 2004-05, the Commission recommended that the share of

the states be fixed at 28 per cent of the net proceeds of all taxes and duties referred to in the Union list, except the taxes and duties referred to in articles 268 and 269, and the surcharges and cesses, for each of the five years starting from 2000-01 and ending in 2004-05.

7.11 The Eleventh Finance Commission further noted that as a consequence of the amendment, which *inter alia* deleted article 272, additional excise duties levied under the Additional Excise Duties (Goods of Special Importance) Act, 1957, had become part of the revenue receipts of the central government and were shareable with the states. It was felt that there was a need for a review of the earlier arrangement and pending such a review, the commission recommended that 1.5 per cent of all shareable union taxes and duties be allocated to the states separately and its *inter se* distribution among the states may be done in the same manner as the distribution of 28 per cent of the net proceeds. If any state levied and collected sales tax on the commodities covered under this Act, it would not be entitled to any share from this 1.5 per cent. This brought the total tax devolution recommended by the Eleventh Finance Commission to 29.5 per cent of the net proceeds of all shareable central taxes and duties.

Trends in Vertical Sharing

7.12 At this stage, it may be useful to examine the historical trends in the transfers from centre to states through major channels in India. As can be seen from Table 7. 1, over the period covered by the seventh to eleventh finance commissions, the award period-wise average ratio of total transfers to central government gross revenue receipts had remained around 38 per cent during the seventh and eighth finance commission periods. It went up to 40 per cent during the Ninth Finance Commission period.

Table 7. 1

Transfers from Centre to States as Percentage of Gross Revenue Receipts of the Centre: Finance Commission Period Averages

Year	Finance Commission Transfers			Other Transfers			Total Transfers (4+7)
	Share in Central Taxes	Grants	Total Transfers through Finance Commission (2+3)	Grants through Planning Commission	Non-plan Grants (Non-statutory)	Total Other Transfers (5+6)	
1	2	3	4	5	6	7	8
VII FC	22.39	1.96	24.35	12.11	1.66	13.77	38.11
VIII FC	20.25	2.52	22.77	13.56	1.54	15.10	37.86
IX FC	21.37	3.42	24.79	14.48	1.06	15.54	40.33
X FC	21.40	2.34	23.75	10.57	0.63	11.19	35.79
XI FC (first two years)	20.93	5.20	26.13	10.39	0.82	11.21	37.20

Source: **Union Government Finance Accounts and Revenue Receipts are from Central Government Receipts Budget (Various issues).**

Note: **In 1997-98, an amount of Rs 7,594 is on account of VDIS, which is included in non-plan grants to the states in the Finance Accounts. Since it should logically form part of the tax devolution, this amount is taken out from the non-plan grants and added to the Finance Commission transfers.**

Thereafter, it came down steeply to 35.8 per cent during the Tenth Finance Commission period. During the first two years of Eleventh Finance Commission award period it has shown a rise to 37.2 per cent.

7.13 The finance commission transfers have accounted for about 60 to 70 per cent of total central transfers to states and have also shown variation over time. The average ratio to the gross revenue receipts of the centre for the Seventh Finance Commission period was 24.4 per cent. It went down to 22.8 per cent during the Eighth Commission. It rose to 24.8 per cent during the Ninth Commission and declined to 23.8 per cent during the Tenth Commission period. During the first two years of the Eleventh Finance Commission period, however, the average ratio was 26.1 per cent (Table 7. 1). Of particular interest are the finance commission transfers through tax devolution. The ratio of the tax devolution component to centre's gross tax revenue has been stable at around 21 per cent during the last three finance commissions.

7.14 The aggregate share of states in the net proceeds of all Union taxes and duties, excluding surcharges and cesses, during the last two decades has varied between 26.2 per cent (1988-89) and 31.8 per cent (1993-94) (annexure 7.3). The finance commission award period average has varied from a low of 27.3 per cent to a high of 28.8 per cent. This ratio is stipulated to be 29.5 per cent by the Eleventh Finance Commission.

Views of the Central Government

7.15 The central government in its memorandum of September 2003, has stated that in the light of the tight fiscal situation of the centre and the external macroeconomic imperatives of containing central fiscal deficit, there should be a gradual reduction in devolution to states. With the additional availability of revenues through collection of service tax on specified items, states' mobilization of revenue will increase to the detriment of the centre. Further, the centre has agreed in principle to allow the states to levy sales tax on sugar, tobacco and textiles. The central government has, therefore, urged that the tax devolution may be kept to a maximum of 28 per cent of the net proceeds of the shareable taxes, with the additional 1.5 per cent of the net proceeds being distributed as long as additional excise duty *in lieu* of sales tax on sugar, textiles and tobacco continues.

7.16 The memorandum also stated that in the event of abolition of additional excise duty, the states would regain the right to levy sales tax and would compensate themselves for the 1.5 per cent revenue loss resulting from the termination of the tax rental arrangement. The memorandum also referred to the fiscal responsibility legislation, which makes it obligatory for the centre to rein in the level of deficit and debt and suggested that the Commission may review the maximum level of overall transfer from centre to states and prescribe a ceiling lower than what was recommended by the Eleventh Finance Commission, that is, 37.5 per cent of the gross revenue receipts of the centre.

7.17 In a subsequent communication on August 9, 2004, the central government urged the Commission to take a view consistent with the National Common Minimum Program objectives and after taking into account the following

considerations:

i) Under 88th Constitutional amendment, "Taxes on services" are to be excluded from the single, divisible pool of central taxes/duties [*vide* article 270 of the Constitution].

ii) Centre is presently discharging a number of expenditure obligations pertaining to subjects/areas in the state list, both through plan transfers and non-plan transfers/expenditures.

iii) Demands on the resources of the central government and statutory requirement of eliminating revenue deficit of the centre as stipulated in the Fiscal Responsibility and Budget Management Act and rules framed thereunder.

7.18 The National Common Minimum Program, while dealing with the subject of centre-state relations, has observed that "the share of states in the single, divisible pool of taxes (be) enhanced"[6].

7.19 With regard to the adverse impact on the states in the event of centre's revenue projections remaining unfulfilled, it has been stated in the communication that the basic rationale of creating a single, divisible pool of Union taxes is to ensure that both the centre and the states share the buoyancy. Partaking a share in positive buoyancies also implies acceptance of sharing of negative buoyancy.

Views of the States

7.20 In their memoranda, states have, almost unanimously, sought an increase in the total share of central taxes. A large number of states such as Chhattisgarh, Rajasthan, Tripura, Meghalaya, Mizoram, and Uttar Pradesh have asked for raising the tax share to 33 per cent. A share of 40 per cent has been suggested by Bihar, Jharkhand, Gujarat, Himachal Pradesh, Karnataka, Orissa and Goa. The states of Arunachal Pradesh, Andhra Pradesh, Assam, Haryana, Nagaland, Punjab and Tamil Nadu have sought as much as 50 per cent share. The arguments advanced by the states for seeking a higher share can broadly be summarized as follows.

i) It was resolved on the basis of a consensus in one of the meetings of the Standing Committee of the Inter-State Council that, to begin with, the divisible portion of the central taxes should be raised to 33 per cent.

ii) The suggestions for including all the taxes in the divisible pool emanated, *inter alia*, out of the pleadings for higher share of central taxes, but the share fixed by the Eleventh Finance Commission at 29.5 per cent of net central tax revenues has not resulted in increased devolution.

iii) Government of India has accepted the recommendations of the Expenditure Reforms Commission and if these recommendations are implemented, there will be considerable economy of expenditure and it would be possible for the central government to provide increased share in central taxes.

iv) A decision has been taken by the Government of India to transfer centrally sponsored schemes along with funds to the states and this transfer could be effected in the form of higher share of central taxes.

v) It would be possible for the central government to reduce its expenditure further by dispensing with many of the departments, which deal with subjects that are exclusively in the state list and do not pursue or implement any important national policy.

vi) Central tax collection has not been in accordance with the estimates of the Eleventh Finance Commission, as a result of which the states have not received amounts due to them.

vii) Some of the states desire that service tax should be in the state list or it should be collected by the centre and transferred to the states.

viii) As regards surcharges, states have expressed the view that in case a surcharge / cess is continued for a long period (beyond one or two years), it should be integrated with the basic tax and counted towards the shareable taxes.

ix) The concept of 'net' proceeds, instead of 'gross' proceeds of Union taxes, does not provide any incentive to the Union to reduce the collection cost. The cost of collection of the Union taxes, which was only 0.67 per cent of the gross tax revenue in 1980-81, has gone up to 1.06 per cent of the gross tax revenue. Some states desire that the devolution should be on 'gross receipts' and not on 'net receipts' basis.

x) Over the years, the non-tax revenue of the Union has increased significantly. In 1980-81, non-tax revenue was only 24 per cent of the total revenue receipts of the Union. It grew to almost 30 per cent in 1999-2000. The non-tax revenue is non-shareable and hence, the Union government is now financially better equipped and there is a scope for higher devolution to the states.

7.21 Some states desire that at least 30 per cent of the states' share in the divisible pool should be earmarked for distribution amongst the Special Category States [Assam, Himachal Pradesh, Jammu & Kashmir and Manipur]. Some of the states, notably Assam, Jammu & Kashmir, Kerala, Manipur and Tripura have suggested that the finance commission may indicate a minimum amount that must be transferred by the central government to the states. States have also referred to the shortfall in the revenues of the central government as compared to the projections of the Eleventh Finance Commission and suggested that such difference during the award period be made good either by providing for a minimum guaranteed devolution based on the Twelfth Finance Commission's assessment of states' share or by giving grants-in-aid to the extent of the difference. Another demand of the states pertains to the tax on railway passenger fares, shared earlier by the states on the basis of the state's contribution to the earnings. After the repeal of the Railway Passenger Fares Act, 1957 in 1961, the states had been getting compensation for the repealed tax on the basis of non-suburban passenger earnings from traffic originating in each state. It has been suggested that either (a) the practice of compensating the states for repealed Act should be continued or (b) the Act may be reintroduced and the states should be allowed to collect taxes on fares on behalf

of the Union and keep the proceeds.

Recommendations Regarding Vertical Devolution

7.22 While determining the share of the states in the divisible pool of central taxes, it is necessary to look at the level of overall transfers relative to centre's gross revenue receipts, the relative balance between tax devolution and grants, and feasible redistribution that can be undertaken in the *inter se* share of states in tax devolution. As mentioned earlier, many states have asked for increasing the share of states in the shareable pool from 29.5 per cent to 33 per cent. Some states have even suggested a figure of 50 per cent. We consider that if the share of states is increased, the redistributive content in the *inter se* distribution will have to be increased significantly by altering the weights among the distribution criteria so as to be consistent with the equalization objective. However, for this purpose, grants provide a more effective mechanism. We have, therefore, used grants to a larger extent as an instrument of transfers. At the same time, we recommend that the share of the states in the net proceeds of shareable central taxes be raised from 29.5 per cent to 30.5 per cent. For this purpose, additional excise duties *in lieu* of sales tax on textiles, tobacco and sugar are treated as part of the general pool of central taxes. If, however, the tax rental arrangement is terminated and if states are allowed to levy sales tax (or VAT) on these commodities without any prescribed limit, the share of the states in the net proceeds of shareable central taxes will be 29.5 per cent. According to estimates available from the budget papers, additional excise duties *in lieu* of sales tax constituted about one per cent of the shareable taxes in 2003-04 and 2004-05 (BE). The recommended increase can be accommodated easily by the central government by rationalizing the centre's participation in areas that are directly the responsibility of the states. We have treated the service tax as shareable. This is, in fact, the current position. The position will change after the eighty eighth Constitutional amendment is notified. In that situation, as indicated in Chapter 2, any legislation that is enacted in respect of service tax must ensure that the revenue accruing to a state under the legislation should not be less than the share that would accrue to it, had the entire service tax proceeds been part of the shareable pool. Further, as suggested earlier, the indicative amount of overall transfers to states in central gross revenue receipts, which was fixed at 37.5 per cent by the Eleventh Finance Commission, may be fixed at 38 per cent.

Horizontal Sharing

7.23 As regards the determination of the *inter se* shares of the states, the basic aim of the finance commission transfers in the past has been to (i) to correct the differentials in revenue capacity and cost disability factors inherent in the economies of states and (ii) to foster fiscal efficiency among the states. The criteria used in the past for these purposes can be grouped under: (a) factors reflecting needs, such as population and income measured either as distance from the highest income or as inverse; (b) cost disability indicators such as area and infrastructure distance; and (c) fiscal efficiency indicators such as tax effort and fiscal discipline. (annexure 7.4).

7.24 Over the past few finance

commissions, the distributive criteria have converged towards the following. Among the need factors, population and income distance have gained acceptance; among the cost disability factors, area and infrastructure index distance have tended to be the preferred indicators; and among the fiscal efficiency factors, tax effort and fiscal discipline as measured by the ratio of own tax revenue to revenue expenditure, are regarded as appropriate.

Views of the States on Horizontal Sharing

7.25 States in their memoranda have expressed their desire for the continuation of the use of population as a factor, with weights suggested varying from 5 per cent (Rajasthan) to 88 per cent (Gujarat) [annexure 7.5]. Bihar, Jharkhand, Karnataka preferred retaining a 10 per cent weight, while many states wanted a higher weight. On the use of income distance criterion, states have suggested weights ranging from 10 per cent (Tamil Nadu and Haryana) to 70 per cent (Assam). Andhra Pradesh, Karnataka and Maharashtra desire 25 per cent weight while Jharkhand and Uttar Pradesh want the weight to be 62.5 and 50 per cent, respectively. Many states have asked for continuation of 'area' as a factor with weights ranging from 5 per cent (Haryana and Karnataka) to 20 per cent (Rajasthan). Also, states have suggested retaining of the tax effort and index of fiscal discipline criteria. The suggested weights for tax effort range from 5 per cent (Rajasthan, Tripura, Maharashtra and Jharkhand) to 40 per cent (Tamil Nadu). The suggested weights for fiscal discipline range from 5 per cent (Karnataka, Maharashtra and Rajasthan) to 10 per cent (Andhra Pradesh, Bihar, Kerala, and Punjab). Andhra Pradesh, Assam, Haryana, Kerala, Maharashtra, Rajasthan and Uttaranchal prefer the same weight for both the criteria. Jharkhand and Karnataka prefer a smaller weight to fiscal discipline than tax effort. Chhattisgarh, Tamil Nadu and Tripura have recommended only tax effort, while Punjab has recommended only fiscal discipline.

Criteria and Weights

7.26 As per the formula used by the Eleventh Finance Commission, the share of each state in tax devolution was determined by the following criteria and relative weights: population (10 per cent), income distance (62.5 per cent), area (7.5 per cent), index of infrastructure (7.5 per cent), tax effort (5 per cent) and fiscal discipline (7.5 per cent)[7]. We have examined each of these criteria and the weights assigned and have suggested changes, where necessary.

Population

7.27 Population (annexure 7.6) is the basic indicator of need for public goods and services and as a criterion, it ensures equal per capita transfers across states. The weight attached to population has varied substantially over time. Looking at the recent periods, during the seventh and eighth finance commissions, the weight attached to population varied between 22.5 per cent and 25 per cent. This weight was reduced to 20 per cent by the Ninth Commission and further to 10 per cent by the Eleventh Commission. We feel that a strong case exists for increasing the weight and have fixed it at 25 per cent.

Per capita Income Distance

7.28 Among the criteria used for correcting differential fiscal capacities and

for enabling poorer states to meet better the needs for public goods and services, per capita income distance appears to be the preferred indicator. It imparts progressivity in distribution. The Fifth Finance Commission, while using this criterion, recommended that a portion[8] of the shareable Union excise duties be distributed among the states "whose per capita income is below the average per capita income of all states in proportion to the shortfall of the states' per capita income from all states' average, multiplied by the population of the state"[9]. The Sixth Commission followed the distance method for all states with no cut-off point for eligibility. In this method, the distance of per capita income of each state from the per capita income of the state which had the highest per capita income was measured. This value was then multiplied by the population of each state. In this method, the distance in the case of the state with the highest per capita income would be zero, but various commissions have adopted a method by which this state is also given a share on the basis of a notional distance between the per capita income of that state and that of the next highest per capita income state. The eighth and ninth commissions have used this method[10]. The tenth and eleventh finance commissions, while following this method, have used the average of the top three states with highest per capita incomes for measuring the distance. In all the cases, the commissions had taken the average GSDP for three years in order to even out year-to-year variations.

7.29 For determining the state-wise income distance index, we considered the average per capita comparable GSDP of each of the 28 states for the last three years, 1999-2000, 2000-01 and 2001-02 (annexure 7.7) provided by the Central Statistical Organization (CSO). Following the tenth and the eleventh finance commissions, the average of the top three states with highest per capita income, namely Goa, Punjab and Maharashtra was taken to compute the income distance of each state. For the top three states, the notional distance was assigned by taking their distance with the per capita income of the fourth highest ranked state, namely Haryana. We have assigned a weight of 50 per cent to the income distance criterion. This criterion combined with the criterion of population, representing together the needs and deficiency in fiscal capacity, will thus have a combined weight of 75 per cent.

Area

7.30 The use of 'area' of a state as a criterion for determining its share emanates from the additional administrative and other costs that a state with a larger area has to incur in order to deliver a comparable standard of service to its citizens. It should be noted that the use of 'area' as a criterion in the formula can also be interpreted as inverse of population density multiplied by population[11]. It should be recognized, however, that the costs of providing services may increase with the size of a state, but only at a decreasing rate. At the other end, even the smaller states may have to incur certain minimum costs in establishing the framework of governmental machinery. The Tenth Finance Commission provided for a floor level of 2 per cent and a ceiling of 10 per cent in the measurement of the area. The Eleventh Finance Commission also followed the same procedure. We have also assigned a minimum 2 per cent share for states with their area share smaller than 2

per cent. But, we have not fixed an upper ceiling of 10 per cent, as there is only one state (Rajasthan) which marginally exceeds 10 per cent. States that are assigned 2 per cent minimum share are; Goa, Haryana, Himachal Pradesh, Kerala, Manipur, Meghalaya, Mizoram, Nagaland, Punjab, Sikkim, Tripura and Uttaranchal (annexure 7.8). We have assigned a weight of 10 per cent to the area criterion.

7.31 Another cost disability criterion used by the last two commissions was the index of infrastructure, as an indicator of the relative availability of economic and social infrastructure in a state. This index was inversely related to the share. We find that the infrastructure index distance criterion is correlated with the income distance criterion. More importantly, our attention was drawn to the fact that this index is better used in an ordinal way. For these reasons, we have dropped the index of infrastructure as a criterion.

Tax Effort

7.32 As observed by the Tenth Finance Commission, measurement of tax effort on a comparable basis among the states is not a straightforward exercise, because tax effort must be related to some notion of tax potential and there are differences in the nature and composition of tax bases among the states. Given the data constraints, the Tenth Commission had used per capita GSDP as a proxy for the aggregate tax base. Tax effort was measured by the ratio of per capita own tax revenue of a state to its per capita income. The Commission felt that there was a need to provide for an adjustment for states with poorer tax bases. If the tax effort ratio as defined above is weighted by the inverse of per capita income, it would imply that if a poorer state exploits its tax-base as much as a richer state, it gets an additional positive consideration in the formula. The Eleventh Finance Commission, while considering the tax effort index, reduced the weight of inverse of per capita income from 1 to 0.5. We have adopted the same practice, but have raised the weight given to the tax effort criterion to 7.5 per cent, as the need for fiscal consolidation has become more urgent. The tax effort criterion is worked out by taking the three-year average (1999-2000, 2000-01 and 2001-02) of the ratios of own tax revenue to comparable GSDP (annexure 7.9) weighted by the square root of the inverse of the per capita GSDP.

Fiscal Discipline

7.33 The index of fiscal discipline was proposed by the Eleventh Finance Commission with a view to providing an incentive for better fiscal management. The Eleventh Finance Commission adopted improvement in the ratio of own revenue receipts of a state to its total revenue expenditure, related to a similar ratio for all states, as a criterion for measurement. The ratio so computed was used to measure the improvement in the index of fiscal discipline in a reference period, in comparison to a base period. For the base period, the Commission took the average for the three-year period from 1990-91 to 1992-93 and for the reference period that from 1996-97 to 1998-99. It may be noted that such an improvement can be brought about by higher own revenues or lower revenue expenditure or a combination of the two. The comparison of the performance of a state with the all state performance reflects the consideration that, if the performance

of the states is deteriorating in general, the state that accomplishes a relatively lower deterioration is rewarded. Similarly, if all revenue balance profiles are improving, the state where improvement is relatively more than average is rewarded relatively more. While retaining the index of fiscal discipline criterion we have computed it using the base period from 1993-94 to 1995-96 and the reference period from 2000-01 to 2002-03 (annexure 7.10) and kept the weight at 7.5 per cent.

7.34 Table 7. 2 shows the criteria and the weights, thus assigned for *inter se* determination of shares of states.

Table 7. 2

Criteria and Weights

Criteria	Weight (per cent)
Population	25.0
Income Distance	50.0
Area	10.0
Tax Effort	7.5
Fiscal Discipline	7.5

Recommendations regarding Horizontal Devolution

7.35 We have tried to evolve a formula that balances equity with fiscal efficiency. Equity considerations, however, dominate, as they should, in any scheme of federal transfers trying to implement the equalization principle. In view of the above considerations, we recommend that the states should be given a share as specified in the Table 7. 3 in the net proceeds of all the shareable Union taxes (excluding service tax, as it is not leviable in Jammu & Kashmir) in each of the five financial years during the period 2005-06 to 2009-10.

Table 7. 3

***Inter se* Shares of States**

State	Share (per cent)
Andhra Pradesh	7.356
Arunachal Pradesh	0.288
Assam	3.235
Bihar	11.028
Chhattisgarh	2.654
Goa	0.259
Gujarat	3.569
Haryana	1.075
Himachal Pradesh	0.522
Jammu & Kashmir	1.297
Jharkhand	3.361
Karnataka	4.459
Kerala	2.665
Madhya Pradesh	6.711
Maharashtra	4.997
Manipur	0.362
Meghalaya	0.371
Mizoram	0.239
Nagaland	0.263
Orissa	5.161
Punjab	1.299
Rajasthan	5.609
Sikkim	0.227
Tamil Nadu	5.305
Tripura	0.428
Uttar Pradesh	19.264
Uttaranchal	0.939
West Bengal	7.057
All States	**100.000**

7.36 As mentioned above, service tax is presently not leviable in the state of Jammu & Kashmir, and its proceeds are, therefore, not assignable to this state. We have worked out the share of each of the remaining 27 states in the net proceeds of service tax and these will be as indicated in Table 7. 4. If in any year, this tax becomes leviable in the state of Jammu & Kashmir, the share of each

state including that of Jammu & Kashmir would be in accordance with the percentages given in Table 7. 4.

7.37 If in any year during the period 2005-10, a tax under Union is not leviable in a state, the share of that state in that tax should be put to zero and the entire proceeds should be distributed among the remaining states by proportionately adjusting their share.

Table 7. 4

Share of States other than Jammu & Kashmir in the Service Tax

State	Share excluding J&K (per cent)	State	Share excluding J&K (per cent)
Andhra Pradesh	7.453	Maharashtra	5.063
Arunachal Pradesh	0.292	Manipur	0.367
Assam	3.277	Meghalaya	0.376
Bihar	11.173	Mizoram	0.242
Chhattisgarh	2.689	Nagaland	0.266
Goa	0.262	Orissa	5.229
Gujarat	3.616	Punjab	1.316
Haryana	1.089	Rajasthan	5.683
Himachal Pradesh	0.529	Sikkim	0.230
Jharkhand	3.405	Tamil Nadu	5.374
Karnataka	4.518	Tripura	0.433
Kerala	2.700	Uttar Pradesh	19.517
Madhya Pradesh	6.799	Uttaranchal	0.952
		West Bengal	7.150
		All States	**100.000**

Endnotes

1 Report of the Seventh Finance Commission, Chapter 9, para 22 p81-82.

2 "We have fixed the states' share with reference to the amount which, in our scheme as a whole, we consider it appropriate should be transferred to the states by the division of excise duties." (Report of the First Finance Commission, Chapter V, p82).

3 "Considering their size, the Union excise revenues must have a predominant role in the transfer of financial resources to the states. We have also decided, as mentioned earlier, that the bulk of the fiscal transfers to the states should be by way of tax shares, reducing the elements of grants-in-aid under article 275 to a residual position on the one hand and leaving surpluses on revenue account with as large a number of states as possible on the other" [para 31 of the Report of the Seventh Finance Commission, centre state financial relations and our scheme of transfers].

4 Report of the Tenth Finance Commission: Share of states in Aggregate Central Tax Revenues, Table 2.

5 Annexure VI.1 Chapter 7 of the Report of the Eleventh Finance Commission.

6 National Common Minimum Program of the UPA Government, New Delhi, May 27, 2004

7 Report of the Eleventh Finance Commission, Table 6.2, p 58.

8 13.34 per cent, that is, 2/3rd of 20 per cent

9 Report of the Fifth Finance Commission, p36.

10 Mention may be made here of another criterion that uses the per capita income was the Income Adjusted Total Population (IATP) which was the inverse of per capita income of a state. The share of a state is determined by the percentage of IATP of the state to the aggregate IATP of all states. The Seventh and Eighth Commissions, and the Ninth Commission in its first report, used this method. But in view of certain technical flaws the use of this criterion was discontinued since the Tenth Finance Commission.

11 Since Area = (Area/Population) $\times$Population.