

## CHAPTER II

### UNION-STATE FINANCIAL RELATIONS: OUR APPROACH

The purpose of the Finance Commission, as envisaged in the Constitution, is primarily to facilitate a periodical assessment of the fiscal needs of the States and the formulation on an objective basis of proposals for transfer of resources from the Centre to the States through devolution of taxes and grants-in-aid. But an incidental and by no means insignificant advantage of the appointment of a Finance Commission has generally been to rekindle interest in issues pertaining to financial relations between the Centre and the States and to promote an enlightened national debate on the several facets of our federal fiscal set up. We have had the benefit of being able to draw on the ideas, concepts and analytical tools evolved by the earlier Commissions. The implications of the several provisions of the Constitution governing the financial relations between the Union and the States, the new trends in federal finance set in motion by the establishment of the Planning Commission as a major agency for canalisation of resources for the financing of State Plans, and other related issues have received elaborate treatment at the hands of the earlier Finance Commissions and also the Administrative Reforms Commission and its study teams. We do not consider it necessary to traverse the ground covered by them. In indicating our general approach to leading issues of current interest in the sphere of fiscal relations between the Union and the States, we feel that it would be more purposeful if we confine ourselves to delineating certain directions in which, in our judgment new initiatives need to be attempted, without of course disturbing too violently the delicate framework that has been painstakingly evolved in the last 25 years.

2. Among the various federal polities in the world today, the Indian federal fiscal system, whether one views it as federal or quasi-federal, is undoubtedly among the few that have demonstrated remarkable resilience in coping satisfactorily with the new demands made on it from time to time. The provisions of the Constitution concerning financial relations between the Centre and the States seem to have been designed with great care and circumspection so as to forestal precisely the kind of difficulties that even the older federations do not appear to have overcome in securing closer correspondence between resources and functions of the different layers of Government. These observations should not be construed as implying that the present matrix of financial relations between the Centre and the States does not admit of improvement or simplifications. All that we would like to stress is that the financial provisions of our Constitution give enough room for reconciling such conflicts of interest as may arise from time to time between the Union and the constituent units. If despite these well

conceived provisions of the Constitution, some signs of dissatisfaction are discernible in the actual conduct of financial affairs between the Centre and the States, the reasons are to be found partly in the stresses and strains which the national economy as a whole has had to face in recent years and also perhaps in the spirit in which the provisions of the Constitution have sometimes been worked.

3. We must bear in mind that the country as a whole and every part thereof has gained significantly from the maintenance of a vast unified market within which there is free movement of goods and men. Having regard to the trends all over the world even for independent political entities to come together to forge closer economic links in the form of common markets and economic groupings, our best hopes of accelerated economic development lie in the further strengthening of our national market and in the promotion of fiscal arrangements that are most conducive to the effective functioning of this market. Given this basic fact, there can be no room for argument that the levy and administration of taxes with wide economic base such as income tax, corporation tax, union excise duties and of course also import and export duties will have to remain with the Union Government. In fact the architects of our Constitution drew on the experience of some of the other federations in which the assignment of taxes with wide economic base to units had led to intractable problems of conflicting tax jurisdictions. They wisely averted the possibility of such conflicts by assigning such taxes right from the beginning to the Union Government. At the same time, the framers of our Constitution rightly allocated to the States' subjects such as agriculture, education, medical care, public health, irrigation and law and order that touch intimately the lives of the people. These can be efficiently administered in a vast country only by the State Governments who are closer to the people and are more keenly alive to their problems and needs. The heads of revenue and responsibilities were distributed on the basis of whether the Centre or the State was better equipped to deal with the particular head. It was however realised that the delimitation of resources and functions on this basis would call for appropriate corrective measures to bring about better correspondence between resources and responsibilities of the two tiers in our federal set-up. That is why, the Constitution embodies both mandatory and enabling provisions for facilitating a wide ranging transfer of resources from the Centre to the States. It is not necessary for us to spell out at any great length the several devices that have been imaginatively incorporated in the Constitution for this purpose. These have been dealt with adequately in the reports of

the earlier Commissions. Briefly stated, the Constitution provides for transfer of resources from the Centre to the States in the following forms :—

- (i) Through the levy by the Centre, but assignment in whole of the proceeds of certain taxes. (Article 269 of the Constitution).
- (ii) Through mandatory sharing of the proceeds of income-tax (Article 270 of the Constitution).
- (iii) Through permissive participation in the proceeds of the union excise duties (Article 272 of the Constitution).
- (iv) Through statutory grants-in-aid of the revenues of the States (Article 275 of the Constitution).
- (v) Through grants for any public purpose (Article 282 of the Constitution).

Apart from these provisions pertaining to assistance on revenue account, the Centre of course has also the power to grant loans for any purpose to the State Governments under Article 293 of the Constitution. The Constitution does not merely mark out the channels through which resources can flow from the Centre to the States; it also provides for a machinery for regulating the flow of resources in the form of the Finance Commission. The fact that the Planning Commission has come into prominence in the last two decades as another channel for resource transfers does not in anyway detract from the efficacy of the provisions embodied in the Constitution. The advent of economic planning has only further strengthened the bonds of financial kinship between the Centre and the States and has underlined, even in a more pronounced manner than envisaged in the Constitution, the common stake that the Centre and the States have in the proper utilisation of the resources of the nation as a whole. It may be stated that the Planning Commission has emerged as an effective instrument for raising the scale of transfer of resources from the Centre to the States. The following table highlights the steadily rising trend in the transfer of resources from the Union to the States :—

	(Rs. crores)			Total
	Resources transferred through		Other transfers	
	Finance Commission	Planning Commission		
1951—56	447	880	104	1431
1956—61	918	1344	606	2868
1961—66	1590	2738	1272	5600
1966—69	1782	1917	3415	7114
1969—74	5316	4230	5307	14853
<b>Total 1951—74</b>	<b>10053</b>	<b>11109</b>	<b>10704</b>	<b>31866</b>

4. These figures can of course be interpreted in two ways. They can be looked upon as an indication of the increasing dependence of the States on the Centre and therefore symptomatic of an unhealthy development in our federal polity. But a generous interpretation would be that despite the centralisation of resources inherent in a growing economy, the Centre has responded to the expending needs of the States and thereby ensured the use of national resources in a decentralised fashion.

5. It may be worthwhile at this stage to pause and examine why, notwithstanding this rise in the flow of resources from the Centre to the States, there have still been complaints about the working of the federal financial arrangements and why, in particular, critical references are being made frequently to centralisation of resources and responsibilities and diminution of the role of the States. May be, some of these complaints have political overtones. But during our visits to the States and the wide ranging discussions we had with the Chief Ministers, other Ministers and senior Civil servants, it was heartening to find that despite grievances about inadequacy of resources, there was a deep and abiding sense of commitment to the concept of national unity. There was also sufficient awareness of the need to view local problems in the broader national perspective. It is also generally realised that problems which individual States face cannot be solved, unless the nation as a whole is made economically strong and unless each State is prepared to bear its due share of the burden that the pursuit of the national objectives of economic growth with social justice calls for. It, therefore, becomes all the more necessary to probe the causes for the lingering discontent on certain aspects of the fiscal arrangements between the Centre and the States and initiate corrective action.

6. Before we deal with some of the grievances which are real and call for redress, it may be convenient to refer to and dispose of some of the superficial criticisms of the existing federal fiscal set up. It is often cited as the major drawback of the present fiscal structure that while the Centre has all the elastic sources of revenue, States' revenues are comparatively inelastic. As pointed out earlier, given the compulsions of national economic integration, the present division of heads of revenue between the Centre and the States does not seem to admit of any significant change. The relative elasticity of Central resources cannot by itself constitute any ground for legitimate complaint, as long as there are almost automatic mechanisms for canalising resources to the States for meeting all their genuine needs. It is our belief that such arrangements are feasible within our Constitution and if necessary can be further improved upon. While it is undoubtedly true that the Central tax revenues have grown at a faster rate than those of the States, the variations in the pace of growth of State and Central revenues are not of such an order as to permit any sweeping generalisation. Since 1950-51, the State tax revenues have registered an increase from Rs. 221.55 crores to Rs. 1891.91 crores in 1972-73. In other words, the State tax revenues have risen about nine-fold. As against this, the Central revenues

have risen from Rs. 404.51 crores in 1950-51 to Rs. 4537.78 crores in 1972-73 or in other words, they have risen about eleven-fold. It should be mentioned that these are **gross** figures. If the Central transfers to the States through shareable Central taxes are taken into account, the State tax revenues would have increased eleven-fold as against only a nine-fold rise in Central tax revenues **net** of transfers to the States.

7. It may be relevant to mention that if State Governments had been less reluctant to tap the rural sector and particularly had secured reasonable returns on investments in irrigation and power projects, the State revenues would have grown at a faster rate.

8. In our view the difficulties which have been experienced from time to time in the field of Centre-State financial relations are not due primarily to the particular pattern of distribution of resources as laid down in the Constitution. The root cause for dissatisfaction among the States is to be found in the fact that the rate of growth of our economy has not been fast enough to meet the rising expectations of our people. We have also not exploited fully our potential for resource mobilisation. We would therefore urge that attention should be focussed on how best the various instruments in the fiscal armoury of the Central and State Governments can be further 'sharpened' and adequate resources raised for social and economic development.

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

10. There are large arrears of taxes both at the Centre and the States. Investments in industrial and commercial enterprises of the Centre have failed to generate the surpluses out of which fresh resources for expansion of our economy could have been found. The record of the State Governments in this regard, as analysed in greater detail in the Chapter on Fiscal Management, is also poor.

11. While under the Constitution, the Centre and the States have their own distinct responsibilities and resources, the advent of economic Planning and the establishment of the Planning Commission have initiated certain new trends in the conduct of inter-governmental relations. Economic and Social Planning is an item specifically mentioned in the Concurrent List. It is this entry which, among other things, gives the Centre the necessary sanction for the formulation of a national Plan. A national Plan has necessarily to comprehend the entire range of developmental activities, cutting across the delimitation of

powers between the Centre and the States. In this process, the Government of India and the Planning Commission have acquired a voice even in matters recognised to be within the jurisdiction of the States.

12. The State Plans are formulated in conformity with the objectives of the national Plan. This conformity is sought to be secured through an elaborate process of consultations at different levels and, more importantly, through Central assistance for the State Plans. This has brought about such close financial interdependence between the Centre and the States, that it is by no means an exaggeration to say that the Centre can be financially only as strong as the States and *vice versa*. The task of a Finance Commission, in this changed context, ought to be one of settling the optimal distribution of the resources of the public sector between the Centre and the States.

13. The distribution of national resources as between the Centre and States has to be conceived not in static but in dynamic terms. It should have due regard to the relative priorities of the different sectors from time to time. It is misleading to speak in terms of redistribution of resources between the Centre and the States. It will be more appropriate to view the problem as one of distribution of available resources as between the subjects coming constitutionally within the competence of the Centre and those coming within the purview of the States. In a sense, we have already become accustomed to this approach of looking at the distribution of national resources as between different sectors of development, rather than as between Centre and States, in dealing with Plan outlays.

14. In the sphere of planning, there is a growing realisation that the Central and State Plans reinforce each other and together subserve certain widely shared economic and social objectives. But unfortunately, and presumably because of the present unrealistic distinction between Plan and non-Plan, a similar healthy approach is not being brought to bear upon the allocation of resources between the Centre and the States when it comes to assessing the non-Plan requirements.

15. In taking a view on the quantum of resources to be transferred to the States, we have therefore borne in mind the relative priorities to be assigned in the present context to services coming within the purview of the Centre and the State Governments. In reviewing the forecast of resources of Central Government, as presented to us by the Union Ministry of Finance, we cannot help observing that there are some areas in which, given the right policies and the requisite determination, savings on a significant scale can be effected, thus liberating more resources for meeting the pressing needs of the States. In our scheme of devolution of resources to the States, we have taken the view that the resources belong to the nation and they should be applied at points where they are most needed.

16. The Approach to the Fifth Plan has recognised, among other things, the importance of an appreciable increase in social consumption for eradication of poverty. In concrete terms, this approach calls for larger allocations for education, medical care, public health, and welfare of Scheduled Castes and Scheduled Tribes and other backward classes and the like than in the past. This in turn entails provision of additional resources to the States in general and to the States that have lagged behind in these sectors in particular. We found that even in a State like Punjab, with the highest per capita income in the country, the outlay on certain essential social services was very low in per capita terms. The position in some of the backward States is far worse. The enlarged devolution of resources from the Centre to the States, which our proposals involve should therefore be viewed in the light of the new orientation that is sought to be given to our Plan strategy. When the emphasis is on social justice, there is no escape from a realignment of resources in favour of the States, because services and programmes which are at the core of a more equitable social order come within the purview of the States under the Constitution.

17. It is also necessary to stress that the transfers we have proposed look large in absolute terms partly because, of the 21 States now in existence, quite a few are very small in terms of area and population and have virtually no resource base of their own. The result is that almost all their requirements, which are not inconsiderable, have to be met in entirety through Central devolution. It may be relevant to mention in this connection that of Rs. 9608.85 crores sought to be provided to the States through shareable taxes and grants-in-aid in terms of our award, Jammu and Kashmir, Himachal Pradesh, Tripura, Manipur, Meghalaya and Nagaland amongst them accounting for only 2.26 per cent of population absorb Rs. 919.73 crores or 9.57 percentage of aggregate transfers. We are making these observations not because we consider the needs of these States to be unreasonable, but only in order to stress the point that the main burden of supporting the administrative apparatus of these six States would in effect have to be shouldered by the Centre. In comparing the magnitude of the devolution made by us with that of the last Commission, it should be remembered that of these six States constituting a special category, four came into existence only recently and their needs are being dealt with by the Finance Commission for the first time.

18. The question of allocation of resources between the Centre and the States is one which cannot be viewed in isolation from the allied issue of the relative shares of the States in the pool of national resources. It is in this context that the need for using the mechanism of fiscal transfers from the Centre to the States as a means of redressing regional imbalances acquires special significance. Due to various factors, some of which have been operative even from the period prior to Independence, certain States have forged ahead of the rest in terms of social and economic progress. We should however hasten to point out that these disparities between the different States,

adjudged in terms of per capita income, are far less pronounced in our country than in some of the other federations. It may be noted that Punjab has a per capita income of Rs. 953 as compared with Bihar with Rs. 389; the ratio of disparity being less than 2.5:1. But even these disparities, when the absolute levels of per capita income are very low, cannot be ignored. We have, therefore, accorded due priority to the need for correction of disparities among the States in our scheme of devolution. But the part which the Finance Commission can by itself play in bringing about a reduction in disparities in per capita incomes of States cannot be as significant as those of other agencies concerned with allocation of Central resources and formulation of Central policies. Policies such as those relating to allocation of Central assistance for State Plans, location of Central industrial and other projects, lending policies and procedures of financial institutions and norms for industrial licencing have probably more important and pervasive influence in correcting or accentuating regional imbalances.

19. In this connection, we cannot help observing that imbalances also exist among different areas within individual States themselves. In our view, the even development of the different areas within a State can be ensured only through a significant measure of decentralisation of powers and resources in favour of local bodies at district, block and village levels. While notable advance has been made in certain States in building up active local government, most of the States have allowed their local bodies to languish without any reasonable measure of delegation of powers or resources. We would strongly urge that the States should set up suitable Committees to review urgently the existing state of finances and powers of their local bodies. A time-bound programme should be drawn up and implemented, keeping in view the special needs of the backward areas within the States. In transferring resources from the Centre to the States, the Finance Commissions have been largely guided by the consideration that in our vast country, people's needs can be effectively attended to only by the agencies close to them and in the functioning of which they are fully involved. This ideal which has inspired the Finance Commissions in proposing transfer of resources from the Centre to the States can find its full consummation only if the States also in their turn realise the imperative need to transfer resources and powers to local bodies.

20. While the problem of regional imbalances may be less acute in our federation than others in terms of differences in per capita income, the disparities between the States are sharper when assessed in terms of the relative standards of essential administrative and social services. Thus, for example, while the per capita expenditure on education in Bihar was Rs. 8.86 in 1971-72, it was as high as Rs. 31.03 in Kerala. Likewise, the expenditure on medical care and public health was Rs. 3.11 per capita in Uttar Pradesh in 1971-72 as compared with Rs. 8.33 in Tamil Nadu. In our judgment, far greater priority has to be assigned to the abridgment of disparities in essential administrative and social services particularly

in the present context when emphasis is rightly being laid on helping the weaker sections of society. Correction of these disparities comes clearly within the purview of the Finance Commission. What is even more important, differences in levels of public expenditure on vital social services can be eliminated within a shorter time span than the differences in per capita incomes which are determined by various factors, not so easily amenable to control. While the earlier Commissions had assessed the requirements of States largely on the basis of maintenance of administrative and social services at whatever level obtained in the base year in each of the States, we have sought to raise the provision for some of the administrative and social services upto the national average in the backward States. We hope that in doing so we have broken new ground in Indian federal finance.

21. While we have adopted population as the dominant factor in the distribution of shareable taxes, weightage has been given to a limited extent to the factor of contribution in the case of income-tax and backwardness in the distribution of Union excise duties.

22. The special difficulties of backward States have been given further recognition and in particular we have given them access, for the first time, to resources on a liberal scale to come up to the national average in important administrative and social services. This approach in our view ensures a fair deal to the advanced as well as the backward States.

23. The overall transfer of resources resulting from our recommendations has to be viewed in the proper perspective. A part of the grants-in-aid proposed by us under Article 275 of the Constitution is for purposes of equalisation of administrative standards. A significant portion of this grant relates to raising the level of social services and should be used for the expansion of these services. With all the emphasis at our command, we wish to state here that effective mechanisms must be evolved to see that the funds provided by us for those services are not diverted to other purposes. If this is ensured, the disparities in Plan outlays among the different States can be kept within a narrower range than in the past and every State will be enabled to have a plan of reasonable size.

24. The growing indebtedness of the States to the Centre and the significant diminution in the net flow of resources from the Centre to the States on capital account have caused great concern in recent years. The Central and the State Governments alike have been anxious to seek a satisfactory solution to this problem. The reference of this problem to the Finance Commission enables us to take a total view of the revenue and capital accounts of the States and devise some remedies. We have outlined the principles of debt relief in detail in the relevant chapter. It might suffice to mention here that while our objective has been to give some relief to all the States, in the case of States with relatively heavier burden of debt, we

have recommended debt relief on a discriminatory basis with reference to certain principles. If in the process some States emerge with surpluses on non-Plan capital account, it cannot be helped. In fact, some of the States would have had such surpluses even without any re-scheduling of debt. We gave very careful consideration to the question whether there was need and scope for any significant conversion of outstanding Central loans into grants and for reasons explained in greater detail in the concerned chapter, decided against any such conversion. It is only necessary to mention here that in adopting this course, we have been largely influenced by the consideration that any such conversion would impede the reverse flow of resources from some of the relatively advanced States to the Centre and thus impair the latter's capacity to redirect larger resources to the relatively backward States. While it is true that conversion of outstanding Central loans into grants would make no material difference to the resources position of the nation as a whole, we felt that the Centre should not be deprived of the leverage it now has for adjusting the flow of resources in such a way as to promote balanced development of different regions of the country. The debt outstanding between the Centre and the States could be looked upon as a revolving fund fed by the payments due from the past beneficiaries and drawn on by those now in need.

25. Our survey of trends in evolution of Centre-State financial relations has revealed that on the whole helpful and co-operative solutions have been found for the problems as they have arisen. But if despite this, a feeling still persists that the States have not had a fair deal, it would seem to be due not to any basic deficiencies in the Constitutional set up, but perhaps to the style of functioning of Central Ministries at times. The role of the Central Ministries is primarily one of leadership, guidance and coordination in the fields which are Constitutionally within the sphere of the States. While States should be only glad to draw on the expertise available with the Central Ministries in solving their problems, the fullest measure of latitude should be given to the States in shaping their Plans and programmes to suit their needs, as long as national priorities are not lost sight of. The Central Ministries should increasingly transform themselves into expert, specialised agencies for providing guidance to the States on problems which they cannot tackle with their limited technical and other resources. They should cease to encumber themselves with routine administrative and supervisory functions which only annoy the States and result in avoidable duplication of effort and expenditure. Provisions for Centrally sponsored schemes pertaining to subjects coming within the jurisdiction of the States should be considerably pruned. This has also been repeatedly urged by the National Development Council. These observations apply not merely to Central Ministries, but also to their agencies such as the University Grants Commission.

26. In the course of our discussions, we gathered the impression that many States felt aggrieved about the spirit in which the Centre had interpreted certain

provisions of the Constitution. Some of these grievances have been referred to in the succeeding chapters. Reference may be made in this connection to the replacement of tax on Railway passenger fares by a fixed lump sum grant, the changes introduced in the scheme of taxation of Companies in 1959-60, the exclusion of advance income tax collections till recently from the shareable pool of income-tax, and the recent imposition of auxiliary duties of excise on non-shareable basis. We would only like to point out that there could be a significant improvement in the climate of Centre-State financial relations, if decisions that affect

the revenues of the States are taken after the widest possible measure of consultation. The spirit underlying Article 274 of the Constitution would also seem to call for such consultation. It is perhaps the absence of such consultation and the consequent lack of comprehension of the difficulties of the Centre that is largely responsible for the feeling of dissatisfaction among the States. If the process of consultation between the Centre and the States on fiscal issues is placed on a systematic basis and speedy decisions are taken in the light of these consultations, a good deal of this type of dissatisfaction would disappear.