# Strategic Trends & Issues in Centre-State Financial Relations in India

**Ch.S.D.Nageswara Rao**

**Faculty Member, Dept of Commerce and Management Studies,**
**Dr.B.R.Ambedkar University, Srikakulam, Eteherla**

**Abstract:** *States in India are plagued by recurrent and severe fiscal crisis from the middle of the eighties. Mismanagement of the finances by the State governments is the reason for the crisis, most often highlighted during the current discussions on the paper. The role of the Central government, pivotal under the existing Centre-State financial relationship, is seldom mentioned as a possible reason. It requires reiteration in this context that India is a semi federal polity and the existing constitutional allocation of financial powers between the Centre and the States is heavily skewed in favour of the former. The 80th Amendment of the Constitution provided for the sharing of all Union taxes between the Centre and the States except the proceeds of taxes referred to in Articles 268 and 269 and the cesses and surcharges levied on Union taxes.*

*The Finance Commission is a Constitutional body entrusted with the responsibility of recommending transfer of resources from the Centre to States to address both vertical and horizontal imbalances. In terms of the Constitutional provisions, the Finance Commission recommends States' share in shareable Central taxes and grants-in-aid to States under Article 275. With the initiation of Five-Year Plans for the development of the economy, transfers from the Planning Commission have gained in importance. The concept of a special category state was first introduced in 1969 when the 5th Finance Commission sought to provide certain disadvantaged states with preferential treatment in the form of central assistance and tax breaks. Initially three states Assam, Nagaland and Jammu & Kashmir were granted special status but since then eight more have been included (Arunachal Pradesh, Himachal Pradesh, Manipur, Meghalaya, Mizoram, Sikkim, Tripura and Uttarakhand). There have been three important changes in the post-reform era with a major bearing on the planned economic development. In the Indian context where growth has been far from inclusive, planning has an important indicative role to perform. Even in a market economy, the State has an important role not only as a facilitator but also as a provider of basic infrastructure, physical, social and financial. Given the glaring inequalities in income levels and living conditions across the regions, the redistributive role of planning cannot be over emphasized. Another function of planning is prescriptive, that of influencing the behaviour of private agents to serve public goals through enabling public policies and ensuring the smooth functioning of the common market.*

## Introduction

States in India are plagued by recurrent and severe fiscal crisis from the middle of the eighties .Mismanagement of the finances by the State governments is the reason for the crisis, most often highlighted during the current discussions on the paper . The role of the Central government, pivotal under the existing Centre-State financial relationship, is seldom mentioned as a possible reason. It requires reiteration in this context that India is a semi federal polity and the existing constitutional allocation of financial powers between the Centre and the States is heavily skewed in favour of the former. The Indian Constitution places considerable constraints on the States' capacity for resource mobilisation while saddling them with enormous expenditure responsibilities. The Constitution of India however envisaged a fiscal transfer mechanism to transfer adequate funds from the Central government to the States, taking into account the disproportion between the financial powers and responsibilities of the two tiers of the government. The Finance Commission to be appointed every five years under Article 280 of the Constitution is the main agency for effecting such transfers. It is a semi-judicial body and is entrusted with the twin responsibilities of apportioning Central Government revenues between the Centre and the States on the one hand and among the individual States on the other.

Since the submission of the Sarkaria Commission Report in the late eighties ,momentous changes have taken place in the Indian economy having a bearing on the Centre-State relations. Some of the issues examined by the Sarkaria Commission like the inclusion of corporation tax in the divisible pool of Central taxes have since been resolved with the 80th Amendment to the Constitution. Many other issues raised by that Commission, such as, levy of cesses and surcharges on Central taxes, plan formulation, pattern of plan assistance, CSS, regional development and strengthening of local bodies are relevant even today There are also developments outside the realm of economic reforms. This chapter identifies major developments since the Sarkaria Commission and analyses their implications for Centre-State financial relations.

The economic reforms and other associated changes had repercussions on the Indian economy in a number of ways. One such major repercussion is the greater role cast on the States in economic development. With the major portion of investment envisaged to come from the private sector in the Five-Year Plans, States are required to put in place the necessary enabling conditions such as the provision of adequate infrastructure to attract private investments. States which have taken proactive policy measures and having better infrastructure facilities have been able to attract private investment. States failing to attract private investment have lagged behind. This has resulted in increasing inequalities in economic growth thus accentuating imbalances across States. The poorer States with lower resource base and lack of infrastructure have been unable to catch up with the rest of the States. There has been large scale migration from poorer States to richer States and a faster pace of urban growth stretching the already inadequate civic amenities in urban areas to the hilt.

A major development in the management of public finances in the country was the enactment of Fiscal Responsibility and Budget Management Act (FRBMA) by the Centre and all the States with the exception of West Bengal and Sikkim, ushering in an era of rule based management of public finances. Since, the late eighties, the finances of the Centre and the States witnessed an alarming deterioration. The combined fiscal deficit of the Centre and the States reached an alarming level of nearly 10 per cent of GDP by 1990-91 from a level of 6.4 per cent in 1981-82. The combined revenue account slipped into a deficit of 4.2 per cent of GDP in 1990-91 from a surplus of 0.6 per cent of GDP in 1981-82. These ratios indicate that in 1990-91 nearly 64 per cent of the borrowings were used to finance revenue expenditure. By 2001-02, while the combined deficit remained at 9.3 per cent of GDP, the combined revenue deficit increased sharply to 6.9per cent of GDP. Alarmed by the deteriorating fiscal situation, the Centre had enacted the FRBMA in 2003, which became operational from July 5, 2004. The main obligations of the Centre under the Act and the rules framed under the Act are the elimination of revenue deficit by 2008-09 and reduction of fiscal deficit to no more than 3 per cent of GDP by 2008-09. There was slippage in meeting these targets because of the fall in revenue following global downturn, increase in food and fertilizer subsidies and higher expenditure necessitated by farm loan waiver, pay revision following the recommendations of the Sixth Central Pay Commission and the fiscal stimulus package put in place as a countercyclical measure.

**Changing Pattern of Plan Assistance to States:**

There are two distinct changes in Central plan assistance to States. The first one is the reduced budgetary support to the State Plan and the second is the significant change in the pattern of plan assistance. At the time of the formulation of the Tenth Plan, the Centre’s Gross Budgetary Support (GBS) to the Plan was distributed between the Central Plan and the State Plan in the ratio of 58:42. The actual support turned out to be 66:34, indicating a shortfall even in the lower level of support to the State Plans by a substantial margin. Realised Central assistance to States and UTs was 67.6 per cent of the projected level. As indicated in the Eleventh Plan document, this was the result of increasing the resource transfers through CSS, especially in sectors like health, education and rural development. For the Eleventh Plan, the percentage of GBS envisaged for the State Plans is only 23 per cent. Central assistance to State Plans is envisaged to come down from 1.48 per cent of GDP during the Tenth Plan period to 1.20 per cent of GDP in the Eleventh Plan. In contrast, the gross budgetary support to the Central Plan is envisaged to go up from 2.77 per cent of GDP in the Tenth Plan period to 3.97 per cent in the Eleventh Plan.

ISSN 2321-2926

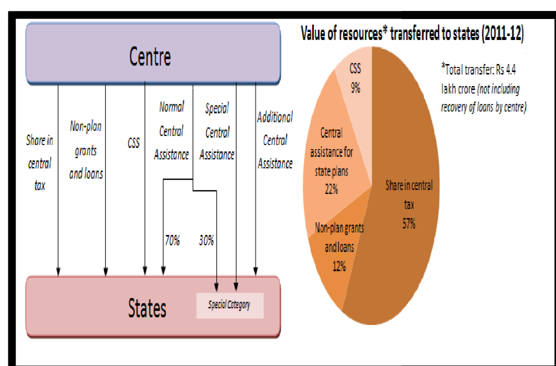
Special Category Status and central state finances

The concept of a special category state was first introduced in 1969 when the 5th Finance Commission sought to provide certain disadvantaged states with preferential treatment in the form of central assistance and tax breaks. Initially three states Assam, Nagaland and Jammu & Kashmir were granted special status but since then eight more have been included (Arunachal Pradesh, Himachal Pradesh, Manipur, Meghalaya, Mizoram, Sikkim, Tripura and Uttarakhand). The rationale for special status is that certain states, because of inherent features, have a low resource base and cannot mobilize resources for development. Some of the features required for special status are:

(i) Hilly and difficult terrain;
(ii) Low population density or sizeable share of tribal population;
(iii) Strategic location along borders with neighboring countries;
(iv) Economic and infrastructural backwardness; and
(v) Non-viable nature of state finances.

The decision to grant special category status lies with the National Development Council, composed of the Prime Minster, Union Ministers, Chief Ministers and members of the Planning Commission, who guide and review the work of the Planning Commission.

In India, resources can be transferred from the centre to states in many ways (see figure 1). The Finance Commission and the Planning Commission are the two institutions responsible for centre-state financial relations.




Source: Finance Commission, Planning Commission, Budget documents, PRS

**Planning Commission and Special Category**

The Planning Commission allocates funds to states through central assistance for state plans. Central assistance can be broadly split into three components: Normal Central Assistance (NCA), Additional Central Assistance (ACA) and Special Central Assistance. NCA, the main assistance for state plans, is split to favour special category states: the 11 states get 30% of the total assistance while the other states share the remaining 70%. The nature of the assistance also varies for special category states; NCA is split into 90% grants and 10% loans for special category states, while the ratio between grants and loans is 30:70 for other states.

For allocation among special category states, there are no explicit criteria for distribution and funds are allocated on the basis of the state's plan size and previous plan expenditures. Allocation between non special category states is determined by the Gadgil Mukherjee formula which gives weight to population (60%), per capita income (25%), fiscal performance (7.5%) and special problems (7.5%). However, as a proportion of total centre-state transfers NCA typically accounts for a relatively small portion (around 5% of total transfers in 2011-12).

Special category states also receive specific assistance addressing features like hill areas, tribal sub-plans and border areas. Beyond additional plan resources, special category states can enjoy concessions in excise and customs duties, income tax rates and corporate tax rates as determined by the government. The Planning Commission also allocates funds for ACA (assistance for externally aided projects and other specific project) and funds for Centrally Sponsored Schemes (CSS). State-wise allocation of both ACA and CSS funds are prescribed by the centre.

**The Finance Commission**

Planning Commission allocations can be important for states, especially for the functioning of certain schemes, but the most significant centre-state transfer is the distribution of central tax revenues among states. The Finance Commission decides the actual distribution and the current Finance

Commission have set aside 32.5% of central tax revenue for states. In 2011-12, this amounted to Rs 2.5 lakh crore (57% of total transfers), making it the largest transfer from the centre to states. In addition, the Finance Commission recommends the principles governing non-plan grants and loans to states. Examples of grants would include funds for disaster relief, maintenance of roads and other state-specific requests. Among states, the distribution of tax revenue and grants is determined through a formula accounting for population (25%), area (10%), fiscal capacity (47.5%) and fiscal discipline (17.5%). Unlike the Planning Commission, the Finance Commission does not distinguish between special and non special category states in its allocation.

**Composition of Central Transfers**

Table 1

| Period | Finance Commission Transfers | | | Other Transfer | | | Total Transfers (4+7) | Transfers as a percen-tage of GDP |
|---|---|---|---|---|---|---|---|---|
| | Share in Central Taxes | Grants | Total Finance Comm-ission | Plan Grants | Non-plan Grants | Total other Trnsfers (5+6) | | |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 |
| Eighth (1984-89) | 53.48 | 6.65 | 60.13 | 35.80 | 4.07 | 39.87 | 100.00 | 4.83 |
| Ninth (1989-95) | 52.98 | 8.48 | 61.46 | 35.91 | 2.63 | 38.54 | 100.00 | 4.89 |
| Tenth (1995-2000) | 62.06 | 6.55 | 68.61 | 29.52 | 1.87 | 31.39 | 100.00 | 4.09 |
| Eleventh (2000-2005) | 58.38 | 11.00 | 69.38 | 28.65 | 1.97 | 30.62 | 100.00 | 4.16 |
| Twelfth (2005-10) | 56.48 | 11.55 | 68.03 | 28.55 | 3.43 | 31.97 | 100.00 | 5.21 |
| 2005-06 | 57.00 | 14.95 | 71.94 | 25.36 | 2.70 | 28.06 | 100.00 | 4.69 |
| 2006-07 | 57.93 | 13.47 | 71.40 | 25.54 | 3.05 | 28.60 | 100.00 | 5.11 |
| 2007-08 | 58.82 | 10.21 | 69.02 | 27.69 | 3.29 | 30.98 | 100.00 | 5.46 |
| 2008-09 (RE) | 56.04 | 9.69 | 65.74 | 30.92 | 3.34 | 34.26 | 100.00 | 5.37 |
| 2009-10 (BE) | 53.62 | 11.22 | 64.84 | 30.88 | 4.28 | 35.16 | 100.00 | 5.23 |

Source: Basic data from Indian Public Finance Statistics, Union Finance Accounts and Central Budget documents

**Transfers Relative to Centre's Gross Revenue Receipts**

Table 2 presents aggregate revenue account transfers to States relative to the gross revenue receipts of the Centre. Aggregate transfers to States after declining from 40.33 per cent of Centre's gross revenue receipts during the Ninth Finance Commission(FC-IX) period to around 36 per cent in the periods covered by FC-X and FC-XI increased to 38.40 per cent in FC-XII period. FC-XII recommended an indicative ceiling on aggregate revenue account transfers at 38 per cent of Centre's gross revenue receipts. Thus, the current level of transfers is marginally higher than the indicative ceiling.

Table No.2

| Finance Commission | Revenue Account Transfers to States as a Percentage of Centre's Gross Revenue Receipts |
|---|---|
| Eighth (1984-89) | 37.86 |
| Ninth (1989-95) | 40.33 |
| Tenth (1995-2000) | 35.79 |
| Eleventh (2000-05) | 35.27 |
| Twelfth (2005-10) | 38.40 |

Source: Indian Public Finance Statistics for period 1984-2005. Percentages from 2005-06 onwards are based on CentralBudget documents.

**FINANCE COMMISSION TRANSFERS**

The Finance Commission is a Constitutional body entrusted with the responsibility of recommending transfer of resources from the Centre to States to address both vertical and horizontal imbalances. In terms of the Constitutional provisions, the Finance Commission recommends States' share in shareable Central taxes and grants-in-aid to States under Article 275. With the initiation of Five-Year Plans for the development of the economy, transfers from the Planning Commission have gained in importance. In addition, over the years, the Central Ministries have emerged as another channel of resource transfers to States. The emergence of two more parallel channels of resource transfers through the Planning Commission and the Central Ministries has made

the system of resource transfers complex. Issues relating to the role of the Finance Commission and the transfers recommended by the Finance Commissions are discussed in this chapter.

**Divisible Pool of Taxes**

The 80th Amendment of the Constitution provided for the sharing of all Union taxes between the Centre and the States except the proceeds of taxes referred to in Articles 268 and 269 and the cesses and surcharges levied on Union taxes. This has met the long standing demand of the States for the enlargement of the divisible pool of Central taxes. But the extension of the scope of cesses and surcharges imposed on Central taxes has greatly reduced the divisible pool over the years. The share of cessses and surcharges witnessed a sharp increase from 4.9 per cent of the gross tax revenue of the Centre in the award period of FC-VIII to 11.34 per cent in the award period of FC-XII. In the years 2008-09 and 2009-10, the share of cesses and surcharges increased further to over 13 per cent of the gross tax revenue (Table 3).

Table 3-

| Finance Commission | Gross Tax Revenue of the Centre | Cesses and Surcharges | Cesses, and Surcharges as Percent of Gross Tax Revenue of the Centre | Actual Tax Devolution (Rs. crore) | Actual Tax Devolution as Per cent of Gross Tax Revenue of the Centre |
|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 |
| Eighth (1984-89) | 167119 | 8225 | 4.92 | 42009 | 25.14 |
| Ninth (1989-95) | 419250 | 16642 | 3.97 | 112569 | 26.85 |
| Tenth (1995-2000) | 694756 | 21474 | 3.09 | 182925 | 26.33 |
| Eleventh (2000-05) | 1148007 | 68203 | 5.94 | 305013 | 26.57 |
| 2000-01 | 188705 | 7502 | 3.98 | 51688 | 27.39 |
| 2001-02 | 186327 | 6541 | 3.51 | 52842 | 28.36 |
| 2002-03 | 215905 | 13987 | 6.48 | 56122 | 25.99 |
| 2003-04 | 253668 | 15598 | 6.15 | 65766 | 25.93 |
| 2004-05 | 303402 | 24574 | 8.10 | 78595 | 25.90 |
| Twelfth (2005-10) | 2663337 | 301944 | 11.34 | 691056 | 25.95 |
| 2005-06 | 357244 | 31557 | 8.83 | 94385 | 26.42 |
| 2006-07 | 461620 | 41343 | 8.96 | 120330 | 26.07 |
| 2007-08 | 575445 | 58179 | 10.11 | 151800 | 26.38 |
| 2008-09 (RE) | 627949 | 83478 | 13.29 | 160179 | 25.51 |
| 2009-10 (BE) | 641079 | 87387 | 13.63 | 164361 | 25.64 |

Source: Finance Accounts of the Union Government and Budget documents of the Central Government

The Sarkaria Commission examined the issue regarding the levy of surcharge on income tax and recommended that the surcharge should not be levied except for a specific purpose and for a strictly limited period. FC-XI expressed the view that while there was no harm in levying surcharge on any specific tax for meeting an unexpected and unforeseen item of expenditure, it should not be resorted to as a revenue raising measure to fill the budgetary gaps. The Commission felt that surcharges should be levied for a specific purpose, for a limited period13. Though the extension of surcharges and cesses has been done for specific purposes, they are being continued on a permanent basis and more as a revenue raising measure. We are concerned about the increase in the revenue collected through cesses and surcharges. We recommend that the Central Government should

review all the existing cesses and surcharges with a view to bringing down their share in the gross tax revenue.

**Role of Planning in a Market Economy**

There have been three important changes in the post-reform era with a major bearing on the planned economic development. These are the declining share of public investment in total investment, the financial constraints emanating from the FRBM legislation and the Public-Private Partnership (PPP) emerging as the preferred mode of project financing. In the Indian context where growth has been far from inclusive, planning has an important indicative role to perform. Even in a market economy, the State has an important role not only as a facilitator but also as a provider of basic infrastructure, physical, social and financial. Given the glaring inequalities in income levels and living conditions across the regions, the redistributive role of planning cannot be over emphasized. Another function of planning is prescriptive, that of influencing the behaviour of private agents to serve public goals through enabling public policies and ensuring the smooth functioning of the common market. The usefulness of planning in providing indication, coordination and prescription has been acknowledged in countries avowedly market oriented such as Korea and France16. Despite the usefulness of planning, it cannot remain on the same footing in a market driven economy as in the case of controlled economy.

**Conclusion**

Following the introduction of economic reforms in the country, the role of Central planning seemed to have lost much of its relevance. There was a shrinking of the share of the public sector investment. States saw an opportunity to regain ground lost to the Planning Commission. However, this hope was belied. Plan transfers have become more tied to schemes and projects. There has been a quantum jump in allocations for Centrally Sponsored Schemes. Thus leaving limited space for States to address their priorities. Greater autonomy for States is also seen as an impediment towards the realization of the goal of a common market for the entire country.

In the changed situation, planning still has an important role. That it needs to be more indicative in nature has been recognized from the Eighth Plan onwards. That its primary role should relate to optimal allocation of limited resources, as a facilitator for the provision of basic infrastructure facilities and in influencing the behaviour of private agents to serve public goals needs to be recognized. Furthermore, the redistributive role of Central Planning assumes added importance in the wake of growing inequalities across States. We have made recommendations envisaging a higher role for the Planning Commission in the development of the North-East and in compensating forest and mineral rich States. It also needs to concentrate on bringing about a system of multi-year budgeting in conjunction with the Ministry of Finance. It also has an important role in making recommendations over a wide area of public policy along with the Reserve Bank of India, the Economic Advisory Council to the Prime Ministers and other Commissions and think tanks. These are important tasks, which the Commission has been unable to perform well because of its excessive attention towards sectoral plans of Central Ministries and those of the States. The reorientation suggested by us would enable it to remove the crevices which have appeared in Centre-State relations in planning for the nations development.

**References:**

1. Our Sincere Thanks to Commission on Central-State Relationship Report by Government of India.
2. Bagchi, Amaresh and Chakraborty, Pinaki (2004)., 'Towards a Rational System of Centre-State Revenue Transfers,' Economic and Political Weekly July 26.
3. Commission on Centre-State Relations (2009), 'Report of the Task Force 2 on Economic and Financial Relations,' New Delhi.
4. Rangarajan, C and Srivastava, D.K. (2008) 'Reforming India's Fiscal Transfer System: Resolving Vertical and Horizontal Imbalances,' Working Paper No.31 Madras School of Economics Chennai.
5. Srivastava, DK (2010), 'Taxation of Goods and Services in India'- A Study done by the Madras School of Economics for the Commission on Centre-State Relations.