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CENTRE - STATE FINANCIAL RELATIONS
Reassessment of an Old Model

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The air is now thick with the talk about the forthcoming changes in the Indian Constitution. The major changes that are currently attracting interest, and quite understandably so in the present political climate, concern the relationship between the judiciary on the one hand and the executive and Parliament including legislatures in the States on the other. One cannot but be conditioned by the developments in one's environment in recent past.

The question of Centre-State relations in general, have figured somewhat in the current discussions,¹ but not the question of financial relations between the Centre and the States. Only very recently has an indirect reference been made to this last question and that too in connection with the appointment by the Central Government of the Committee on Indirect Taxes.²

I propose to deal here with the question of Centre-State Financial relations, because I feel that it should be of considerable interest in the wider context of today, however subdued the references may be to these relations in whatever debate and discussion are currently going on. But the procedure I have adopted is to first to go back to a 'model' of Centre-State financial relations that I myself tried to develop some twenty

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years back and then ask myself how valid that model still is. If in following this procedure I speak a lot in the first person, I ask for the readers' forgiveness.

I

In 1956-57, I was considerably impressed by the need for and the requirements of planned national development. I was concerned about the wastes "likely to result within a country if the governments of the different federating units may decide upon different economic objectives and therefore pursue conflicting policies - policies which might retard the achievement of the national optima". I argued on the general plane therefore for greater and greater co-ordination of policies between the governments at various levels in the country and against financial exclusiveness.

State Taxes

More specifically, I argued for the Centre "to undertake the entire tax effort" for financing the plans because the experience then seemed to me to suggest that "the Central Government is in a better position to put in the required amount of tax effort" whereas "the States themselves are unable to match their tax receipts with their expenditures to the extent that economic considerations require such matching up". That led me to ask for "the extension of the concurrent jurisdiction of the Centre over the present States taxes".

My judgement was based primarily on the performance of the States, taken together, in the matter of raising additional taxation towards the financing of State programmes and schemes under the First Five-Year Plan. To quote from my earlier paper:

"According to the financial schemes of the First Plan the States were expected to raise about Rs.230 crores (the figure actually given in the First Plan is Rs.232 crores) from additional taxation. The actual receipts from additional taxation during the five years are estimated to have been in the vicinity of Rs.20 crores. During this period, the States increased their expenditures not covered by the schemes in the Plan. As a result therefore, the actual contributions from the States' tax revenues to the financing of their Plans fell far short of the estimates". (Parentheses have been added now.)

States' Borrowing

In regard to borrowing, my position was that under the Constitution the Centre already enjoyed effective control over the States' borrowing operations. What was actually being done, namely the Centre's allocation of the credit market to itself and the various States when the time was appropriate to float loans, was unnecessary as well as somewhat inefficient, the latter because of the higher interest which the State loans invariably carried as compared to the Central loans. So I urged that the Centre alone should "undertake the entire borrowing operations".

Of course, the above suggestion on borrowing was made alongside the suggestion that the transfer of funds from the Centre to the States should be made in the form of grants and not loans. It was not spelt out by me clearly however whether all transfers from the Centre to the States should be in the form of grants or only

transfers over and above those already provided for in the Constitution in the form of tax sharing and grants-in-aid. Perhaps it was the latter only that I had then mind.

The Old Model

So the sort of 'model' that I possibly envisaged then of Centre-State financial relations could be said to have as its major elements (1) a division of tax sources whereby while the Centre would have exclusive jurisdiction along with the States over some sources it will also have concurrent jurisdiction along with the States over the rest of the tax sources; (2) an unaltered division of expenditure functions; (3) exclusive jurisdiction of the Centre over borrowing and (4) transfer of funds from the Centre to the States in non-repayable forms.

How far do I now subscribe to this model. It is to this question that the rest of this paper is devoted.

II

The fact that the revenue they actually raised from additional taxation for financing the First Plan fell far short of the target originally agreed upon by the States - achievement was hardly 35 per cent - was the most important consideration which led me to conclude that the States could not be depended upon to harness adequately the tax sources assigned to them under the Constitution. One question that immediately arises is whether it was right to base my judgement on the States' performance relative to the target set for additional tax effort to finance the Plan. Whether the

five-year period was too short to rush to conclusion on such an important matter as the division of tax powers between the Centre and the States is also a valid question that could justifiably be raised.

States' Tax Performance

Before trying to answer the above questions, let us look at the States' tax performance over the past twenty five years or so. Then it should be easy to say whether or not either additional taxation alone is enough to judge the tax performance of the States or a five-year period is not too short a period to arrive at a judgement in this regard.

It can be seen from the accompanying table on Growth of Central and State Tax Revenues, 1950-51 to 1975-76, that, taking 1950-51 as the base year, while the total tax revenues of the Central Government increased by a little over 18 times the own tax revenues of the States (i.e. without including the revenues devolving to them from the Centre) increased by a little over 17 times.⁴ In both cases, 1976-77, the year for which only Budget Estimates are available, is taken as the terminal year.

Even during the five-year period of the First Plan, however short one may consider it to be in retrospect, taking the two terminal years, 1950-51 and 1955-56, the rate of growth (26%) in the States' own tax revenues was somewhat higher than that (21%) in the Centre's tax revenues. Thus, if one were to have judged the performance of the States on the basis of the rate of growth of their own tax revenues, the States could not have come out badly, not even on the basis of the rate of growth in the five years of the First Plan.

Growth of Central and State Tax Revenues
1950-51 to 1975-76

Year	Central Tax Revenues		States' Tax Revenues	
	Amount (Rs. crores)	Rate of Growth %	Amount (Rs. crores)	Rate of growth %
1950-51	405		215	
1955-56	486	20	283	32
1960-61	910	87	456	61
1965-66	2061	126	865	90
1970-71	3207	56	1528	77
1975-76 (R)	7470	133	3317	117
1976-77 (B)	7837		3731	

- Notes. 1) Central tax revenues include full proceeds of the taxes which are sharable with the States.
- 2) States' tax revenues are the combined receipts of the State Governments from the tax sources which are within the States' jurisdiction and do not include the proceeds of the sharable Central taxes which are transferred to them from year to year.
- 3) Rates of Growth are worked out with respect to the terminal year of the preceding quinquennium.
- 4) The figures for 1975-76 are based on the Revised Estimates for that year presented along with 1976-77 Budget Estimates.

So the question that really has to be answered is whether it was right to take additional taxation as the criterion of the States' tax performance. As a general proposition, it will have to be granted that targets of additional taxation have a relevance of their own in this context once it is granted that they are possibly set for the States as well as the Centre, after examining each tax source, its various characteristics, particularly those on which hinges the scope for raising additional revenue, and the level upto which it has been tapped already. Also as between different States, the targets for additional taxation are possibly fixed taking into account differences not only in their levels of existing taxation but also in the structure of their economies. So on a deductive level, the relevance of comparing the achievement with the target of additional taxation has got to be accepted. One can still try to raise doubts about the objectivity of target fixation and thereby question the validity of the above comparison.⁵

Let us however go back to the facts first of the period of the First Plan and then of the years to follow. The States' own tax revenues grew at a rate higher than the Centre's; still they feel miserably short of the Plan target. In the following two plan periods while the rate of growth of State tax revenues was lower than that of the Centre's, the targets of additional taxation were fully achieved by the States. During the five years, 1965-66 to 1970-71, the States did better than the Centre in regard to the growth of tax revenues but in the subsequent five years ending 1975-76 the Centre's performance was a little better.

Thus it would appear that the targets of additional taxation in the First Plan were set too high for the States; this cannot be said of the targets set thereafter. There can be no doubt, therefore, that it was quite rash on my part to conclude on the basis of the limited experience in the First Plan-period that the States could not be depended upon to raise the targeted tax revenues for the plans in the future. In the plan-periods to follow the States were actually able not only to realise their targets but also to keep shoulder to shoulder with the Centre in regard to the rate of growth of tax revenues. So on the basis of their performance in regard to tax effort over the past twenty five years the States, taken together, cannot easily be faulted. In fact, considering the division of tax sources between the Centre and the States, one might justifiably argue that the States' tax effort has been much more commendable than is suggested by its comparison with the Centre's tax effort. That being so, the rather sweeping suggestion I made for the extension of the Centre's concurrent jurisdiction over the tax sources which the Constitution originally assigned to the States does not stand scrutiny.

But let us take note of the other possible arguments that might still be put forth to give some over-riding powers - powers which might not go as far as the extension of concurrent jurisdiction to the Centre with respect to the tax sources now belonging exclusively to the States.

Arguments for Uniformity

One argument quite often advanced, in particular by trade and industry, has been that the territorial division of tax jurisdiction had led to disparities in tax rates and regulations and that these disparities distort the pattern of inter-State trade. This argument is particularly made with respect to sales tax which today accounts for over 50% of the States' own tax revenues. The Taxation Enquiry Commission (1953-54) had taken note of this complaint, in all its facets, and come to the conclusion that while "centralisation of sales tax must be ruled out", the Centre might be given power of both taxing sales or purchases taking place in the course of inter-State trade and also imposing restrictions on the taxation by the States of 'declared goods'.⁶ As a result of these recommendations, the Constitution was duly amended and the Centre given the necessary powers. Thus today inter-State sales are subject to tax under only a Central legislation and 'declared goods' can be taxed by the States at rates not exceeding those laid down by Parliament. But at least one consequence of these steps has been that the States, in particular those growing industrial raw materials for sale in other States, find themselves constrained revenue-wise in regard to not only the rate they can charge under the Central legislation but also coverage.⁷

But this trend towards extension of Central jurisdiction over State taxes did not stop there. In 1957 was enacted a law whereby the Centre would levy additional excise duties on textiles, sugar and tobacco - described as goods of special importance - in

lieu of sale taxes levied by the States. The proceeds of these excise duties were to be distributed among the States. The principal argument adduced in favour of this step was not to secure uniformity in rates but the convenience with which excise duties could be collected at the point of production with minimum scope for evasion. But it is interesting that when this experiment came up for review after ten years the States were generally opposed to its continuation on the ground that they had suffered loss of potential revenue by surrendering their right to levy sales tax⁸.

All the same, there exists today a very strong and influential lobby for putting further constraints on the States' power to impose sales tax. For instance, it is being urged that the rates of sales tax should be made uniform for a long list of commodities throughout the country. Since inter-State sales are already subject to uniform taxation and since the major raw materials cannot be taxed at rates exceeding those laid down by Parliament, evidently the current plea for uniformity in sales tax rates is being made with respect to intra-State sales.

The case for uniformity now rests largely on the grounds (1) that disparities in the taxation of even intra-State sales cause distortions in the pattern of development and (2) that these disparities place consumers in the States charging higher rates in a relatively worse position than others. The first argument ignores that disparities in tax rates may quite appropriately be used as a fiscal device to influence the pattern of regional

development in a country of India's size with wide inter-regional disparities in the levels of income, employment and industrialisation.

As for the consumers,¹⁰ the argument in favour of uniformity ignores that the composition of the consumption basket varies quite considerably between different parts of the country once you leave out the few very basic essentials. Also, it is overlooked that at the State level the choice can often be between slightly higher-priced private goods and low-priced or free public goods like education, medicine and public health so that the overall position of the consumers in the State with higher rates of taxation may be no worse off compared to that of the consumers in other States. In fact the overall position of the consumers in the former State might well be relatively better in terms of total welfare if we can assume a more equal distribution of public goods than private goods. A third point against attempts at securing uniformity in the rates of sales tax on a wide range of commodities is that it will considerably restrict the States' freedom of action and might virtually kill all initiative on their part. How could anyone then accuse the States of not tapping their tax sources adequately?

In fact, a point that can appropriately be raised in this context is that while the States have done reasonably well so far in tapping their tax sources, they have still become financially quite dependent on the Centre.¹¹ This could evidently have happened because the States expenditure commitments have tended to expand at least as fast as their tax and other revenues. Could not this be in argument, one might ask, in favour of a shift of tax powers

exactly in the opposite direction, i.e. in favour of the States, to re-establish a better balance between the States own-revenues and expenditures?

On the whole, I am now inclined to the view that there is no case for a shift in favour of the Centre in the present division of tax powers. Nor is there a case for placing any further constraints on the States' tax powers. To say this is not at all to argue against greater co-ordination among the States, and also between the Centre and the States, in such spheres of taxation where there is either overlap or where they can mutually benefit from each other's experience.

III

On borrowings from the public, the view I had taken earlier was, as already stated, that the Centre alone should undertake the entire borrowing operations. I took this view largely on the grounds that (1) the Constitution already gave to the Centre an overriding control on the States' public borrowing and (2) in actual practice the States have got to take only what the Centre allocates to them. So why continue with a fiction?

True that public borrowing is a major instrument of monetary and fiscal policy available to any government and that since the Centre has the sole responsibility of deciding upon appropriate policy one could possibly argue also for vesting borrowing completely in the Centre. I did not, however, use this as an argument for

the Centre to assume complete responsibility for the borrowing operations for the simple reason that the same argument also applies to taxation. Taxation is another major instrument of fiscal policy but in a federal set up no one has ever suggested therefore that it should be vested altogether in the Centre.

I could add however another additional argument in support of the suggestion for centralisation of public borrowing. A major component of public borrowing is what is usually referred to as market borrowing and to the extent that the so-called market tends to favour the more advanced States, the case would be stronger for centralised borrowing which is shared equitably between the various States.

This brings us to the question of the States' sharing the proceeds of borrowing. I am not concerning myself in this paper with the principles of sharing, be they proceeds of taxation or borrowing. I am concerned here with the form of transfer of funds from the Centre to the States. I suggested twenty years back that these transfers should take place in non-repayable forms, that is the States should be under no obligation to repay to the Centre any part of the amounts they secure from the Centre.

Existing Practice

I had anticipated three possible arguments in favour of the existing practice of transferring a part of the resources from the Centre to the States in the form of loans:

- "(a) The funds transferred in loans to the States are mostly obtained by the Centre itself in loans from the public and on which it incurs a certain liability

in the form of interest charges in addition to the liability for the repayment of the principal. (b)

The liabilities in regard to interest payment and the repayment of principal deter the States from venturing upon wasteful and extravagant schemes of expenditure.

(c) And if the loans are spent by the States on remunerative schemes (in the restricted sense of yielding revenue) it is only proper that the Centre should share in the income from such schemes".

On examination, these arguments were found to be wanting.

As for the first, and possibly the weightiest of the three arguments, it was pointed out that a good part of the Centre's borrowing could comprise of deficit financing. In any case, the repayment of Central loans to the public will have to be phased in accordance with the overall aggregate demand in the economy and not in accordance with the States' repayments. The argument regarding waste could not be meant seriously when half or more than half of the Central transfers to the States were already being made in non-repayable forms. This should not be taken to suggest that there is no waste but to control it legislative, audit and other checks would have to be made more effective against all forms of wasteful spending. As regards the argument about the Centre sharing the revenue from remunerative schemes, financed out of its funds, to the extent that that the States' schemes yield revenue, this enhances their ability to meet their commitments without assistance from the Centre. So the Centre could be said to share indirectly in the income from such schemes.

Outstanding Debt

An objection that was not anticipated by me earlier could be that at no point could things start on a clean slate. To suggest now that all Central transfers should be made on a non-repayable basis ignores that at any given point there would exist a backlog of outstanding debt which the States would be owing to the Centre. Is it the suggestion that only new transfers should be in non-repayable form or that in addition the outstanding debt should be written off? The loans of the past may or may not have been made in accordance with the criteria which are acceptable to-day. So if past loans are recoverable, it will add to the available pool of resources with which the criteria of today-can be promoted.¹³ But if this argument were to be pursued to its logical conclusion it should lead one to ask that all Central transfers should be made to the States in the form of loans because the criteria which are acceptable tomorrow may not be the same as the criteria of today. Moreover, to the extent that the correction of past imbalances in resource transfers is called for it can effectively be done through the allocation of currently transferable funds without their being supplemented by recoveries of past loans.¹⁴

Thus even on re-assessment the view expressed twenty years back on both the centralisation of public borrowing and the transfer of resources to the States in non-repayable forms appears to be quite valid. The major change I would like to make to my 'model' of twenty years back is to rescind the suggestion then made for the extension of the concurrent jurisdiction of the Centre over the tax sources assigned to the States under the Constitution.

CONCLUSION

To sum up, the Constitutional changes which seem to be called for in the sphere of Centre-State financial relations should be (i) to give the Centre alone the power to raise loans and (ii) to oblige, at the same time, the Centre to make all resource transfers to the States in non-repayable forms. The latter would naturally imply that to the extent the transfers are effected through the mechanism of grants and not tax sharing, it will enhance the role of bodies (as e.g. the Finance and Planning Commissions) which decide, or advise, on the magnitude of these transfers and their distribution.

NOTES AND REFERENCES

1. The Swaran Singh Committee (the committee set up by the Congress Party to formulate proposals for necessary Constitutional changes) is reported to have suggested the inclusion of Education and Agriculture in the Concurrent List but the Party has decided to retain Agriculture on the State List.
2. According to its Terms of Reference, this Committee has been asked, among other things, to review the existing structure of indirect taxes, Central, State and Local, in all its aspects. It can suggest changes, if any, required in the Constitution and related tax statutes to implement whatever changes are called for in the existing structure of indirect taxes. But the Committee is asked to bear in mind at the same time the revenue needs of the Centre and the States.
3. This was a paper I came to write on Sachin Chadhuri's encouragement. He published it in The Economic Weekly of March 23, 1957 under the title, Federal Finance and National Planning. I must add also that what I am now referring to as a model was presented rather non-formalistically in the form of a few suggestions on the financial relations between the Centre and the States. To call them collectively a model now is clearly an after-thought of today.
4. Even then, the choice of the base year, it must be immediately stated, makes some difference. If we take 1951-52 as the base year the Centre's tax revenues show an **increase by 15 times** as against the increase by 16 times in the States' own tax revenues. (The terminal year continues to be 1976-77.) It should be added that both the Fifth and Sixth Finance Commissions took note of the fact that the States' tax revenues had been expanding almost as fast as the Centre's tax revenues. Of course, both the Finance Commissions did so with a view to rebutting the argument sometimes advanced that the States' sources of tax revenue are indistinct (See pages 83 and 6 respectively of the Fifth and Sixth Finance Commissions' Reports.) and not to emphasising that the States' tax performance cannot be said to be relatively less encouraging.
5. There does exist a feeling among the States that the targets of additional taxation are not set for them as objectively as is often assumed. It is felt that the size of a State's plan ultimately determines its target for additional taxation. The interesting part of the scenario usually is that the States tend to ask for higher-size plans with a view to laying

claim on larger Central assistance but end up, collectively, having higher additional tax targets to fulfill. All the same, as we shall see presently, the complaint about over-targeting is not borne out by the experience of the plans subsequent to the First Plans.

6. A declared good is a raw material which is important both in inter-state trade and also from the point of view of the consumers or industry. Chapter IV of VOL. III of the Commission's Report spells out its recommendations in this regard.
7. Several ways and means have been devised by trade to avoid payment of the Central sales tax on sales across the State borders by comouflaging them as non-taxable transfers and this has assumed serious proportions in terms of the magnitude of tax avoidance, for at least some of the States. Then there is scope for dressing up intra-State sales as inter-States sales where the rates applying on the former are higher. (See Report of the Kerala State Committee on Commodity Taxation, 1976.) It is fortunate, in a sense, that the Taxation Enquiry Commission (1953-54) recommended also that the administration of the Central sales tax should be delegated to the States. Otherwise, the leakages in revenue might well have been much larger than to-day.
8. Report of The Finance Commission, 1969, pages 38 to 42.
9. Report of the Committee on Commodity Taxation, Government of Kerala, 1976, para 5.24.
10. The Taxation Enquiry Commission (1953-54) had also considered this matter of the interests of the consumers within a State and came to the following conclusion:

"Assuming that no such policy (e.g. statutory price control or price support) is significantly affected by sales tax, and assuming further that sales tax is not utilised, for example, as a species of internal tariff to create substantial price differentials in favour of one line of production as against another, there is no reason why a State should not determine the range and rates of its sales tax, the incidence of which rests on its resident consumers and the collection of which is made from its resident dealers". Report, Vol.III, page 51.

11. Between the terminal years of the five quinquennia in the 25-years period, 1950-51 to 1975-76, the ratios of transfers from the Centre to the States' total revenue on current account have been as under:

Year	States' total revenue on current account	Central transfers on current account	Central transfers on capital account	Total Central transfers
1950-51	1.00	0.21	0.16	0.37
1955-56	1.00	0.27	0.46	0.73
1960-61	1.00	0.38	0.32	0.71
1965-66	1.00	0.36	0.45	0.81
1970-71	1.00	0.39	0.30	0.69
1975-76	1.00	0.37	0.16	0.53

- Note: 1. States and Union Territories have been taken together.
2. Central transfers on current account include (a) shared tax receipts (b) statutory grants and (c) other grants and transfers.
3. Central transfers on capital account represent gross loans made by the Centre to the States on various accounts.

12. I had earlier fallen completely for the argument that grants against specific schemes of development can be less wasteful than general grants. I am not at all certain that this is so. I have come across far more waste in spending, at both Central and State levels, when funds are earmarked than when the rules permit flexibility.
13. Here I must refer to the Report of the Sixth Finance Commission, to which I was a signatory, because this was a major argument advanced to reject the plea for writing off the outstanding Central loans to the States:

"To take a composite view of Central and State finances, it is true that the clearance of the debt liabilities of the States to the Centre in whole or part would hardly make any difference to the resource position. But this and similar arguments in favour of write-off overlooked one important point. Recoveries of old loans enable the Centre to re-lend the amounts so realised to States on the basis of criteria that can be revised from time to time to promote certain national priorities and to bring about a progressive reduction of regional disparities". (P 84)

My comments in the text should be taken by way of self-criticism rather than as an attempt to dissociate myself from the above Report.

14. The highest proportion the loan repayments contributed to the so-called pool was in 1970-71 when they comprised 27.0 per cent of the total resource transfer made from the Centre to the States. The corresponding proportion for the other terminal years of the quinquennia were: 1950-51 (3.1%), 1955-56 (6.3%), 1960-61 (14.3%), 1965-66 (18.9%), 1975-76 (19.3%).