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Centre - State Financial Relations:  
An Issue States Must Squarely Face

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## Centre - State Financial Relations

### An Issue States must Squarely Face

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Whether our Constitution is genuinely federal or not appears to me to be a matter for unending, unnecessary polemics. The important thing is that in a country of our size there has to be considerable decentralisation all along the line in government's functioning. How far should this decentralisation go cannot however be discussed in abstract. But one can talk about decentralisation in concrete terms only if one is quite clear about the areas of activity and the levels of government concerned in each case.

I propose to write about decentralisation in the financial sphere and that too between the Centre and the States. But this should not be taken to imply that the question of even financial decentralisation between the States and the lower levels of government is any less important.

Let me also put it straightaway that one cannot speak of financial decentralisation without having a clear notion of not only the formal distribution of expenditure responsibilities between various levels of government within the country but also the national priorities between the various heads of expenditure in terms of the development strategy one would like to be pursued. It is in the latter context that the observation of the Sixth Finance Commission acquires significance: "When the emphasis is on social justice, there is no escape from a re-alignment of resources in favour of the States, because sources and programmes which are at the core of a more equitable social order come within the purview of the States under the Constitution".

One need not however use the above argument to seek one to one correspondence between revenue and expenditure responsibilities at various levels of government. But once one allows for a sizeable divergence between revenue powers and expenditure responsibilities, one cannot simply get away from the need for other corrective measures to bring about better correspondence between resources and responsibilities of the various tiers of government. The Sixth Finance Commission, which, on the whole, was satisfied with the mix of "both mandatory and enabling provisions embodied in the Constitution" for facilitating a wide ranging transfer of resources from the Centre to the States" spoke at the same time of the need of an "almost automatic mechanism" to effect such resource transfer. The Commission noted however that in actual practice resource transfers through the Finance Commissions, transfers that could come closest to automatic transfers, worked out to less than one-third of the total resource transfers from the Centre to the States during 1951-74. More than two-thirds of the resource transfers were effected, during that period, through non-statutory channels, half through the Planning Commission and half through the Central Ministry of Finance.

While the emergence of Planning Commission and Central Ministries as major channels of resource transfer did not, apparently, cause concern to the Sixth Finance Commission it is significant that while examining the reasons why "a feeling still persists that the States have not had a fair deal", the Commission

expressed the view that "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". It was therefore that the Commission not only recommended relatively larger devolution of funds from the Centre to the States but also suggested that, (i) "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", (ii) "the Central Ministries should increasingly transform themselves into expert, specialised agencies for providing guidance to the States but should cease to encumber themselves with routine administrative and supervisory functions which only annoy the States", and (iii) devise a "process of consultation between the Centre and States on fiscal issues on a systematic basis" so that "decisions that effect the resources of the States are taken after the widest possible measure of consultation". Evidently, the Commission was not quite satisfied with whatever consultations were already taking place on fiscal matters between the Centre and the States, say, in a forum like the National Development Council.

No doubt, the Sixth Finance Commission's specific recommendations with respect to (a) devolution of funds through tax sharing and grants-in-aid and (b) revision in the terms of repayment

of outstanding loans were accepted in toto. In this context, however it is pertinent to point out that while as a result of the acceptance of these recommendations, the proportion of statutory transfers to the States increased from 35.5% during 1969-74 to 50.9% in 1974-77, the total transfers declined relatively. This can be seen from the table given below. It shows that during the first 3 years of the Fifth Plan, the Central funds transferred to the States as a proportion of the States' own revenues declined sharply from 119% during the Fourth Plan period to 79%. So in overall terms, the States' relative financial position can be said to have suffered a set back in very recent years.

Table 1 Resource Transfers from the Centre to the States 1951-7  
(Rs. crores)

	States' own tax and non-tax revenues	Total funds transferred from the Centre to the States	Statutory transfers to the States
<u>First Plan</u> 1951 - 56	1823	1431 ( 78.5)	447 (31.2)
<u>Second Plan</u> 1956-61	3005	2868 (95.5)	918 (32.0)
<u>Third Plan</u> 1961-66	4925	5600 (113.7)	1590 (28.4)
<u>Annual Plans</u> 1966-69	4674	7114 (152.2)	1782 (25.0)
<u>Fourth Plan</u> 1969 - 74	12572	14958 (118.9)	5316 (35.5)
<u>Fifth Plan</u> 1974 - 77 (i.e. three years only)	14509	11456 (79.0)	5834 (50.9)

Figures in brackets in column (2) and (3) are percentages. However, the percentages in column (2) are of the absolute figures in that column to corresponding absolute figures in column (1) and the percentages in column (3) are of the absolute figures in that column to corresponding figures in column (2).

Sources: 1. Report of the Finance Commission, 1973. 2. RBI Bulletins

What was the fate of the Sixth Finance Commission's recommendations of general nature? Was any step taken, for instance, to place the process of consultation between the States and the Centre on fiscal matters on a systematic basis? No regular machinery has been set up for a regular consultation between the Centre and the States on financial issues of concern to the latter. Nor does it appear that any informal arrangement has been devised for such consultation. And still, practically every year changes have been made in income tax and excise duties, the two taxes levied by the Centre but shared with the States. In fact, measures have been introduced by the Centre affecting the taxes levied directly by the States (e.g. the exemption of exports from sales tax, going two stages backward) without consultation with the States. The most recent instance of the Centre's acting without consultation with the States is the imposition of excise on coal and electricity in full knowledge that the States have used precisely the same two bases for raising revenue for themselves. True, there is no legal bar to both the Centre and the States tapping the same base. But should there be no understanding on the limits to which each can go in such cases? Won't a free-for-all approach create situations of unnecessary competition and conflict between the Centre and the States?

We referred earlier to one positive development in very recent years, namely that the share of statutory transfers in the total resources transferred from the Centre to the States had increased during 1974-77. While between 1951 and 1974, the share of statutory transfers was less than one third it had increased to one-half during 1974-77.

It is a healthy or positive development not only because the States will feel more assured about the inflow through statutory transfers but also because for the proper working of the scheme of distribution of revenue and expenditure functions envisaged in the Constitution, it is extremely important that the principal channel of resource transfer to the States should be an "almost automatic mechanism" which is objectively devised. But, as we noted also, it was also during these past three years that the relative importance of total Central transfers had declined sharply. So, if the States are clamouring to-day for an urgent rethinking on the whole business of the Centre-State financial relations, it is not without a strong basis in facts.

The moment, however, one speaks of an objectively devised mechanism of resource transfer, one cannot overlook the problem of just and equitable distribution of resources between the States. In fact, one thing that stands out prominently in the study of inter-State distribution of Central resources, revenue and capital, over the past 25 years, is that the overall bias has been against low per capita income States and therefore clearly regressive. It is important therefore that in any discussion of Centre-State financial relations, the need for just and equitable distribution between the States must not be overlooked. It is relevant in this context to refer to the findings of a recent study by K.K.George and myself that all types of Central transfers, statutory, plan and discretionary, operate against the low income States. As for

statutory transfers, the inequity arises because of the use, so far, of two highly unjust yardsticks, to determine inter-State distribution of Central funds. One is the yardstick of tax collection used for inter-State distribution of a part of the income tax revenue and the other is the yardstick of non-plan revenue account gap. Tamil Nadu, for instance, gains on the first account but not on the second account, whereas a much poorer State like Bihar loses on both accounts. The net losers have, on the whole, been the low income States, however. If the demand for greater devolution of Central funds on the basis of an automatic mechanism is, in any sense, going to entrench the present inequitous system of statutory transfers in particular and of overall transfers in general, it will be simply unacceptable. That will aggravate inter-State income disparities further. The States must agree first among themselves on the choice of equitable criteria for inter-State distribution of Central devolution whether on revenue or capital accounts and then put up a united demand for a larger allocation from the Centre on an automatic basis so that their present state of 'medicant' dependence on non-statutory transfers is reduced drastically, if not altogether done away with. But this is not going to be an easy task. However, without such an agreement among the States, any formal machinery or informal arrangement for Centre-State consultations on fiscal issues will

bear little positive results. Whether the States which have benefitted more than others in the past will now see beyond their immediate narrow interests becomes a moot question. If they don't, there will be a real danger of a realignment between the Centre and the States resulting in an even more inequitable inter-State distribution of Central funds than in the past. And that will be a tragedy for it will only strengthen divisive forces in the country.