TASK BEFORE THE ELEVENTH FINANCE COMMISSION

*H.L. Bhatia**

This article highlights some of the leading problems tormenting the Centre-State financial relations in India and the role which the forthcoming 11th Finance Commission can play in their amelioration. Though the Commission will have to work within some major constraints, it will still have scope for charting out an innovative and productive framework.

CENTRE-STATE FINANCIAL RELATIONS

Centre-State finanical relations are in turmoil and call for an immediate review. The problem has become so deep-rooted that it has not been possible to implement a major "suggestion" of the Tenth Finance Commission (FC) intended to resolve it to a substantial extent, even when all the parties concerned agreed with its rationale and logic. Differences over some details weighed more with the decision-makers than the merits of the main framework of the proposed change. The irony of the situation is that the existing set up favours the Centre at the cost of States, but it is the States which are more adamant on some additional concessions than the ones recommended by the 10th FC, and this stand of theirs has scuttled the initiation of reconstruction of Centre-State financial relations.

The need for freeing the operation of Centre-State financial relations from personal whims and political views of the decision-makers (particularly at the Centre) is driven home not only by the performance of all the previous FCs, but also by the delay in constituting of the 11th FC which was due in June 1997. Now, as and when it is constituted, it will have hardly any time at its disposal for proper scrutiny of (a) financial projections of both the Centre and States on the one hand and (b) specific problems faced by them on the other. It will be equally difficult, if not impossible, for the Commission to seriously research and recommend innovations for placing Centre-State financial relations within a framework of mutual trust and objectivity. In addition, there is very high probability that it will have to tackle a flood of competitive populist measures incorporated in every government's expenditure projections.

The framework of current Centre-State financial relations was borrowed from the Government of India Act, 1935, in which a clear-cut division of subjects (including financial resources) was provided as between the Centre and British Provinces. The Constitution makers made an honest and creditable attempt in improving this framework with sound theoretical underpinnings. While items of non-tax revenue like earnings from interest, profits and dividends through manufacturing, business, and trading activities were subjected to overlapping jurisdiction of both the Centre and States, tax revenue was subjected to a different treatment. Each tax source was viewed as having three dimensions, namely (1) its levying, (2) its collection, and (3) its appropriation. No

* Reader, Department of Economics, Shri Ram College of Commerce, University of Delhi, Delhi.

overlapping was allowed in either levying or collection of a tax. If any good or activity admitted of more than one tax base, the same were clearly demarcated and allocated between the Centre and States; and if need be, even a single tax base was split up unambiguously and allocated. For example, production, distribution, transportation and consumption of a good can be conceived of as separate tax bases. Thus in practice, while the Centre can levy an excise duty on the generation of electricity, the States can levy a duty on its consumption. Similarly, the Constitutional provision that the States can tax advertisements but not those appearing in a newspaper is one of several examples of splitting up a single tax base between the Centre and States.

Actual allocation of levying and collecting a tax was decided on three sound theoretical criteria, namely, those of (a) uniformity, (b) economy and (c) efficiency. An assessment was made as to which tax bases (such as non-agricultural incomes) qualified for an all-India uniform treatment, while others (like agricultural incomes, retail selling, etc.) called for only Statewise uniformity. The spatial extent to which the concept of uniform treatment of a tax base was desirable and feasible was used as the deciding factor for allocating a tax base to the Centre or States. The same considerations applied when it came to the collection of a tax. The idea was that the spatial boundaries. within which levying/ collection of tax was to conform with the concept of uniformity was to be decided on pure economic merits of the case. The criterion of economy called for eliminating avoidable cost of collection while that of efficiency related to repercussive effects of a tax. As against levying and collection of a tax on the above-mentioned criteria, appropriation of its revenue was guided by the perceived needs of Centre and States. It was on this basis that tax on non-agricultural incomes by the Centre was made compulsorily divisible between them, and division of Union excise duties was made optional for the Centre. In contrast, the Centre was barred from sharing its revenues from any other tax or any surcharge on a tax.

ROLE OF FINANCE COMMISSION

It was but natural that allocation of tax resources on the criteria of uniformity and economy, though highly commendable, would result in an ever-growing financial imbalance in favour of the Centre. Accordingly, provision was made for transfer of financial resources to the States, not only in the form of tax sharing, but also in the form of grants and loans. In addition, it was provided that a Finance Commission would be constituted by the President of India every fifth year or, if need be, earlier to undertake the job of reviewing the existing financial situation with projections and estimates. It recommends, within its terms of reference, the proportion of income tax that should go to the States. In addition, it also recommends which of the Union excise duties are to be shared and in what proportion. Within their combined total, shares of individual States are also recommended by it. The Centre also levies and collects additional duties of excise on cloth, sugar and tobacco (including manufactured tobacco) and their total net receipts are deivided between the States as recommended by the FC. The Centre may also levy taxes under Article 269 (currently no tax is being levied under this Article) in which case all net collections are to be divided between the States. In addition, the FC also assesses (if its terms of reference permit it to do so) the need for grants-in-aid by each State and makes recommendations to that effect. The President may also ask the FC to recommend distribution of some additional

grants between the States (such as grants in lieu of tax on railway fares) and any other matter in the interest of sound finance.

Equally relevant is the fact that the FC is constituted by the President and its terms of reference are also decided by him. In effect, it means that the Central government performs this task without States having any say in it even though it concerns them at least as much as it does the Centre.

Inherent Weaknesses

Such an agreement, though commendable in many respects, harboured some inherent weaknesses. Some of these could not be anticipated at the time of its framing while others originated from some faulty presumptions — the most important being the one that only the Centre can be a dispassionate guardian of the financial interests of the country as a whole, and that only it has requisite integrity and expertise in working the entire system on an objective basis.

Firstly, the Constitution ignored the rationale and existence of local bodies. It provided a division of subjects only between the Centre and States. The creation of the third tier, namely, the local bodies was left to the discretion of States. Their contours were determined by the respective State legislature. Their activities were also financed by resouces reserved and transferred to them by States which were themselves put in the grip of a perpetual resource crunch. In these circumstances, local bodies could never be expected to do justice to their existence. Moreover, it was forgotten that the development of the economy and continuous transformation of society is a breeding ground for emerging needs and aspirations of the society which can be met only at the local level. Faced with this perpetual resource scarcity, local bodies have not been able to employ efficient and skilled workforce, nor have they been able to afford modernisation and upgradation of their equipment, machinery, and work methods.

The seventy-third and seventy-fourth Amendments of the Constitution have not yet eased the financial difficulties of local bodies. Apathy of State governments towards their needs continues unabated, which is partly borne out of the historical past, partly because the States themselves suffer from chronic resource scarcity, and partly on account of their *acquired* financial imprudence.

The terms of reference of the Eleventh Finance Commission would include consideration of the fact that, under the 73rd and 74th Amendments of the Constitution, the States are expected to transfer resouces to local bodies. As things stand, the FC may not be in possession of reliable information on the recommendations of State FCs and their respective acceptance by States. It should therefore, try out, within Constitutional provisions, a more reliable method of resource transfers to local bodies which should meet their growing needs on an assured basis. Probably, it should seek a solution in line with the "suggestion" of the 10th FC ragarding resource transfers from the Centre to States. That is to say, to the effect that local bodies should get a specified percentage share of State tax revenue in addition to resouces on their own.

Secondly. the Constitution makers made the mistake of assuming that the allocation of tax levying worked out by them would continue to be ideal for all times to come. They ignored the fact that economic development of a country is characterised, amongst other things, by an increasing degree of integration of its economy, with crumbling local and regional barriers and

emergence of new tax bases. In our Constitution, these are reserved for the Centre on a residual basis. Consequently, the States have no incentives to exploit *new* tax sources because they just cannot. Moreover, in the wake of economic integration and development, spatial boundaries of some tax bases tend to widen, when judged on the criteria of uniformity and economy. Therefore, a periodic review of the tax bases reveals that some of them should be moved from the jurisdiction of States to that of the Centre.

These tendencies necessitate reallocation of tax bases so as to conform to changed realities coupled with an alternative system of resource transfers like the one suggested by the 10th FC. Legally the 11th FC would not be authorised to make recommendations pertaining to either. But, given the precedence of the 10th FC, it can certainly study the entire problem and make a strong "suggestion" for an alternative system of tax-sharing. It, of course, goes without saying that such a suggestion cannot be implemented without a corresponding Constitutional Amendment. There is also the apprehension that the Commsission would be short of time in making an effective study for refining and streamlining the details of its suggestion, if any, for an alternative scheme of tax-sharing.

Thirdly, the problem of taxation of agricultural incomes has been debated unendingly with a fair mixture of both economic and non-economic arguments. The type of integration of the two types of incomes recommended by the Raj Committee and implemented two and half decades ago has heightened the element of inequity as between tax payers placed in similar circumstances. In all fairness, all incomes should be taxed (provided they are to be taxed) on a uniform basis irrespective of their source. This step also requires a Constitutional Amendment and the 11th FC, guided by the precedence of the 10th FC, should make a strong suggestion to this effect.

Fourthly, the Constitution makers made an implicit but all too obvious assumption that while the Centre would be an epitome of financial prudence, the States would never be able to learn this art. They would always be in need of 'help' and 'guidance' so as to avoid the pitfalls of financial mismanagement. For this reason, they were put under severe restrictions of several kinds — particularly in the field of public debt policy and operations. Article 293 stipulates that if any part of a State loan taken from or guaranteed by the Centre is outstanding, then the State concerned cannot go in for additional borrowing without permission from the Centre and the latter, while granting such permisison, can impose any conditions on the State it deems fit. In contrast, there is no such binding on the Centre, so much so that even the RBI cannot turn down its request for a loan. The RBI, however, can say no if a State makes a request for a loan. It is also noteworthy that, in effect, every State was compelled to get and remain indebted to the Centre by a deliberate policy of the Centre and was thereby deprived of any option of a public debt policy of its own. It may be recalled that the allocation of resources was designed to result in ever-growing financial imbalance in favour of the Centre and in corresponding need for resource transfers from it. The policy of the Centre should have been to effect these transfers, to the extent feasible, in the form of tax-sharing and grants. In practice, however, successive FCs systematically underestimated the revenue needs of States. In many cases, their terms of reference restricted them to consider only non-plan revenue budgets of the State governments. And in addition, the Centre also preferred to assist the States by way

of loans instead of grants. This was mostly so even when a State needed assistance for meeting consumption needs like relief in a natural calamity without any revenue potential. Increasing indebtedness of the States to the Centre with the passage of time was an inevitable consequence of this approach, and one suspects, was intended to be so by the Centre. The FC is not authorised to recommend to the Centre to revise its policy of discretionary transfers (which constitute about 60 per cent of the total, while only the balance is transferred on the recommendations of FC) in favour of grants and away from loans. Its terms of reference, at the most, enable it to recommend a relief to States on their outstanding debt.

While a search for specific loopholes in the Constitutional provisions has its own merits, the real fault for their failure lies with those operating it. The States have earned a notoriety of indifference to their own financial health in which policies pursued by the Centre have played their role. At the same time, a lot can also be said about financial imprudence on the part of the Centre. It expects a certain standard of performance from the State undertakings wihtout any better record of its own. It accuses the States of populist expenditure schemes while itself practising the same. This double standard on the part of the Centre and supported by the FC must be stemmed for improving the health of public finances.

Actual operation of the Constitutional provision by all the three parties directly involved in the process (the Centre, the States and the FC) has led to a cumulative erosion of mutual trust between the Centre and States with the States being the greater losers and with inevitable ill-consequences for the economy as a whole. It is for this reason that the States have resisted even some very desirable changes like abolition of octroi and replacement of State sales tax by additional duties of excise by the Centre. The States, on the basis of their past experience, are genuinely apprehensive of a fair deal from the Centre in future. Their resistance spells serious repercussions for growth and integration of the economy as a whole and hinders reduction of regional disparities. The removal of this atmosphere of mistrust and resistance to reforms lies in ensuring that the Centre does not have any interest in developing some specific revenue resources in preference to others, and that its policies are guided not by partisan motives but by overall interest of the country. To that end, therefore, the 11th FC should refine and strongly suggest a Constitutional Amendment guaranteeing a specified percentage share of all Central tax revenue to the States.

Fifthly, the determination of shares of States within their combined total has generally attracted adverse comments. Opinions differ as to the extent recommendations of the FC should contribute to inter-State distributive justice and reduction in regional disparities. The terms of refernce of successive FCs have been silent over this issue, just as the Constitutional provisions have been. The result has been not only a lack of consistency in the stance adopted by the successive FCs, but also by the same FC as between different items of resource transfers. The issue assumes greater seriousness because over all these decades, recommendations of the FCs (albeit expected to have a limited effect) and efforts of the Planning Commission have failed to reduce regional disparities. Some States have persisted in lagging behind others both in performance and in efforts: In this regard, they exhibit a total lack of motivation. Instead, they consider it their right to be favourably treated in resource transfers without any obligation on their part to mend their ways.

CONCLUDING REMARKS

Any pursuit of a deliberate "egalitarian" policy in determining shares of individual States in the total of resource transfers, though a half-hearted one, has failed to make any impact. Moreover, no one advocates that a better-off State should provide official assistance to a poorer one for welfare schemes or growth projects of the latter. And, in the final analysis, transfers favouring poorer States at the cost of better-off ones amount to the Centre forcing some States to assist the others — which they woud not (and not expected to) do on their own. If this line of reasoning is accepted, then the FC should estimate the potential contribution of each State to the Central kitty and determine their individual shares accordingly. Since share of a State will not be affected by its financial performance, each State will have an inherent incentive to be financially more prudent. Moreover, while economic growth of a State will automatically entitle it to a larger share in the transferred resources, slackness in areas like population control will not help.

Reference has already been made to the fact that the President constitutes the FC and assigns in its terms of reference. It is suggested that the President should adopt the convention of consulting States in this matter before issuing actual orders. This should help in diluting the current atmosphere of mutual distrust. In addition, every FC has been complaining of non-availability of a variety of essential data (such as on consumption). This deficiency should also be removed quickly and effectively.