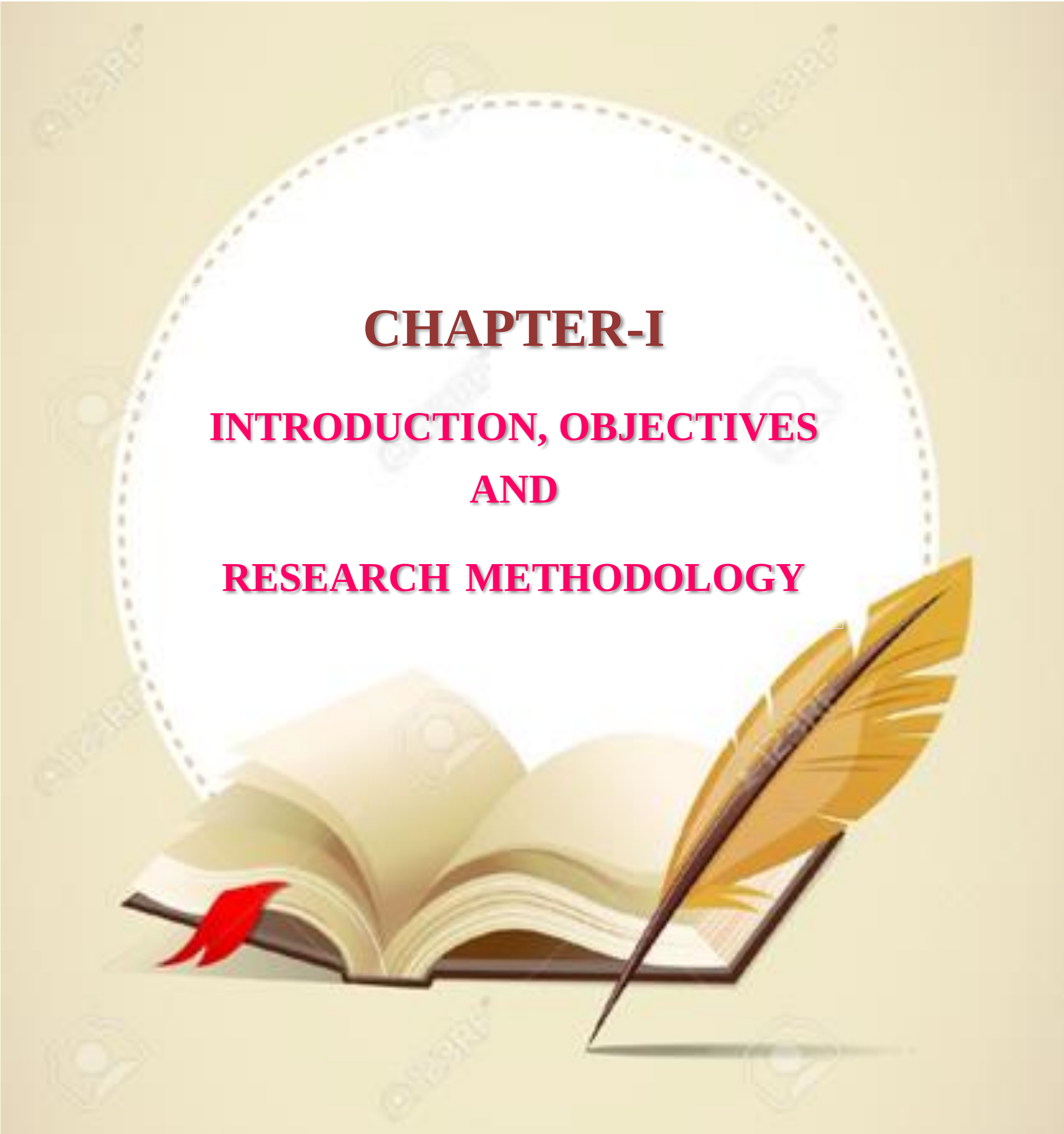

CHAPTER-I

INTRODUCTION, OBJECTIVES AND RESEARCH METHODOLOGY

CHAPTER - I

INTRODUCTION, OBJECTIVES AND RESEARCH METHODOLOGY

1.1 Introduction:

India is a multi-tier federal country with 29 States, 7 Union Territories and about 2.5 lakh local bodies all of which having constitutional status as institutions of self-government. The unique federal Constitution of India described variously as federal structure with strong Centre or federal in nature but unitary in spirit or even as quasi-federal provided for distribution of sovereign legislative powers between the Union (or Centre) and the State Governments. The third tier of government viz., the *Panchayats* and municipalities are basically devolution of State legislative powers, though accorded constitutional status, since local government remained a State subject under the Constitution.

The Indian State has often been viewed to be characteristically federal with certain 'unitary features'. It faces problems of vertical and horizontal imbalances between the Centre and the states. Vertical imbalances occur due to the expenditure patterns of states which is often disproportionate to the states' source of revenue, a large part of which flows from the Centre. On the other hand, factors such as geographical location, historical backgrounds and differences in resource endowments are major reasons for horizontal imbalance within the states. Recognizing the importance of equalisation among states to bring in a parity of development across the regions, the Constitution made several provisions to bridge the gap in finances between the Centre and the States (Mitra, 2014).

There is a division of legislative, administrative and financial powers between the Centre and the state governments. These are elaborated in list I, II and III of the seventh schedule of the constitution. List I (Union List) describes the functions and powers of the Union Government. List II (State List) mentions the functions and powers of the state governments. List III (concurrent list) describes the subject matter on which both the Union and the state governments can legislate. According to Article

254 of constitution of India, if any provision of a state law is repugnant to any provision of a central law, then the central law shall prevail and the law made by the state shall be void to the extent of repugnancy.

It is pointed that the distribution of the financial powers and functions between the Centre and the states provided in the Indian constitution has been responsible for the sufferings of the states. Firstly, the constitution assigns wide responsibilities to the states, like building up social and industrial infrastructure, rural development, education, medical and public health, and welfare of scheduled castes and scheduled Tribes. Moreover these social and economic services tend to expand overtime. This means that the need of the states for more and more resources also goes on increasing. Secondly, the resources available to the states are few and less elastic. Thirdly, more Buoyant taxes like customs duties and corporation taxes are not shareable. Even in the case of shareable taxes, the Centre has the right to impose surcharges and earmark cesses, which are exclusively used by it. Fourthly, the Finance Commission has no authority to enlarge the size of the divisible pool of shareable taxes. Finally, the Centre is in a much better position because it can resort to deficit financing and borrow from the Reserve Bank of India. Financial institutions both national and foreign and collect savings and deposits from within the economy in different forms. In Short, the states are in a very weak position. Consequently, the states have become dependent on the Centre for financial resources. This dependence has progressively eroded the jurisdiction, authority and initiative of the states. The Centre has also been complaining about the inadequacy of resources because a major portion of its resources is consumed by defence, interest payments and subsidies. So the friction in the Centre state financial relations continues to exist (Hajela, 2004).

1.2 **Fiscal Federalism**

The term was introduced by the German-born American economist Richard Musgrave in 1959. Fiscal federalism deals with the division of governmental functions and financial relations among levels of government. Musgrave argued that the federal or central government should be responsible for the economic stabilization and income redistribution but the allocation of resources should be the responsibility of state and local governments.

The following are benefits of fiscal decentralization: regional and local differences can be taken into account; lower planning and administrative costs; competition among local governments' favours organizational and political innovations; and more efficient politics as citizens have more influence. There are several disadvantages of fiscal federalism as well: the lack of accountability of state and local governments to constituents; the lack of availability of qualified staff; the possibility for people to choose where to reside; a certain degree of independence of the local governments from the national government; and unavailability of infrastructure of public expenditure at the local level (Fiscal Federalism, 2016).

In India the fiscal relations between the Centre and the States have been defined under the Constitutional provisions of distribution of revenues between the Union and the States. Under the scheme of distribution of taxing powers, the major sources of revenue assigned to the Union are: taxes on income other than agricultural income; customs duties including export duties; excise duties on goods manufactured in India except alcohol and liquors for human consumption; taxes on capital value of the assets, exclusive of agriculture land, of individuals and companies; taxes on the capital of companies; estate duty and succession duty in respect of property other than agricultural land; etc. The major sources of revenue allocated to the States, on the other hand, are: land revenue; taxes on agricultural income; succession duty in respect of agricultural land; estate duty in respect of agriculture land; taxes on land and buildings; taxes on mineral rights; excise duties on alcoholic liquors for human consumption; sales tax; professional taxes; taxes on the consumption of electricity; taxes on advertisements; etc. While the resources of the States are limited, they have larger responsibilities for social, educational and economic development of the people. Further there are wide differences in the level of development of the States. In order to address the issues of this vertical and horizontal imbalance in the Centre-State and inter-State relations, the Constitution of India has provided for inter-governmental transfers through the mechanism of Finance Commission which is constituted once in five years to recommend transfers of central revenue to the States for a five yearly fiscal cycle. Further such transfers also take place through the Planning Commission (replaced by a new institution named NITI Aayog from 1st January, 2015). There are three main channels of Central transfers to States; the finance commission transfers, plan transfers and assistance for central sector and centrally sponsored schemes (Inter-State Council Secretariat, n.d.).

1.3 Finance Commission

Under article 280 of the constitution; the president of India appoints a Finance Commission every five years. Its working etc. is further governed by the Finance Commission (Miscellaneous Provisions) Act, 1951. It is an advisory body and deals with the transfer of resources from the Centre to the states, determination of individual shares of states in the transferred resources, reviewing the financial situation both at the Centre and the states and several other related issues and problems as determined by its terms of reference.

The commission is charged with making recommendations to the president on the distribution of the taxes between the Centre and states and the consequent distribution among the states themselves. It also recommends grants-in-aid to states and suggests measures to strengthen the functioning of Panchayat Raj and Municipal bodies. Fourteen such Finance Commissions have been set up so far.

1.4 Choice and Relevance of the Subject

The constitution of India, operative since 1950, has shown flexibility towards changing needs and aspirations of the people. The passage of the constitution (Seventy-third Amendment) Act, 1992 is landmark in the history of Modem India. With this amendment, a uniformity structure of *Panchayats* emerged throughout the country. Further, Seventy-Fourth Amendment (1992) of the constitution also included Municipal Administration.

In short, Panchayats and Municipalities are now constitutional bodies forming third tier to the federal policy of India. India's decentralization initiative in the form of seventy-third and seventy fourth Amendments poses challenges and offers opportunities.

Furthermore, the constitution (Eightieth Amendment) Act, 2000, significantly changed the manner of distribution of central tax collections between the central and state governments. Prior to constitution (Eightieth Amendment) Act 2000, Income tax and Union excise duty were the only taxes shared with the states. The aforesaid amendment altered the pattern of sharing of central taxes between the Centre and the states significantly by providing for the sharing of the net proceeds of all Union taxes and duties (except taxes under Articles 268 and 269 and earmarked cesses, and surcharges under Article 271) with the states. Still further, the constitution (Eighty-eighth Amendment) Act, 2003 has included 'taxes on services' under entry 92C in the union list (List 1) in the seventh schedule of the constitution (Sury, 2005).

Regarding the magnitude of central transfers to the states it is natural to expect claims and counter claims by the two levels of the government. The states have often complained that resources allocated to them are inadequate to enable to discharge their responsibilities. They complain against widening gap between their own resources and needs, a trend indicating their increasing dependence on the Centre for resources. They assert that their resources should be commensurate with their obligations and responsibilities. Similarly, the Centre also feels constrained at the widening gap between its resources and needs, as reflected in the budgetary deficits. Since the early 1980s, the Centre has been running considerable deficit on its revenue accounts. Its commitments towards defence, subsidies and interest payments claim a major chunk of its resources and there is little hope of any respite on these accounts in the near future (Sury, 2008).

In the present study, apart from reviewing Indian Finance Commissions, recommendations of the last three Finance Commissions (Eleventh to Thirteenth) have been studied in detail.

1.5 **Objectives**

The main objective of this study is to study Centre-State financial relations in India. However, following are the specific objectives.

1. To take a review of the Indian Finance Commissions.
2. To study sharing of shareable taxes revenue between Centre and States and among states.
3. To study criteria used for allocating Grants-in-aid to States and Union Territories by the Finance Commissions.
4. To examine and compare recommendations of last three Finance Commissions.

5. To examine recommendations of the Fourteenth Finance Commission.

1.6 Hypotheses

Following are the hypotheses:

1. In the federal financial system financial power is concentrated with central Government.
2. States are mostly relied on financial support from center due to more state activities.
3. Progressive States are getting more share of Grants-in-aid compare to tax share.

1.7 Research Methodology

The scope of the present study is at national level, in which Centre-State financial relations have been studied with special reference to last three Finance Commissions. This study is based on secondary data i.e. the study is relied only on secondary data. Data have been collected from various secondary sources which include Report on Finance and Revenue Accounts of Centre and State Governments, RBI Reports on Study of State Finances: A Study of Budgets, Handbook of Statistics on Indian Economy, Indian Public Finance Statistics, CAG, Ministry of Finance (Government of India), Central Statistical Organisation, Census of India reports, magazines, journals, books, articles, published and unpublished work and various commission reports etc.

Data so collected have been processed and analysed, for drawing inferences and making suggestions. In the study simple statistical tools, viz. averages, percentages etc. and advanced statistical tools like correlation coefficient and regression analysis, Buoyancy of taxes, cross-section and time series analysis have been used for analysis. The compound annual growth rates have been calculated to estimate the year wise population. Income category wise distribution (i.e. low, middle and high income) of the states have been taken as given by the Eleventh Union Finance Commission.

To calculate buoyancy of each year of State's tax revenue following formula was used:

Buoyancy of State's Tax Revenue

$$= \frac{\text{Percentage Change in State's Tax Revenues}}{\text{Percentage Change in Composite GSDP At Current Prices}}$$

To calculate buoyancy of each year of Union tax revenue following formula was used:

Buoyancy of Union Tax Revenue

$$= \frac{\text{Percentage Change in Union gross Tax Revenue}}{\text{Percentage Change in GDP at market Prices}}$$

To calculate the composite buoyancy of States and Union taxes for 2001 to 2014 duration the following equation was used:

$\log Y = \log b_0 + b_1 \log X$

Where,

Y = Composite GSDP at current prices in case of states
and GDP at market prices in case of Union.

X = Tax Revenue.

b_1 = Derivative of log Y with respect to log X, the constant tax buoyancy.

Projection Error of Finance Commission's Transfers has been measured using the following formula:

$$\text{Projection Error} = \frac{R-A}{A} * 100$$

Where,

A = Actual Transfers

R = Recommended Transfers

The projection error gives us an idea about the rate by which States were expecting greater amounts or less amounts than actual share.

Vertical transfers and horizontal transfers have been calculated using the following formula:

Vertical transfers = Per Capita Transfers received by the highest
Per Capita State * Population of the Respective States.

This amount indicates the minimum transfer that was given to every state independent of differences in fiscal capacity.

Horizontal Transfers = Per Capita Horizontal Transfers *
Populations of respective States.

The progressivity of Finance Commission's Transfers has been measured by taking regression of per capita Finance Commission's transfers on per capita NSDP. The rate of responsiveness of per capita transfers to changes in per capita NSDP has been measured using the following equation:

$$\text{Ln } Y_i = \alpha + \beta \text{ Ln } X_i + U_i.$$

Where,

Y_i = Per Capita Transfers,

X_i = Per Capita NSDP,

α = Intercept and

β = Slope, which indicates the average response of per capita transfers in rupees as per capita NSDP increases by one rupee.

The collected data has been presented in the form of tables, graphs and charts etc.

1.8 Limitation

The present study is relied only on secondary data, due to the nature and scope of the subject.

1.9 Chapter Scheme

The study has been divided into eight chapters. The chapter scheme has been designed keeping in view the objectives of the study.

Chapter 1: Introduction, Objectives and Research Methodology

In this chapter brief introduction to the subject has been given. Theoretical framework of Fiscal Federalism, role of Finance commission, choice and relevance of the subject, objectives of the research study, hypotheses of the research study, research methodology and limitation of the of the research study have been discussed.

Chapter 2: Review of Literature

In this chapter various research papers, books, commission reports which discusses allocation of funds between Centre and States, Criteria used for allocating financial resources among states, Criteria used for allocating Grants-in-aid and evaluates the recommendations of the Finance Commission have been reviewed.

Chapter 3: Indian Federal Financial System

In this chapter the evolution of fiscal federalism in India in which pre-independence history of fiscal federalism such as Mayo Scheme, 1870, Government of India Act, 1919, Indian Taxation Enquiry Committee, 1924-25, Government of India Act, 1935 have been discussed. In the post-partition financial adjustments Deshmukh Award, Expert Committee on Financial Provisions of the Constitution, 1947, Financial Integration of Princely States, Indian States Finances enquiry committee, 1948 have been discussed. Further Constitutional Provisions regarding fiscal federalism such as taxation powers and expenditure responsibilities have been discussed. Furthermore fiscal decentralisation initiatives have been reviewed.

Chapter 4: Indian Finance Commissions: An overview

In this chapter review of all Indian Finance Commissions with respect to changes in the terms of references of the Finance Commissions, allocation of tax share and grants-in-aid to states and its distribution among States, criteria used by different Finance Commissions to distribute the share of each state, principles governing the design of grant-in-aid: shift from gap-filling approach to normative approach, Pattern of Transfers from Centre to States by Finance Commissions have been reviewed in detail.

Chapter 5: Finance Commissions and tax sharing

In this chapter recommended and actual amounts of tax share of State's in Central taxes from First to Thirteenth Finance Commissions, Per cent and per capita share of Low, Middle and High Income States in Central Taxes and Duties

Recommended by the Finance Commission of India, Degree of Equalisation of Finance Commission’s transfers have been studied. More emphasis is given on last three Finance Commissions.

Chapter 6: Finance Commissions and Grants-in-aid

In this chapter recommended and actual amounts of grants-in-aid of State’s in Central taxes from First to Thirteenth Finance Commissions, per cent and per capita Share of Low, Middle and High Income States in grants-in-aid recommended by the Eleventh to Fourteenth Finance Commissions, objective wise allocation of grants-in-aid and criteria used to allocate the same have been studied in detail.

Chapter 7: Recommendations of Fourteenth Finance Commission

In this chapter major recommendations of the Fourteenth Finance Commission pertaining to devolution of Central taxes and duties, grants-in-aid, Criteria used for horizontal sharing of tax share and grants-in-aid and other important recommendations have been examined.

Chapter 8: Conclusions and Suggestions.

In this chapter conclusions and suggestions have been put forward based on the entire research study.

References :-

Fiscal Federalism. (2016). In Encyclopædia Britannica. Retrieved from http://www.britannica.com/topic/fiscal-federalism

Hajela, T.N. (2004). Public Finance. New Delhi: Ane Books Pvt. Ltd.

Inter-State Council Secretariat. (n.d.). Fiscal Federalism. Retrieved from http://interstatecouncil.nic.in/Fiscal_Federalism.html

Mitra, S. (2014, October). Significance of the Finance Commission. Budget Track, 10(1-2), 3.

Sury, M. M. (2005). Finance Commissions of India, I to XII (1952-57 to 2005-10). New Delhi: New century Publications.

Sury M. M. (2008). Centre-State Financial Relations in India 1870 to2010. New Delhi: New Century Publications.