CHAPTER-II

FINANCE COMMISSIONS IN INDIA
INTRODUCTION

Under the provision of Article 280 of the Indian Constitution, the President is required to appoint a Finance Commission for the specific purpose of devolution of non-plan revenue resources. The function of the Commission is to make recommendation to the President in respect of the following matters:

a. The distribution of net proceeds of taxes to be shared between the Union and the States (i.e., income taxes, excise duties levied and collected by the Union) and the allocation of shares of such proceeds among the States.

b. The principles which should govern the payment by the Union of grants-in-aid to the revenue of the States.

c. Any other matter concerning financial relation between the Union and the State.


This chapter comprises three sections. Section-I analyses Finance Commissions' recommendations in general. Section-II deals with the principles governing grant-in-aid by Finance Commissions in particular, and Section-III evaluates Finance Commissions' recommendations.

SECTION-I

FIRST FINANCE COMMISSION (1951)

The First Finance Commission was appointed in November 1951 under the Chairmanship of K.C. Niyogi. It recognised the urgent need
for a substantial income in revenue of the States. Simultaneously it recommended that limitation to the Center's ability to transfer funds to the States should be also taken into account.

**Major Recommendations**

**Division and distribution of Income Tax:**

The personal income tax is imposed and collected by the Union Government but the net proceeds are shared between the Centre and the States under Article 270 of the Indian Constitution. The Finance Commissions have to give their award on two points:

a. The share of the States in the total collection of the income tax, and,

b. The principle/principles which should govern the share of each State in the divisible pool.

The First Finance Commission recommended that the State should share 55 percent of proceeds of the income tax. The share of each State in the total divisible pool was determined on the basis of the double criteria of (1) population and (2) the collection of income tax from each State.

According it recommended the allocation of income tax proceeds on the basis of 80 percent and 20 percent of population and collection respectively. This criterion benefited populous States as well as those richer States which contributed more tax revenue.

**Division and Distribution of Excise Duty:**

The First Finance Commission selected three excise duties – on tobacco, matches and vegetable oil and recommended that 40 percent of
the net proceeds of the excise duties be distributed to States on the basis of their population.

Grant-in-Aid in Lieu of Jute Export Duties:

Under the Government of India Act, 1935, there was a provision to distribute a share of the jute export duties to the jute growing States. But in the Constitution of India, there is no such provision. But still the Constitution provides for grants-in-aid in lieu of the share in jute export duty for a traditional period.

The First Finance Commission recommended the annual grants-in-aid to be paid in lieu of jute export duty as under:

- Assam: Rs. 75 lakhs
- Bihar: Rs. 75 lakhs
- Orissa: Rs. 15 lakhs
- West Bengal: Rs. 150 lakhs

Grants-in-Aid to the States:

The Indian Constitution has entrusted important welfare and development function to the States but various tax resources provided to the States were found to be inelastic and wholly inadequate. To overcome this problem the Constitution provided for a mechanism of grants from the Centre to the States. Grants-in-aid may take the general form of aid to overcome current revenue deficits or to correct inter-State disparities in resources. Grants-in-aid may be for specific purposes such as the promotion of education or for toning up administration to face natural calamity or to develop economic conditions and so on. Under
Article 275 of the Constitution, the Finance Commission has to decide about the grants-in-aid to the State corresponding to each five-year plan. The Commission recommended more grants-in-aid to the economically backward States. It recommended grants-in-aid for 7 States, to cover their deficit during the period 1951-56 and 8 States to improve primary education facilities.

**Setting up of a Permanent Small Body:**

The First Finance Commission recommended the setting up of a small organisation to study the problems of finances of State continuously to provide data to the next Finance Commission to be appointed after next five years.

**Observations:**

Most recommendations of the First Finance Commission were accepted. Some States were dissatisfied though the Commission had tried its best.

**SECOND FINANCE COMMISSION (1956)**

The Second Finance Commission was appointed in May 1956 under the Chairmanship of K. Sundaram. It considered both the basic as well as the developmental needs of the States.

**Major Recommendations:**

**Division and Distribution of Income Tax:**

The share in the net proceeds of income tax was raised from 55 percent to 60 percent.
The 90 percent of the total share was to be distributed on the basis of population and 10 percent on the basis of allocation.

**Division and Distribution of Excise Duties:**

The Commission increased the items of excise duties to be shared between the Union and the States from the existing three to eight including sugar, tea, coffee, paper and vegetable non-essential oils. But the share of the States was reduced from 40 percent to 25 percent of the net proceeds of the excise duties on these items.

**Grants-in-Aid in Lieu of Export Duty:**

The Commission recommended that grants to the States of Assam, Bihar, Orissa and West Bengal in lieu of their jute export duties were to be continued as prescribed by the First Finance Commission. All these grants were abolished in 1959-60.

**Grants-in-Aid to the States:**

This Commission recommended large grants-in-aid to the States for two reasons, firstly, their tax shares were moderate and secondly, their large investment in the developmental plan in the context of the Second Five-Year Plan.

**Distribution of Estate Duty:**

The estate duty was imposed and collected by the Union Government but the proceeds were to be assigned on the States. It was levied in 1953. The Second Finance Commission recommended that one percent of the net proceeds should be assigned to the Union Territories.
and balance to be divided among States. The basis of distribution is population of the State for movable property and location for immovable property.

**Loan by the Centre to the States:**

The Second Finance Commission made recommendations in regard Centre's loan to the States. There was a phenomenal growth in the account of such loans from Rs.43.97 crores on August 1947 to Rs.195.41 crores on March 1951 and to Rs.900 crores by March 1956. These loans were given for the implementation of Five-Year Plans. The Commission recommended that the State should be entitled to only two loans a year, a long term and a medium term loan at a rate of interest at which the Central Government was borrowing from the market.

**Distribution of Tax on Railway Fare:**

The Commission recommended that the tax on railway passenger fares be distribute on the basis of the actual passenger traveled on the railways within each State. Under the Constitution of India, this tax is to be levied and collected by the Union but to be wholly assigned to the States. This tax was first imposed in 1957.

**Distribution of Additional Excise Duties:**

The Union Government imposed additional excise duties on mill-made textiles; tobacco and sugar replacing the sales tax levied by each State and decided to distribute it to the States. For distribution the Finance Commission considered the present income from sales tax (during the year 1956-57) on these commodities earned by each State.
and this sum was to be ensured to the concerned State. The reminder if any was distributed according to the table prepared by the Commission.

Other Recommendations:

In view of unexpected contingencies caused by natural calamities, the Commission recommended that States set up a regular fund to meet such contingencies.

Besides the Commission opined against giving of grants outside the Plan schemes, stipulating Central grants to the States equal to the States own contribution to such schemes.

THIRD FINANCE COMMISSION (1960)

The Third Finance Commission was appointed on December 1960 under the Chairmanship of A.K. Chanda.

Major Recommendations:

Division and Distribution of Income Tax:

The share of the State in the net proceeds of income tax was raised from 60 percent to 66.2/3 percent. Because the income tax paid by companies was included in the Corporation tax from 1960-61 and was not available for distribution.

80 percent of the total share was to be distributed on the basis of population and 20 percent on the basis of collection.
Division and Distribution of Excise Duties:

The list of items for sharing excise duties was expanded from 8 to 35 but reduced the State’s share from the divisible pool from 25 percent to 20 percent. Except population, the Commission considered three more factors as the basis of distribution.

(i) The relative financial weakness of the State.

(ii) The percentage of Schedule Caste and Schedule Tribes and the backward class in the State, and

(iii) The disparity in the level of development.

Additional Excise Duties:

Additional excise duty was levied on silk fabrics in lieu of sales tax in 1961-62, in addition to the commodities already subjected to excise duties.

Estate Duty:

No change was suggested in the existing arrangement by the Commission.

Grants in Lieu of Tax on Railway Passenger Fares:

The Commission recommended a grant of Rs.12.5 crores to the States in lieu of their shares in the tax on Railway passenger fares as basis of compensation.

Grants-in-Aid:

The Commission raised the amount of grants-in-aid. The amount was assigned to all States, except Mharastra to cover the deficit in the States’ budget.
FOURTH FINANCE COMMISSION (1964)

The Fourth Finance Commission was appointed in May 1964 under the Chairmanship of Dr. P.V. Rajamannar.

Major Recommendations:

Income Tax Proceeds:

The share of States in the income tax proceeds was increased from 66.2/3 to 75 percent. The basis of distribution was kept the same, 80 percent on the basis of population and 20 percent on collection.

Union Excise Duties:

The Commission recommended that all Union excise duties currently levied and also those that might be levied during the coming Five Year Plan should be shared between the Centre and the States. It enlarged the list of excisable commodities from 35 to 45, but the share of the duties was retained at 20 percent.

80 percent of the divisible pool was to be distributed on the basis of population and 20 percent on the basis of economic and social backwardness of the States. Social and economic backwardness was to be indicated by the following factors:

i. Per capita value added by manufacture.

ii. Percentage of worker to the total population.

iii. Per capita gross value of the agricultural population.

iv. Population per hospital be.
v. Percentage of rural population to total population.

vi. Percentage of population of Schedule Cast and Schedule Tribes to total population etc.

The relative deficits were not taken into account unlike the Third Finance Commission.

Additional Excise Duties:

The recommendation of the Third Finance Commission was remained unchanged in the Fourth Finance Commission.

Estate Duty:

The Commission recommended 2 percent of the estate duties to be assigned to Union Territories and balance to be distributed among States on the same basis as before.

Grants-in-Lieu of Tax on Railway Passenger Fares:

The Commission suggested no change in the existing grants-in-lieu of tax on railway passenger fare to all States. This is to compensate the States for their loss due to abolition of taxes on railway fares. It used the latest statistics of railway routes length in each State and the average earnings from passenger traffic during the end of the year 1964.

Grants-in-aid:

The Commission considered only the non-plan revenue expenditure of the States and did not deal with their plan expenditure.

Borrowings:

The Commission recommended that a competent body be set up to study the problem of indebtedness of the States.
Inadequate Staff:

The Commission pointed out that the staff appointed in the cell of Ministry of Finance to compile statistical data was inadequate and of little help.

FIFTH FINANCE COMMISSION (1968)

The Fifth Finance Commission was appointed in 1968 under the Chairmanship of Mahavir Tyagi.

Major Recommendations:

Income Tax:

There was no change in percentage of income tax proceeds. 75 percent of the proceeds were to be distributed among States and 25 percent to be distributed between Union Territories. The State wise distribution has to be 90 percent on the basis of population and 10 percent on the basis of collection.

Union Excise Duties:

The Fifth Finance Commission retained with the existing arrangement, that is, 20 percent of the Union excise duties to be distributed among States. But it recommended the inclusion of additional excise duties on the divisible pool. The duties were levied on 1963 during the emergency due to Chinese aggression and States were kept outside its ambit.
Two-third of this proceeds to be distributed to States whose per capita income was below the national average and one-third to be distributed according to the integrated index of backwardness determined on the basis of:

i. Number of factory workers per lakh of population.

ii. Schedule Tribe population.

iii. Rail-road length per 100 square kilometers.

iv. The extent of irritated area per cultivator.

v. The number of school going children compared to those of school-going age.

vi. The number of hospital beds per thousand population.

The larger share of the Union duties went to Uttar Pradesh and lowest to Nagaland.

Additional Excise Duties:

The State insisted on reverting to the sales tax on sugar, textiles and tobacco instead of additional excise duties composed by the Union. The Government decided to refer the matter to the National Development Council.

In the meanwhile, the Commission recommended a change in the existing arrangement, i.e., distribution of guaranteed amount first and the balance to be distributed in the proportion of the sale tax revenue realised by each State in the total collection of all States.
Estate Duty:

The Commission made no change in the distribution of estate duty except raising the share of Union Territories from 2 percent to 3 percent.

Grants-in-Lieu of Tax on Railway Passenger Fare:

The Commission suggested no change in these grants and retained with the existing arrangement of distribution.

Grants-in-Aid:

The Commission recommended grants to ten States as other States were expected to have revenue surplus. Rs.637.85 crores were granted to cover deficits during the period 1966-71. The excluded States were Bihar, Gujarat, Haryana, Madhya Pradesh, Maharastra, Punjab and Utter Pradesh.

Unauthorized Overdrafts of the States:

The Commission examined the issue of unauthorized overdrafts by the States from the RBI. There are ways and means advances to the States to meet their current expenditure in anticipation of their revenue receipts to be later used for repayment. It found that these overdrafts remained unpaid for a considerable length of time and for exceeded the limit.

For this problem the Commission made several recommendations:

i. Periodical review by RBI of advances made to States is necessary.
ii. The State use such advances to meet their anticipated revenue receipts and not for meeting budgetary deficits.

iii. The timely and frequent release of the State’s share of income tax by the Union Government is necessary.

iv. Procedure regarding Union loans to the States should be modified such that their repayment will correspond to the release of Central funds to States.

v. The State should apply the Union for short-term loans to meet additional expenditure.

vi. The Planning Commission should modify Annual Plan of a State Government to be within capacity.

vii. The RBI must stop payment of overdrafts if the earlier ones are not repaid within a stipulated period.

viii. The Union Government advises the State Government on measure to be taken by such defaulting States.

ix. The Central Government may even declare a financial emergency under Article 360 of Indian Constitution.

SIXTH FINANCE COMMISSION (1972)

The Sixth Finance Commission was appointed in 1972 under the Chairmanship of Bramhananda Reddy.

Major Recommendations:

Income Tax:

The share of State in the net proceeds of income tax was raised from 75 percent to 80 percent. 90 percent weight on the basis of
population and remaining 10 percent on the basis of collection. Union Territories received 1.79 percent of the net proceeds.

**Union Excise Duty:**

The Commission retained with the existing manner of distribution of 20 percent of the net proceeds of Union excise duties to the States. It changed the pattern of distribution in that 75 percent to be distributed on the basis of population and 25 percent on the economic backwardness.

**Additional Excise Duties:**

The Commission recommended that 1.41 percent of the additional excise duties to be distributed to Union Territories and balance among the States. The distribution is made of 70 percent on the basis of population, 20 percent on domestic production and 10 percent on production of goods per capita.

**Grants-in-Lieu of States' Taxes on Railway Fares:**

The Commission recommended the continuation of existing arrangement of giving the grants.

**Grants-in-Aid:**

The Commission recommended grants to the deficit States to enable them to cover their non-plan capital expenditure. It was found that even after devolution of Union tax share, there would be 21 States under deficit on account of non-plan expenditure of about Rs.2510 crores. So the Commission recommended giving them grants. Certain States such as Gujarat, Karnataka, Haryana, Maharashtra, Tamilnadu, Madhya Pradesh and Punjab were surplus States. Manipur, Meghalaya
and Tripura were economically backward States and received fully subsidy. Nagaland, Jammu and Kashmir and Orissa got maximum grants followed by West Bengal and Assam.

Estate Duties:

Union Territories received 2.5 percent of the net proceeds of estate duties and balance was to be distributed among States.

Grants-in Lieu of Agricultural Wealth Tax:

The Commission recommended grants on account of agricultural wealth tax as the basis of gross value of the agricultural wealth tax in each State.

Extensive Development Programmes for Drought and Flood Prone Areas:

The Commission also recommended extensive development programmes for drought and flood prone areas. It recommended a total debt relief of Rs.1969.62 crores.

SEVENTH FINANCE COMMISSION (1977)

The Seventh Finance Commission was appointed in 1977 under the Chairmanship of Justice J.M. Shelat.

Major Recommendations:

Income Tax:

The share of States' in the income tax proceeds were increased from 80 percent to 85 percent and share of Union Territories increased to 2.69 percent from 1.79 percent.
The basis of State wise distribution was 90 percent on the basis of population and 10 percent on collection.

**Union Excise Duties:**

The States' share in the Union excise duties hiked to 40 percent from 20 percent. It also recommended a larger relief to the poorer States. The share of the State was to be distributed by giving equal weight to:

i. The population factor.

ii. The inverse of the per capita State domestic product.

iii. The percentage of the poor in each State, and

iv. A formula for revenue equalization.

**Additional Excise Duties:**

The additional excise duties on tobacco, sugar and textile be distributed on the basis of population (1971 census) and or on the basis of average disparities of sugar during the three years ending 1976-77.

**Grants-in-Lieu of States' Taxes on Railway Fares:**

The basis of the abolition of States' taxes on railway fares was decided on the earnings from passenger traffic in each State.

**Union Excise Duty on Electricity:**

The Commission recommended that the entire proceeds (100 percent) of the duty on the generation of electricity be transferred to the State concerned.
Estate Duty:

The distribution of the proceeds of estate duty was to be on the basis of gross value of such estates in each State.

Grants-in-Aid:

The total amount of grants-in-aid recommended by the Seventh Finance Commission was Rs.1609.01 crores to cover deficits of a few poorer States and also to upgrade the standard of administration. Gujarat, Punjab, Maharashtra, Haryana and Karnataka were surplus States and they are excluded from the grants.

Grants-in-Lieu of Wealth Tax on Agricultural Property:

The grants given to the States in lieu of wealth tax on agricultural property were to be equal to the net proceeds from such tax in each State.

Debt Policy:

The Commission, receiving the debt position of the State regarding the Central loans given to them, came to the conclusion that there would be a deficit of Rs.3512 crores in the non-plan capital budgets of the States during the five year period 1979-84. So, the Commission recommended a total debt relief of Rs.256 crores to the States in their loan repayment liabilities during the period.

Central loan advanced to the States out of small savings should be converted into loans in perpetuity, that is, only interest is to be paid and not the principal amount. These recommendations were accepted by the Central Government.
EIGHTH FINANCE COMMISSION (1982)

The Eighth Finance Commission was appointed in June 1982 under the Chairmanship of Y.B. Chavan.

Major Recommendations:

Income Tax:

There was no change in the share of States in income tax proceeds. It was kept at 85 percent as before. Union Territories got 1.8 percent.

The Commission introduced a new formula for distribution of tax proceeds among States.

- 10 percent on the basis of collection of tax.
- 90 percent to be distributed among States on the following criteria:
  - a. 25 percent on the basis of population.
  - b. 25 percent on the basis of inverse of the per capita income of the State multiplied by population, and;
  - c. 50 percent on the basis of distance of the per capita income of a State from the highest per capita income State (i.e. Punjab) and multiplied by the population of the State.

Union Excise Duties:

The Commission raised the States' share to 45 percent of the net proceeds of Union excise duties and distributed 40 per cent on the basis
of a new formula, i.e., the same as for income tax and 5 percent to the deficit States.

Additional Excise Duties:

Union Territories received 2.39 percent of the proceeds on additional excise duties on tobacco, sugar and textiles and the balance was to be distributed among the States on the basis of equal weight to the State domestic product and its production.

Grants-in-Lieu of Tax on Railway Passenger Fares:

These grants were increased from Rs.23.12 crores to Rs.95 crores for the period 1984-89. The basis of distribution was to be the proportion of the average non-suburban passenger carryings in each State to the total earnings of all States.

Estate Duty:

The Commission has not made any change in estate duty.

Grants-in-Lieu of Wealth Tax on Agricultural Property:

The Commission recommended the existing principles to follow.

Grants-in-Aid:

A grant of Rs.1556 crores recommended for the period 1985-90 to cover the deficits and a grant of Rs.915 crores to certain States to upgrade the standard of administration.

Non-Plan Capital Gap in States' Budgets:

The total debt relief of Rs.2285.39 crores was recommended by the Commission to bridge non-plan capita gaps in the budget of States
for the five year period (1984-89). The relief was given by rescheduling of interest and also by writing off debts.

**Finance Relief Expenditure:**

Grants were recommended for meeting expenses of the States on relief measures with regard to natural calamities such as cyclone, flood, earthquake, drought, famine etc. This provision is known as margin money. The Center's share was fixed at 50 percent of margin money for each State for each year and 50 percent was to be borne by each State.

**NINTH FINANCE COMMISSION (1987)**

The Ninth Finance Commission was appointed in 1987 under the Chairmanship of N.K.P. Salve.

**Major Recommendations:**

The recommendations of the Ninth Finance Commission are in nature of continuation of the existing arrangements as per the recommendations of the Eighth Finance Commission. There is no radical departure.

**Income Tax:**

The States' share in the income tax proceeds remained unchanged at 85 percent.

The Commission basically followed the formula of Eighth Finance Commission for distribution of income tax proceeds with more modifications.
The Ninth Finance Commission added one more criterion, i.e., a composite index of backwardness of States based on:

i. Population of Schedule Caste and Schedule Tribes, and;

ii. The number of agricultural labourers in different States as revealed in the 1981 census.

According to the Commission the composite index would correctly reflect poverty and backwardness of the State in large measure. The State having a larger share of these two components are required to bear substantial expenditure responsibilities.

**Union Excise Duties:**

The share of States in Union excise duties remained same at 45 percent. The only change is the Commission proposed to distribute the entire amount of 45 percent as a consolidated amount without dividing it into two components of 40 percent and 5 percent as Eighth Finance Commission.

**Other Duties and Grants:**

The Commission has also retained the existing arrangement for the distribution of the proceeds of estate duty, additional excise duty in lieu of sales tax, for grants to be paid in lieu of tax on railway passenger fares and grants in lieu of wealth tax on agricultural property.

No change has been suggested in respect of financing of relief expenditure of the States, with some increase in margin money.
Grants-in-Aid:

The Commission recommended a grant of Rs.15017 crores to cover deficits on plan and non-plan revenue account during 1990-95.

A special annual grant of Rs.603 crores recommended towards Center’s contribution to the Calamity Relief Fund – totaling Rs.3015 crores for the five year period 1990-95.

A grant of Rs.122 crores recommended to Madhya Pradesh towards the expenditure on rehabilitation and relief of victims of Bhopal gas leak.

Public Debt:

The Commission pointed out that there is a rapid rise in public debt in India. It has recommended that large public borrowings are inevitable due to large public sector and economic growth programmes of the Central Government. The burden of interest is felt because of low earnings of the public sector enterprises and other financial assets. It advised that the public enterprises should ensure a return of at least 6 percent in its investment.


The Tenth Finance Commission was appointed in 1994. Its Chairman was K.C. Pant. Its recommendation was the period 1995-2000. Its main recommendation was relating to substantial increase in transfer of resources to States.
Major Recommendations:

Income Tax:

The Commission recommended that the States share in the income tax proceeds would be 77.5 percent.

The Commission evaluated the formula of both Eighth and Ninth Finance Commission and introduced the following criteria to determine the share of the different States in the sharable proceeds of income tax.

i. 20 percent on the basis of population of 1971;

ii. 60 percent on the basis of distance of per capita income of a State from that of the State having the highest income;

iii. 5 percent on the basis of area adjusted, i.e., area of the State concerned after making certain adjustments;

iv. 5 percent on the basis of index of infrastructure, and;

v. 10 percent on the basis of tax-efforts.

Union Excise Duties:

The Commission has raised the share of the States in the net proceeds of Union excise duties to 47.5 percent. Out of this 40 percent will be distributed among States on basis of the principle followed to distribute income tax. Another 7.5 percent are to be distributed among the States, assessed by the Commission to be in deficit, in accordance with the share specified by it.
Additional Excise Duties (Devolution of Tax):

It is in the nature of tax-rental arrangement whereby the States are compensated for the sale taxes replaced by additional excise duties on sugar, tobacco and fabrics.

In the absence of inadequate State wise consumption figures, the Eighth and Ninth Finance Commission had given equal weight to population and State domestic product (SDP) in the formula for sharing. The Tenth Finance Commission has slightly modified it as 50:40:10 for population, SDP and State sales tax collection.

Grants-in-Lieu of Repealed Tax on Railway Passenger Fares:

The Commission agreed with most States that grants should be equal to 10.7 percent of the non-suburban passenger earnings. As the total non-suburban passenger earnings for the latest available year (1992-93) was Rs.3540 crores, the Commission recommended 10.7 percent of the amount, i.e., Rs.380 crores to be paid to the States annually for the period 1995-2000.

Grants-in-Aid:

The Commission recommended a grant of Rs.7580 crores to cover deficit on revenue account during 1995-2000.

Up-gradation grants of Rs.1360 crores recommended for selected items as police, fire services, jails, promotion of girls’ education, additional facilities for upper primary schools, drinking water facilities in primary schools etc.
A grant of Rs.1250 crores recommended to solve special problems of States.

Another grants of Rs.5380 crores recommended to local bodies, such as Panchayats and Municipalities.

A total amount of Rs.203000 crores was granted.

Finance Panel for 15 Years Freeze on Tax Transfer Rate:

The Tenth Finance Commission has recommended that uniform rate of 29 percent at which tax resources are to be transferred by the Centre to State should remain frozen for the next 15 years.

If the recommendations accepted it would mean that he next two Finance Commissions will have nothing to say in the ratio at which vertical transfer of resources are to be effected from the Centre to the States.

But they can go into the horizontal transfer of resources among different States. However, vertical transfer from the Centre to the States will have to be effected at the ratio of 29 percent of the divisible pool which shall include all Central taxes including corporation tax, customs, wealth tax, gift tax and service tax.

The Commission has laid equal emphasis on the horizontal transfer of resources among States. There are States with surplus budget like Maharashtra, even before resources transferred from Centre to it. On the other hand weaker States like Bihar, Orissa and non-eastern
States should eventually gain through a combination of vertical and horizontal transfer of resources.

For this logic, the Commission recommended to drop collection as a criterion for distribution of resources among the States. Developed States like Maharashtra, Tamil Nadu which collected more income tax have been getting a larger share. So the Commission recommended withdrawing.

Overall the Tenth Finance Commission anticipated a larger quantum of resources transfer from the Centre to State for the 5 years due to greater buoyancy in corporation tax and custom duty even though excise collection is expected to be elastic as the economy grows.

The Finance Ministry has stopped to give any comment on the Tenth Finance Commissions' recommendations to include all Central taxes in the divisible pool and transfer them to the States at a uniform rate of 29 percent. However, it accepted the recommendation relating to the transfer of income tax and Union excise duties to the States at ratio of 77.5 percent and 47.5 percent respectively.

ELEVENTH FINANCE COMMISSION (2000-2005)

Major Recommendations:

In the overall scheme of transfer of funds, 37.5 percent of the gross revenue receipt is suggested to be the ceiling to be transfer to the States. This includes:

i. 28 percent of the net proceeds of sharable Central taxes and duties to the States;

ii. 1.5 percent of the net proceeds of sharable Central taxes in lieu of sales tax on sugar, tobacco and textiles, and;

iii. Grants-in-aid to States facing revenue deficits after devolution, grants meant for local bodies and grants for calamity relief.

Income Tax and Excise Duties:

The Eleventh Finance Commission has modified the formula for sharing the taxes and duties in the following respects:

i. The weight of the population factor has been reduced from 20 percent to 10 percent.

ii. The share of area as well as index of infrastructure has been raised from 5 percent to 7.5 percent.

iii. The Tenth Finance Commission used the tax efforts of the State for resource mobilization. The Commission has used two criteria i.e., tax effort and fiscal discipline. The fiscal discipline index has been defined as improvement in the ratio of own revenue receipts of a State to its total revenue expenditure to a similar ratio for all
States as a criterion for measurement. Thus, the Commission intends to measure the improvement of fiscal health of a State not only with reference to tax effort resulting in high revenues, but also in terms of its effort to reduce revenue expenditure.

The Commission has reduced the weight of tax effort from 10 percent to 5 percent and has given a weight of 7.5 percent to fiscal discipline.

Another basis of sharing the tax proceeds, the distance of per capita income of the State that of State having highest per capita income. The weight to this measure has increased from 60 percent to 62.5 percent. The intention is to provide further help to the poorer States than the richer States.

In view of all considerations, the relative share of the States in the divisible pool of taxes and duties for the 5 year period (2000-01 to 2004-05) work out as given in Table-2.1.

From Table-2.1 it becomes clear that four States, Uttar Pradesh, Bihar, Madhya Pradesh and West Bengal would receive 51.3 percent of all sharable taxes and duties. These States comprise 43 percent of total population of India. Obviously, relative lower per capita income has contributed to enhancement of their share.

Uttar Pradesh, Bihar, Madhya Pradesh, West Bengal, Rajasthan, Orissa and Karnataka are the States which have improved their position in the formula of Eleventh Finance Commission as against Tenth Finance Commission.
Table-2.1: Relative Share of States in the Divisible Pool of Taxes and Duties for the 5 Years Period (2000-01 to 2004-05).

<table>
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<th>Sl. No.</th>
<th>States</th>
<th>Tenth Finance Commission</th>
<th>Eleventh Finance Commission</th>
<th>Gainer (+)</th>
<th>Losers (-)</th>
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<td>Uttar Pradesh</td>
<td>11.248</td>
<td>19.798</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Bihar</td>
<td>11.293</td>
<td>14.597</td>
<td>+</td>
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<tr>
<td>3</td>
<td>Madhya Pradesh</td>
<td>7.403</td>
<td>8.838</td>
<td>+</td>
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<td>4</td>
<td>West Bengal</td>
<td>6.836</td>
<td>8.116</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Rajasthan</td>
<td>4.970</td>
<td>5.473</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Andhra Pradesh</td>
<td>7.912</td>
<td>7.701</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Tamil Nadu</td>
<td>6.117</td>
<td>5.385</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Orissa</td>
<td>4.257</td>
<td>5.056</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Karnataka</td>
<td>4.863</td>
<td>4.930</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Maharashtra</td>
<td>6.232</td>
<td>4.632</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Kerala</td>
<td>3.497</td>
<td>3.075</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Gujarat</td>
<td>3.884</td>
<td>2.821</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Punjab</td>
<td>1.532</td>
<td>1.147</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Haryana</td>
<td>1.238</td>
<td>0.944</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td></td>
<td>All the States</td>
<td>100.00</td>
<td>100.00</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Expenditure tax and service tax are presently not levied in the State of Jammu and Kashmir. Therefore, no share has been assigned to the States from these taxes. The entire proceeds from these two taxes
may be distributed among the remaining States by proportionately adjusting their share.

An amount of Rs.4973 crores has been recommended towards upgradation of standards in the non-developmental social factors and special problems grants for the period 2000-05.

A total grant of Rs.1600 crores for the Panchayats and Rs.400 crores for the Municipalities is to be given to States for each of the five years starting from the financial year 2000-01. Thus, a total of Rs.10,000 crores has been provided for the five year period (2000-05).

The criteria and relative weight for determining the share of the States in grants provided for Panchayats and Municipalities are:

i. 40 percent for rural/urban population of the State;

ii. 20 percent for index of decentralization;

iii. 20 percent for distance from the highest per capita income;

iv. 10 percent for revenue effort of local bodies, and;

v. 10 percent for geographical area.

The Eleventh Finance Commission has recommended a total devolution of Rs. 4, 34,905 crores for the five year period (2000-05) in terms of devolution of taxes and grants. The devolution break up in various heads is indicated in Table-2.2.
Table-2.2: Devolution Breakup in Various Heads.

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>States</th>
<th>Tenth Finance Commission</th>
<th>Eleventh Finance Commission</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Amount (Rs. in crore)</td>
<td>% of total</td>
</tr>
<tr>
<td>1.</td>
<td>Share in Central taxes and duties</td>
<td>2,06,343</td>
<td>91.0</td>
</tr>
<tr>
<td>2.</td>
<td>Grants-in-aid</td>
<td>20,300</td>
<td>9.0</td>
</tr>
<tr>
<td>a.</td>
<td>Non-plan revenue deficit</td>
<td>7,583</td>
<td>3.3</td>
</tr>
<tr>
<td>b.</td>
<td>Upgradation and special problem</td>
<td>2,608</td>
<td>1.2</td>
</tr>
<tr>
<td>c.</td>
<td>Local bodies</td>
<td>5,381</td>
<td>2.4</td>
</tr>
<tr>
<td>i.</td>
<td>Panchayats</td>
<td>8,000</td>
<td>1.8</td>
</tr>
<tr>
<td>ii.</td>
<td>Municipalities</td>
<td>2,000</td>
<td>0.5</td>
</tr>
<tr>
<td>d.</td>
<td>Relief expenditure</td>
<td>4,728</td>
<td>2.1</td>
</tr>
<tr>
<td>Total (1+2)</td>
<td>2,26,643</td>
<td>100.0</td>
<td>4,34,905</td>
</tr>
</tbody>
</table>

Calamity Relief Funds:

The Eleventh Finance Commission has recommended that the existing Calamity Relief Funds in States with an aggregate size of Rs.11008 crores during 2000-05 should be continued. This includes the Center’s share at Rs.8256 crores and States’ share at Rs.2752 crores worked out in the ratio 75:25. The Commission recommended the discontinuance of
existing National Fund for Calamity Relief. The Central assistance to States in national calamities should be financed by levy of a special surcharge on the Central taxes for a limited period and to be kept in a separate fund known as National Calamity Contingency Fund created in the public amount of the government of India.

The pattern of total transfer of resources from Centre to States in accordance with the recommendation of the Eleventh Finance Commission is shown in Table-2.3. It provides information about the share of two major components of devolution: (i) Sales tax and excise duties and (ii) grants-in-aid for 25 States in India. Whereas in most of the States taxes and duties are contributed over 80 percent of total transfer, in case of Jammu and Kashmir it is 29.5 percent and for Mizoram share of taxes and duties was 29.4 percent only. For Himachal Pradesh it was 34.5 percent. In case of North-Eastern States except Nagaland it was 40-44 percent. For Nagaland it was very low at 18.6 percent. Jammu and Kashmir has the largest non-plan gap in budget deficit and a similar situation also prevailed in Himachal Pradesh. Most of the small hilly tribal States had also large budget deficits. Therefore, the Eleventh Finance Commission had provides funds to meet the non-plan budget deficits.
Table-2.3: Pattern of Total Transfer of Resources from Centre to States due to the Recommendation of Eleventh Finance Commission.

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>States</th>
<th>States Share in taxes and duties</th>
<th>Grants-in-aid</th>
<th>Total</th>
<th>% of share of taxes and duties (Rs. in crores)</th>
<th>% of share of Grant-in-aid (Rs. in crores)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Uttar Pradesh</td>
<td>74502</td>
<td>4007</td>
<td>78509</td>
<td>94.9</td>
<td>5.1</td>
</tr>
<tr>
<td>2.</td>
<td>Bihar</td>
<td>54935</td>
<td>1793</td>
<td>56728</td>
<td>96.8</td>
<td>3.2</td>
</tr>
<tr>
<td>3.</td>
<td>Madhya Pradesh</td>
<td>33259</td>
<td>1739</td>
<td>34998</td>
<td>95.0</td>
<td>5.0</td>
</tr>
<tr>
<td>4.</td>
<td>West Bengal</td>
<td>30540</td>
<td>4680</td>
<td>35220</td>
<td>86.7</td>
<td>13.3</td>
</tr>
<tr>
<td>5.</td>
<td>Rajasthan</td>
<td>20596</td>
<td>2993</td>
<td>23589</td>
<td>87.3</td>
<td>12.7</td>
</tr>
<tr>
<td>6.</td>
<td>Andhra Pradesh</td>
<td>28980</td>
<td>2031</td>
<td>31011</td>
<td>93.5</td>
<td>6.5</td>
</tr>
<tr>
<td>7.</td>
<td>Tamil Nadu</td>
<td>20265</td>
<td>1336</td>
<td>21601</td>
<td>93.8</td>
<td>6.2</td>
</tr>
<tr>
<td>8.</td>
<td>Orissa</td>
<td>19027</td>
<td>1728</td>
<td>20755</td>
<td>91.7</td>
<td>8.3</td>
</tr>
<tr>
<td>9.</td>
<td>Karnataka</td>
<td>18552</td>
<td>1140</td>
<td>19692</td>
<td>94.2</td>
<td>5.8</td>
</tr>
<tr>
<td>10.</td>
<td>Maharashtra</td>
<td>17431</td>
<td>1956</td>
<td>19387</td>
<td>89.9</td>
<td>10.1</td>
</tr>
<tr>
<td>11.</td>
<td>Kerala</td>
<td>11504</td>
<td>843</td>
<td>12317</td>
<td>93.4</td>
<td>6.6</td>
</tr>
<tr>
<td>12.</td>
<td>Gujarat</td>
<td>10616</td>
<td>1384</td>
<td>12000</td>
<td>88.5</td>
<td>11.5</td>
</tr>
<tr>
<td>13.</td>
<td>Punjab</td>
<td>4316</td>
<td>1112</td>
<td>5428</td>
<td>84.5</td>
<td>20.5</td>
</tr>
<tr>
<td>14.</td>
<td>Haryana</td>
<td>3552</td>
<td>653</td>
<td>4205</td>
<td>84.5</td>
<td>45.5</td>
</tr>
<tr>
<td>All the States</td>
<td>376318</td>
<td>58587</td>
<td>434905</td>
<td>86.5</td>
<td>13.5</td>
<td></td>
</tr>
</tbody>
</table>
Table-2.4 depicts the gainer/loser States with reference to the share as determined by Tenth Finance Commission formula and the award as given by the Eleventh Finance Commission.

**Table-2.4: Gainer/Loser States with Reference to the Share as Determined by Tenth and Eleventh Finance Commission.**

<table>
<thead>
<tr>
<th>Gainer States</th>
<th>Loser States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uttar Pradesh</td>
<td>+ 7476</td>
</tr>
<tr>
<td>Bihar</td>
<td>+ 6536</td>
</tr>
<tr>
<td>West Bengal</td>
<td>+ 2425</td>
</tr>
<tr>
<td>Madhya Pradesh</td>
<td>+ 2062</td>
</tr>
<tr>
<td>Orissa</td>
<td>+ 2112</td>
</tr>
<tr>
<td>Karnataka</td>
<td></td>
</tr>
<tr>
<td>Punjab</td>
<td></td>
</tr>
<tr>
<td>Haryana</td>
<td></td>
</tr>
<tr>
<td>Rajasthan</td>
<td></td>
</tr>
<tr>
<td>Maharashtra</td>
<td>- 5622</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>- 4711</td>
</tr>
<tr>
<td>Gujarat</td>
<td>- 4610</td>
</tr>
<tr>
<td>Kerala</td>
<td>- 3078</td>
</tr>
<tr>
<td>Andhra Pradesh</td>
<td>- 2875</td>
</tr>
<tr>
<td>Karnatakak</td>
<td>- 1540</td>
</tr>
<tr>
<td>Punjab</td>
<td>- 1182</td>
</tr>
<tr>
<td>Haryana</td>
<td>- 1107</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>- 294</td>
</tr>
</tbody>
</table>

**TWELFTH FINANCE COMMISSION (2005-2010)**

The Twelfth Finance Commission was constituted under the Chairmanship of C. Rangarajan. The endeavour of the Commission has been to recommend a scheme of transfers that could serve the objectives of both equity and efficiency and result in fiscal transfers that are
predictable and stable. These transfers, in the form of tax devolution and grants are meant to correct both the vertical and horizontal imbalance.

Major Recommendations:

Plan for Restructuring Public Finance:

By 2009-10 the combined tax-GDP ratio of the Centre and the States should be reached to 17.6 percent, primary expenditure to a level of 23 percent of GDP and capital expenditure to nearly 7 percent of GDP.

The combined debt-GDP ratio be brought down to 75 percent by the end of 2009-10.

The system of lending should be brought to an end over time and the long-term goal for the Centre and States for debt-GDP ratio should be 28 percent each.

The fiscal deficit to GDP ratio targets for the Centre and the States may be fixed at 3 percent of the GDP each.

The Center’s interest payment relative to revenue receipts should reach about 28 percent by 2009-10. In the case of States, the level of interest payments relative to revenue receipts should fall to about 15 percent by 2009-10.

The revenue deficit relative to GDP for the Centre and the States, for their combined as well as individual accounts should be brought down to zero by 2008-09.
States should follow recruitment and wage policy, in a manner such that the total salary bill relative to revenue expenditure net of interest payments and pensions does not exceed 35 percent.

Sharing of Union Tax Revenue:

The share of taxes in the net proceeds of sharable Central taxes shall be 30.5 percent. For this purpose additional excise duties in lieu of sales tax are treated as a part of the general pool of Central taxes. If the tax rental arrangement is terminated and the States are allowed to levy sales tax (or VAT) on these commodities without any prescribed limit, the share of the States in the net proceeds of sharable Central taxes shall be reduced to 29.5 percent.

The indicative amount of overall transfers to States may be fixed at 38 percent of the Central gross revenue receipt.

Calamity Relief:

The scheme of Calamity Relief Fund be continued in its present form, with contribution from the Centre and States in the ratio of 75:25.

The scheme of National Calamity Contingent Fund may continue in its present form with core corpus of Rs.500 crore. The outgo of the fund may continue to be replenished by way of collection of National Calamity Contingent Duty and levy of special surcharge.

Grants-in-Aid to States:

The system of imposing 70:30 ratios between loans and grants for extending plan assistance to non-special category States (10:90 in the
case of special category States) should be done. Instead, the Central
should continue itself to extending plan grants to the States, and leave it
to the State to decide how much they wish to borrow and from whom.

An additional grant of Rs. 10171.65 crore and Rs. 5887.08 crore
shall be provided for education and health respectively over and above
the normal expenditure to be incurred by the States in these sectors.

An additional grant of Rs. 15,000 crore over the period is
recommended for maintenance of roads and bridges.

An extra amount of Rs.5000 crore is provided as grants for
maintenance of public buildings.

For maintenance of forests, an additional grant of Rs. 1000 crores
is recommended. A grant of Rs. 625 crores is provided for maintenance
of heritage conservation.

For specific needs of the State and amount of Rs. 7100 crore has
been granted.

**Debt Relief and Corrective Measures:**

Each State must enact a fiscal responsibility legislation
prescribing specific annual targets with a view to eliminating the
revenue deficit by 2008-09 and reducing fiscal deficits based on a path
for reduction of borrowings and guarantees.

The Central loan to States contracted till 31.3.04 and outstanding
on 31.3.05 (amounting to Rs. 128795 crores) may be consolidated and
rescheduled for a fresh term of 20 years and an interest rate of 7.5
percent are charged on them. This will be subject to the State enacting the fiscal responsibility legislation and will take effect prospectively from the year in which such legislation is enacted.

A debt-write off scheme linked to the reduction of revenue deficit of State may be introduced. Under the scheme, the repayments due from 2005-06 to 2009-10 in Central loan contracted up to 31.3.04 and recommended to be consolidated will be eligible for write-off.

THE THIRTEENTH FINANCE COMMISSION

The Thirteenth Finance Commission was constituted in November 2007 under Article 280 of the Indian Constitution. The Commission is to submit its report in October 2009.

The Thirteenth Finance Commission recommendations would pertain to the period 2010-15. In its core constitutional mandate, the Commission would make recommendations as follows;

(a) The distribution between the Union and the State of the net proceeds of taxes, which are to be or may be divided between them (Article 270),

(b) The principle which should govern the grants-in-aid of the revenues of the State out of the consolidated Fund of India (Article 275), and

(c) The measures needed to augment the consolidated fund of a State to supplement the resources of Panchayats and Municipalities in
the State on the basis of recommendations made by the Finance
Commission of the States.

While making the recommendations, the Commission will take
into consideration the demands on the resources of the Central
Government, the resources of the State governments, the tax efforts of
both the Central and State governments and potential for additional
resource mobilization. It will also consider, inter alia, the impact of
proposed implementation of goods and service tax, the need to improve
the quality of public expenditure and the need to manage ecology,
environment and changed climate consistent with sustainable
development.

The Thirteenth Finance Commission has been constituted against
the backdrop of strong fiscal correction and consolidation through the
implementation of Fiscal Responsibility Legislation by most of the State
governments. The improvement in own tax revenue of the States, partly
on account of the implementation of Value Added Tax and higher
transfer and devolution from the Central government, provided the
necessary momentum for strengthening the fiscal position of State
governments. There is an urgent need for considering reallocation of
expenditure towards social sector expenditure, particularly education
and health, thereby enhancing India’s position in the Human
Development Index. Public-Policy has a critical role to play in achieving
this. So, continuing forward with the work done by the Twelfth Finance
Commission, the Thirteenth Finance Commission may undertake a
focused assessment of the vertical and horizontal fiscal transfer.
Fiscal Consolidation and Quality of Fiscal Adjustment:

In the context of fiscal restructuring, the issues before the Thirteenth Finance Commission are:

(a) Prudent fiscal management with durable fiscal consolidation through fiscal empowerment, i.e., by expanding the scope and size of revenue flows,

(b) Fiscal space based on revenue maximization to provide the necessary flexibility to shift the pattern of expenditure towards developmental purposes,

(c) Emphasis on the criticality of quality of fiscal adjustment for higher capital outlays and enhancement of infrastructure and social sector spending with beneficial impact on growth and employment.

Process of Fiscal Transfers:

As regards the vertical dimension of the fiscal transfers, one option before the Thirteenth Finance Commission is to examine the enhancement of the base by incorporating service tax into the total pool of sharable taxes.

With regard to horizontal sharing, over the past Finance Commissions, the need factors, namely, population and income distance have gained acceptance. The cost disability factors such as area and infrastructure and distance have tended to be the preferred indicators and among the fiscal efficiency factors, tax effort and fiscal discipline are regarded as appropriate.
Approaches to Determining Grants:

The Thirteenth Finance Commission has been set up against the backdrop of a strong fiscal consolidation when most of the States would eliminate the revenue deficit. It is expected that for most of the States non-plan revenue deficit would not exist during the period of reference of the Commission. In view of this, one option for the Commission is to abolish the post-devolution non-plan revenue deficit grant. The Commission may recommend grants for education, health, local bodies, natural calamities, maintenance expenditure and rural development. The principle of grant-in-aid in a normative sense may focus on social sector expenditure. While recommending grants to local bodies also, the emphasis may be placed on social sector expenditure.

SECTION-II

First Finance Commission:

The First Finance Commission considered the question of principles which should govern the grants-in-aid of the revenues of a State out of the consolidated fund in India. They recommended that budgetary needs of the State should be an important criterion for determining the assistance required by the States. Appropriate allowances have to be made based on a number of considerations. The considerations were:

i. Budget should be reduced to a standard form by eliminating the non-repetitive items.
ii. Due consideration should be given to the tax effort by the State to the extent to which the state itself made efforts to raise resources in relation to its tax potential.

iii. Allowance should be made for the scope for economy in expenditure.

iv. The grants-in-aid should avoid large disparities in the standards of basic social services.

v. Grants-in-aid may be given to help individual States to meet their special burdens, if such burdens are of national concern and they are likely to cause undue strains on the States' finances.

vi. Grants-in-aid should be given for broad national purposes with a view to further beneficent service of primary importance in regards to national interest to assist the less advanced States to go forward.

**Second Finance Commission:**

The Second Finance Commission considered these principles unexceptionable. However, it added the eligibility of a State to grant-in-aid and quantum of such aid should depend upon its fiscal needs in comprehensive sense.

**Third Finance Commission:**

The Third Finance Commission was also agreed with the principles prescribed by the earlier Commissions. However, it considered that fiscal needs as assessed by the Commission should take
into account not only non-plan expenditure but also plan expenditure. It also recommended that the Centre should put forward the conditions of utilization of the grants-in-aid but the State should have freedom to re-appropriate funds from one allocation to another in respect of grants meant generally to strengthen the State sector.

**Fourth Finance Commission:**

The Fourth Finance Commission agreed with the principles laid down by the previous Commissions but opined that plan grants and special purpose grants should not be included in grants-in-aid.

**Fifth and Sixth Finance Commissions:**

The Fifth and Sixth Finance Commissions retained with the principles of earlier Finance Commission enunciated.

**Seventh Finance Commission:**

The Seventh Finance Commission felt that due to changed circumstances there was a need to reformulate the principles of grants-in-aid. Accordingly it formulated the following principles:

i. Grants-in-aid may given to States to cover fiscal deficits if any are left after devolution of taxes and duties.

ii. Grants-in-aid may be made as a corrective measure to reduce the disparities between availability of various administrative and social services of development and less developed States.

iii. Grants-in-aid may be given to States to face the special burden on their finances.
The Commission recommended grants to eight States on the first principle and seven States on the second principle but confined the grants to non-plan, non-developmental sectors only. No grants were made under the third principle.

**Eighth Finance Commission:**

The Eighth Finance Commission agreed with the principles of Seventh Finance Commission. It cautioned that new problems would involve new approach and that a new Finance Commission should consider the matter in every fifth year.

**Ninth Finance Commission:**

The Ninth Finance Commission in its first report for 1989-90 had broadly analyse the earlier principles for grants-in-aid and recommended grants not to fill the budgetary gaps but to meet the fiscal needs as represented by the difference between normatively determined revenue receipts and non-plan expenditure. Further grants were recommended to raise standard of social services, up gradation of administration in less developed States.

The Nine Finance Commission in its second report for 1990-95 noted that vast disparity exists among States in the size of non-plan revenue account position and that the Gadgil Formula has no linkage to the non-plan revenue account position or the overall financial position of the State Government. Further there is no formal channel through which additional assistance could be extended to those States whose non-plan revenue account have no surplus and whose share of Gadgil Formula grants are substantially less than their approved revenue plan.
expenditure. Such States have to divert their borrowings to meet a part of their plan revenue requirement and this would invalidate the concept of balanced regional development. To introduce a mechanism and to correct this basic flow in the present system of federal fiscal transfers the Ninth Finance Commission has recommended grants-in-aid on account of plan revenue deficits.

The earlier Finance Commissions related the gap grants under Article 275 to each States' deficit each year so that all States non-plan revenue accounts were balanced every year. That was because they were dealing only with non-plan revenue account.

The Ninth Finance Commission were not only dealing with the total revenue account but were also worked towards eliminating deficits in revenue account. Therefore, the net deficit (after adjustment of deficit and surplus of different years) was taken for assessing the need for grants.

**Tenth Finance Commission:**

The Tenth Finance Commission recommended grants to States to cover deficit on revenue account. The Commission also recommended grants for selected items as police, fire service, jails, promotion of girl's education, additional facilities for upper primary school drinking water facilities in primary schools etc.

**Eleventh Finance Commission:**

The Eleventh Finance Commission recommended grants-in-aid to States facing revenue deficit after devolution, grant meant for local bodies and grants for calamity relief.
The criteria and relative weights for determining the share of States in grants, provided for Panchayats and Municipalities are:

(a) 40 percent for rural/urban population of States,
(b) 20 percent for index of decentralization,
(c) 20 percent for distance from the highest per capita income,
(d) 10 percent for revenue effort of local bodies and
(e) 10 percent for geographical area.

The Commission recommended that the existing Calamity Relief Fund in States should be continued during the period 2000-05.

Twelfth Finance Commission:

The system of imposing a 70:30 ratio between loans and grants for extending plan assistance to non-special category State (10:90 in the special category State) should be done. Instead, the Central should confine itself to extending plan grants to the States, and leave it to the States to decide how much they wish to borrow and from whom.

SECTION-III

The appointment of a Finance Commission at intervals of five years or less has great significance for the financial relations between Union and the States.

According to Article 270 of the Indian Constitution the personal income tax is levied and collected by the Union but shared between the Centre and the States. The Finance Commissions have to give their award on two points: (i) share of the States in the total collection of
income tax proceeds, and (ii) the principle/principles on which the 
share of each State in the net proceeds are to be distributed.

The Finance Commission considers the double criteria of 
population and collection of income tax for distribution of the tax 
proceeds among the States. But from Eighth Finance Commission they 
consider double criteria along with economic backwardness such as 
distance of per capita income, index of infrastructure, area adjusted etc.

Table-2.5 depicted the recommendations of Finance Commissions 
on income tax. From the table it is observed that the States’ share in the 
total divisible pool of income tax has increased in successive Finance 
Commissions except the Tenth Finance Commission. The proceeds are 
mainly distributed among States on the basis of population, economic 
backwardness and other criteria.

Table-2.6 shows the recommendations of Finance Commissions on 
Union excise duties. From the table it is cleared that all the Finance 
Commissions kept one basic objective, that to increase the share of the 
States in the Union excise duties. The first four Finance Commissions tried 
to include more and more central excise duties under the divisible pool, 
but they reduced the percentage share of the States. Fifth and Sixth 
Finance Commissions did not suggest any change in it. But the Seventh 
and subsequent Finance Commissions have brought all the duties under 
the divisible pool and increase the share of the States from 20 percent of 45 
percent and eventually in Tenth Finance Commission to 47.5 percent.

As regards the distribution of proceeds of excise duties the 
Finance Commission also did the same as in income tax proceeds. They 
mainly consider the population and economic backwardness.
### Table-2.5 Recommendation of Finance Commissions on Income Tax.

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Finance Commission</th>
<th>States' share of income tax (in percent)</th>
<th>Distribution of income tax on the basis of</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Population and other criteria</td>
</tr>
<tr>
<td>1.</td>
<td>First</td>
<td>55</td>
<td>80</td>
</tr>
<tr>
<td>2.</td>
<td>Second</td>
<td>60</td>
<td>90</td>
</tr>
<tr>
<td>3.</td>
<td>Third</td>
<td>66.2/3</td>
<td>80</td>
</tr>
<tr>
<td>4.</td>
<td>Fourth</td>
<td>75</td>
<td>80</td>
</tr>
<tr>
<td>5.</td>
<td>Fifth</td>
<td>75</td>
<td>90</td>
</tr>
<tr>
<td>6.</td>
<td>Sixth</td>
<td>80</td>
<td>90</td>
</tr>
<tr>
<td>7.</td>
<td>Seventh</td>
<td>85</td>
<td>90</td>
</tr>
<tr>
<td>8.</td>
<td>Eighth</td>
<td>85</td>
<td>90</td>
</tr>
<tr>
<td>9.</td>
<td>Ninth</td>
<td>85</td>
<td>90</td>
</tr>
<tr>
<td>10.</td>
<td>Tenth</td>
<td>77.5</td>
<td>90</td>
</tr>
</tbody>
</table>

### Table-2.6 Recommendation of Finance Commissions on Union Excise Duties.

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Finance Commission</th>
<th>States' share of excise duties (in percent)</th>
<th>Distribution of excise duties on the basis of</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Population</td>
</tr>
<tr>
<td>1.</td>
<td>First</td>
<td>40% of 3 duties</td>
<td>40</td>
</tr>
<tr>
<td>2.</td>
<td>Second</td>
<td>25% of 8 duties</td>
<td>40</td>
</tr>
<tr>
<td>3.</td>
<td>Third</td>
<td>20% of 35 duties</td>
<td>40</td>
</tr>
<tr>
<td>4.</td>
<td>Fourth</td>
<td>20% of 45 duties</td>
<td>80</td>
</tr>
<tr>
<td>5.</td>
<td>Fifth</td>
<td>20% of 45 duties</td>
<td>80</td>
</tr>
<tr>
<td>6.</td>
<td>Sixth</td>
<td>20% of 45 duties</td>
<td>75</td>
</tr>
<tr>
<td>7.</td>
<td>Seventh</td>
<td>40% of all duties</td>
<td>25</td>
</tr>
<tr>
<td>8.</td>
<td>Eighth</td>
<td>45% of all duties</td>
<td>25</td>
</tr>
<tr>
<td>9.</td>
<td>Ninth</td>
<td>45% of all duties</td>
<td>25</td>
</tr>
<tr>
<td>10.</td>
<td>Tenth</td>
<td>45% of all duties</td>
<td>20</td>
</tr>
</tbody>
</table>
Apart from the usual excise duties, the Central Government has been levying additional excise duties mainly on sugar, tobacco and textiles from the year 1957. So the States did not exercise their power to levy sales tax on these commodities and they are getting shares from the proceeds of additional excise duties in accordance with the principles of distribution laid down by Finance Commissions from time to time.

Article 269 of the Constitution empowers the Government to levy and collect taxes on railway fares and freights but the net proceeds are to be assigned to the States. The tax was first imposed in 1957.

From the year 1953, the estate duty was levied and the proceeds have been assigned to the States up to 1985. But the estate duty has been discontinued from 1985.

List II of the Seventh Schedule of the Constitution has entrusted the important welfares and developmental functions to the States but the various tax resources provided to the States were found to be inelastic and wholly insufficient. To overcome this problem the Constitution provided grants-in-aid to States. Under Article 275 of the Constitution, the Finance Commissions have to decide about the grants-in-aid to States corresponding to each five-year plan. The recommendations of the Finance Commissions on grants-in-aid are shown in Table-2.7. It will be observed from the table that every Finance Commissions, till Sixth Finance Commission, have increased the amount of grants-in-aid to the States. There were two basic reasons for this.
First, the Finance Commissions realised that for the ever-growing public expenditure on law and order, welfare and development, an increasingly larger amount is necessary.

**Table-2.7** Recommendations of Finance Commissions on Grants-in-aid.

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Finance Commission</th>
<th>Grants-in-aid (Rs. in crores)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>First</td>
<td>—</td>
</tr>
<tr>
<td>2.</td>
<td>Second</td>
<td>—</td>
</tr>
<tr>
<td>3.</td>
<td>Third</td>
<td>595</td>
</tr>
<tr>
<td>4.</td>
<td>Fourth</td>
<td>610</td>
</tr>
<tr>
<td>5.</td>
<td>Fifth</td>
<td>638</td>
</tr>
<tr>
<td>6.</td>
<td>Sixth</td>
<td>2510</td>
</tr>
<tr>
<td>7.</td>
<td>Seventh</td>
<td>1600</td>
</tr>
<tr>
<td>8.</td>
<td>Eighth</td>
<td>2471</td>
</tr>
<tr>
<td>9.</td>
<td>Ninth</td>
<td>4532</td>
</tr>
<tr>
<td>10.</td>
<td>Tenth</td>
<td>20300</td>
</tr>
</tbody>
</table>

Secondly, the States were incurring a large revenue deficit even if a huge amount of tax resources were transferred from Centre to the States.

Accordingly, successive Finance Commissions recommended larger grants to the States from the Centre.

The Seventh and Eighth Finance Commissions reversed this trend by providing more devolution of tax resources to the States. These Commissions raised the share of States in the income tax proceeds from 80 percent to 85 percent. Previously the excise duties of some selected
commodities were shared among States. But this time all the Central excise duties were included in the divisible pool to be shared between States. The States share in the excise duties also increased from 20 percent to 40 percent and Eight Finance Commission was further increased it to 45 percent. As a result of these recommendations, the devolution of tax revenue to the States was so much that the Seventh and Eighth Finance Commissions did not find it necessary to recommend large grants-in-aids to cover revenue deficit of States. This trend was reversed by Ninth Finance Commission resort to large share in income tax proceeds along with a large grant amount. But the Tenth Finance Commission has reduced the share of States’ in the income tax proceeds and there was a huge amount of grants-in-aid.

Miscellaneous Financial Provisions:

Under Article 280(3)(b) of Indian Constitution it is the duty of the Finance Commissions to make recommendations to the President as to the principles which should govern the grants-in-aid of the revenues of the State act of the consolidated fund of India. The substantive portion of the Clause (1) of Article 275 states that the amount of grants-in-aid shall be determined and paid out of the consolidated fund of India. Under Article 282 the Union or the State make grants for any public purpose.