Chapter II

THE PROBLEM OF UNION-STATE FINANCES IN INDIA
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This chapter aims at providing brief exposé to the problem of Union-State finances in India and outlining an analytical framework which can be useful in analysing the problem. Section I of this chapter deals with the nature of the problem of Union-State finances in India, while Section II shows the scope of the present work and our approach for analysing the problem. The final section, i.e. Section III deals with the data-base and coverage of years of the study.

I

Nature of the Problem

A chronic gap between States' own revenue resources and their expenditure potential has remained the common feature of all well established federations. However, in Indian fiscal federalism the problem of mismatch between States' own revenue resources and their potential fiscal needs seems relatively chronic. This happens because the Indian federal framework is more of a quasi-

federal nature.

Due to the quasi-federal fiscal arrangements in India, the Constitutional division of functional responsibilities and revenue resources between Union and State governments is more inequitable than other federations. The elastic and productive revenue resources in India have remained centralised and the functional responsibilities have remained highly decentralised. This arrangement has, on the one hand, made the States primarily responsible for major developmental and welfare functions without providing adequate elastic and productive revenue resources which are required for discharging the Constitutionally assigned functions to them2/ and, on the other hand, made them substantially dependent on federal aid. Thus, the problem of vertical fiscal imbalance in India appears more chronic. The problem of States' finances gets further aggravated in India due to the marked disparities in the socio-economic

2/ The Seventh Schedule of the Indian Constitution provides the Lists in which List II is the State List and List III is the Concurrent List. The State list has about 66 items which include Medical and Public Health, Education, Law and Order and Agriculture. For these functions the States are directly responsible. The Concurrent List covers 47 items including important functions like Economic and Social Planning, Social Security, Labour Welfare and Relief and Rehabilitation works etc. In practice, the States shoulder the major burden of executing above said functions incorporated in the Concurrent list.
conditions of the States. In India, there are wide variations in the factor-endowment, the level of economic development, the degree of socio-economic backwardness and fiscal capacity of the States. The Constitution of India has without recognising these disparities assigned same set of functions to each of the States. This leads to serious horizontal fiscal imbalance in India.

Visualising the serious implications of the inherent vertical and horizontal fiscal imbalances in a given quasi-federal fiscal arrangements in India, the framers of the Constitution have, also, incorporated various federal transfer devices and provided a quinquennial statutory body, viz. Finance Commission for periodic reviewing of the States' finances and Union-State financial relations and for recommending transfer of surplus funds of the Union Government to the State units in such a way so that the working of whole federal fiscal system become conducive to aspirations of the federal citizens.

Unfortunately, the process of economic planning as well as the unfavourable attitude of the Centre toward the State units has altered the profile of the constitutionally given federal fiscal system and the federal transfer mechanism. With the process of planning in India, the hardening of centralisation tendencies with respect to revenue resources which were helping the States in augmenting
their revenues and ensuring fiscal autonomy have compelled them to remain contented with less elastic and productive revenue resources. Contrary to this, the central unit has shifted the major responsibility of economic and social planning on the States which has further decentralised the functions. These tendencies have, on the one hand, given unitary slant to the quasi-federal system and, on the other hand, made problem of fiscal imbalances more chronic and complex.

The Finance Commissions were not able to play the anticipated role because of their constrained scope and effectiveness due to the emergence of Planning Commission as a body which will also recommend transfer of funds from Union to the States. What is more serious is the fact that in spite of increasing absolute amount of federal transfer through the recommendations of Finance Commissions and Planning Commission, the States are unable to bridge the gap between their available resources and potential fiscal needs. The increasing aggregate deficit of the States,

3/ Besides, the federal transfer through recommendations of these two agencies, the State units have received additional amount of Rs. 1070 crores from the Centre through various departments. This amount constitutes 33.6 per cent of total federal transfer to the States during the period of 1951-70.
the inter-state disparities in the provision of economic, social and administrative services, the increasing States' debt burden of Central loans and the abject dependence of States on federal transfer show that the problem of States' finances or the problem of vertical and horizontal fiscal imbalances is yet not resolved.

As the States are primarily responsible for the major economic and social services, their fiscal performance are crucial for attaining the objectives of economic development as well as the distribution of incomes. Due to the inadequate, elastic and productive tax-resources and their dependence on Union government for federal aid, their abilities to influence the developmental and welfare programs have remained constrained. Besides, their varying fiscal capacity and public expenditure performance have increased the inter-state disparities in fiscal incidence on the individual, and in provision of economic, social and administrative services. As a consequence, the realisation of the objective of balanced regional economic development becomes difficult. Their increasing budgetary gaps generate expansionary effect through increasing deficit financing by the Centre and accelerate the forces which increase general

\[\text{See Venkataraman, K., States' Finances in India, 1968, pp.16-18.}\]
price level in India. Thus, the problem of States' finances has serious developmental, distributional and stabilizational implications and hence, we cannot neglect it.

The States have demanded either substantial increase in federal transfer or the complete fiscal autonomy for them. Each of the alternatives has its own implications on the objectives of our fiscal policy as well as for our federal policy. As in each of the fiscal years the Centre will have given amount of disposable funds, it will be very difficult for it to financially assist the States beyond a point without cutting its expenditure on developmental programs or without resorting to deficit financing. Thus, the choice of this alternative will adversely affect the objectives of growth with stability. The alternative of the complete fiscal autonomy to the States will decentralise the present fiscal system to greater extent than the desirable. In an extremely decentralised fiscal system, it becomes very difficult to execute distributional and stabilizational policies more effectively.


2/ This aspect of fiscal federalism has been discussed in Section I:B(1) of Chapter I.
Thus, the problem of States' finances in our multi-unit fiscal system is chronic as well as complex. And looking to the serious developmental, distributional and stabilizational implications of this problem, we can infer that it needs careful scrutiny and appropriate and timely corrective measures. The present study makes an attempt to analyse some of the aspects of the problem of States' finances in the context of present federal fiscal arrangements in India.

II

Scope for the Present Work

The survey of the literature on Indian fiscal federalism suggests that the existing official and non-official studies can be broadly classified into following categories: (1) The studies related with the Union-State Financial Relations in India. These studies mainly concentrate upon the Union-State financial relations in our federal set-up and analyse the working of federal transfer mechanism, especially the working of Finance Commissions and Planning Commission. Most of these

For the brief survey of this type of literature and its evaluation, see Lakdawala, D.T., "A Trend Report - Public Finance" in ICSSR: A Survey of Research in Economics, Vol. II, 1976, pp.333-343. Besides, following official and non-official studies are, also, dealing with this aspect of our fiscal system. See in the bibliography, Adarkar, P.P. (1933); Administrative Reforms Commission (1968, 1968a); Agarwal, P.P. (1959); contd..
are either descriptive and/or based on casual empiricism.2/

(2) The Studies on States' Finances: Some studies have dealt with the States' finances in general,10/ while few

Footnote 8 contd.


studies have exclusively concentrated on the finances of individual states like Bombay, Gujarat, Uttar Pradesh, Bihar, Mysore and Rajasthan etc.11/ These studies analyse the working of States' finances and highlight their fiscal difficulties. In this analysis, the given federal fiscal arrangement and its implications on the working of States' finances have remained in remote background. Hence, their usefulness in evaluating the working of the whole federal fiscal system remain limited.

(3) The Empirical Studies: Few studies have tried to provide empirical analysis of some of the positive issues of States' finances like variations in tax-effort of the States and the differentials in the public expenditure performance of the States.12/ But these studies end up with the analysis of the determinants of the said differentials and do not provide set of prescriptions for resolving the issues.


All of these studies take only one of the positive issues of the States' finances or one of the aspects of the working of the present federal fiscal system and analyse it. Hence, they provide the partial analysis of the issues of States' finances or the working of our fiscal federalism. Besides, the objectives of these studies, their approaches for the analysis, their data-base as well as coverage of fiscal years etc. are varying. Hence, we get wide range of prescriptions from these studies. As a consequence, the task of sorting out appropriate corrective measures for solving the problem of vertical and horizontal fiscal imbalances and improving the efficiency of the whole federal fiscal system becomes difficult.

Actually, we require a comprehensive and rigorous quantitative analysis of the issues of the States' finances in relation to the Constitutionally provided federal fiscal arrangements in India for arriving at meaningful conclusions. On the basis of these conclusions, we can suggest the appropriate changes in the present federal fiscal arrangements to make it conducive to the socio-economic objectives of the policy. Such a task is beyond the capacity and resources of the individual researcher. Hence, we take up some of the relevant issues of the working of States' finances and federal transfer mechanism and try to quantify and analyse them. With the help of
this analysis, we will be able to propose required changes in the present federal fiscal arrangements which will, on the one hand, reduce the intensity of the problem of States' finances and on the other hand, make the working of the whole federal fiscal system more smooth and efficient.

Approach for Analysing the Problem

The comprehensive and rigorous analysis of the problem of States' finances in relation to the given federal fiscal arrangement involves two types of the issues: (a) The issues related with the normative aspect of the fiscal federalism and (b) the issues related with the positive aspects of the system.

The normative aspect of fiscal federalism deals with mainly following two crucial issues: (1) The appropriate division of functional responsibilities and financial resources between the Central, Regional and Local governments and (2) the appropriate federal transfer mechanism for balancing the federal-state-local fiscal system. The positive side of fiscal federalism is mainly concerned with the following issues: (1) The working of Union and States' finances and federal transfer mechanism and their implications on the realisation of accepted macro-economic objectives, (2) The wide range of variations in fiscal capacity, tax-capacity, tax-income ratio, tax-efforts, public expenditure performance and in the fiscal incidence of the simultaneous budgetary operations of the federating units and their implications, (3)
the determinants of the above said differentials (4) the effects of federal transfer on the fiscal behaviour of the regional and local units etc. Actually this classification of federal fiscal issues provides us guidelines for the analysis of the problem. We can start with the analysis of some of the relevant positive issues of the States' finances and on the basis of this we can think about appropriate changes in the present arrangement.

For this purpose, we start our analysis with the hypothesis that "the working of federal transfer mechanism in particular and federal fiscal system in general has remained inefficient in India". For the verification of this hypothesis we have to show that (1) the problem of vertical and horizontal fiscal imbalances has got intensified over time in India (2) the differential in provision of economic, social and administrative services are widening over a period of time (3) the inter-state disparities in tax-income ratio are increasing and (4) the workings of the federal transfer mechanism and the federal fiscal system have constrained the States in efficient and effective execution of the Constitutionally assigned functions to them. In the present study we have attempted to analyse above said issues of the States' finances and suggested appropriate changes in the present arrangement.
III

Data-Base and Coverage of the Study

The quantitative analysis of the fiscal issues of States' finances is based on secondary sources of data. For the budgetary data of Union and State governments, the major sources are: (1) Reserve Bank of India Bulletins and (2) Currency and Finance Reports. For the data on National Income and Net State Domestic Products, the only reliable source is Central Statistical Organisation (CSO). For calculating per capita figures, the mid-year population estimates, provided by the Registrar General of India are used.

It should be noted, here, that the available budgetary data from above two sources and net state domestic products data provided by State Statistical Bureaux (SSBs) are not strictly useful in analysing and quantifying the positive issues of the States' finances. Many researchers and experts have highlighted the difficulties in employing the available data for this type of analysis. Therefore, at this stage, it is necessary to know the limitations and difficulties of the available data and their implications on the conclusions which we are going to draw for suggesting appropriate changes in the present fiscal system.
The major difficulties in handling the available budgetary data are as under: First, the concepts and the classification of budgetary items adopted by these agencies before the fiscal year 1974-75 are not strictly useful in measuring the fiscal capacities and the needs of the state units and the differentials therein. When we are using the available budgetary data for this purpose without the required reclassification, we get the results which are the first approximation of the reality. Secondly, the data provided by these sources are in absolute terms. The statewise comparison of fiscal performance on the basis of absolute budgetary figures has no meaning, for there are wide range of variations in geographical area, size of the population, level of economic development, degree of socio-economic backwardness.

and administrative capacity of the States. For meaningful comparison and reliable empirical observations, these differences in the State units should be taken care of and data should be made reasonably comparable. The per capita figures, ratios and rates of changes in the variables are the popular statistical measures which are useful in this respect. Here, we have accordingly tried to make the available budgetary data comparable.

The State or Regional per capita income is considered as one of the most important indices of State's fiscal capacity. Besides, the reliable and comparable State per capita income data provide the rational basis for federal transfer to the States. Unfortunately, in our


country, there is a great paucity of reliable, comparable, detailed and year-wise upto-date State income or State per capita income data. First time in 1961, the Planning Commission emphasized the need for such data. At the later stage, the Fifth Finance Commission asked for such data for recommending federal transfer to the States. Since then Central Statistical Organisation (CSO) and State Statistical Bureaux (SSBs) have endeavoured to provide such data on regular basis.

The SSBs provide estimates of per capita Net State Domestic Products (PCNSDPs) regularly. But they are less reliable and not strictly comparable. Therefore, the CSO attempts to make them comparable. So far CSO is able to furnish comparable data on PCNSDPs only for the few years, viz. the estimates for the years 1960-61 to

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The CSO has so far not worked out the estimates of State income on the basis of available Net State Domestic Products data. The net State domestic product covers the income originated in the State and excludes the income accrued to the State from other States of the federation and from abroad. For the most accurate and precise measurement of fiscal capacity or tax-capacity and tax efforts of the State, the calculations should be based on the estimates of per capita State income not on the per capita net state domestic product. In absence of such data on State incomes we have employed the data of Net State Domestic Products. The lack of time series data on net state domestic products compelled us to adopt the cross-sectional analysis of certain aspects of State finances.

Coverage of the Study

The study covers the period of 14 years, beginning from 1960-61 to 1973-74. The reasons for restricting the time period for the study are in order.

Till the end of the Second Five Year Plan, i.e. upto 1960-61, the nature of the federal fiscal issues faced by us were not that serious. The working of the constitutionally given federal fiscal system gave us the impression that it works smoothly in our mixed economy.
But since 1960, the system has become victim of mounting tensions which are due to the working of centripetal and centrifugal forces inherent in the system. The reasons for accelerating these forces are discussed in the Introduction (pp. 2-3). These changes have actually put the system to the test. Many weaknesses which were latent during the first decade of planning became obvious and found more serious and complex after the year 1960-61. Hence, for empirical analysis of the problem and for evaluating the working of our federal fiscal system, the period after 1960-61 seems to be the appropriate time period.

The years after 1973-74 are dropped from this exercise for the following two reasons: (1) After 1973-74, new budgetary classification became effective. Because of this change, the data available from REI Bulletins and Currency and Finance Reports do not remain comparable with those relating to the earlier fiscal years. (2) The final estimates for the National Income and for the Net State Domestic Products were not available for the latest years at the time of analysis.