



An Overview of Central-State Financial Relations in India

Prof.
P.DHIRAVIYAM

Head & Assistant Professor in Economics, Arignar Anna Government Arts College, Vadachenimalai Post, Attur Tk, Salem Dt, Tamil Nadu.

KEYWORDS :

Introduction

In the share out of tax rights in the Indian Constitution the states (including the as yet hardly developed local authorities) have done well, relatively to the position of the states in several other federations. In the first place they have rights over a fair variety of indirect taxes, excises, sales taxes and stamp duties, apart from the traditional land revenue. Well managed, these should be sufficient to secure a high degree of state, autonomy in budgetary policy. Secondly and most important, these rights are absolute; there are no true concurrent tax rights in the Constitution. Contrast with this for instance the position of the states in Australia, where nothing but direct taxes accrue to the states, and even in respect of these they enjoy only concurrent rights with the Commonwealth Government. The result has been that the central government has gradually squeezed the states out of the all important income-tax, leaving them to balance their budgets mainly by forcing high profits in their trading services, which now account for over 45 per cent of their total revenue.

In addition to the independent tax rights of the Indian states, the Constitution has opened wide opportunities for the Union Government to distribute additional revenue to the states in the form of grants and subsidies. There is first, under Article 270, the all important sharing of income-tax, the proportions to be settled finally by the Finance Commission, but being unlikely to fall below the traditional 50 per cent; there is secondly, under Article 272, the possibility that Parliament may sanction the distribution of certain indirect tax revenues; thirdly, there is the grant to four states in lieu of the jute duty distribution, although only for a limited period; fourthly, there is the provision for special assistance to needy states, and finally, under Article 182, the power given to the Union Government to make grants "for any public purpose" even where no specific legislation exists.

Under these various Articles the states have of course been receiving substantial grants, both on income and capital accounts, in addition to the share of income-tax. Moreover the greater part of the funds transferred from the centre to the states is non-specific and unconditional; the grants can thus be incorporated directly into state budgets and in no way impede their financial autonomy. Indeed some might claim that the states have done too well in the fiscal share out, especially in their unfettered rights over sales taxes and certain tolls and similar exactions, which it misused might almost amount to local customs barriers. Against this must be set the denial of any rights over income-taxes (except for the difficult care of agricultural income-taxes). Limited rights over a proportional income-tax are common in federation, and even in unitary countries where (as in Scandinavia) the local government element is important. What is essential however is that control over the predominant progressive section of income-tax should belong to the central government, since this is the all important tool both for a social policy of interlocal equalising of opportunity and for an economic policy of stable development.

The total exclusion of the states from control over income-tax and the consequent inelasticity of their revenue makes it the more necessary that the principles of an effective grant structure should be carefully thought out. This is of course to be the business of the Finance Commission which under the Constitution must shortly be set up. Under Article 280 of the Constitution the terms of reference of this body could be interpreted very widely and it is much to be hoped that in determining the principles which should govern grants-in-aid, they should include the whole problem of the distribution of revenue, grants to needy states and so on, so that a unified and articulated

grant structure, including all funds transferred from the centre, may be developed. Such a grant structure, as distinct from individual grants, is fast becoming as much a necessity in modern systems of public finance, as a well balanced tax structure. This must inevitably be so, since modern central governments—and the Government of the Indian Union no less than others—have accepted wide responsibilities for the economic and social well-being of their citizens. It is also much to be hoped (a matter on which the Constitution is silent) that the states should be directly and adequately represented on the Commission, in a way that has been found so fruitful in the Australian Grants Commission.

There are of course two problems to be determined in any grant structure: (l) the total amount to be distributed and (h) the distribution of this total between the different states. The answer to the first depends mainly on the distribution of powers and duties allotted by the constitution to the different "layers" of government; but it may properly also be influenced by the considerations that from the technical point of view many of the most important taxes can be more efficiently and more economically collected on a national basis, and, on the other hand that some indirect taxes which may be allotted to state, have undesirable social and economic effects, if pushed too hard. These considerations point to a fairly large grant structure in relation to state powers and duties, subject of course to the overriding consideration that state budgetary autonomy on the one hand and sense of financial responsibility on the other, should not be weakened.

In this connection it is interesting to note that the U.S. (Shoup) Mission of public finance experts who recently visited Japan to advise on a long term programme for the reform of Japanese finances recommended a grant structure which would total 38 per cent, of pre-federal and local revenue. Although Japan is not a federation, the lower layers of government under the new constitution will be responsible for 42 per cent of public outlay, so that these percentages may not be irrelevant to the Indian situation.

So long as tax revenue is redistributed to the areas from which it has been collected strictly according to the principle of "derivation," the operation hardly merits the name of a grant; it is a mere revenue division, such as would take place in a Customs Union where the member states join together for convenience without any consciousness of national unity.

But when only part of the revenue is handed back, and especially when it is distributed on some modification of the strict derivation principle, we enter the realm of grants, where policy becomes not only possible but imperative. The Indian distribution of income tax has hardly yet moved out of the "revenue allocation" stage; even the progressive Sarkar Committee recommended that 58 per cent, of the state share should be distributed on the basis of derivation.

There are several disadvantages in the use of the derivation principle. When applied to indirect taxes (as has been done in East Africa and in Nigeria) the technical problem of correctly allocating the revenue collected to the different states is almost insuperable; where income tax revenue is being distributed this problem is less serious, (except in respect of incomes derived from several places), but the economic disadvantages are greater. One of the main arguments for reserving income tax for central governments is that national governments can better stand the inevitably heavy fluctuations in revenue of a

tax which is closely correlated with changes in the national income. To transmit these fluctuations to state revenues is to remove a large part of the benefit of centralising the income tax. A grant from the general revenue pool has none of these disadvantages, and indeed it will generally be found that a grant whose magnitude is fixed on independent principles, and whose total is calculable in advance, is preferable to any form of revenue sharing.

It must nevertheless be expected that in a federation the derivation principle will have to play some part in the grant structure. The fact that a country adopts a federal constitution in preference to a unitary one implies that the citizens of one part are not prepared to regard the citizens of another part as quite on all fours with themselves, in the sense of being prepared to share their taxed incomes with them man for man.

If the income tax revenue has in the past mainly been distributed on the derivation principle, quite another policy is discernible in respect of certain other Indian grants—that of promoting development. This principle can have a very important part to play especially in a country which suffers from a great shortage of capital equipment. Promotional grants were in most countries the first to be given, and until quite recently have been far the commonest. (In the US they still are). In the UK, up to 1929, practically all grants were of this nature, and much useful experimenting was undertaken with their aid by certain local authorities. It is the rationale of these grants that it is in the national interest that areas, which have the ability and the willingness to get ahead should be enabled to do so.

Useful as this kind of grant can be it is as well that it should not play too important a part in a grant structure, for several reasons. Firstly grants of this nature, being specific to a particular purpose tend to distort state (or local) budgets by encouraging growth in these directions to the possible neglect of others. Secondly they almost inevitably have attached to them certain conditions, such as the attainment of a given standard of service, and this entails a greater degree of central supervision than may be desirable or desired. Again, the plea of national interest can all too easily develop into sectional interest. Thus it would be perfectly reasonable in an early stage of development, when all areas are short of schools, to make grants to (those areas which are exceptionally eager and ready to expand facilities. At a later stage, when all areas are fairly well provided for, it would be desirable to change over to a more equalising grant that would give the backward areas a chance of catching up.

Finally, grants of this type tend to be disequalising, favouring the richer areas who alone can afford the supplementary expenditure necessary to derive full advantage from them. This was very largely the reason why the UK changed over to an equalising grant in place of the promotional health services grants in 1929. It is interesting to find that the Shoup Mission recommend that in Japan promotional grants should not exceed 9 per cent, of the total distributed.

The main purpose of grants is increasingly coming to be recognised as one of equalising opportunities, that is of distributing central funds according to the needs of the states and local authorities. Most of the experiments in recent years have been occupied in trying to find a suitable and objective method of carrying out this purpose. Needs can be defined either on the "supply side" of relative taxable capacity or on the "demand side" of services that have to be provided; a grant formula will probably have to take account of both. If there are available regional figures of income per head (as there are in the US) this would form an excellent basis for estimating relative taxable capacity.

Alternatively the total value of land and buildings in the area may provide a suitable basis for the purpose, if valuations have been made; more or less simultaneously and on a uniform basis. Thus "Rateable Value per Head" figures as one of the elements in the U.K. grants both of 1929 and 1948, (owing to want of uniform valuations not too much weight could be put upon it). For Japan the Shoup Mission have recommended the more complicated but essentially similar basis of the standard yield of all the more important local taxes.

On the expenditure side the most rational principle would probably be to determine a basic minimum standard unit cost—say of school

places or hospital beds—and multiply these by the number of units required in each area. The total grant would then be some percentage of this figure. This is in fact what has been recommended for Japan; the grants are to be given in three instalments per year, the first two on advance estimates of the number of units required, the last when the number of units actually provided can be ascertained.

Unfortunately it is very doubtful how far it will be practicable to make accurate estimates on either side, but especially on the expenditure side. Also for many areas actual unit costs will unavoidably diverge considerably from the average, and if the grant is to be really equalising to needs some allowance will have to be made for this. There is also room for difference of opinion as to the number of units "required" in many services.

The British block grant of 1929 attempted an easier way out by weighting population figures for special costs for instance children under school age (the others being covered by the education grants which were to some extent equalising) and for percentage unemployed in the area. The total grant was however too small and the weighting too timid to provide much equalising. The grant under the Local Government Act, 1948, is much more equalising. This first brings "taxable capacity" up to the national average, by measuring the difference between local rateable value per head and the national average (valuations will henceforward be on a rational basis and hence uniform). This difference is then multiplied by the local level of expenditure, as measured by rate poundage. The grant is thus equivalent to 100 per cent of the cost of all services within the defined range.

Roth this and the proposed Japanese equalisation grants have the disadvantage from the national point of view that the amounts required in the budget will not be known until local expenditure takes place, the total is thus outside the control of the central government, a condition which not all central finances could stand. However, although it would not be nearly so equalising, something of this method could be used as the basis of relative allocations, the total to be transferred being fixed by negotiation.

It may well be the case, however, that there are available no reasonable objective figures of either relative taxable capacity or of costs of services. In that case it is difficult to see how a straight population basis can be improved on, at least temporarily. After all it is necessary not merely that grants should be fair but that they should seem fair, and the idea of treating heads equally has an obvious appeal to equity, it is interesting that Canada, after much difficult discussion between the Dominion Government and the Provinces, has come down on something very little different from straight population.

It is out of these elements—derivation, national interest and needs that an appropriate grant structure can be built. In just what proportions they should be combined in any particular country depends on local circumstances; obviously an existing distribution of grants cannot suddenly be disrupted. In India the derivation principle could not immediately be abandoned, but it would be wise to lay plans for its gradual modification. In this respect the precedent of Australia is interesting. There the sums transferred to the states as compensation for the loss of income tax were initially given on a "reimbursement" (derivation) basis; but this is being changed over a ten year period (1947-1957) to one of needs, based on a formula resembling that of the U.K. 1929 grant. This equalisation grant is combined with a series of "special grants" negotiated by the Grants Commission in conjunction with the Commonwealth Treasury.

Conclusion

There remains one more point. A grant structure can only be built on the foundation of fairly long term and more or less normal capacity and needs; it cannot be made to cover sudden local calamity. Thus the onset of very heavy and highly localised unemployment in the U.K. in 1930-31 seriously disrupted the 1929 system; in Japan the attempt to cover post-war rehabilitation in the existing grant system has broken down completely. For special needs of this type—which would include natural disasters and such things as the localised additional costs arising from partition special arrangements would have to be made. In most cases it would probably be best for the central government itself to finance and carry out rehabilita-

tion, (this is what is recommended for Japan). For recurrent natural disasters, the practicability of establishing some sort of national insurance fund might be considered. It should be possible for afflicted states to draw from this by arrangement with the Finance Commission or its permanent successor.