UNION STATE FINANCIAL RELATIONS

- Vertical and horizontal imbalances are common features of most federations and India is no exception to this
- The Constitution assigned taxes with a nation-wide base to the Union to make the country one common economic space unhindered by internal barriers to the extent possible
- States being closer to people and more sensitive to the local needs have been assigned functional responsibilities involving expenditure disproportionate to their assigned sources of revenue resulting in vertical imbalances
- Horizontal imbalances across States are on account of factors, which include historical backgrounds, differential endowment of resources, and capacity to raise

Union State Financial Relations

- Unlike in most other federations, differences in the developmental levels in Indian States are very sharp
- In an explicit recognition of vertical and horizontal imbalances, the Indian Constitution embodies the following enabling and mandatory provisions to address them through the transfer of resources from the Centre to the States

FEDERAL FINANCE IN INDIA

- India is a federal country as per its constitution
- There is an allocation of resources between centre and states
- There is a clear mention regarding financial powers in the constitution and according to which, there are three types of lists
- Union List, State List and Concurrent List

Features of Federal Financial System

- Sources of income and expenditure are distributed between the central and state government
- The jurisdictions and rights are clearly mentioned in the constitution
- Sources of income and expenditure are different for the central and state government
- Although, state government has some administrative autonomy, yet they remain subordinate to the centre
- Disputes are resolved via constitution
- THEREFORE, INDIA FOLLOWS A FEDERAL FINANCE SYSTEM…

DISTRIBUTION OF TAXES

- 1. Levy of duties by the Centre but collected and retained by the States (Article 268)
- 2. Taxes and duties levied and collected by the Centre but assigned in whole to the States (Article 269)
- 3. Sharing of the proceeds of all Union taxes between the Centre and the States under Article 270. (Effective from April 1, 1996, following the eightieth amendment to the Constitution replacing the earlier provisions relating to mandatory sharing of income tax under Article 270 and permissive sharing of
  Union excise duties under Article 272)

DISTRIBUTION OF TAXES

- 4. Statutory grants-in-aid of the revenues of States (Article 275)
- 5. Grants for any public purpose (Article 282)
- 6. Loans for any public purpose (Article 293)

268. Duties levied by the Union but collected and appropriated by the States.-

- (1) Such stamp duties and such duties of excise on medicinal and toilet preparations as are mentioned in the Union List shall be levied by the Government of India but shall be collected-
- (a) in the case where such duties are leviable within any Union territory, by the Government of India, and
- (b) in other cases, by the States within which such duties are respectively leviable.
- (2) The proceeds in any financial year of any such duty leviable within any State shall not form part of the Consolidated Fund of India, but shall be assigned to that State.

269. Taxes levied and collected by the Union but assigned to the States

- 226A[(1) Taxes on the sale or purchase of goods and taxes on the consignment of goods shall be levied and collected by the Government of India but shall be assigned and shall be deemed to have been assigned to the States on or after the 1st day of April, 1996 in the manner provided in clause (2).
- Explanation-For the purposes of this clause, -
- (a) the expression "taxes on the sale or purchase of goods" shall mean taxes on sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce;
- (b) the expression "taxes on the consignment of goods" shall mean taxes on the consignment of goods (whether the consignment is to the person making it or to any other person), where such consignment takes place in the course of inter-State trade or commerce;
- (2) The net proceeds in any financial year of any such tax, except in so far as those proceeds represent proceeds attributable to Union territories, shall not form part of the Consolidated Fund of India, but shall be assigned to the State within which that tax is leviable in that year, and shall be distributed among those States in accordance with such principles of distribution as may be formulated by Parliament by law.]
- 227[(3) Parliament may by law formulate principles for determining when a 230[sale

270. Taxes levied and distributed between the Union and the States

- 227A[(1) All taxes and duties referred to in the Union List, except the duties and taxes referred to in articles 268 and 269, respectively, surcharge on taxes and duties referred to in article 271 and any cess levied for specific purposes under any law made by Parliament shall be levied and collected by the Government of India and shall be distributed between the Union and the States in the manner provided in clause (2).
- (2) Such percentage, as may be prescribed, of the net proceeds of any such tax or duty in any financial year shall not form part of the Consolidated Fund of India, but shall be assigned to the States within which that tax or duty is leviable in that year, and shall be distributed among those States in such manner and from such time as may be prescribed in the manner provided in clause (3).
- (3) In this article, "Prescribed" means -
- (i) until a Finance Commission has been constituted, prescribed by the President by order, and
- (ii)after a Finance Commission has been constituted, prescribed by the President by order after considering the recommendations of the Finance

271. Surcharge on certain duties and taxes for purposes of the Union.

- Notwithstanding anything in articles 269 and 270, Parliament may at any time increase any of the duties or taxes referred to in those articles by a surcharge for purposes of the Union and the whole proceeds of any such surcharge shall form part of the Consolidated Fund of India.

274. Prior recommendation of President required to Bills affecting taxation in which States are interested.-

- (1) No Bill or amendment which imposes or varies any tax or duty in which States are interested, or which varies the meaning of the expression "agricultural income" as defined for the purposes of the enactments relating to Indian income-tax, or which affects the principles on which under any of the foregoing provisions of this Chapter moneys are or may be distributable to States, or which imposes any such surcharge for the purposes of the Union as is mentioned in the foregoing provisions of this Chapter, shall be introduced or moved in either House of Parliament except on the recommendation of the President.
- (2) In this article, the expression "tax or duty in which States are interested" means-
- (a) a tax or duty the whole or part of the net proceeds whereof are assigned to any State; or
- (b) a tax or duty by reference to the net proceeds whereof sums are for the time being payable out of the Consolidated Fund of India to any State.

275. Grants from the Union to certain States.-

- (1) Such sums as Parliament may by law provide shall be charged on the Consolidated Fund of India in each year as grants-in-aid of the revenues of such States as Parliament may determine to be in need of assistance, and different sums may be fixed for different States:
- Provided that there shall be paid out of the Consolidated Fund of India as grants-in-aid of the revenues of a State such capital and recurring sums as may be necessary to enable that State to meet the costs of such schemes of development as may be undertaken by the State with the approval of the Government of India for the purpose of promoting the welfare of the Scheduled Tribes in that State or raising the level of administration of the Scheduled Areas therein to that of the administration of the rest of the areas of that State:
- Provided further that there shall be paid out of the Consolidated Fund of India as grants-in-aid of the revenues of the State of Assam sums, capital and recurring, equivalent to-
- (a) the average excess of expenditure over the revenues during the two years immediately preceeding the commencement of this Constitution in respect of the administration of the tribal areas specified in 232[Part I] of the Table appended to paragraph 20 of the Sixth Schedule; and
- (b) the costs of such schemes of development as may be undertaken by that State with the approval of the Government of India for the purpose of raising the level of

275. Grants from the Union to certain States.-

- (1A) On and from the formation of the autonomous State under article 244A,-
- (i) any sums payable under clause (a) of the second proviso to clause (1) shall, if the autonomous State comprises all the tribal areas referred to therein, be paid to the autonomous State, and, if the autonomous State comprises only some of those tribal areas, be apportioned between the State of Assam and the autonomous State as the President may, by order, specify;
- (ii) there shall be paid out of the Consolidated Fund of India as grants-in-aid of the revenues of the autonomous State sums, capital and recurring, equivalent to the costs of such schemes of development as may be undertaken by the autonomous State with the approval of the Government of India for the purpose of raising the level of administration of that State to that of the administration of the rest of the State of Assam.]
- (2) Until provision is made by Parliament under clause (1), the powers conferred on Parliament under that clause shall be exercisable by the President by order and any order made by the President under this clause shall have effect subject to any provision so made by Parliament:
- Provided that after a Finance Commission has been constituted no order shall be made under this clause by the President except after considering the recommendations of the Finance Commission.

Finance Commission

- In addition to provisions enabling transfer of resources from the Centre to the States, a distinguishing feature of the Indian Constitution is that it provides for an institutional mechanism to facilitate such transfers
- The institution assigned with such a task under Article 280 of the Constitution is the Finance Commission, which is to be appointed at the expiration of every five years or earlier. Under the Constitution, the main responsibilities of a Finance Commission are the following

Finance Commission

- 1. The distribution between the Union and the States of the net proceeds of taxes which are to be divided between them and the allocation between the States of the respective shares of such proceeds
- 2. Determination of principles and quantum of grants-in-aid to States which are in need of such assistance
- 3. Measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of
  the recommendations made by the Finance Commission of the State

Vertical Distribution

- Initially, the Constitution provided for the sharing of only two Central taxes with States
- Article 270 permitted mandatory sharing of the net proceeds of income tax levied and collected by the Union with the States. Such proceeds assigned to States did not form part of the Consolidated Fund of India
- Article 272 provided for sharing of Union excise duties, if Parliament by law so provided
- The shares of the States in Union excise duties were to be paid from the Consolidated Fund of India

Vertical Distribution

- This position continued till the 80th amendment of the Constitution in 2000 which provided for sharing of the proceeds of all Union taxes and duties with the States, except the Central sales tax, consignment taxes, surcharges on Central taxes and earmarked cesses
- This was done taking into account the recommendation of the Tenth Finance Commission to enable the States to derive the advantage of sharing the buoyancy of all Central taxes, to ensure greater certainty in the resource flows to the States and to facilitate increased flexibility in tax reforms

Vertical Distribution

- As per the then Constitutional provisions, tax sharing recommended by the first ten Finance Commissions was restricted to the proceeds of income tax and Union excise duties
- The share of States in the proceeds of income tax as recommended by the Finance Commission witnessed a significant jump from 55 per cent (the First Commission) to 85 per cent (the Ninth Commission)
- For the first time, the Tenth Commission lowered the shares of States to 77.5 per cent on the ground that the authority that levied and administered the tax should have a significant and tangible interest in its yield
- The higher share of States in income tax recommended by the Commissions was partly due to historical reasons and partly on account of the Constitution providing for compulsory

Vertical Distribution

- As far as the distribution of the proceeds of Union excise duties was concerned, initially the share of States was restricted to certain specified commodities
- From the Fourth Commission onwards, States were being given a share in the proceeds of the tax on all the commodities
- The shares of States in the Union excise duties as recommended by the First, Second and Third Finance Commissions were 40 per cent of the proceeds of the tax on three commodities, 25 per cent of the proceeds of the tax on eight commodities and 20 per cent of the proceeds of the tax on 35 commodities, respectively.
- During the periods covered by the Fourth to Sixth Commissions, the shares of States remained static at 20 per cent of the net proceeds of the tax on all commodities
- The Seventh Commission made a major departure by recommending an increase in the share of the States from 20 per cent to 40 per cent

Vertical Distribution

- That Commission felt that the Union excise duties should have a predominant role in the transfer of financial resources to States, considering the size of the proceeds
- Another factor that prompted the Commission to increase the share of the States was to effect bulk of the transfers through tax devolution, reducing the grants to a residual on the one hand and to leaving surpluses on revenue accounts with as large a number of States as possible on the other hand

Vertical Distribution

- The Eleventh Finance Commission, for the first time, introduced the concept of overall ceiling on total Central transfers to States from all channels on the revenue account
- The indicative ceiling recommended by the Commission was 37.5 per cent of the gross revenue receipts of the Centre
- This was raised to 38 per cent by the Twelfth Finance Commission
- This indicative ceiling was based on the then prevailing level of transfers on the revenue account
- The recommendation of the indicative ceiling seems to have been prompted by considerations relating to macro-economic and fiscal stability
- This has prompted States to demand that the total revenue account transfers might be fixed at 50 per cent of the gross revenue receipts of the Centre on the ground that this was the level reached in the year 1999-2000

Vertical Distribution

- "The revenue receipts under GST is very important from the point of view of the Commission. It is important to know the expenditure commitments of the Centre and the States and also the revenues of both."
- "This year, GST revenues may not reflect the appropriate picture to take a view and make projections for 2020-25. But, next year, the Commission has to give the report in October 2019 with GST revenues in 2018-19, which will be available by May. That will guide the Commission, presenting a more realistic picture," the official pointed out.
- Published on February 18, 2018 The Hindu Business Line

Vertical Distribution

- The shares of States in tax devolution had gone up from about 10 per cent of the total tax receipts of the Centre in the 1950s to 30.5 per cent during the period of 2005-10 covered by the recommendations of the Twelfth Finance Commission
- This was mainly facilitated by the higher buoyancy of Central taxes as compared with the State taxes, reforms and broad basing of Central taxes and the levy of taxes on services by the Centre from the year 1994
- The tax devolution recommended by the successive Finance Commissions was without much controversy
- The States, however, have been demanding the fixation of their share in Central taxes at a higher level

Vertical Distribution

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Horizontal Distribution

- The Twelfth Finance Commission increased the weight to population from 10 to 25 per cent and reduced the weight assigned to distance of per capita income from 62.5 per cent to 50 per cent
- Furthermore, the Commission doubled the weightage assigned to efficiency parameters like tax effort and fiscal self sufficiency

Horizontal Distribution

- The criteria used by the Finance Commissions for the interse distribution of tax shares across States can be broadly grouped under,
- a) factors reflecting needs, such as population and income measured either as distance from the highest income or as inverse,
- b) cost disability indicators, such as area and infrastructure distance and
- c) fiscal efficiency indicators, such as tax effort and fiscal discipline

GRANTS-IN-AID

- Grants recommended by the Finance Commissions are predominantly in the nature of general purpose grants meeting the difference between the assessed expenditure on the non-plan revenue account of each State and the projected revenue including the share of a State in Central taxes. These are often referred to as ‘gap filling grants’

GRANTS-IN-AID

- The Twelfth Finance Commission further extended the scope of grants to achieve equalization of expenditure across different states
- While full equalisation of expenditure would require a steep step up in the grants, the Commission restricted itself to partial equalization of services in two sectors, namely education and health
- The Commission recommended grants under education to eight States and those under health to seven States, where the levels of revenue expenditure were lower relative to the average expenditure
- The Commission adopted a new approach by recommending grants for the maintenance of roads and bridges and public buildings

Grants in Aid

- Thus, over the years, there has been considerable extension in the scope of grants-in-aid
- Now the Finance Commission grants cover in addition to meeting the non-plan revenue deficits, requirements of States on account of special problems, and partial equalisation of certain basic services
- They even cover the capital expenditure needs of States in these sectors
- As a result, the share of the gap grants in total grants had come down to about 40 per cent during the period covered by the Twelfth Finance Commission

Finance Commission

- Despite the changing fiscal environment and considerable expansion in its functions, the institution of the Finance Commission has ensured smooth functioning of Centre-State fiscal relations
- If there has been no breakdown in the Centre-State relations, the credit for this entirely goes to the Finance Commissions
- It also goes to the credit of the framers of the Indian Constitution that the provisions relating to Central- State fiscal relations have stood the test of time
- They proved adequate even in meeting the changing environment. Fiscal federalism will always remain a work in progress and the institution of the Finance Commission, as in the past, will continue to deal with the changing

Benefits of Federal Finance

- Independence & Responsibility
- Transfer Adequacy & Elasticity Accountability
- Administrative Efficiency
- Mutual Relation and Coordination
- Uniformity
- Flexibility
- Financially disciplined
- Efficient
- Away from double taxation
- Away from disputes

Centre-State Relations during Emergency

- (i) During a national emergency (under Article 352), the state government become subordinate to the central government. All the executive functions of the state come under the control of the union government.

Centre-State Relations during Emergency

- (iii) During the operation of financial emergency (under Article 360), the Union may give directions to any State to observe such canons of financial propriety as may be specified in the directions, and to the giving of such other directions as the President may deem necessary and adequate for the purpose.

- Reference by-dr.saurabh agarwal