



सत्यमेव जयते

COMMISSION
ON
CENTRE-STATE RELATIONS
REPORT
VOLUME - III
CENTRE-STATE FINANCIAL
RELATIONS AND PLANNING

MARCH 2010



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REPORT

VOLUME III

**CENTRE-STATE FINANCIAL RELATIONS
AND PLANNING**

MARCH 2010

THE COMMISSION

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Former Chief Justice of India

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Former Director,
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Dr. Amaresh Bagchi was a Member of the Commission from 04.07.2007 to 20.02.2008, the date he unfortunately passed away. The Commission expresses its deep gratitude to late Dr. Bagchi for his signal contribution during his tenure as a Member.

SECRETARIES

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(17.07.2007 - 31.05.2008)

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(25.06.2008 - 31.03.2009)

Shri Mukul Joshi

(01.04.2009 - 31.03.2010)

The Commission on Centre-State Relations presents its Report to the Government of India.



Justice Madan Mohan Punchhi

Chairman



Dhirendra Singh
Member



Vinod Kumar Duggal
Member



Dr. N.R. Madhava Menon
Member



Vijay Shanker
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New Delhi
31 March, 2010

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CHAPTER 1

INTRODUCTION

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1

INTRODUCTION

1.1 The Mandate

1.1.01 The Terms of Reference (ToR) mandate this Commission to examine and review the working of the existing arrangements between the Union and States as per the Constitution of India, the healthy precedents being followed and pronouncements of courts in regard to powers, functions and responsibilities, *inter alia*, in the sphere of financial relations, economic and social planning and sharing of resources. While making the recommendations, the Commission has been asked to take into account certain considerations. The considerations relevant to the examination and review of financial relations and economic and social planning are the following:

- i) The role, responsibility and jurisdiction of the Centre *vis-à-vis* the States in promoting the concept and practice of independent planning and budgeting at the district level;
- ii) The role, responsibility and jurisdiction of the Centre *vis-à-vis* the States in linking Central assistance of various kinds with the performance of States;
- iii) The role, responsibility and jurisdiction of the Centre in adopting approaches and policies based on positive discrimination in favour of backward States;
- iv) The impact of the recommendations made by the Eighth to Twelfth Finance Commissions on the fiscal relations between the Centre and the States, especially the greater dependence of the States on devolution of funds from the Centre; and
- v) The need and relevance of separate taxes on the production and on the sales of goods and services subsequent to the introduction of Value Added Tax (VAT) regime.

1.2 Material and Methodology

1.2.01 In this volume, we examine and review the Centre-State relations in the areas of finances and economic and social planning. Intergovernmental fiscal relations are intended to facilitate the Centre and the States to discharge their assigned responsibilities in an effective and efficient manner, whose ultimate objective is to maximize the welfare of citizens. These arrangements must be stable and flexible enough to adapt to the changing economic situation. These considerations have guided the Commission in examining various issues involved in Centre-State financial relations and formulating recommendations on them. Including this introduction (Chapter-1), this volume is organized into eleven chapters. Chapter-2 summarizes the existing Constitutional provisions governing the Centre-State relations and the recommendations of the Commission on Centre-State Relations (Sarkaria Commission) 1988 and the National Commission to Review the Working of the Constitution (NCRWC). Chapter-3 looks at the major developments in the area of Centre-State financial relations since the Sarkaria Commission. Chapter-4 presents the trends in Centre-State financial transfers since the Eighth Finance Commission (FC-VIII) by components. Chapter-5 is devoted to the identification and discussion of the major issues of contemporary relevance in Centre-State financial relations. Chapters-6 and 7 are devoted to a discussion of the roles of Finance Commission and Planning Commission and their transfers, respectively. Issues relating to fiscal domain of the rural and urban local bodies are presented in Chapter-8. The relevance of the Goods and Services Tax (GST) is dealt with in Chapter-9. Issues relating to a unified and integrated domestic market are discussed in Chapter-10. The last chapter summarizes the recommendations relevant to the issues discussed in this volume.

CHAPTER 2

CONSTITUTIONAL PROVISIONS

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CONSTITUTIONAL PROVISIONS

2.1 Background

2.1.01 The Indian Constitution has all the features of a federation with the specification of financial powers and functional responsibilities of the Centre and the States and the institutions needed for a federal structure and a well defined mechanism for inter-governmental transfers to address vertical and horizontal imbalances which characterise most federations¹.

2.2 Taxation Powers

2.2.01 In the Constitution, there is a clear demarcation of the taxation powers of the Union and the States. Under Article 246 of the Constitution, there are three Lists, namely, the Union List, the State List and the Concurrent List. In respect of the subjects listed in the Union List including taxes, Centre has the exclusive power to make laws. Similarly, for the taxes listed in the State List, States have exclusive power to make laws. No taxes are listed in the Concurrent List. Thirteen taxes are listed in the Union List. The important taxes listed in the Union List or those assigned to the Centre are taxes on income other than agricultural land, duties of custom, duties of excise except those on alcoholic liquor for human consumption, corporation tax, estate duty in respect of property other than agricultural land, terminal taxes on goods and passengers carried by railways, sea or air, taxes other than stamp duty on transactions in stock exchanges and futures markets and taxes on sale and purchase of goods other than newspapers, when such sale takes place in the course of inter-State trade or commerce. Nineteen taxes are listed in the State List. The important taxes listed in the State List are land revenue, taxes on agricultural income, taxes on land and buildings, taxes on mineral rights subject to restrictions imposed by Parliament, duties of excise on alcoholic liquor for human

¹ Bagchi Amaresh, 'Fifty Years of Fiscal Federalism in India: An Appraisal', Working Paper 2, 2003. National Institute of Public Finance and Policy.

consumption, taxes on sale and purchase of goods other than newspapers, taxes on goods and passengers carried by road, taxes on vehicles, taxation on professions, taxes on luxuries including on entertainments, taxes on entry of goods into a local area and taxes on advertisements other than those published in newspapers and broadcast by radio or television.

2.3 Expenditure Responsibilities

2.3.01 The Union and the State Lists under the Seventh Schedule prescribed in the Constitution under Article 246 contain subjects in respect of which the Union and the States have exclusive jurisdiction to make laws, respectively. In addition, a few subjects are listed in the Concurrent List in respect which both the Union and the States have concurrent powers to make laws. Conforming to the broad pattern prevalent in other federations, subjects of national importance, such as, defence, foreign affairs, money and banking, communications, national highways, shipping, ports, airways and macroeconomic management have been assigned to the Union. Subjects of regional concern, such as, public order, agriculture, irrigation, public health and sanitation, roads and bridges not specified in the Union List and industries other than those declared by Parliament to be of strategic importance are assigned to States. The important subjects specified in the Concurrent List are criminal law, administration of justice, contracts, forests, economic and social planning, population control and family planning, education and newspapers. The subjects listed in the Union and the State Lists broadly define the expenditure responsibilities of the Centre and the States, respectively.

2.4 Institutional Mechanism for Intergovernmental Transfers

2.4.01 From the division of subjects between the Union and the States, it is clear that there is an asymmetry between the taxation powers and the functional responsibilities. While the Centre is assigned with taxes with higher revenue potential, States are assigned with more functional responsibilities. To address the issue of a gap in the resources assigned to States and their expenditure responsibilities, the Constitution provides an institutional mechanism in the form of a Finance Commission and other enabling provisions for the transfer of resources from the Centre.

2.4.02 Article 280 mandates the setting up of a Finance Commission within two years from the commencement of the Constitution and thereafter at the expiration of every fifth year or at such earlier time as the President of India considers necessary. The duties of the Finance Commission as prescribed under this Article are, a) the distribution

between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them and the allocation between the States of the respective shares of such proceeds, b) the principles which should govern the grants-in-aid out of the Consolidated Fund of India, c) the measures needed to augment the Consolidated Fund of a State to supplement the resources of the panchayats and municipalities in the State, and d) any other matter referred to the Commission by the President in the interests of sound finance. Under Article 281, every recommendation made by the Finance Commission together with an explanatory memorandum as to the action taken thereon is required to be laid before each House of Parliament.

2.4.03 All the taxes and duties referred to in the Union List with the exception of duties referred to in Articles 268 and 269 and surcharges referred to in Article 271 and any cesses levied for specific purposes, shall be distributed between the Union and the States under Article 270. Article 268 refers to duties levied by the Union but collected and appropriated by the States. These are such stamp duties and such duties of excise on medicinal and toilet preparations as are mentioned in the Union List. Under Article 269, taxes on the sale of goods and taxes on the consignment of goods shall be collected by the Government of India but shall be assigned to States.

2.5 Grants to States

2.5.01 There are two Articles governing the grants-in-aid from the Union to the States. Article 275 (1) provides for 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. There are two provisos to clause (1) of this Article. These deal with the promotion of the welfare of Scheduled Tribes in the State of Assam. Under clause (2) of Article 275, no order with regard to grants under clause (1) shall be made except after considering the recommendations of the Finance Commission. Keeping in view these provisions, the terms of reference of Finance Commissions stipulate that the Commission shall make recommendations for the purposes other than those specified in provisos to clause (1). Thus, the Finance Commissions recommend grants under the substantive provision of Article 275 (1). Grants under Article 275 are charged on the Consolidated Fund of India.

2.5.02 Under Article 282, the Union or a State can make any grants for any public purpose, notwithstanding that the purpose is not one with respect to which Parliament or the Legislature of a State, as the case may be, may make laws. Unlike the grants under Article 275 which can be dispensed only on the recommendations of the Finance Com-

mission and are charged, grants under Article 282 can be made with no such restriction and are voted.

2.6 Public Borrowing

2.6.01 Articles 292 and 293 define the borrowing powers of the Union and the States, respectively. Under Article 292, the executive power of the Union extends to borrowing upon the security of the Consolidated Fund of India within such limits, if any, as may from time-to-time be fixed by Parliament by law. This power extends to giving guarantees. Article 293 empowers a State to borrow within the territory of India upon the security of the Consolidated Fund of the State. Thus, States can borrow only within the territory of India. Clause (2) of Article 293 imposes the condition that a State may not raise any loan if any part of the loan extended by the Government of India remains outstanding. In such cases, the permission of the Government of India is required for a State to raise a loan.

2.7 Recommendations of the Previous Commissions

2.7.01 Prominent among the Commissions appointed by the Government of India which examined the Centre-State financial relations are the First Administrative Reforms Commission (FARC), Commission on Centre-State Relations (Sarkaria Commission) and the National Commission to Review the Working of the Constitution (NCRWC). Among these, the mandate of the Sarkaria Commission was specific to the task of comprehensively reviewing the whole gamut of Centre-State relations.

2.7.02 The FARC highlighted the need for a new balance between the national and State level requirements following the developments since independence. In matters of finance and planning, the Commission recommended greater role for States. A realignment in the roles of the Planning Commission and the Finance Commission with a greater role for the latter was recommended by the Commission. The FARC also recommended setting up of an Inter-State Council (ISC) under Article 263 for resolution of conflicts between the Centre and the States.

2.7.03 The Sarkaria Commission was the first national level Commission to have comprehensively reviewed the Centre-State relations. The main issues considered by the Commission in the area of financial relations broadly related to correspondence between the resources and responsibilities of States, autonomy of States in raising resources from their mineral wealth, shrinking of divisible pool of Central taxes following the levy of

cesses and surcharges, enactment of Central Sales Tax in 1956, administered prices, impact of the pay revision by the Centre, lower exploitation of revenue potential of taxes under Articles 268 and 269, increasing Central transfers outside the purview of the Finance Commission and increasing expenditure of the Union Government on the subjects listed in the State List. The important recommendations of the Commission² in the area of financial relations and planning which are still relevant are listed below under certain broad heads.

a) Resource Sharing

- i) The Union Government should, in consultation with the State Governments, periodically consider and explore the revision or imposition of duties under Article 268.
- ii) The monetary limit on tax on professions should be revised.
- iii) In view of its revenue potential, the question of raising resources from taxation of agricultural income would require comprehensive consideration by the proposed National Economic and Development Council (NEDC).
- iv) Surcharge on income tax should not be levied by the Union Government except for a specific purpose and for a strictly limited period.
- v) An expert Committee may be appointed to recommend desirable directions in taxation and *inter alia* to consider from time-to-time, in consultation with States, the scope of levying taxes and duties included in Article 269.
- vi) The review of royalty rates on minerals, petroleum and natural gas should be done every two years.

b) Expenditure Reforms

- i) Central and State governments should take into account the high opportunity cost of populist measures.
- ii) It is necessary that a comprehensive paper on direct, indirect and cross-subsidies, covering both the Union and the State Governments is prepared by the Planning Commission every year and brought before NEDC for discussion.

² Report of the Commission on Centre-State Relations, 1988.

c) Finance Commission and Planning Commission

- i) The present division of responsibilities between the Finance Commission and the Planning Commission may continue.
- ii) The Finance Commission Cell/Division proposed to be located in the Planning Commission should continuously monitor the behaviour of States' finances.
- iii) The Finance Commission should take into account the expenditure liability of States on account of revision of dearness allowance.
- iv) It may be desirable to provide in the special ToR of the Finance Commission to make available finances with effective monitoring arrangements to fill up the inter-State gap in administrative capabilities.
- v) Information gathered by the Finance Commission as well as the detailed methodology followed by it, should be published within six months of the publication of the Report.
- vi) It will be a healthy practice if the observations and suggestions made by the Finance Commission on matters other than the ToR are also considered expeditiously by the Government and a statement placed in Parliament.
- vii) It is necessary that the National Development Council (NDC) should be renamed and reconstituted as National Economic and Development Council (NEDC) by a Presidential Order under Article 263.
- viii) For effective functioning, a Standing Committee of the NEDC should be constituted consisting of the Prime Minister, three Union Ministers nominated by the Prime Minister, Deputy Chairman of the Planning Commission, Governor of the Reserve Bank of India and six Chief Ministers of States, one from each zone selected by rotation or consensus.
- ix) State Planning Boards should be strengthened and should perform functions for the State Governments as the Planning Commission does at the national level.

- x) Close and fullest involvement of the States at all stages of plan formulation is very essential.
- xi) The practice of States submitting plan proposals aggregating to much higher plan size than that warranted by resources estimated by the Resources Working Group (RWG) should be firmly discouraged by the Planning Commission.
- xii) As the different components of Central assistance for the State plans got incorporated at different points of time, a review of Central assistance is over due.
- xiii) A segmented approach in respect of the channeling of Central assistance for externally aided projects should not be followed.
- xiv) A periodic review of the system of earmarking of outlays is desirable and should be discussed and approved by the NEDC.
- xv) The number of Centrally Sponsored Schemes (CSS) should be kept to the minimum. The need for the Union Government initiating pilot projects even in regard to subjects in the States' sphere, having inter-State, regional or overall country wide significance but carrying high national priority is recognized. But these should be formulated in prior consultation with the States. Once a programme has passed the pilot stage and has been accepted as desirable for implementation on a larger scale, it should appropriately form part of the State Plan.
- xvi) The Central assistance towards CSS should be kept to a minimum in relation to the Central assistance for the State Plans. The ratio as recommended by the NEDC should be adhered to.
- xvii) State Governments should be fully involved in determining the contents and coverage of the CSS so that local variations are taken care of.
- xviii) Besides the general reviews contained in the Annual Plan and the mid-term appraisal, a quinquennial review should be brought out by the Planning Commission, which should be taken advantage of in finalizing the next Five-Year Plan.

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- xix) Consultation with District Planning Boards should be made obligatory for formulating plans at higher levels.
 - xx) Institutions like Zila Parishads and elected municipal corporations need to be significantly strengthened-both financially and functionally.
 - xxi) It is necessary to evolve a mechanism like Finance Commission at the State level to enable the State Government to take an objective view of resources to be devolved or transferred to the districts. The State Planning Boards can conveniently and with advantage be entrusted with this function. This body could then be designated as State Planning and Finance Board.
 - xxii) The flow of capital from various sources to the States and their allocation among them should form part of an integrated plan. This task should be attended to by the Planning Commission in consultation with the Ministry of Finance and the Reserve Bank of India and approved by the NEDC as part of plan financing.
 - xxiii) A Sub-Committee of Finance of the Standing Committee of NEDC may be constituted consisting of Union Finance Secretary and Finance Secretaries of States and Union Territories to consider all matters involving coordination of economic policies.

d) Natural Calamities

- i) In the event of natural calamity, relief must be given immediately. Prescription of standard formats for submission of memoranda by States will greatly help in dealing with requests for assistance.
- ii) In a situation of natural calamity, States should have discretion to make inter-district or inter-sectoral adjustments.
- iii) Relief assistance should extend beyond the financial year.

e) Other Matters

- i) It is necessary to develop organizational capabilities and enterprise urgently in States where the flow of institutional finance is not to the desired extent.

- ii) Consideration of adequate flow of funds to the backward areas in States would necessitate creation of expert bodies like the Finance Commission at the State level.
- iii) Non-productive expenditure should not form part of the capital budget.
- iv) The rationality of transfers from the Union to the States would involve more of revenue transfers to the less-developed States with lower prepayment capacity and weak financial base. In contrast, keeping in view the needs of development in the advanced States, a suitable mix of budgetary and non-budgetary access to capital may be allowed to them.
- v) The Union Government should give its consent freely to States for borrowing from banks and financial institutions for periods less than one year.
- vi) The system of tax-free municipal bonds should be introduced in the country.
- vii) The treatment of small saving loans to States should be related to inflows and outflows of small savings in a State.
- viii) Any problem of the working of the arrangements concerning flow of development finance should be looked into by the Sub-Committee of Finance of the NEDC.

2.7.04 The NCRWC made, *inter alia*, a number of recommendations³ with regard to the Constitutional provisions having a bearing on financial matters. Important recommendations made by the Commission are as follows:

- i) There should be a specific enumeration of services that may become amenable to taxation by the States. To augment the resources of States, Constitution may be amended to enable States to levy and collect certain taxes, now levied and collected by the Union;
- ii) Parliament should by law establish an authority called the 'Inter-state Trade and Commerce Commission' under Article 307 to ensure removal of barriers to inter-State trade and commerce;

³ Report of the National Commission to Review the Working of the Constitution, 2002

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- iii) The Eleventh and the Twelfth Schedules should be restructured in a manner that creates a separate fiscal domain for panchayats and municipalities. Accordingly, Articles 243H and 243X should be amended making it mandatory for the State Legislature to make laws devolving powers to panchayats and municipalities;
 - iv) The provisions of Article 280 (3)(bb) and (c) may be amended to enable the Central Finance Commission to make its recommendations after taking into account the recommendations of State Finance Commissions;
 - v) Article 243-I should be amended to provide for the appointment of a State Finance Commission at the expiration of every fifth year or earlier;
 - vi) Action Taken Report (ATR) on the recommendations of a State Finance Commission should be placed before the Legislature of the State within six months of the submission of the report by the State Finance Commission;
 - vii) Parliament may be vested with legislative powers to fix the upper limit on taxes on professions, trades, callings and employment under Article 276;
 - viii) All local bodies may be allowed to borrow from the State Government and financial institutions;
 - ix) Out of the total plan outlay of the Centre and each State, an outlay equivalent to the population proportion of SCs and STs should be placed at the disposal of the proposed National SCs and STs Development Authority and the State SCs and STs Development authority, respectively; and
 - x) Public policy should move decisively in the direction of doing away with surcharges as part of the Union's fiscal armoury.

CHAPTER 3

DEVELOPMENTS SINCE THE SARKARIA COMMISSION

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DEVELOPMENTS SINCE THE SARKARIA COMMISSION

3.1 Background

3.1.01 Since the submission of the Sarkaria Commission Report in the late eighties, momentous changes have taken place in the Indian economy having a bearing on the Centre-State relations. Some of the issues examined by the Sarkaria Commission like the inclusion of corporation tax in the divisible pool of Central taxes have since been resolved with the 80th Amendment to the Constitution. Many other issues raised by that Commission, such as, levy of cesses and surcharges on Central taxes, plan formulation, pattern of plan assistance, CSS, regional development and strengthening of local bodies are relevant even today. A number of new issues have come to the fore in the wake of economic reforms introduced in the country in the early nineties. There are also developments outside the realm of economic reforms. This chapter identifies major developments since the Sarkaria Commission and analyses their implications for Centre-State financial relations.

3.2 Economic Reforms

3.2.01 There was a paradigm shift in economic policy with the initiation of economic reforms in the country in the early nineties. The earlier focus on planned economic development, primacy of the public sector, location of public sector undertaking to address regional imbalances and regulation of industry and trade through a system of licensing and permits gave way to market-oriented economic policies. The focus has shifted from public investment to promoting private investment. The shift in economic policy has been a major contributory factor in putting the Indian economy on a higher growth trajectory.

3.2.02 The economic reforms and other associated changes had repercussions on the Indian economy in a number of ways. One such major repercussion is the greater role cast on the States in economic development. With the major portion of investment envisaged to come from the private sector in the Five-Year Plans, States are required to put in place the necessary enabling conditions such as the provision of adequate infrastructure to attract private investments. States which have taken proactive policy measures and having better infrastructure facilities have been able to attract private

investment. States failing to attract private investment have lagged behind. This has resulted in increasing inequalities in economic growth thus accentuating imbalances across States. The poorer States with lower resource base and lack of infrastructure have been unable to catch up with the rest of the States. There has been large scale migration from poorer States to richer States and a faster pace of urban growth stretching the already inadequate civic amenities in urban areas to the hilt.

3.3 Changes in Tax Sharing

3.3.01 One of the long standing grievances of the States was that the divisible pool of Central taxes was restricted to income tax and Union excise duties. Till the 80th amendment, the Constitution provided for mandatory sharing of the net proceeds of income tax (Article 270) and permissible sharing of the net proceeds of Union excise duties (Article 272). The States were particularly peeved by the exclusion of income tax paid by the companies from the divisible pool by an amendment of the Income Tax Act in 1959. Following the recommendations of the Tenth Finance Commission, Article 270 of the Constitution was amended in 2000 (80th Amendment) to provide for the sharing of net proceeds of all Union taxes and duties except those referred to in Articles 268 and 269 and cesses and surcharges referred to in Article 271. This has resulted in a more rational division of net proceeds of Central taxes between the Union and the States. The new dispensation has enabled the States to share the overall buoyancy of Central taxes. The States, by and large, have favoured the sharing of all Union taxes and their grievance is now restricted to the percentage share devolved to them.

3.4 Introduction of Tax on Services

3.4.01 Introduction of service tax initially on three services in 1994 and its gradual extension to other services was a major development in the area of indirect taxation in the country. Services now account for over 50 per cent of the Gross Domestic Product (GDP). With the expansion of the service sector and the extension of service tax to more and more services, revenue from the tax improved from 0.29 per cent of GDP in 2003-04 to 1.22 per cent of GDP in the revised estimates of 2008-09. The share of service tax in the total gross tax revenue of the Centre improved from 3.10 per cent to 10.35 per cent in the same period. The introduction of service tax resulted in higher buoyancy of Central taxes.

3.5 73rd and 74th Constitutional Amendments

3.5.01 The 73rd and 74th Amendments to the Constitution in 1993 conferring statutory status to rural and urban local bodies, respectively were developments of far reaching

importance. Article 243 provides for the constitution of elected rural and urban local bodies. The Article also provides for the constitution of a State Election Commission in each State entrusted with the responsibility of holding regular elections to these local bodies. Article 243(I) (1) mandates the appointment of a Finance Commission within one year of the commencement of the Constitutional Amendment Act and thereafter at the expiry of every fifth year to review the finances of the local bodies and to make recommendations on the principles of distribution of net proceeds of taxes between the State Government and the local bodies and the principles governing grants-in-aid to local bodies. Following these developments, Article 280 was also amended mandating the Central Finance Commission to make its recommendations regarding the augmentation of the Consolidated Fund of a State to supplement the resources of local bodies on the basis of the recommendations made by the Finance Commission of the State. These developments have given rise to demands for a separate fiscal space for local bodies.

3.6 Tax Reforms

3.6.01 The introduction of Value Added Tax (VAT) with commonly agreed rates by States in 2005 was a major landmark in the history of State taxes. It was the culmination of efforts stretching over a decade towards reforms in sales taxation. It put an end to the cascading effect of sales taxation and rate wars among States, which was a zero-sum game and heralded a spirit of cooperation among States. Though the Empowered Committee of State Finance Ministers is now entrusted with decision making with regard to VAT, it does not amount to any dilution of the autonomy of States. On the other hand, it is a healthy development towards cooperative federalism for the common good of all.

3.6.02 Another major development is the proposed introduction of Goods and Services Tax (GST) shortly. This tax to be levied concurrently by the Centre and the States is likely to subsume a number of Central and State taxes making the tax administration less cumbersome, more industry friendly and more transparent. Furthermore, it is expected to do away with most of the tax exemptions involving huge revenue loss and improve voluntary tax compliance because of the input credit. The introduction of VAT and the proposed introduction of GST have to be perceived from the point of view of larger interests of the nation and in making the country an integrated market rather from the narrow perspective of loss of autonomy of States. Even, if there is a loss of some autonomy, it is the result of voluntary abdication on the part of States for their common good.

3.7 Fiscal Responsibility Legislation

3.7.01 A major development in the management of public finances in the country was the enactment of Fiscal Responsibility and Budget Management Act (FRBMA) by the Centre and all the States with the exception of West Bengal and Sikkim, ushering in an era of rule based management of public finances. Since, the late eighties, the finances of the Centre and the States witnessed an alarming deterioration. The combined fiscal deficit of the Centre and the States reached an alarming level of nearly 10 per cent of GDP by 1990-91 from a level of 6.4 per cent in 1981-82. The combined revenue account slipped into a deficit of 4.2 per cent of GDP in 1990-91 from a surplus of 0.6 per cent of GDP in 1981-82. These ratios indicate that in 1990-91 nearly 64 per cent of the borrowings were used to finance revenue expenditure. By 2001-02, while the combined deficit remained at 9.3 per cent of GDP, the combined revenue deficit increased sharply to 6.9 per cent of GDP. Alarmed by the deteriorating fiscal situation, the Centre had enacted the FRBMA in 2003, which became operational from July 5, 2004. The main obligations of the Centre under the Act and the rules framed under the Act are the elimination of revenue deficit by 2008-09 and reduction of fiscal deficit to no more than 3 per cent of GDP by 2008-09. There was slippage in meeting these targets because of the fall in revenue following global downturn, increase in food and fertilizer subsidies and higher expenditure necessitated by farm loan waiver, pay revision following the recommendations of the Sixth Central Pay Commission and the fiscal stimulus package put in place as a countercyclical measure.

3.7.02 The Twelfth Finance Commission (FC-XII) recommended the Debt Consolidation and Relief Facility (DCRF) comprising consolidation of States' outstanding debt to the Centre and debt write-offs linked to the reduction of revenue deficit and containment of fiscal deficit at the 2004-05 level. Enactment of FRBMA by States was made a pre-condition to avail of the benefits under the DCRF. Following this inducement and the stipulation, 21 States had enacted FRBMA beginning 2005-06. The States of Karnataka, Kerala, Tamil Nadu, Punjab and Uttar Pradesh had enacted the legislation even before the stipulation by FC-XII. West Bengal and Sikkim are yet to enact the legislation. These State legislations also mandate elimination of revenue deficit and the containment of fiscal deficit. The enactment of FRBMA has brought discipline in the management of public finances in the country. The aggregate revenue account of States turned into a surplus in 2006-07 ahead of the target year of 2008-09 prescribed by FC-

XII. Even fiscal correction was achieved ahead of the target year of 2008-09. The global developments in 2008-09 and the resultant shortfall in tax revenue have resulted in partial reversal of the fiscal correction achieved till 2007-08.

3.8 Borrowings by States

3.8.01 Following the recommendations of FC-XII, the Centre terminated on lending to States from 2005-06 on account Central Plan assistance. Prior to 2005-06, the Centre was dispensing normal plan assistance in the grant-loan ratio of 30:70 in the case of General Category States (GCS) and in the ratio of 90:10 in the case of Special Category States (SCS). States are now allocated additional market borrowings in lieu of loan component of normal Central assistance. Termination of on lending by the Centre has cast a burden on the States in terms shorter duration of the market borrowings. The Central loans had a repayment period spread over 25 years with a moratorium of five years in repayment. In contrast, the market loans have a repayment period of 10 years with a bullet repayment at the end of the tenth year. This will result in bunching of repayments for the States.

3.8.02 Till 1998-99, small saving collections were being credited to the Consolidated Fund of India and the Centre was extending loans to a State against small saving collections in that State. In April 1999, the National Small Savings Fund (NSSF) was created in the Public Account with the Centre taking on the responsibility of servicing outstanding small saving deposits from the date NSSF became operational. The share of the States in net small saving collections was increased from 66.66 per cent to 75 per cent in April 1987 and further to 80 per cent from April 2000 following the requests of the State Governments. From April 2002 to March 2007, the entire net collections under small savings were being invested in securities issued by the State Governments. The mandatory sharing of net collections by the States was reduced to 80 per cent from 2007-08 with the States being given the option to borrow up to 100 per cent of net small saving collections. States' borrowings against net small saving collections are no more treated as loans from the Centre following the setting up of NSSF. With these changes, Finance Commissions have been excluding small saving loans from the purview of consolidation and relief offered on outstanding Central loans to States. Besides, loans from the NSSF carry a high interest rate of 9.5 per cent per annum.

3.9 Changing Pattern of Plan Assistance to States

3.9.01 There are two distinct changes in Central plan assistance to States. The first one is the reduced budgetary support to the State Plan and the second is the significant change in the pattern of plan assistance. At the time of the formulation of the Tenth Plan, the Centre's Gross Budgetary Support (GBS) to the Plan was distributed between the Central Plan and the State Plan in the ratio of 58:42. The actual support turned out to be 66:34, indicating a shortfall even in the lower level of support to the State Plans by a substantial margin. Realised Central assistance to States and UTs was 67.6 per cent of the projected level. As indicated in the Eleventh Plan document, this was the result of increasing the resource transfers through CSS, especially in sectors like health, education and rural development. For the Eleventh Plan, the percentage of GBS envisaged for the State Plans is only 23 per cent. Central assistance to State Plans is envisaged to come down from 1.48 per cent of GDP during the Tenth Plan period to 1.20 per cent of GDP in the Eleventh Plan. In contrast, the gross budgetary support to the Central Plan is envisaged to go up from 2.77 per cent of GDP in the Tenth Plan period to 3.97 per cent in the Eleventh Plan.

3.9.02 Besides the reduction in the budgetary support to the State Plans, the composition of the budgetary support has undergone major changes over the years. The share of normal plan assistance in the total budgetary support to the State Plan has come down drastically and that of CSS, additional Central assistance and special plan assistance has gone up considerably. The issues relating to the changing pattern of plan assistance are addressed in another chapter of this volume.

3.10 Growing Inter-State Inequalities

3.10.01 Disparities among States have been steadily increasing particularly since the initiation of economic reforms in the country. The Eleventh Five-Year Plan document expressed concern over the widening income differentials between more developed and relatively poorer States. In the post-reform period, private investment had gone mostly to southern and western States because of proximity to ports, better infrastructure and perceptions regarding better governance. Table 4.1 presents the trends in inter-State differentials in comparable estimates of per capita Gross State Domestic Product (GSDP) over the years.

Table 4.1: Trends in Inter-State Disparities in Per Capita GSDP

Year	State With the Lowest Per Capita GSDP	State With the Highest Per Capita GSDP	Ratio of Minimum to Maximum Per Capita GSDP
1993-94	Bihar	Punjab	30.53
1996-97	Bihar	Maharashtra	27.59
1999-00	Bihar	Maharashtra	28.90
2000-01	Bihar	Punjab	21.56
2001-02	Bihar	Punjab	21.61
2002-03	Bihar	Punjab	22.70
2003-04	Bihar	Maharashtra	20.10
2004-05	Bihar	Maharashtra	20.10
2005-06	Bihar	Haryana	20.75
2006-07	Bihar	Haryana	19.27

Source: Planning Commission, Eleventh Five-Year Plan, Volume-I for the years 1993-94 to 2003-04 and the Report of the Thirteenth Finance Commission for the years 2004-05 to 2006-07

3.10.02 In 1993-94, the per capita GSDP of Bihar, the lowest income State was 30.53 per cent of the highest income State of Punjab. By 2006-07, the per capita income of Bihar slipped to 19.27 per cent of the highest income State of Haryana. In the above Table, the per capita income Goa, the highest income State in the country has not been taken into account as it is an outlier. In 2006-07, the per capita income of Goa was double that of Haryana, the next highest income State. If Goa is included, the ratio between the per capita incomes of the highest and the lowest State will be 10:1 in the year 2006-07, the latest year for which the comparable estimates of per capita GSDP are available.

CHAPTER 4

TRENDS IN FISCAL TRANSFERS TO STATES SINCE THE MID-EIGHTIES

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4

TRENDS IN FISCAL TRANSFERS TO STATES SINCE THE MID-EIGHTIES

4.1 Background

4.1.01 The ToR mandate this Commission to consider the impact of the recommendations made by the Eighth to Twelfth Finance Commissions on the fiscal relations between the Centre and the States, especially the greater dependence of the States on devolution of funds from the Centre. Following this mandate, we have reviewed the trends in fiscal transfers to States since the period covered by FC-VIII and the findings of this review have broadly informed our recommendations on various aspects of Centre-State fiscal relations.

4.1.02 In India, transfers from the Centre to States, comprising statutory and non-statutory transfers, take place through three channels, namely, Finance Commission, Planning Commission and the Central Ministries. Statutory transfers in the form of share in the proceeds of Central taxes and non-plan grants are on the basis of the recommendations of the Finance Commissions. Non-Statutory transfers in the form of plan grants take place through the channel of the Planning Commission and in addition there are both plan and non-plan grants from various Central Ministries. The States get loans against the net small saving collections. These are from the NSSF which is outside the Consolidated Fund of India and cannot strictly be termed as loans from the Centre.

4.2 Vertical Imbalance

4.2.01 The relative shares of the Centre and States in the combined revenue receipts before and after transfers presented in Table 4.2 give an idea of the extent of vertical imbalances and extent of transfers from the Centre to States.

Table 4.2: Relative Shares of the Centre and the States in Combined Revenue Receipts Before and After Transfers

Finance Commission	Percentage Share Before Transfers		Percentage Share After Transfers	
	Centre	States	Centre	States
Eighth (1984-89)	64.9	35.1	38.4	61.6
Ninth (1989-95)	62.1	37.9	35.3	64.7
Tenth (1995-2000)	61.3	38.7	37.1	62.9
Eleventh (2000-05)	60.9	39.1	36.9	63.1
Twelfth (2005-08)	62.9	37.1	36.5	63.5

Source (Basic Data): Ministry of Finance, Indian Public Finance Statistics, Various Years.

4.2.02 The share of the States in the combined revenue receipts before transfers was 35.1 per cent in the period 1984-89 and thereafter varied in the narrow range of 37.1 to 39.1 per cent. The share of the States after transfers was 61.6 per cent in the period 1984-89 and thereafter increased marginally and fluctuated in the range of 62.9 per cent to 64.7 per cent. The relative shares become just the reverse after transfers with the share of States going up and that of the Centre coming down.

4.2.03 Another indicator of the vertical imbalance is the relative shares of the Centre and the States in the combined revenue and total expenditure. These are presented in Table 4.3.

Table 4.3: Relative Shares of the Centre and the States in Combined Revenue and Total Expenditure

Finance Commission	Total Expenditure Before Transfers		Revenue Expenditure (Percent)	
	Centre	States	Centre	States
Eighth (1984-89)	47.86	52.14	44.22	55.78
Ninth (1989-95)	45.58	54.42	43.45	56.55
Tenth (1995-2000)	43.35	56.65	43.18	56.82
Eleventh (2000-05)	43.77	56.23	44.03	55.97
Twelfth (2005-08)	43.74	56.26	44.45	55.55

Source (Basic Data): Ministry of Finance, Indian Public Finance Statistics, Various Years.

4.2.04 The share of the States in the combined total expenditure was 52.14 per cent in the period covered by FC-VIII (1984-89) and there has been remarkable stability in the share of the States since the period covered by the Tenth Finance Commission (FC-X). The share of the States in revenue expenditure exhibited remarkable stability since the award period of FC-VIII. The share remained stable at around 56 per cent.

4.3 Composition of Central Transfers

4.3.01 The composition of Central transfers to States since the award period of FC-VIII is presented in Table 4.4.

Table 4.4: Percentage Composition of Revenue Transfers from the Centre to States

Period	Finance Commission Transfers			Other Transfer			Total Transfers (4+7)	Transfers as a percentage of GDP
	Share in Central Taxes	Grants	Total Finance Commission	Plan Grants	Non-plan Grants	Total other Trnsfers (5+6)		
1	2	3	4	5	6	7	8	9
Eighth (1984-89)	53.48	6.65	60.13	35.80	4.07	39.87	100.00	4.83
Ninth (1989-95)	52.98	8.48	61.46	35.91	2.63	38.54	100.00	4.89
Tenth (1995-2000)	62.06	6.55	68.61	29.52	1.87	31.39	100.00	4.09
Eleventh (2000-2005)	58.38	11.00	69.38	28.65	1.97	30.62	100.00	4.16
Twelfth (2005-10)	56.48	11.55	68.03	28.55	3.43	31.97	100.00	5.21
2005-06	57.00	14.95	71.94	25.36	2.70	28.06	100.00	4.69
2006-07	57.93	13.47	71.40	25.54	3.05	28.60	100.00	5.11
2007-08	58.82	10.21	69.02	27.69	3.29	30.98	100.00	5.46
2008-09 (RE)	56.04	9.69	65.74	30.92	3.34	34.26	100.00	5.37
2009-10 (BE)	53.62	11.22	64.84	30.88	4.28	35.16	100.00	5.23

Source: Basic data from Indian Public Finance Statistics, Union Finance Accounts and Central Budget documents

4.3.02 The composition of transfers presented in Table 4.4 is in respect of the revenue account transfers. Prior to 2005-06, normal plan transfers included a loan component which was 70 per cent for the general category States and 10 per cent for the special category States. Till 1999-2000, the Centre was also advancing loans to States against the net small saving collections. Of the total transfers from the Centre, Finance Commission transfers are predominant accounting for over 68 per cent since the award period of FC-X (1995-2000). Over the periods, there has been an increase in the share of Finance Commission transfers from 60.13 per cent in 1984-89 to 68.03 per cent in the period 2005-10. Within the Finance Commission transfers, there has been an increase in the share of grants particularly in the award periods of FC-XI and FC-XIII. The share of plan grants declined from 35.80 per cent in 1984-89 to 28.55 per cent in 2005-10. In recent years, there has been an increase in the share of plan grants to over 30 per cent of total transfers because of higher transfers through CSS. There has also been a marginal increase in the share of non-plan grants in total transfers in recent years. As a percentage of GDP, total revenue account transfers to States remained stable till the award period of FC-XI and increased marginally in the period covered by FC-XII.

4.4 Transfers Relative to Centre's Gross Revenue Receipts

4.4.01 Table 4.5 presents aggregate revenue account transfers to States relative to the gross revenue receipts of the Centre. Aggregate transfers to States after declining from 40.33 per cent of Centre's gross revenue receipts during the Ninth Finance Commission (FC-IX) period to around 36 per cent in the periods covered by FC-X and FC-XI increased to 38.40 per cent in FC-XII period. FC-XII recommended an indicative ceiling on aggregate revenue account transfers at 38 per cent of Centre's gross revenue receipts. Thus, the current level of transfers is marginally higher than the indicative ceiling.

Table 4.5: Revenue Account Transfers to States Relative to Centre's Gross Revenue Receipts

Finance Commission	Revenue Account Transfers to States as a Percentage of Centre's Gross Revenue Receipts
Eighth (1984-89)	37.86
Ninth (1989-95)	40.33
Tenth (1995-2000)	35.79
Eleventh (2000-05)	35.27
Twelfth (2005-10)	38.40

Source: Indian Public Finance Statistics for period 1984-2005. Percentages from 2005-06 onwards are based on Central Budget documents.

4.5 Dependence of States on Central Transfers

4.5.01 The dependence of States on Central transfers can be analysed in terms of the share of the transfers in the total revenue receipts of States. The share of Central transfers in the aggregate revenue receipts of States remained stable at around 40 per cent except during the periods covered by FC-X and FC-XI. This was mainly on account of the lower growth of Centre's revenue receipts during this period (Table 4.6). Within the total transfers from the Centre, dependence on share in Central taxes was more stable as compared with the grants from the Centre.

Table 4.6: Dependence of States on Central Transfers

Finance Commission	Transfers from the Centre as a Percentage of States' Aggregate Aggregate Revenue Receipts		
	Share in Central Taxes	Grants from the Centre	Total Revenue Account Transfers
Eighth (1984-89)	21.65	18.50	40.15
Ninth (1989-95)	21.86	18.51	40.37
Tenth (1995-2000)	22.12	14.92	37.04
Eleventh (2000-05)	20.61	16.45	37.06
Twelfth (2005-10)	22.24	17.68	39.97

Note: Figures in respect of the Twelfth Finance Commission period are averages for the four-year period 2005-09.

Source (Basic Data): Reserve Bank Of India, Study of State Finances, Various Issues.

4.5.02 The dependence on Central transfers may vary across States depending on the capacity to generate own resources. Appendix 4.1 indicates the extent of dependence of individual States over the periods covered by FC-IX to FC-XII. For the high-income States, the dependence on Central transfers varies from one-fourth to one-sixth of their revenue receipts. In respect of the middle-income States, the dependence on Central transfers is between one-third to one-fifth except in the case of Chattisgarh and West Bengal, where the dependence is much higher (40 to 50 Per cent). The dependence of low income States is much higher and varies in the range of 42 to 80 per cent. The dependence on Central transfers is much higher in the case of special category States. In these States, the dependence varies from 64.98 per cent to 92.95 per cent of their revenue receipts.

4.5.03 The analysis of Central transfers to States indicates a relative stability in the dependence of States. The share of the States in the combined revenue receipts after transfers remained in the narrow range of 62 to 65 per cent over the last 25 years. Relative stability is also observed in respect of Central transfers as a percentage of revenue receipts of States and the dependence of States on Central transfers.

CHAPTER 5

ISSUES IN CENTRE – STATE FISCAL RELATIONS

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5

ISSUES IN CENTRE-STATE FISCAL RELATIONS

5.1 Background

5.1.01 In this chapter, we have identified some important and contentious issues raised by States and other stakeholders and issues which have come to the fore following economic liberalisation and other policy changes in the area of Centre-State fiscal relations. Issues relating to the role of the Finance Commission and the Planning Commission are discussed separately in the relevant chapters of this volume

5.2 Vertical Imbalance in Resource Sharing

5.2.01 The States have been nursing a feeling that the resource transfers to them have not been commensurate with their growing responsibilities. In a common memorandum submitted to the Thirteenth Finance Commission (FC-XIII) and in response to our questionnaire, States have demanded an increase in their share of Central taxes from 29.5 per cent to 50 per cent. We have observed in Chapter-4 that the relative shares of the Centre and the States in combined revenue receipts have remained stable before and after Central transfers. The focus of the Eleventh Five-Year Plan (2007-12) is on the achievement of inclusive growth. As most areas contributing to a broad based growth like agriculture, education, skill development, provision of health services, welfare of weaker sections, etc., are in the realm of States, there is a clear need to realign the resources in favour of States. There are clear advantages in empowering the States fiscally. As the Sixth Finance Commission (FC-VI) observed, 'When the emphasis is on social justice, there is no escape from realignment of resources in favour of States, because services and programmes which are at the core of a more equitable social order come within the purview of the States under the Constitution⁴.' Since the period covered by FC-VI, there has been a further shift in expenditure in favour of the social sectors adding to the expenditure commitments of States.

⁴ Report of the Sixth Finance Commission.

5.3 Growing Central Expenditure on Functions in the State List

5.3.01 FC-XII estimated that a fifth of the expenditure incurred by the Centre was on subjects, which were in the domain of the States⁵. With the introduction of new Central Plan Schemes and new CSS, this proportion would have gone up considerably since the submission of the Report of FC-XII. A number of developments have resulted in increasing Central expenditure on State subjects. These are increasing discretionary transfers in the form of assistance for CSS, special plan assistance and special Central assistance. Growing discretionary transfers from the Centre have severely constrained the States in drawing and implementing schemes according to their priorities and the felt needs of people. Since our mandate is vast, we cannot look into the composition of all transfers to States. We are, however, convinced about the need for a detailed review of all transfers to States. We, therefore, recommend a comprehensive review of all transfers to States with a view to minimizing the component of discretionary transfers, particularly those channeled through CSS.

5.4 Regional Imbalances

5.4.01 Growing regional imbalances both inter-State and intra-State are matters of serious concern and are counter to the objective of realising the goal of inclusive growth. The strategy consisting of area specific programmes and the area specific tax exemptions have so far failed to address the problem adequately. A number of Committees have gone into the issues relating to growing imbalances in regional development and made recommendations to address these issues. The National Committee on Development of Backward Areas (B. Sivaraman Committee) drew attention to the large variations in climate, rainfall, topography and soil conditions across the underdeveloped regions and called for a differential approach to address the problems confronting them. The Committee also observed that special area development programmes were more in the nature of palliatives that failed to tackle the root of the problem and that most of the backward regions had potential for growth which could be tapped if certain special initiatives were taken. The Committee recommended that it should be the task of planning to identify the special initiatives suited to each backward region⁶. The Eleventh Plan document observed that redressing regional disparities is not only a goal in itself but crucial for maintaining the integrated social and economic fabric of the country without which the country may be faced with a situation of discontent, anarchy and breakdown of law and order⁷.

⁵ Report of the Twelfth Finance Commission.

⁶ Planning Commission, "Report on General Matters Relating to Backward Areas Development," National Committee on Development of Backward Areas. 1981

⁷ Planning Commission, "Eleventh Five Year Plan 2007-12, Vol. - I" 2008

5.4.02 A large part of the population lives in the less developed regions in the country resulting in increased migration with its resultant consequences. With public investment constituting less than 20 per cent of aggregate investment in the country, there should be a paradigm shift in the role of the States from being undertaking direct investments to that of facilitating investments in backward regions. This calls for States to improve infrastructural facilities - both physical and human. As the resources at the command of the States are limited, we recommend higher central transfers to backward States to enable them to improve their physical and human infrastructure.

5.4.03 It is generally observed that there is an emphasis on taking up new programmes for the development of the backward regions of the country to the neglect of the maintenance of assets created under earlier plan schemes. To realize the benefits of past investments in backward regions of the country, we recommend that maintenance of assets already created should form an integral part of planning in these regions.

5.4.04 As the problems facing the backward regions are multi-dimensional, there a need for a multi-pronged strategy to address the problem of regional imbalances. We recommend the adoption of a multi-pronged strategy in the backward regions of the country comprising public investment in infrastructure development, pro-active policies to attract private investment, higher public expenditure on social sectors, such as health and education and area specific strategy for the growth of agricultural production.

5.4.05 Poor quality of governance and service delivery characterize most backward States. These act as deterrents to private investments. Full benefits of public investment will not be realized in the absence of good governance. We recommend that there should be greater focus on the issues of governance in the less developed States of the country.

5.4.06 Access to banking services and institutional finance is crucial for financial inclusion. Regional spread of banking assumes importance in this context. The average population served by a bank branch at the end of July 2009 was 25,000 in Bihar and 18,000 in Jharkhand as compared with the all-India average of 15,000. In most north-eastern States, the average population served by a bank branch is much higher than the national average. In most backward States, the Credit-Deposit Ratio (C-D ratio) of commercial banks is much lower in relation to other States. The C-D ratio as per sanction at the end of July 2009, was 37.0 in Bihar, 40.2 in Jharkhand and 52.5 in north-eastern States as compared with the ratio of 96.1 in southern States and the all-India average of 80.2⁸. This Commission is concerned about the low C-D ratio in the backward States. Suitable policy initiatives should be taken to improve the C-D ratio of bank credit in the

⁸ Reserve Bank of India. Report on Trend and Progress of Banking in India 2008-09, November 2009.

poorer States in a time-bound manner. Efforts should also be made to spread the habit of banking among the poorer sections of society to achieve the objective of financial inclusion.

5.5 Compliance and Enforcement Cost of Central Legislation

5.5.01 There are a number of Central legislations, the compliance and enforcement cost of which are entirely borne by the States. Central legislations, such as, the Environment Protection Act, the Wildlife Protection Act, the Forest Conservation Act, the Biodiversity Conservation Act, the Tribal Conservation Act and many other national policies require compliance on the part of States. At present, States are not compensated for the cost of compliance and the revenue loss on account of compliance.

5.5.02 Recently, the Government of India has taken a number of initiatives to build a structure of legally enforceable rights and entitlements to ensure uniform service delivery across States and to ensure accountability on the part of the Government at all the levels. Provision of free education and food security are some of the areas where the legislative process has already been initiated. The Right of Children to Free and Compulsory Education (RTE) Act, 2009 has mandated provision of free and compulsory education to all the children in the age group of 6 to 14 years. The Act also contains provisions relating to the responsibilities of the Central Government, State Governments and local authorities. The Central Government is entrusted with the responsibility of creating a national curriculum, developing and enforcing teacher training standards and providing State Governments with technical assistance for innovation, research and capacity building. The main responsibilities assigned to State Governments and the local authorities are provision of free and compulsory education for the children in the age group of 6-14 years, ensuring compulsory admission, providing for the availability of neighbouring schools, preventing discrimination of children from weaker sections, provision of infrastructure facilities and maintaining quality of education.

5.5.03 The RTE Act mandates the Central Government to provide grants-in-aid to States towards meeting a percentage of expenditure as may be determined from time-to-time in consultation with the States. Under section 7(4) of the RTE Act, the Central Government may make a request to the President to make a reference to the Finance Commission to examine the need for additional resources to be provided to any State Government so that the said State Government may be provided its share of funds for carrying out the provisions of the Act. The RTE Act has broken new ground in clearly delineating the functional and financial responsibilities of the Central and State Government. There is no such clear delineation of financial responsibilities in other Central

legislations, where the States are entrusted with their implementation. We recommend that all future Central legislations should provide for cost sharing as in the case of the RTE Act. Existing Central legislations where the States are entrusted with the responsibility of implementation should be suitably amended providing for sharing of costs by the Central Government.

5.5.04 The Government has announced its commitment to enact legislation providing food security to the poor. Under the proposed legislation, families below the poverty line will be entitled to a prescribed quantity of food grains every month. The proposed legislations will impose additional costs on the State Governments. We recommend that the proposed enactment should clearly delineate the responsibilities of the Central and State Government in meeting the additional cost of implementing the provisions of the Act.

5.5.05 Extraction of minerals involves huge costs in terms of environmental protection and rehabilitation of people. At present these costs are borne mainly by the States and only partly by the leaseholders. As the extraction of mineral wealth serves national interests, costs of environmental protection and rehabilitation cannot be left entirely to the mineral bearing States. The Government of India also derives substantial revenue from export duties on minerals. In Volume VI of our report, we have recommended a mechanism to compensate the mineral bearing States.

5.5.06 Central legislations/Administrative instructions also impose additional costs on the States. These mainly relate to (a) Schemes of Central Government like Sarva Siksha Abhiyan (SSA); (b) Climate Change and Environment Management; (c) Judicial work resulting in increased case load on the courts; and (d) fulfillment of international treaty obligations entered into by the Central Government. It is the considered view of this Commission that the additional expenditure liabilities on States on the above counts should be suitably compensated for which a mechanism needs to be institutionalised. The Commission feels that this purpose would be best served by incorporating the issues giving rise to such liabilities as a part of the permanent Terms of Reference of the Finance Commissions.

5.6 Impact of Pay Revision by the Central Government on State Finances

5.6.01 The periodic pay revision by the Central Government gives rise to demand on the part of State government employees for a similar pay hike. For the States, it is a demand which is difficult to resist. Following the implementation of the recommendations of the Sixth Central Pay Commission (SCPC), a number of States have revised their pay scales and others are in the process of doing so. Some States have simply adopted the pay

scales recommended by the SCPC. FC-XIII has estimated that the additional cost of pay revision is likely to be asymmetrical as between the Centre and the States. FC-XIII has concluded that the additional liability on account of pay revision will be much higher for States than for the Centre taking into account the additional income tax revenue that accrues to the Centre following higher salary payments⁹.

5.6.02 In a common memorandum submitted to FC-XIII, States have demanded that the Central Government should bear at least 50 per cent of the additional consequential burden, following the pay revision in the case of general category States and 100 per cent of the additional burden in the case of special category States¹⁰. A similar demand was contained in the response of States to our questionnaire. As an alternative, the common memorandum urged the Finance Commission to take full consideration of the States' expenditure on civil administration and committed expenditure including the additional burden of pay revision. The memorandum further contended that the enhanced income tax revenue to the Centre consequent upon the pay revision fully justifies such a demand. We recommend that the ToR of future Finance Commissions should be formulated in such a way that the additional commitments of States on account of pay revision are fully taken into account.

5.7 Revision of Royalty Rates on Major Minerals

5.7.01 At present, the power to fix royalty on major minerals is vested with the Central Government. Under the provisions of the Mines and Minerals (Development and Regulation) Act 1957, the Central Government shall not enhance the royalty in respect of any mineral more than once during any period of three years. One of the main grievances of the States is that the provision of revision of royalty rates is not being adhered to and that there are undue delays in the revision of these rates at periodic intervals depriving the States of potential revenue. The rates of royalty were revised in August 2009 after an interval of nearly five years. The delay was not justified as an Expert Committee (Hoda Committee) had recommended the pattern on which these were to be revised. Another issue is the conversion of specific rates of royalties into *ad valorem* rates based on mineral prices. The revision of royalty rates effected in 2009 addressed the concerns of the States partly with regard to the conversion of specific rates into *ad valorem* rates on certain minerals. In August 2009, rates of royalty on amphibole asbestos,

⁹ Report of the Thirteenth Finance Commission.

¹⁰ Presentation by the States Before the Thirteenth Finance Commission on Financial Issues in Centre-State Relations. New Delhi, September 16, 2008.

china clay, graphite, iron ore, quartz, silica sand, moulding sand and quartzite were shifted from tonnage to *ad valorem* basis. The Sarkaria Commission had recommended revision of royalty rates at an interval of every two years. We are of the opinion that the royalty rates should be revised at least every three years without any delay. States should be properly compensated for any delay in the revision of royalty beyond three years. In Volume VI of our Report, we have recommended a mechanism for the periodic revision of royalty rates.

5.8 Sharing of Off-Shore Royalty and Sale Proceeds of Spectrum

5.8.01 With the increased exploitation of offshore oil and gas reserves, the non-tax revenues of the Centre are likely to improve considerably through higher royalty collections. Under the present Constitutional arrangements, offshore royalty accrues entirely to the Centre. There is a case for reviewing the present arrangement and giving a share of the offshore royalty to States. Similarly, substantial revenue is likely to accrue to the Centre through the sale of 3G spectrum. The realization from the sale of spectrum mainly depends on the market for telecom and related services available in a State/Circle, which in turn depends on the infrastructure for business development and an enabling environment. States are largely responsible for the development of infrastructure and creating an enabling environment for the industry and business. We recommend that a part of the sale proceeds of spectrum should be devolved to States for expenditure on infrastructure projects.

5.9 Service Tax

5.9.01 Service tax is being levied since 1994 by the Centre under its residual powers relating to subjects that are not specified in any of three lists in the Seventh Schedule to the Constitution. With the 88th Amendment of the Constitution, service tax was brought under the purview of Article 268 A (3) under the Union List. Article 268 provides that taxes on services shall be levied by the Government of India and such tax can be collected and appropriated by the Government of India and the States. The Article further provides that the principles of levy and appropriation shall be determined by Parliament. Till now the sharing of the service tax is on the basis of the recommendations of the Finance Commissions. Once the Constitutional amendment is notified, taxes under Article 268 A would be excluded from the purview of the Finance Commission.

5.9.02 FC-XII observed that the exclusion of the proceeds of service tax from the purview of the Finance Commission would amount to reversing the pooling of all Central taxes facilitated by the 80th Amendment of the Constitution. With the proposed

introduction of GST, service tax will be subsumed under the GST. Therefore, it is unlikely that the 88th Amendment would be notified. FC-XII recommended that any legislation passed by Parliament with respect to appropriation of service tax proceeds should ensure that the revenue accruing to the States through any proposed changes should not be less than the share that would accrue to them, had the entire tax proceeds been part of the divisible pool. We endorse fully the recommendation of FC-XII with regard to the sharing of service tax in the event of the notification of the 88th Amendment to the Constitution.

5.9.03 In response to our questionnaire, a number of States and other stakeholders favoured vesting the States with the power to levy service tax. Conferring such powers on States will need a Constitutional amendment. With the proposed introduction of GST within the next one or two years, States will have concurrent power to tax services. We, therefore, do not see any need to change the status quo in the interim period.

5.10 Profession Tax

5.10.01 Under Article 276 (2), tax on professions, trades, callings and employments shall not exceed Rs. 2, 500 per annum. The limit was raised to Rs. 2,500 by a Constitutional amendment in 1988 from Rs. 250. The Sarkaria Commission recommended raising of the then existing limit of profession tax. As income and salary levels are increasing, a limit on the profession tax constraints revenue mobilizations. In most States, proceeds from profession tax are devolved to the local bodies. There is a consensus on the need to empower local bodies in terms of financial resources to enable them to discharge their responsibilities. We recommend that the current ceiling on profession tax should be completely done away with by a Constitutional amendment.

5.11 Taxes under Articles 268 and 269

5.11.01 States have been nursing a grievance that the Centre has not been exploiting the revenue potential of taxes listed under Articles 268 and 269. The duties mentioned in Article 268 relate to stamp duties and duties of excise on medicinal and toilet preparations. Service tax was included in this Article by the 88th Amendment. Examination of the scope of taxes under Article 268 was referred to FC-VIII. The Commission expressed the view that there was scope for raising the rates of duties in respect of bill of lading, letters of credit and the policies of general insurance¹¹. As regards duties of excise on medicinal and toilet preparations, the Commission indicated that it did not have data to suggest specific increases in the rates.

¹¹ Report of the Eighth Finance Commission.

5.11.02 Under Article 269, duties in respect of succession to property other than agricultural land, estate duty, terminal taxes on goods or passengers carried by railway, sea or air, taxes on railway fares and freights, taxes other than stamp duties on transactions in stock exchanges and futures markets, taxes on the sale and purchase of newspapers and on advertisements published therein, Central Sales Tax (CST) and consignment tax were leviable and collectable by the Centre but assigned to States. Of these, only two taxes, namely, estate duty and CST were being levied. With the 88th Amendment to the Constitution, the list of taxes leviable under Article 269 has been reduced to CST and consignment tax, of which the latter is not levied. The rate of CST was reduced from 4 per cent to 2 per cent and is likely to stand abolished once GST is introduced.

5.11.03 The scope for raising more revenue from taxes under Article 269 is now almost non-existent with the reduction in the number of taxes leviable and the imminent abolition of CST. The scope for raising more resources from the taxes mentioned in Articles 268 and 269 was last examined by FC-VIII more than 20 years ago. We, therefore, recommend that the scope for raising more revenue from the taxes mentioned in Article 268 should be examined afresh. This issue may be either referred to the next Finance Commission or an expert Committee be appointed to look into the matter.

5.12 FRBM Legislation

5.12.01 Following the incentives under the Debt Consolidation and Relief Facility recommended by FC-XII, all the States with the exception of West Bengal and Sikkim had enacted fiscal responsibility legislations. We consider it as a game changing development, ushering in an era of rule based management of public finances. The all round improvement in public finances in the post-FRBMA era is evidence enough as to the effectiveness of such legislation. At the time of the formulation of the Eleventh Plan, there was considerable debate on the need to relax FRBMA targets to enhance public investment. The Approach Paper to the 11th Five-Year Plan hinted that the first two years of the Plan could be vulnerable because of the possibility of a cyclical downturn, oil price hike and lack of flexibility in the FRBMA. The Paper further stated that there was a need to review the targets under the FRBMA, particularly those relating to the elimination of revenue deficit because of the shift in Plan expenditure towards social sectors. The Paper observed that internationally, FRBM legislations only focused on fiscal and primary deficits as targets. The Paper called for redefining approach to FRBM to conform to international position in the long run¹².

¹² Planning Commission, 'Towards Faster and More Inclusive Growth - An Approach to the 11th Five-Year Plan', December 2006.

5.12.02 We feel that the ballooning of revenue deficits was the root cause of fiscal deterioration observed in the nineties. We are, therefore, not in favour of doing away with the target of revenue deficit elimination in the FRBM legislations. At present, the deficit reduction targets are uniform across all States. This ‘one-size fits all’ approach has constrained fiscally strong States to raise more resources. We, therefore, recommend State-specific targets of fiscal deficit. The fiscal correction path may factor in the variations in the initial fiscal situation across States and be made State-specific.

5.12.03 The targets under the FRBMA can be adhered to either by revenue augmentation or expenditure compression. The fiscal correction achieved in the post-FRBM period was mostly through revenue augmentation and partly through revenue compression. It is a matter of concern that in years of fiscal stress, there is a tendency to cut down capital expenditure. At the level of the Central Government, capital expenditure witnessed a decline from 22.86 per cent of total expenditure in 2004-05 to 12.35 per cent of total expenditure in 2008-09. In the case of the States, capital expenditure declined from 28 per cent of the total expenditure in 2004-05 to 23 per cent in 2007-08. Thus, with overall targets for revenue and fiscal deficit reduction under the FRBMA, there is a tendency to adhere to targets by compressing productive expenditure, thus defeating the very purpose of such legislation. It is, therefore, necessary that quality of fiscal adjustment is built into the FRBMA targets. We recommend specification of targets with regard to maintaining certain levels of expenditure on social services, maintenance and creation of capital assets in the FRBMA legislations.

5.12.04 One of the methods of circumventing the FRBM targets is through off-budget liabilities. The Government of India has been issuing bonds to oil marketing and fertilizer companies which are off-budget and do not add to the fiscal deficit. But these are nevertheless liabilities of the Central Government. It is therefore necessary to bring all the off-budget liabilities of both the Central and State Governments into fiscal accounting. In addition changes in accounting practices also make it easier to adhere to FRBM targets. Termination of onlending to States from 2005-06 has considerably reduced the fiscal deficit of the Central Government. With a view to deriving the full benefits of FRBMA we recommend bringing all off-budget liabilities into fiscal accounting. Suitable adjustments should be made for changes in accounting practices if any.

5.12.05 At present under the FRBMA targets of deficit reduction can be exceeded in the event of unforeseen circumstances. In the event of non-adherence to the targets the

Union Finance Minister/State Finance Minister is required to make a statement in Parliament/State Assembly detailing the circumstances leading to the non-adherence to targets and the steps proposed to be taken to adhere to the targets. Thus, there are no effective deterrents preventing the Centre or the States from deviating from the fiscal correction path set out in the FRBMA. We recommend that the FRBMA should be amended to clearly specify the circumstances which should warrant deviation from the targets.

5.12.06 Some of the State fiscal responsibility legislations provide for an independent evaluation of adherence to the legislation. In most cases this has not been operationalised. The Central Legislation does not provide for an independent evaluation. To bring greater accountability all fiscal legislations should provide for an annual assessment by an independent body and the reports of these bodies should be laid in both Houses of Parliament/State Legislature.

5.13 Market Borrowings

5.13.01 Under Article 293 of the Constitution, State Governments require the approval of the Centre for borrowing from the market, if they are indebted to the Centre. The Centre has been setting the limits on the market borrowings of States as part of the overall pattern of plan financing. States have been complaining from time-to-time that their share in overall market borrowings has come down significantly. In the year 2008-09, the shares of the Centre and the States in the aggregate market borrowings were 75 and 25 per cent, respectively. In their common memorandum submitted to FC-XIII, States have contended that their share in market borrowings should be restored to the level of 50 per cent as was prevalent in the fifties. We were also urged to recommend such an increase in the share of the States.

5.13.02 With the enactment of FRBM legislations by the Centre and the States, overall borrowing limits for each year are fixed taking into account the fiscal deficit target for the year and the fiscal correction path recommended by FC-XII. A prescribed share in market borrowings for States has lost much of its relevance in the post-FRBM regime. It is necessary that the present system of fixing overall borrowing limits is continued to ensure adherence to FRBM targets.

5.14 Small Saving Loans

5.14.01 As indicated in Para 3.8.02, the mandatory sharing of net small saving collections in the form of loans from the NSSF by the States was reduced from 100 per cent to 80 per cent from 2007-08. Though the mandatory sharing is set at 80 per cent, States

are given the option of borrowing from the NSSF to the extent of 100 per cent of net collections in a year. Loans from the NSSF carry an interest rate of 9.5 per cent per annum, which is perceived by States to be very high in relation to the cost of raising small savings by the Centre. Another grievance of the States is that with the transfer of small saving collections to the NSSF from 1999-2000, loans from the NSSF are no more treated as loans from the Centre depriving them of the facility of relief offered on outstanding debt to the Centre by the successive Finance Commissions. In their responses, States have demanded that the Finance Commissions should take into account their entire loan burden, including the outstanding loans from the NSSF.

5.14.02 A number of committees have gone in to the question of administration of NSSF. One of the important recommendations of these committees was the linking of interest rate on loans from NSSF to the interest rate on Government securities. We endorse this and recommend that interest relief may be offered on loans from the NSSF by aligning the interest rate on loans from the NSSF to the rate of interest on Government securities. The present repayment period of 25 years may continue.

5.15 Direct Transfers to Local Bodies and Implementing Agencies

5.15.01 Over the years, a number of district level agencies have been created for the implementation of CSS. The Central Ministries are directly transferring substantial amounts of money to these implementing agencies in States bypassing the State Governments. This has considerably eroded accountability and undermined the role of States. In the Central Budget for 2009-10, an amount of Rs. 95,567 crore is budgeted to be passed on directly to implementing agencies. This system put in place ostensibly to address the problem of delays on the part of the State Governments in releasing funds to implementing agencies has given rise to a number of problems. It has eroded accountability. Large sums are reportedly lying unspent in the bank accounts maintained by the implementing agencies. There is no proper accounting of these funds. Implementing agencies are part of the State Government but are not accountable to it. We are of the opinion that direct transfers to implementing agencies should be stopped. It should be ensured that the State Governments pay interest in case of delays in the transfer of funds beyond 15 days of their receipt from the Central Ministries. We have dealt with this issue further in Volume IV of our Report on Local Bodies.

5.16 Macroeconomic Stabilisation

5.16.01 Macroeconomic management is the responsibility of the Union Government as per the Constitution of India. In the wake of the countercyclical measures initiated to

neutralise the impact of the global downturn in the last two years, the Centre has raised fiscal deficit targets of States to 3.5 per cent of GSDP in 2008-09 and further to 4.0 per cent of GSDP in 2009-10 and accordingly raised the market borrowing limits of States. The proposal to include aviation turbine fuel in the list of declared goods was under the consideration of the Central Government to help the ailing airline industry in the country. Such a measure would have reduced revenue from VAT by the States. It was reported that the Government of India had put on hold the decision relating to the revision of royalty rates on major minerals as well as the conversion of rates into *ad valorem* system in the interest of maintaining price stability (Economic Times, June 4, 2008). We are of the view that the maintenance of macroeconomic stability is the responsibility of the Union and that States should be properly compensated for any additional expenditure they bear or revenue loss they suffer on account of measures taken by the Union to maintain macroeconomic stability.

CHAPTER 6

FINANCE COMMISSION TRANSFERS

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6

FINANCE COMMISSION TRANSFERS

6.1 Background

6.1.01 The Finance Commission is a Constitutional body entrusted with the responsibility of recommending transfer of resources from the Centre to States to address both vertical and horizontal imbalances. In terms of the Constitutional provisions, the Finance Commission recommends States' share in shareable Central taxes and grants-in-aid to States under Article 275. With the initiation of Five-Year Plans for the development of the economy, transfers from the Planning Commission have gained in importance. In addition, over the years, the Central Ministries have emerged as another channel of resource transfers to States. The emergence of two more parallel channels of resource transfers through the Planning Commission and the Central Ministries has made the system of resource transfers complex. Issues relating to the role of the Finance Commission and the transfers recommended by the Finance Commissions are discussed in this chapter.

6.2 Constitution of the Finance Commissions and Their ToR

6.2.01 Under Article 280 of the Constitution, Finance Commission is constituted by the President at the expiry of every fifth year or earlier. The constitutionally mandated responsibilities of a Finance Commission are making recommendations regarding: i) the distribution between the Union and the States of the net proceeds of taxes which are to be or may be shared or divided between them and the allocation between the States of the respective shares of such proceeds; ii) the principles which should govern the grants-in-aid of the revenues of States out of the Consolidated Fund of India; and iii) measures needed to augment the Consolidated Fund of a State to supplement the resources of panchayats and municipalities in the State. These Constitutionally mandated responsibilities are the same for all the Finance Commissions and are spelt out as such in the ToR. In addition to these responsibilities, any other matter can be referred to a Finance Commission in the interest of sound finance.

6.2.02 In addition to the above matters, it has become customary for the ToR to include some considerations, which the Finance Commissions are required to take into account, among others. There has been an enlargement of the considerations over the years. States have been contending that the specification of considerations are loaded in favour of the Centre and have been restricting the freedom of the Finance Commissions in delineating their approach. In their response to our questionnaire, a number of States pleaded for their involvement in the finalisation of the ToR. One of the suggestions was that the States and the Centre should jointly constitute the Finance Commission and select the members through the Inter-State Council (ISC).

6.2.03 An examination of the ToR of the Finance Commissions reveals that there is some merit in the contention of the States. The ToR of FC-XIII had stipulated that the Commission shall take into account the demands on the resources of the Central Government, in particular, on account of projected Gross Budgetary Support (GBS) to the Central and State Plans, expenditure on civil administration, defence, internal and border security, debt servicing and other committed liabilities and expenditure. In respect of the States, the Commission was asked to take into account the resources and there was no mention of needs except expenditure on the non-salary component of maintenance and upkeep of capital assets. Expenditure on civil administration, debt servicing and other items of committed expenditure are as much a demand on the resources of States as in the case of the Centre. The practice of not mentioning the needs of the States started with FC-XII. Despite the omission of needs of States in the considerations, FC-XII indicated that it had assessed the needs of the States with the same degree of comprehension as was done by the previous Commissions.

6.2.04 The consideration in the ToR asking FC-XIII to take into account the GBS from the Centre to the Central and State Plans as a demand on the resources of the Centre was seen by many States as a blatant attempt to make the Finance Commission transfers residual. In the dispensation of the previous Commissions, GBS emerged as a residual after fully providing for the non-plan commitments of the Centre, tax devolution to States and grants to States under Article 275. If the GBS is taken upfront as a demand on the resources of the Centre, there may not be adequate transfers to enable States to meet their non-plan commitments fully.

6.2.05 We are of the view that the considerations specified in the ToR of the Finance Commission should be even handed as between the Centre and the States. There should be an effective mechanism to involve the States in the finalization of the ToR of the Finance Commissions.

6.3 Divisible Pool of Taxes

6.3.01 The 80th Amendment of the Constitution provided for the sharing of all Union taxes between the Centre and the States except the proceeds of taxes referred to in Articles 268 and 269 and the cesses and surcharges levied on Union taxes. This has met the long standing demand of the States for the enlargement of the divisible pool of Central taxes. But the extension of the scope of cesses and surcharges imposed on Central taxes has greatly reduced the divisible pool over the years. The share of cesses and surcharges witnessed a sharp increase from 4.9 per cent of the gross tax revenue of the Centre in the award period of FC-VIII to 11.34 per cent in the award period of FC-XII. In the years 2008-09 and 2009-10, the share of cesses and surcharges increased further to over 13 per cent of the gross tax revenue (Table 4.7).

Table 4.7: Gross Tax Revenue, Cesses and Surcharges

Finance Commission	Gross Tax Revenue of the Centre	Cesses and Surcharges	Cesses, and Surcharges as Percent of Gross Tax Revenue of the Centre	Actual Tax Devolution (Rs. crore)	Actual Tax Devolution as Per cent of Gross Tax Revenue of the Centre
1	2	3	4	5	6
Eighth (1984-89)	167119	8225	4.92	42009	25.14
Ninth (1989-95)	419250	16642	3.97	112569	26.85
Tenth (1995-2000)	694756	21474	3.09	182925	26.33
Eleventh (2000-05)	1148007	68203	5.94	305013	26.57
2000-01	188705	7502	3.98	51688	27.39
2001-02	186327	6541	3.51	52842	28.36
2002-03	215905	13987	6.48	56122	25.99
2003-04	253668	15598	6.15	65766	25.93
2004-05	303402	24574	8.10	78595	25.90
Twelfth (2005-10)	2663337	301944	11.34	691056	25.95
2005-06	357244	31557	8.83	94385	26.42
2006-07	461620	41343	8.96	120330	26.07
2007-08	575445	58179	10.11	151800	26.38
2008-09 (RE)	627949	83478	13.29	160179	25.51
2009-10 (BE)	641079	87387	13.63	164361	25.64

Source: Finance Accounts of the Union Government and Budget documents of the Central Government.

6.3.02 The introduction of new cesses and surcharges has neutralised the higher tax devolution recommended by the successive Finance Commissions. FC-XI and FC-XII recommended States' shares in net Central taxes at 29.5 and 30.5 per cent, respectively. But because of large scale resort to the levy of cesses and surcharges, actual tax devolutions to States were lower at 25.95 per cent of gross tax revenue in the award period of FC-XII as compared with tax devolution amounting to 26.57 per cent in the award period of FC-XI. Thus, the increase of States' share in Central taxes by one percentage point by FC-XII was more than neutralised. The Finance Commissions' recommendations are based on the assessment of the resource position of the Centre and the States and their needs. Extension of cesses and surcharges amounts to dilution of the recommendations of the Finance Commissions and deprives the States of their due share in Central tax revenue.

6.3.03 The Sarkaria Commission examined the issue regarding the levy of surcharge on income tax and recommended that the surcharge should not be levied except for a specific purpose and for a strictly limited period. FC-XI expressed the view that while there was no harm in levying surcharge on any specific tax for meeting an unexpected and unforeseen item of expenditure, it should not be resorted to as a revenue raising measure to fill the budgetary gaps. The Commission felt that surcharges should be levied for a specific purpose, for a limited period¹³. Though the extension of surcharges and cesses has been done for specific purposes, they are being continued on a permanent basis and more as a revenue raising measure. We are concerned about the increase in the revenue collected through cesses and surcharges. We recommend that the Central Government should review all the existing cesses and surcharges with a view to bringing down their share in the gross tax revenue.

6.4 Non-Plan and Plan Conundrum

6.4.01 Finance Commissions have been criticised often for restricting their assessment of needs to the non-plan revenue accounts of the Centre and the States. In the Constitution, there is no distinction between the expenditure on plan and non-plan accounts. The distinction came into operation with the adoption of planned development to better monitor the implementation of the Five-Year Plans. The Second and the Third Finance Commissions were asked to take into account the requirements on account of

¹³ Report of the Eleventh Finance Commission.

the Plan. The Third Commission took into account 75 per cent of the estimated revenue component of the Plan while recommending tax devolution and grants-in-aid. The Government did not accept the plan grants recommended by the Commission as there was specific assistance for Plan schemes. The Fourth Commission did not consider plan expenditure on the ground that the Planning Commission should have unhampered authority in the domain of planning. The Finance Commissions from the Fifth to Eighth did not recommend any grants for meeting plan revenue expenditure¹⁴.

6.4.02 FC-IX after obtaining a legal opinion took the stand that grants for plan purposes were very much within the purview of the Finance Commissions and recommended plan grants. The plan grants recommended by FC-IX were considered as the States' own resources for the Plan and the normal formula based Central assistance for State plans was dispensed in the usual manner. Because of practical difficulties in assessing the requirements on the plan revenue account, the subsequent Finance Commissions did not consider plan revenue expenditure.

6.4.03 There are a number of linkages between the plan and non-plan expenditure. Firstly, the expenditure on completed plan schemes becomes committed expenditure on the non-plan account. Secondly, borrowings for financing the plan give rise to debt servicing burden in the form loan repayments and interest payments. Debt servicing adds to the non-plan expenditure. Thirdly, personnel employed for the implementation of plan schemes are transferred to non-plan. FC-XII observed that over the years, the distinction between plan and non-plan was getting blurred as old schemes were continued in the new Plan to show a higher plan outlay. Other issues regarding plan and non-plan distinction are discussed in the chapter on planning.

6.4.04 There are clear advantages if the revenue account is assessed in its entirety. We are conscious of the practical difficulties inherent in a system where two bodies look at the revenue account of the Centre and the States. We are, therefore, recommending that an Expert Committee may be appointed to look into the issue of distinction between the plan and non-plan expenditure.

6.5 Synchronisation of the Periods of the Finance and Planning Commissions

6.5.01 The Second Finance Commission pointed out the difficulties arising from its award period not being coterminous with that of the Five-Year Plan. A few attempts were made in the past to make the periods coterminous. The Third Commission was

¹⁴ <http://www.fincomindia.nic.in> "Finance Commissions - A Historic Perspective."

asked to give a report for four years 1962-66, so that the periods of the Fourth Commission and the Fourth Plan could be coterminous (1966-71). The correspondence was not achieved because of the delay in the finalization of the Fourth Plan owing to the war with China. The second attempt at synchronization was made by curtailing the period covered by the Fourth Commission by two years. With this, the Fifth Commission's award period and the Fourth Plan (1969-74) became coterminous. Thereafter, the period covered by the Sixth Commission (1974-79) coincided with that of the Fifth Plan. The link was broken with the delay in the finalization of the Sixth Plan by a year. The third attempt at synchronization was made by asking FC-IX to give two reports, the first one covering one year of 1989-90 and the second report covering a period of five years (1990-95) to coincide with the Eighth Plan. The intended synchronization was not achieved because of the delay in the finalization of the Eighth Plan by two years. Based on the recommendation of the FARC, from the Sixth Commission onwards, a member of the Planning Commission is being appointed to the Finance Commission to ensure better coordination between these two institutions.

6.5.02 We are of the opinion that there should be much better coordination between the Finance Commission and the Planning Commission. The synchronization of the periods covered by the Finance Commission and the Five-Year Plan will considerably improve such coordination. We recommend that another attempt be made to synchronize the periods.

6.6 Strengthening the Finance Commission Division

6.6.01 One of the criticisms against the working of the Finance Commissions is that the transfers and more particularly the *inter se* distribution of tax devolution recommended by them are based on past indicators and not on forward indicators. Undoubtedly, forward indicators are preferable as they reward future performance rather than past performance. For maintaining a sustainable fiscal situation, what matters more is future performance. FC-XI observed that since relevant data became available only with the passage of time, the Finance Commission could only define a formula, but could not determine the actual shares of States. The successive Finance Commissions have been recommending suitable strengthening of the Finance Commission Division in the Ministry of Finance. A full-fledged Finance Commission Division will ensure proper monitoring of the recommendations of the Commissions and even pave the way for the adoption of forward looking indicators by future Finance Commissions. FC-XII

recommended that the Finance Commission Division in the Ministry of Finance should be converted into a full-fledged department, serving as the permanent secretariat for the Finance Commissions. We strongly endorse this recommendation of FC-XII.

6.7 Finance Commission Transfers

6.7.01 An analysis of the per capita transfers from the First to the Eighth Commissions reveals that there were no marked differences in the transfers across States indicating not so equalizing nature of these transfers. Since FC-IX, the position changed but more markedly from FC-XI onwards with the transfers becoming more and more progressive. This is a welcome development. It is a delicate task for the Finance Commissions to strike a balance between equity and efficiency. From the Tenth Commission onwards, efficiency parameters are being built into the devolution formula, thus addressing the concerns with regard to promoting efficiency.

6.7.02 In the wake of rising inequalities across States, it is not proper to put the blame on the Finance Commission transfers alone. Transfer through Finance Commission, though important, is just one of the channels of resource transfers and cannot address the equity concerns adequately. However, Finance Commission transfers were found to be more progressive than other transfers. Furthermore, inequalities should be addressed from many fronts, particularly on the front of planning and public investments which are outside the realm of the Finance Commission. However, we envisage an enhanced redistributive role for the Finance Commission. Recent Finance Commissions have made recommendations in this direction by recommending grants to address special problems and to bridge the gap in the provision of services like education and health. We are in favour of Finance Commission adopting more sophisticated methods to assess the needs of backward States and providing them with higher transfers. Performance - linked incentive grants are likely to be more effective in addressing the problems of backward States.

6.7.03 Another aspect of the Finance Commission transfers is the relative proportion of tax devolution and grants. States have by and large been seeking predominance of tax devolution because of its inherent buoyancy as compared with the grants which are fixed in nature. Another issue is the conditionalities attached to grants. The proportion of grants in total Finance Commission increased from 9.0 per cent in the award period of FC-X to 13.5 in the period of FC-XI and further to 18.9 per cent in the period of FC-XII. Compared with tax devolution, grants have a greater redistributive role. FC-XII felt that

grants provided a more effective mechanism to address redistributive concerns. The Commission extended the scope of grants to achieve equalization of expenditure across different States in two sectors, namely, education and health. This is a welcome development. We are of the view the relative shares of tax devolution and grants should be better left to the judgment of the Finance Commissions.

6.7.04 A number of States in their response to our questionnaire have favoured Finance Commission to be the main channel of Central transfers. Even today Finance Commission transfers are predominant in total transfers from the Centre. With the rationalization of CSS recommended by us in the next chapter predominance of Finance Commission transfers may improve further.

6.8 Transfers to Local Bodies

6.8.01 Following the 73rd and 74th Amendments to the Constitution, Finance Commission is mandated to make recommendations with regard to the augmentation of the Consolidated Fund of a State to supplement the resources of rural and urban local bodies of the State. These recommendations are to be made on the basis of the recommendations of the State Finance Commission (SFC). FC-XI, the first Central Finance Commission which was required to recommend such augmentation could not adopt the SFC reports as the basis for its recommendations because of non-synchronisation of the period of the recommendations of SFCs with its award period, absence of time frame within which the State Governments were required to take action on the recommendations of the SFCs, non-uniformity of the periods covered by different SFCs and the non-availability of SFC reports. Furthermore, the approach differed from SFC to SFC. FC-XII too faced similar problems. FC-XII recommended suitable initiatives to address these issues. The NCRWC recommended amending Article 280 to enable Central Finance Commissions to make recommendations after taking into account the recommendations of SFCs instead of making recommendations on the basis of SFC reports. Some of these issues are discussed in the chapter IV on local bodies.

CHAPTER 7

PLANNING COMMISSION AND PLAN FORMULATION

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7

PLANNING COMMISSION AND PLAN FORMULATION

7.1 Background

7.1.01 In the aftermath of the initiation of economic reforms in the country in the early nineties, there was a debate as to the relevance of detailed planning the way it was practiced in the first four decades of country's independence. In recognition of the market orientation of the economy, the Eighth Five-Year Plan, the first Five-Year Plan to be formulated after the initiation of economic reforms had stated in its preface that the Plan was indicative in nature. The Ninth and Tenth Plans that followed reiterated that planning had to be primarily indicative and that the State could at best be a facilitator for private investment. In the Eleventh Plan, the share of public sector outlay is estimated to be 21.9 per cent. Despite the diminishing role of public investment in the total investments, the practice of drawing detailed plans, both Five-Year and Annual continues unchanged. States are still required to get their annual plans approved by the Planning Commission. This chapter discusses some of the important issues related to formulation and financing of Plans and the role of the Planning Commission.

7.2 Role of Planning in a Market Economy

7.2.01 There have been three important changes in the post-reform era with a major bearing on the planned economic development. These are the declining share of public investment in total investment, the financial constraints emanating from the FRBM legislation and the Public-Private Partnership (PPP) emerging as the preferred mode of project financing. In the Indian context where growth has been far from inclusive, planning has an important indicative role to perform. Even in a market economy, the State has an important role not only as a facilitator but also as a provider of basic infrastructure, physical, social and financial¹⁵. Given the glaring inequalities in income levels and living conditions across the regions, the redistributive role of planning cannot be over emphasized. Another function of planning is prescriptive, that of influencing the behaviour of

¹⁵ Stiglitz, Joseph (1996), "The Role of Government in Economic Development". Keynote Address at the Annual World Bank Conference on Development Economics.

private agents to serve public goals through enabling public policies and ensuring the smooth functioning of the common market. The usefulness of planning in providing indication, coordination and prescription has been acknowledged in countries avowedly market oriented such as Korea and France¹⁶. Despite the usefulness of planning, it cannot remain on the same footing in a market driven economy as in the case of controlled economy.

7.2.02 One of the issues in the changed context relates to the duplication of work by the Planning Commission which belongs to different Central Ministries. The Planning Commission plays a major role in coordinating the work of various Central Ministries. This role seems to have been overplayed by insisting the Central Ministries to seek its approval for any changes in the approved projects. Perhaps the institutional structure of the Commission which has divisions corresponding to Central Ministries seems to have encouraged this practice. Planning Commission's role in the post-reform period should be that of coordination to ensure that the sectoral plans drawn by different ministries are in conformity with the overall objectives of the Plan. This may not require parallel subject matter Divisions in the Planning Commission. The practice of ministries seeking changes in approved projects may be dispensed with as long as sectoral allocations are adhered to.

7.2.03 There are still consultations with States and Central Ministries on the size of the Annual Plan and its financing. Often, the Annual Plan is decided several months after the presentation of the State Budget. The annual plan is a difficult exercise given the targets for the Five-Year plan and constraints on the availability of resources. Invariably there are shortfalls in realising the targets set out in the Five-Year Plan. There are also occasions of shortfalls in realising the targets set out in the Plan despite fund availability. Thus, the mismatch between the Annual Plans and the Five-Year Plans remains the weakest point in the planning edifice. A case for multi-year budgeting with a firm budget for the first year and provisional for the second and third years assumes importance in this context. The FRBM Act envisages preparation of a Medium Term Fiscal Policy Statement but this cannot serve adequately the purpose a multi-year budgeting. We recommend adoption of multi-year budgeting by the Central and State Governments at the earliest.

7.2.04 It is the considered view of the Commission that the approach to planning needs to be changed in keeping with the changing economic situation. Most of the States which responded to our questionnaire favoured flexibility in the formulation and implementation of State plans. While the Planning Commission may finalise the Five-Year

¹⁶ Kuznets, Paul (1990), "Indicative Planning in Korea", *Journal of Comparative Economics*, Vol. 14, No 4, December.

Plans in consultation with States to ensure broad correspondence with the national objectives, detailed exercise of approving States' annual plans may not be necessary. The States should be given freedom to plan according to their own needs and priorities within the framework of nationally accepted priorities.

7.2.05 There is a tendency on the part of States to seek higher plan outlays and the Planning Commission approving them based on unrealisable estimates of own resources and additional resource mobilisation. When the estimated resources do not materialise, non-plan maintenance expenditure takes the cut. This reduces the life span of the assets created from plan funding and also results in the under utilisation of assets in the absence of complementary operational expenditure as in the case of schools without teachers or hospitals without doctors. Thus, the very purpose of a higher plan outlay is not served. We are of the opinion that the plan outlays should be based on realistic estimates of resources and within the FRBM targets.

7.2.06 At present, Plan outlays are not bifurcated into revenue and capital components. The revenue and capital components of plan expenditure are decided at the stage of annual budget finalisation. With the revenue component of Plan outlays increasing to over 50 per cent, there is no correspondence between the surplus on the non-plan revenue account and plan grants on the one hand and the revenue component of the plan on the other. As a result of this mismatch, borrowings are diverted to meet a part of the revenue component of the Plan. This makes the task of balancing the revenue account difficult. To address these issues we have recommended in Chapter-6 for an expert Committee to look into the issue of doing away with the distinction of plan and non-plan expenditure.

7.3 Share of State Plans in Total Outlay

7.3.01 The share of State Plan outlays in total Plan outlays has witnessed a steep decline from over 63 per cent in the First Plan period (1951-56) to less than 39 per cent during the Eighth Plan period (1992-97). During the Eleventh Plan period, the share of States in the estimated resources for the Plan is envisaged at 39.27 per cent (Table 4.8).

Table 4.8: Share of State Plan outlays in total Plan outlays

Five Year Plan	Outlays (Rs. crore)				Percentage share		
	Centre	States	UTs	Total	Centre	States	UTs
First Plan (1951-56)	706	1245	9	1960	36.02	63.52	0.46
Second Plan (1956-57)	2534	2115	23	4672	54.24	45.27	0.49
Third Plan (1961-66)	4212	4227	138	8577	49.11	49.28	1.61
Fourth Plan (1969-74)	7826	7675	278	15779	49.60	48.64	1.76
Fifth Plan (1974-79)	18755	20015	656	39426	47.57	50.77	1.66
Sixth Plan (1980-85)	57825	49458	2009	109292	52.91	45.25	1.84
Seventh Plan (1985-90)	127520	87492	3717	218729	58.30	40.00	1.70
Eighth Plan (1992-97)	288930	187937	8590	485457	59.52	38.71	1.77
Tenth Plan (2002-07)*	945328	673132	-	1618460	58.41	41.59	-
Eleventh Plan (2007-12)	2156571	1431336	56811	3644718	59.17	39.27	1.56

Source: 1. Planning Commission, 'Indian Planning Experience - A Statistical Profile', 2001 for information from First to Eighth Plans and 'Eleventh Five-Year Plan 2007-12', 2008.

*States include Union Territories.

Note: Outlays in respect of the Tenth and Eleventh Plan are at 2006-07 prices

7.3.02 The main contributory factor for such a reduction was the reduced budgetary support to the State Plan. The extent of reduction in the budgetary support has been discussed in Chapter-3 of this volume. The focus of the Eleventh Five-Year Plan is on inclusive growth and a number of sectors touching on the lives of people are in the States' domain. In view of these, there is a need to align the resources in favour of States.

But contrary to this imperative, the Eleventh Plan has envisaged a higher budgetary support to the Central Plan on the ground that the Centre has taken for itself an enlarged role in providing infrastructure, especially in the backward States through programmes such as NREGP, SSA, Bharat Nirman, etc. The Eleventh Plan document concedes that many of the major CSS are in areas where the States have traditionally borne bulk of the expenditure. We recommend that steps should be taken to restore the share of State plan outlays to the previous levels.

7.4 Composition of Plan Transfers

7.4.01 Over the years, there has been a distinct change in the composition of Central assistance to the extent that the share of Gadgil formula normal plan assistance is now reduced to just 19 per cent of the total assistance for State Plans. In 1969, scheme-based plan assistance to States was replaced by formula based assistance (Gadgil formula). Assistance under the Gadgil formula was intended to be the main channel of plan transfers to States. A number of new channels of assistance were created in the form of additional Central assistance and special Central assistance. In addition, there has been considerable increase in the transfers through CSS and other schemes. This in a way takes the system of Central assistance back to the pre-1969 position of scheme based transfers.

7.4.02 In the Union Budget for 2009-10, Central assistance for State Plans is budgeted at Rs. 78,487 crore (43.6 per cent) out of the total GBS for the Annual Plan amounting to Rs. 179,954 crore. Within the Central assistance for the State Plan amounting to Rs. 78,487 crore, the share of the normal Central assistance, which is formula based, is only Rs. 19,111 crore or 24.35 per cent (Table 4.9). This is in sharp contrast to other assistance under externally aided projects, additional Central assistance, special Central assistance and other assistance amounting to Rs. 59,376 crore (75.65 per cent). It is a matter of concern to States that the Gadgil formula based assistance is lower than the assistance from other channels. Part of the decline in the share of formula based assistance is on account of the termination of plan loans from 2005-06 but a significant decline in the share is attributable to increase in scheme based transfers and increase in the transfers under CSS. Most of the States have sought an increase in the proportion of untied normal Central assistance.

Table 4.9: Composition of Plan Transfers to States**(Rs. Crore)**

Type of Plan assistance	2008-09 (BE)	2008-09 (RE)	2009-10 (BE)
1. Normal Plan assistance	17992	16899	19111
2. Externally aided projects	4550	11241	7500
3. Additional Central assistance	-	1293	1550
4. Special Central assistance	4602	4602	4602
5. AIBP	5550	7850	9700
6. JNNURM	6248	10448	11619
7. Backward region grant	4670	3890	4670
8. Others	14807	17505	19735
Total State Plan (1 to 8)	58419	73728	78487
Assistance for Central Plan and CSS	25289	21678	21777
Total Plan assistance to States	83708	95406	100267

Source: Government of India Ministry of Finance Expenditure Budget 2009-10 Volume - I

7.4.03 The Gadgil formula for normal Central assistance has undergone three revisions so far, the last one in 1991. 30 per cent of the normal assistance is earmarked for the special category States and the distribution of the remaining 70 per cent across the general category is formula based. The components of the revised Gadgil formula are as follows (Table 4.10).

Table 4.10: Components of Gadgil Formula

Criteria	Weightage in Percent
1. Population (1971)	60.0
2. Per capita income	25.0
<i>Of which</i>	
i) Deviation method covering only States with per capita income below the national average	20.0
ii) Distance method covering all the general category States	5.00
3. Performance	7.5
<i>Of which</i>	
i) Tax effort	2.5
ii) Fiscal management	2.5
iii) National objectives	2.5
4. Special problems	7.5
Total	100.0

Notes:

1. Fiscal management is assessed as the difference between States' own total plan resources at the time of finalizing Annual Plans and their actual performance in the latest five years.

2. Under the criterion of performance, four components are considered, viz., population control, elimination of illiteracy, on-time completion of externally aided projects and success in land reforms.

7.4.04 Because of the very high weightage given to population, transfers under the Gadgil formula are not as progressive as the Finance Commission transfers. As the Gadgil formula was last revised more than 18 years ago, we recommend its revision in the light of the recent developments. The share of Gadgil formula transfers may be increased in a phased manner so as to restore the preeminence of these transfers.

7.5 Centrally Sponsored Schemes

7.5.01 The issue relating to CSS has been contentious since a long time. The National Development Council (NDC) appointed a Sub-Committee in 1966 to look into the question of proliferation of CSS. The Sub-Committee recommended that 52 of the then 92 CSS should be retained and the rest abolished. The First Administrative Reforms Commission (FARC) had also recommended that the number of CSS should be kept to the minimum. The FARC had laid down certain criteria for the continuation of CSS. The criteria suggested was that only those schemes which related to demonstration, pilot projects, surveys and research and having regional or inter-State character and over all significance from the all-India angle should be continued. These recommendations were obviously not followed upon. A decision was taken by the NDC in 1968 that no more than one-sixth of Central assistance for State Plan should be outside the Gadgil formula based assistance.

7.5.02 The NDC appointed another Committee in 1978 to examine, *inter alia*, issues relating to CSS. The Committee in turn appointed a Working Group to discuss in detail its terms of reference. At this stage, it was agreed that a detailed review should be made of the CSS with a view to ensuring a substantial reduction in their number and to bring down the outlays on them. A Committee of officials under the Chairmanship of Secretary, Planning Commission was appointed for this purpose. The Committee recommended that CSS of the magnitude of Rs. 600 crore need not be continued. At the meeting of the NDC held in February 1979, it was decided to reduce the number of CSS as well as the outlays on them. But in the Sixth Plan (1980-85), there was a further increase in the number of CSS.

7.5.03 While considering the Approach to the Seventh Plan in July 1984, the NDC decided that a Committee of experts be set up. Accordingly, an Expert Committee under the Chairmanship of Shri. K. Ramamurti was set up in August 1984. The Expert Committee which submitted its report in January 1985 recommended that the number of CSS should be limited and primarily aim at a process of change. It recommended an increase in the limit of assistance to CSS from 1/6 to 1/3 of the normal Plan assistance.

7.5.04 The NDC again appointed a High Level Committee in 1985 under the chairmanship of the then Minister for Human Resource Development, Shri. P.V. Narasimha Rao to go into all the issues concerning the CSS. As per the criteria suggested by the Committee, the CSS should fulfill an important national objective, such, as poverty alleviation, should have a regional or inter-State character and should be in the nature of a pacesetter or should relate to demonstration, survey or research. A Group of Officials appointed by this Committee submitted its report in April 1987. It recommended that 113 schemes with a Seventh Plan outlay of Rs.1,261 crores and a balance outlay of Rs. 800 crore during 1988-90 might be transferred to States. Despite the decisions taken at the NDC and the recommendations of numerous Committees, there was no reduction in the CSS or their outlays. On the contrary, their number as well as outlays witnessed a phenomenal increase. The resistance to the reduction in the number of CSS seems to be mainly from the Central Ministries, which have grown in size. Most of these Ministries operate in areas which are essentially in subjects reserved for States.

7.5.05 The increase in the number of CSS, though largely funded by the Central Government, has implications for States in terms of higher expenditure commitments. There is cost sharing by States in a number of CSS. In respect of some CSS, there has been an increase in the share of the States in funding. For instance, under the Sarva Siksha Abhiyan (SSA), there has been an increase in the matching contribution of States from 15 to 40 per cent. There are proposals now to increase the share further to 50 per cent. While the Centre's funding of SSA is financed through the proceeds of education cess, States have to finance their share through their normal budgetary resources. In addition to contributing their share of the cost, States are ultimately responsible for maintaining the assets created under the CSS. Even the assets created under direct funding to local bodies are required to be maintained by the State Governments as the finances of local bodies are inadequate to take care of such maintenance. Further, the staff deployed to implement the CSS is the responsibility of States after the schemes run through their life span.

7.5.06 States have been demanding a reduction in the number of CSS and transfer of the resultant savings in expenditure through normal plan assistance. States have also sought more flexibility in the implementation of CSS to suit the local conditions. There is merit in the demand of the States. Many of the CSS are in areas which come under the jurisdiction of States. We are of the opinion that the number of CSS should be restricted to flagship programmes of national and regional importance. Accordingly, we recom-

mend reduction in the number of CSS and their funding in a phased manner spread over the next five years. There should also be flexibility in the guidelines governing the implementation of CSS to suit State-specific situations.

7.6 Externally-Aided Projects

7.6.01 Assistance under the Externally Aided Projects (EAP) has mostly gone to relatively developed States. The share of poorer States in EAP has been negligible. Efforts should be taken to enable the poorer States to access the EAP.

7.7 Planning for the North East

7.7.01 India's North East Region, even six decades after independence, has remained one of the most backward in the country. Partition in 1947 had created an isolated region, with over 4,500 km of international border (with Bhutan, China, Myanmar and Bangladesh) connected with rest of the country through the narrow Siliguri Corridor. Due to this factor the region had to bear the burden of severe market disruptions, socio-economic distancing, loss of traditional communication infrastructure (both land and sea), all of which pushed regional costs and prices well above the national norms. This has resulted in the normal market production processes in the region becoming less attractive and State intervention more costly.

7.7.02 The economies of the States in the region are simple, heavily deficit and dependent on the rest of the country for most of the basic needs. Taking these factors into consideration the States in the region have been declared as special category States whose development plans are financed on the basis of 90 per cent grant and 10 per cent loan, thereby making them largely dependent for resources on the Central Government. This situation therefore, warranted an effective mechanism of coordinated regional development and planning with the avowed objective of bridging the gap between the region and the rest of the country.

7.7.03 In the wake of the reorganization of the States of the region in 1972, the North East Council was set up to provide a forum for inter-state coordination, regional planning and integrated development of the region. The Council is presently chaired by the Union Minister for the Department of North-East Development with the Governors and Chief Ministers of North-East States and Sikkim as its Members. Two full time Members have also been inducted within the Council. While no systematic assessment/appraisal seems to have been made regarding the efficacy or otherwise of this Council,

experience has shown that the Council has not been able to live up to its expectations. There are several factors which have contributed to its inability to function as an effective regional planning body. The most important of these are inadequate availability of funds and absence of professional planning and implementation capacity. Also, the increasing State Plan outlays along with enhanced central allocations through statutory transfers, centrally sponsored schemes and adhoc allocations have resulted in a shift of attention of the Member States from the Council to the Planning Commission.

7.7.04 In addition to the North-East Council, an important development with regard to planning for the North-East has been the formation of the Department for Development of North-East Region (DONER) initially under the ministry of Home Affairs in 2001 and subsequently into a full fledged Ministry in 2004. Its main functions include (i) administration of the 'Non Lapsable Central Pool of Resources' (NLCPR), (ii) development of irrigation, power and road works financed from central funds, (iii) development of roadways and waterways in the region and (iv) implementation of special economic packages sanctioned for individual States. However, it may be noted that while the Ministry of Development of North Eastern Region coordinates with various Ministries/Department primarily concerned with development and welfare activities in North Eastern Region, respective Ministries/Departments are responsible in respect of subjects allocated to them. The formation of the DONER Ministry has added to the confusion in an already complicated scenario, particularly in the context of existence of several other institutions created in the region. Ironically, therefore, a region which requires a focused attention on many key issues has been made the responsibility of several organizations with blurred responsibilities. There are problems of coordination and overlapping of functions between the DONER Ministry and NEC, between the Planning Commission and Central Ministries, and between the State Councils and District and Regional Councils. The structures hence need to be simplified. Most of the North-Eastern States feel that coming into existence of the DONER Ministry does not appear to have facilitated the process of planning and implementation of programmes for the region largely on account of the dilatory procedure it has adopted in processing sanction of the proposals received from the States. Hence they do not appear to favour its continuance. The Second Administrative Reforms Commission, based upon the input received by a cross-section of public opinion and most of the State Governments, has come to the conclusion that the continuance of a 'stand-alone' Ministry with partial responsibility for the region is not in long term interest and have therefore recommended its abolition. We endorse this view.

7.7.05 A fact that needs to be recognized is that common features like similar resource base, comparable agro climatic systems and more or less same environment of the States in the region warrant treating the North-East as a logical unit of Regional Planning. While numerous institutions (NEEPCO, NERAMAC, NEDFI, etc.) have been formed for the development of the area, in real terms they have not been able to ensure effective delivery of services. Absence of capacity and lack of coordinated planning are the main contributory factor in this regard. In such a situation it is felt there is need to shift the focus to a single unified institution which could assume the overall responsibility of promoting progress and prosperity in the region by acting as an effective Regional mechanism.

7.7.06 We are of the view that this focus can most effectively be brought about by the Planning Commission which should set up a Regional Unit in the region by subsuming the NEC Secretariat and placing it under a Member of the Planning Commission specifically assigned its responsibility and preferably located in North East. This unit should have the required empowerment and funds. It should be staffed with professionals and departments run by people who are familiar with the subject they deal with. Further, it should ensure that there is inter-departmental coordination and that the planning and policies are based on holistic considerations. It would also require to work closely with the State Government Departments to ensure that the planning efforts at the State level are coordinated with its own proposals. Finally, there should be proper capacity building to design and implement plans and undertake tasks of monitoring and control in order to make the Unit an effective institution.

7.8 Concluding Remarks

7.8.01 Following the introduction of economic reforms in the country, the role of Central planning seemed to have lost much of its relevance. There was a shrinking of the share of the public sector investment. States saw an opportunity to regain ground lost to the Planning Commission. However, this hope was belied. Plan transfers have become more tied to schemes and projects. There has been a quantum jump in allocations for Centrally Sponsored Schemes. Thus leaving limited space for States to address their priorities. Greater autonomy for States is also seen as an impediment towards the realization of the goal of a common market for the entire country. Other distortions crept in as private sector investment has gone mostly to the States endowed with better infrastructure facilities, thus, accentuating the regional imbalances in the growth of the economy.

7.8.02 In the changed situation, planning still has an important role. That it needs to be more indicative in nature has been recognized from the Eighth Plan onwards. That its primary role should relate to optimal allocation of limited resources, as a facilitator for the provision of basic infrastructure facilities and in influencing the behaviour of private agents to serve public goals needs to be recognized. Furthermore, the redistributive role of Central Planning assumes added importance in the wake of growing inequalities across States. We have made recommendations envisaging a higher role for the Planning Commission in the development of the North-East and in compensating forest and mineral rich States. It also needs to concentrate on bringing about a system of multi-year budgeting in conjunction with the Ministry of Finance. It also has an important role in making recommendations over a wide area of public policy along with the Reserve Bank of India, the Economic Advisory Council to the Prime Ministers and other Commissions and think tanks. These are important tasks, which the Commission has been unable to perform well because of its excessive attention towards sectoral plans of Central Ministries and those of the States. The reorientation suggested by us would enable it to remove the crevices which have appeared in Centre-State relations in planning for the nations development.

CHAPTER 8

FISCAL DOMAIN OF LOCAL BODIES

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8

FISCAL DOMAIN OF LOCAL BODIES

8.1 Background

8.1.01 The 73rd and 74th Amendments to the Constitution were game changing developments in the Indian federation and were intended to strengthen self governance at the grassroots level and to make local bodies important agencies for the delivery of public services. Decentralisation is intended to result in greater efficiency in the delivery of services. Local bodies being closer to people are expected to meet the local needs better than a centralized system of governance. Under Articles 243G and 243W, State legislatures may by law transfer powers and authority to rural and urban local bodies as are necessary to enable them to function as institutions of self government. Powers and authority include transfer of functional responsibilities and powers to levy and collect taxes as may be assigned to them by the State legislatures.

8.1.02 Following the 73rd and 74th Amendments to the Constitution, a number of States have notified transfer of functions to local bodies. But there has been limited progress in the direction of transfer of funds and functionaries. The expectation that funds and functionaries will follow functions has remained unfulfilled. Decentralisation is not fiscally neutral. Decentralisation requires empowering local bodies with adequate resources to discharge their assigned responsibilities. In this chapter, issues relating to Centre-State financial relations in so far as they relate to the finances of the local bodies and the need to create a separate fiscal space for the local bodies are discussed.

8.2 Central Finance Commission and Transfers to Local Bodies

8.2.01 The 73rd and 74th Amendments of the Constitution do not provide for direct funding of local bodies by the Union Government. The involvement of the Union Government in strengthening the financial position of the local bodies is indirect following the consequential amendment made to Article 280 mandating the Central Finance Commission to make recommendations on 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 the recommendations made by the Finance Commission of the State. The purpose of this provision is to find ways and means to meet the financial requirements of local bodies without in any way changing the primary role of States. The following observation made by FC-X is very relevant in this context.

“The responsibility of sharing taxes with panchayats and assigning grants to them has not been transferred from the States to the Centre. The responsibility for providing panchayats with an independent source of revenue as also grants for specified purposes is very much that of the State Governments. The State Finance Commissions are there to ensure proper allocation of resources as between the State and the Panchayats. If in the process of supplementation of the resources of panchayats a need arises for the augmentation of the State Consolidated Fund, it has to be considered by the Finance Commission.”

8.2.02 The above observation was made in the context of the memorandum submitted to the Commission by the Ministry of Rural Development. These observations also represent the views of the Commission on transfers to municipalities. FC-X further observed that in terms of the Constitutional amendment, many of the functions of the State would have to be transferred to local bodies. The Commission expressed the view that the transfer of functions to local bodies would not result in any extra burden on the State as this would be accompanied by the transfer of the staff already working on these schemes/projects as also the financial allocations budgeted for and envisaged to be spent on the transferred activities.

8.2.03 FC-XI had further clarified the role of the Central Finance Commission in supplementing the resources of the local bodies under Article 280. The Commission stated as follows:

“If we were to take into account the additional financial burden that falls on a State on account of the acceptance and implementation of the recommendations of the State Finance Commission, such expenditure has to be built into the expenditure stream of the State. Any devolution made by a State for the Panchayats and Municipalities over and above the recommendations of the State Finance Commission is outside the purview of our consideration, as would be evident from the Constitutional provision.”

8.2.04 FC-XII had brought further clarity with regard to the role of the Central Finance Commissions. The Commission felt that the purport of the relevant provisions of the Constitution could be two fold. Firstly, there could be a case to augment the Consolidated Fund of the States through additional grants from the Centre keeping in view the special circumstances of the States, which might justify such assistance. Secondly, cer-

tain recommendations of the State Finance Commissions for augmenting the revenues of the States might require decision making by the Central Government. The Commission felt that there was a need to provide an impetus to the decentralization process keeping in view the spirit of the 73rd and 74th amendments to the Constitution.

8.2.05 The Tenth to Twelfth Finance Commissions recommended ad hoc grants to local bodies and routed them through the respective State Governments. FC-X did not stipulate any conditions for the grants recommended by it to local bodies except that they should be over and above the transfers by States. FC-XI earmarked a portion of the grants recommended by it for the maintenance of accounts and audit and for the development of a database of local bodies and the remaining amount for the maintenance of the core services. FC-XII recommended grants amounting to Rs. 25,000 to local bodies for the five-year period 2005-10. As that Commission mentioned, this was equivalent to 1.24 per cent of the shareable tax revenues and 0.9 per cent of the gross revenue receipts of the Centre as estimated for the period 2005-10. The Commission stipulated that rural local bodies should utilize the grant for repairs/rejuvenation of water supply schemes and sanitation and that at least 50 per cent of the grants to urban local bodies should be utilized for solid waste management through Public-Private Partnership.

8.2.06 FC-XIII has observed that there was an undisputed need to improve the finances of the rural and urban local bodies and that they should be supported through a predictable and buoyant source of revenue. It stressed the need to make local bodies more accountable in the discharge of their functions. Taking into account the demands of the local bodies that they be allowed to benefit from the buoyancy of Central taxes, FC-XIII has recommended that local bodies be transferred a percentage share in the divisible pool of Central taxes after converting this share into grant-in-aid under Article 275. The grant eligibility in a year will be related to the size of the divisible in the preceding year. The Commission has recommended grants equivalent to 2.28 per cent of the divisible pool of 2009-14 for the period 2010-15. The grants recommended by FC-XIII after converting the 2.28 per cent of the divisible pool amount to Rs. 87, 519 crore for the period 2010-15.

8.2.07 The grant recommended by FC-XIII has two components - a basic component and a performance based component. The basic grant which is equivalent to 1.50 per cent of previous year's divisible pool is available to all the States put together without

any conditions. The performance grant effective from 2011-12 will be 0.50 per cent of the divisible pool for the year 2011-12 and 1 per cent thereafter. The release of the performance grant is conditional on meeting certain stipulations. The main stipulations are, putting in place a supplement to budget documents listing out the budget allocations separately for rural and urban local bodies, audit system for local bodies, appointment of an independent ombudsman for local bodies, prescribing through an Act qualification of persons eligible for appointment to SFCs and enabling all local bodies to levy property tax.

8.2.08 For the first time, FC-XIII has linked grants to local bodies to the divisible pool of Central taxes. As the Constitutional provisions do not permit sharing of the divisible pool with the local bodies, FC-XIII recommended grants equivalent to a percentage share of the divisible pool. Like the previous Commissions, FC-XIII too has emphasised that the grants recommended by it are by way of supplementing the transfers from States.

8.2.09 Though we are in agreement with the approach of the Finance Commissions in recommending grants to local bodies, we are constrained in observing that the assessment of the requirements of the local bodies and the estimation of gap in their resources is ad hoc and is only broadly indicative. In most cases, the assessment of the requirements is based on the estimates submitted by the Central Ministries. The requirements as assessed by the States lack rigour and are gross overestimates based on certain norms which can only be met in the long run and not in the five-year award period of a Central Finance Commission. To address this issue, it is necessary to synchronize the periods covered by the State and Central Finance Commissions and to ensure that the reports of the SFCs are available to the Central Finance Commission well in time. Under the provisions of Articles 243-I and 243-Y, State Finance Commission shall be constituted within one year of the 73rd and 74th Amendments and thereafter after the expiration of every fifth year. Currently, there is no uniformity across States regarding the appointment of Finance Commissions and the periods covered by their reports. Annexure 4.2 gives the status of the constitution of the Third State Finance Commissions. The NCRWC recommended amendment of Article 243-I to provide for the constitution of SFCs at the expiration of every fifth year or earlier. A similar recommendation was made by the SARC. We strongly endorse this recommendation which will pave the way for the synchronization of the periods of the Central Finance Commission and the SFCS. Since the timing of

the appointment of the Central Finance Commission is known, SFCs should be appointed in advance so that their reports are available to the Central Finance Commission well in time to ensure their consideration. It should also be ensured that the reference period of the SFCs should match that of the Central Finance Commission.

8.2.10 Other issues relating to the SFCs are the diversity in their approach, wide variations in the contents of their reports and the undue delay on the part of the States in placing the Action Taken Reports (ATR) on the recommendations of SFCs in State Legislatures. Equally worrisome is the practice of States appointing people not well versed in the affairs of local bodies or their finances as members of the SFCs. The quality of SFCs reports continues to remain poor. FC-XII recommended that SFCs should collect information in the formats suggested by it to ensure uniformity in their approach across States. The basis with regard to the assessment of needs and determination of grants is also not found to be uniform. FC-XIII has recommended the adoption of a common template by the SFCs for the preparation of their reports. We recommend adoption of a uniform approach by the SFCs and as a first step in this direction, the ToR should mandate the SFCs to adopt the common template recommended by FC-XIII.

8.2.11 FC-XII emphasised the need to appoint people of eminence and competence as members of the SFCs and expressed the desirability of States following the Central legislation and rules which prescribe the qualifications for the chairperson and members of the Finance Commission. Such a need has also been reiterated by FC-XIII. We recommend enactment of a suitable legislation by all States prescribing qualifications of persons to be appointed to the SFCs.

8.2.12 There are numerous instances of States taking their own time in placing the ATRs on the recommendations of SFCs. Even when the SFC reports are available, it would be difficult for the Central Finance Commission to assess the financial implications of the recommendations in the absence of ATRs. We, therefore, recommend that ATRs on the recommendations of the SFCs should be placed in the State Legislature within a period of three months from the date of their submission.

8.3 Separate Fiscal Space for Local Bodies

8.3.01 Fiscal autonomy is essential for realizing the benefits of decentralization. Decision making at the local level will suffer in the absence of fiscal autonomy. The present system of almost total dependence of local bodies on higher levels of govern-

ment does not promote accountability. As long as local bodies have the pleasure of spending money without the pain of raising it, accountability cannot be ensured in local self governance. Under Articles 243-H and 243-X of the Constitution, State legislatures are authorized to allow local bodies to levy and collect specified State taxes and to assign the proceeds of specified State taxes to local bodies. These provisions of the Constitution do not seem to have served the purpose of empowering the local bodies financially. While there has been some progress in transferring functions to local bodies, States have been by and large reluctant to part with financial powers.

8.3.02 The present provision of SFCs taking into account the tasks entrusted to the local bodies and assessing the resources available to them does not adequately serve the purpose of financial empowerment. We are of the opinion that there should be some initiatives in the direction of allowing local bodies to levy and collect certain State taxes and assigning the proceeds of some other. The State governments should not impose any restrictions on the rates of taxes transferred to local bodies. Such empowerment should be in tandem with our recommendations made in Volume IV on the time bound devolution of functions and its completion by 2015.

CHAPTER 9
GOODS AND SERVICES TAX

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9

GOODS AND SERVICES TAX

9.1 Background

9.1.01 The ToR require the Commission to examine the need and relevance of separate taxes on the production and on sales of goods and services subsequent to the introduction of value added tax regime. Union excise duties and sales tax are the two important indirect taxes on goods levied by the Union and the States, respectively. The tax system was characterized by cascading effects leading to distorted structure of production, consumption and exports and evasion. The first step towards the reforms of taxation on goods was the introduction of Modified Value Added Tax (Modvat) in March 1986. In the late nineties, Modvat was renamed as Central Value Added Tax (CENVAT). The main feature of the CENVAT is allowing credit on the duty paid on inputs and input services. With the distinction between goods and services getting blurred and with the service sector accounting for a predominant share of the GDP, service tax was introduced initially on three services in 1994 and was extended to cover more and more services in a phased manner. Reforms in the sales taxation commenced with the introduction of VAT in 2005-06. The State VAT provides full set-off for the tax paid on inputs as well as tax on previous purchases. Under State VAT, tax liability is self-assessed by the dealers after setting-off tax credit. There are fewer rates of tax and exemptions under VAT as compared with the earlier system of sales taxation.

9.2 Need for Reform

9.2.01 Despite reforms, the system of taxation of goods and services in the country continues to fall short of international norms and practices. The main problems relate to definition of manufacturing, fragmentation of taxation of value addition, inter-State trade and the overarching nature of many services that cut across State borders from the stage of production to final consumption. Currently, CENVAT is levied on the manufacture and production of excisable goods. Excise duty can be levied only if the goods are manufactured and are marketable. Besides definitional problems as to what constitutes manufacturing, there are problems of valuation. There are also problems with regard to the classification of goods and application of duty rate relevant for a group or sub-group of goods. What makes the whole system more complex is the multiplicity of rates, exemptions and irrational structure of the rates.

9.2.02 There are also problems with regard to the system of service taxation in the country. The key problem is the levy of tax on specified services, each of which generates an extensive amount of augmentation. Ideally, the Tax should be levied on all services with a short negative list. The other problem is with regard to the distinction between goods and services, which is getting blurred with the advancement of information technology. Under the Indian law, goods have been defined to include intangibles like copy right and software. But intangibles are often supplied as part of a service contract. Software upgrades are considered as goods but these can be supplied as part of a service contract. A number of value added services are provided to mobile phone users. An online subscription to a magazine can be treated as a service, but online purchase of a book could constitute purchase of goods. Leasing of equipment without transfer of possession and control to the lessee may be interpreted as a service but may also be deemed as sale of goods. In the modern economy, goods and services are often bundled and sold together.

9.2.03 The system of State level VAT also suffers from a number of infirmities. These relate to classification of goods, lack of clarity as to whether a transaction constitutes a sale of good or service. Non-integration of local taxes like entry tax, work contracts, entertainment tax and luxury tax goes against the basic premise of VAT, which is to have uniformity in tax structure.

9.2.04 The taxation system at the Centre and State levels is still characterised by cascading and resultant distortions. The significant contributory factor for cascading is the partial coverage of tax base. Oil and gas production, mining, agriculture, wholesale and retail trade, construction and a range of services remain outside the purview of Central taxation. The exempt sectors are not allowed to claim any credit for the CENVAT or the service tax paid on inputs. Similarly, under the State VAT, no credit is allowed for the inputs used in the exempt sectors, which include the entire service sector, real estate, agriculture, oil and gas production and mining. Another major factor contributing to the cascading is the levy of Central Sales Tax (CST) on inter-State sales which is collected by the State of origin for which no credit is allowed. Besides, CST creates unnecessary tax barriers affecting the free flow of goods and creates hurdles in ensuring an integrated market for the entire country.

9.3 Rationale for Goods and Services Tax

9.3. 01 In order to deal with the above problems, it is considered necessary to bring about two changes in the taxation of goods and services in the country. The first one is bringing services under the purview of State VAT and the second one is the extension of

value addition up to the retail level under the purview of CENVAT. These changes basically amount to integration of goods and services for the purpose of taxation under the value added system. There is a strong rationale for bringing services under State VAT. Service sector is the fastest growing sector in the economy presently contributing over 60 per cent to the GDP. The extension of service taxation will enable States to share the revenue buoyancy. It improves horizontal equity as taxation of goods and services will be at par. Taxation of services at the rates applicable to goods is likely to improve allocation of resources. Lastly, treating services and goods at par is likely to minimize classification disputes and compliance costs.

9.3.02 There are similar advantages in extending the taxation of goods up to the retail stage in respect of the Centre. Firstly, it will do away with the need to define manufacturing and eliminate valuation problems. Secondly, there will be symmetrical treatment of goods and services. Thirdly, there will be no revenue loss for the Centre for sharing the taxation of services with the States. Fourthly, taxation of goods all the way up to the retail stage will create a proper record of all goods leaving State boundaries making settlement of inter-State disputes far easier and will enable the realization of a destination based system of taxation.

9.4 Progress Towards Introduction of GST

9.4.01 Realising the need for reforms in the taxation of goods and services, the Government of India announced in February 2007 that a roadmap for the introduction of destination - based GST from April 1, 2010 would be prepared in consultation with the Empowered Committee (EC) of State Finance Ministers. As a step towards the introduction of GST, CST was reduced from 4 per cent to 3 per cent in 2007 and further to 2 per cent in 2008. In consultation with the GoI, the EC prepared 'A Model and Roadmap for Goods and Services Tax in India' in April 2008. This paper by the EC suggested adoption of a dual GST, identified operational problems and the legal and administrative arrangements necessary for the introduction of GST. Following further discussions, the EC brought out the 'First Discussion Paper on Goods and Services Tax in India' (FDP) in November 2009.

9.4.02 The FDP proposed dual GST, one levied by the Centre and the other levied by States. It also listed out the taxes to be subsumed under Central GST (CGST) and the State GST (SGST). The taxes proposed to be subsumed under CGST are Central excise duty, additional excise duties, excise duty under medicinal and toilet preparations, ser-

vice tax, additional customs duty known as countervailing duty and special additional duty. Cesses and surcharges are also proposed to be subsumed under CGST. The taxes proposed for subsumation under SGST are VAT/Sales Tax, entertainment tax, if not levied by local bodies, luxury tax, tax on lotteries, betting and gambling, cesses and surcharges in so far as they relate to goods and services, entry tax not in lieu of octroi and purchase tax. Taxes on alcohol, tobacco and petroleum products are proposed to be kept out of the purview of GST. The FDP has not suggested any revenue-neutral rates for the CGST and SGST.

9.4.03 FC-XIII appointed a Task Force to examine, *inter alia*, the GST model best suited to the country and the modalities of implementation of GST. The Task Force submitted its report in December 2009¹⁷. Following are the main features of the model GST suggested by the Task Force:

- i) It should be dual levy on a common and identical base imposed concurrently by the Centre and the States but independently to promote cooperative federalism. It should cover all the goods and services. There should be no distinction between raw materials and capital goods in allowing input tax credit. GST should be structured as a destination based tax.
- ii) Exemptions should be minimum and common to the Centre and the States. Exemptions may be limited to services rendered by the Government and the local bodies, unprocessed food Articles and educational and health services rendered by non-governmental organizations. Area based exemptions should be removed. In case there is a felt need for such exemptions, investment linked cash subsidy may be provided.
- iii) Keeping in view the compliance costs, small dealers and manufacturers should be exempted from the purview of CGST and SGST, if their annual turnover (excluding both CGST and SGST) of all goods and services does not exceed Rs.10 lakh.
- iv) Central excise duty, service tax, additional customs duty, surcharges and all cesses may be subsumed under CGST. State taxes proposed for subsumation under SGST are VAT/sales tax, entertainment tax other than that levied by local bodies, entry taxes not in lieu of octroi, luxury tax, taxes on lotteries, gambling and bettings, stamp duties, taxes on motor vehicles, goods and passengers and taxes and duties on electricity.

¹⁷ Report of the Task Force on Goods and Services Tax, Thirteenth Finance Commission, December 2009.

- v) Tobacco and alcohol should be taxed through GST as well as an additional duty with no input credit.
- vi) Consumption of financial services should be taxed under GST and the real estate sector should be integrated into GST framework by subsuming the stamp duty on immovable properties levied by the States to facilitate input credit and to eliminate cascading.
- vii) Inter-State transactions should be handled through a mechanism of permitting sellers in one State to charge SGST from buyers in another State. This SGST should be credited to the consuming State.
- viii) All goods and services should be taxed at the CGST rate of 5 per cent and SGST rate of 7 per cent. There should be zero rating of all goods and services exported out of the country.

9.4.04 Based on the Report of the Task Force, FC-XIII recommended a model GST to be adopted by the Centre and the States and an Incentive Fund. We are in broad agreement with the dual GST recommended by FC-XIII. The adoption of the model will pave the way for realizing the full benefits of a modern and distortion free system of taxation of goods and services. We recommend the adoption of the dual GST to be levied by the Centre and the States concurrently on a common base with fewer exemptions. Exemptions may be limited to unprocessed food services rendered by the governmental organizations and local bodies. All area based exemptions should be replaced by cash subsidy linked to investment. The aggregate GST base should be large enough to permit lower rates. The EC may work towards building up consensus in this direction.

9.5 Concerns of Stakeholders

9.5.01 A few States responding to our questionnaire have expressed concerns regarding the possible accentuation of vertical imbalances with the Centre gaining access to the taxation of consumption. To address this concern, we recommend that the revenue neutral rates should be worked out with care. The rates for the Central and State components should be determined taking into account not only the present activities but likely revenue growth of taxes to be subsumed under GST. In the initial years, it should be ensured that the share of the States in the combined revenue receipts should not be lower than what would have accrued to them in the pre-GST regime. The second concern is while the SGST rate may be revenue neutral at the aggregate level, States with high tax effort may suffer a revenue loss. In a paper, D.K. Srivastava has hinted at the possibility of differential revenue impact of GST on States¹⁸ As the resource base of the States is

¹⁸ Srivastava, D. K. 'Finance Commission and the Southern States: Overview of Issues'. Paper presented at the seminar on 'Finance Commission: Issues before the Southern States'. Madras School of Economics, December 8-9, 2008.

limited, it would be difficult for them to absorb any revenue loss. We, therefore, recommend that the Centre should compensate the States suffering revenue loss, if any, in the initial years of the introduction of GST.

9.5.02 In view of the dire need to arrest environmental degradation it is necessary to integrate environmental considerations within the framework of GST. Environmental taxes act as an indirect mechanism to control pollution and are likely to induce appropriate environmental decisions. We therefore recommend that polluting inputs and outputs may be subjected to a special non-rebatable levy by both the Centre and the States. In addition petroleum products alcoholic beverages and tobacco products may also be subjected to a non-rebatable levy.

9.5.03 There is a need to maintain stability and integrity in the structure of GST to ensure that no distortions creep into the tax system. Therefore, the existing machinery for arriving at collective decisions which has served the purpose well should be institutionalized on a permanent basis. Details with regard to the proposed institutional mechanism may be worked out by consensus.

9.5.04 The success of GST would largely depend on the IT infrastructure available with the States. IT infrastructure will enable States to build a database and better implement the system. We recommend a one-time grant to States for putting in place adequate IT infrastructure.

CHAPTER 10

UNIFIED AND INTEGRATED DOMESTIC MARKET

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UNIFIED AND INTEGRATED DOMESTIC MARKET

10.1 Background

10.1.01 A unified and integrated domestic market is necessary to make the Indian economy efficient and competitive. It goes to the credit of the framers of the Constitution that they made suitable provisions in the Constitution towards the realization of this goal. Article 301 mandates that trade, commerce and intercourse through out the territory of India shall be free. Under Article 302, Parliament may by law impose such restrictions on the freedom of trade, commerce or intercourse between one State and another or within any part of the territory of India as may be required in the public interest. Article 304 confers power on the State Legislature to impose on goods imported from other States any tax to which similar goods manufactured in that State are subject provided there is no discrimination between goods so imported and goods so manufactured or produced within the State. This Article also empowers the Legislature of a State to impose such reasonable restrictions on the freedom of trade, commerce or intercourse with or within that State as may be required in public interest.

10.2 Restrictions on Trade

10.2.01 India has the potential of becoming a vast unified market with a population of over one billion common currency and with the Constitution providing for free movement of goods labour and capital. The economic gains from competition and free-flow of goods capital and labour are so overwhelming that even some independent countries have come together the European Union being the example. Guided by scarcity situation prevailing in the fifties and sixties, a number of restrictions were placed in our country on trade and free movement of goods. Gradually the scope of these restrictions widened with the enactment of Essential Commodities Act (ECA) in 1955 providing for control over production pricing distribution and stocking of goods. The restrictions in respect of marketing of agricultural products are even more severe. The wholesale trade in agricultural produce is governed by the Agricultural Produce and Marketing Acts (APMC) enacted by States. The Act empowers State governments to notify commodities and desig-

nate markets and market areas where the regulated trade should take place. These legislations by States do not allow direct buying of agricultural produce by processing industries or exporters thus preventing the farmers from realizing better prices for their produce which was the main purpose of such legislation. In some States restrictions on agricultural marketing even went beyond the APMC Act. One such example is the monopoly procurement of cotton in Maharashtra.

10.2.02 The Eleventh Plan document observed that regulations such as ECA and APMC Act and the control orders issued under these Acts have created restrictive and monopolistic marketing structures resulting in inefficient operation and high degree of marketing cost. The document further added that these restrictions have an adverse impact on agricultural production and system, efficient flow of commodities and fostering competition.

10.2.03 Besides physical restrictions on free movement of goods, taxation in the States moved in the direction of multiplicity of tax provisions causing distortion in tax application and its administration. This has resulted in tax competition between States often described as the race to the bottom. Tax exportation occurs with States levying origin based sales tax at the first point of sale and also on inputs and capital goods. When the exports from developed States are more than their imports, the poorer States end up paying taxes on larger volume of imports at higher rates. Fragmentation of markets has not been conducive to promoting competition. The major tax impediments to free trade across states include: (i) tax on inter-state trade of goods (CST); and (ii) Octroi/entry tax. While inter-State sales tax is on the export of goods, Octroi is similar to import duty. Octroi has resulted in harassment to taxpayers¹⁹. On account of problems associated with it, States like Karnataka and Madhya Pradesh have replaced it with an Entry tax. The purview of entry tax has been widened in some states. Tamil Nadu has added 15 new items which would be subject to an entry tax. Maharashtra has also imposed entry tax on a number of commodities. The prevailing trend runs counter to removing trade barriers and reaping the advantages of common market. Thus despite the potential, the Indian market continues to remain divided and sub-divided into small economic units. This fragmentation has occurred over the years by multiple tax rates, restrictions on the movement of goods imposed by States and the local bodies.

¹⁹ This has been abolished in all States other than Maharashtra.

10.3 Recent Reforms

10.3.01 Following the economic reforms introduced in the early nineties, the number of commodities coming under the purview of ECA has been substantially brought down. But most of the agricultural commodities still continue to remain under the purview of the Act. To address the problems emanating from APMC Act, the Central Government brought out a model APMC Act in 2003 allowing private agents to set up a market or buy products directly from the market. But the adoption of the Act by the States is voluntary. As indicated in the Eleventh Plan document, only a few States like Andhra Pradesh, Arunachal Pradesh, Assam, Chattisgarh, Goa, Gujarat, Himachal Pradesh, Karnataka, Madhya Pradesh, Maharashtra, Nagaland, Orissa, Rajasthan, Sikkim and Tripura have amended their APMC Acts allowing direct marketing, contract farming and markets in private and cooperative sectors. However, many of these States are yet to notify the relevant rules to make the amendments fully operational. The restrictions on the movement of goods and marketing of agricultural produce would have served some purpose in the days of scarcity. But these restrictions in the current situation are entirely incompatible with the principle of a single unified market for the entire country. We therefore recommend further reduction in the number of commodities covered under the ECA and uniform liberalization of agricultural trade across States thorough suitable changes in APMC legislations.

10.3.02 The Eleventh document has drawn attention to a number of issues relating to taxation of agricultural commodities and expressed the need for bringing uniformity in the State-level tax structure in agricultural commodities for improving market efficiencies, rationalizing taxes and fees on raw agricultural commodities and removing defacto restrictions on movement of goods across State borders. The document emphasized the urgency to coceptualise the country as a unified integrated national market. The document suggested amendment to ECA to provide for imposition of trade and marketing restrictions only during exceptional situations of demand-supply dislocation, market aberration and price volatility. We endorse this suggestion and recommend necessary amendments to the ECA. The number of commodities covered under the Act should also be brought down further.

10.3.03 Besides removing the obstacles to trade, lot more work needs to be done to make India a truly integrated market. Massive investments are required in development of widely dispersed warehousing, improved road/rail network and trucking/rail wagons,

skilled manpower for grading, and scientific storage and handling. The Warehousing (Development & Regulation) Act enacted in 2005 is expected to facilitate transfer of goods through negotiable warehousing receipt system. This will not only spur investment in scientific warehousing and grading/handling facilities but also minimize the costs of handling and transportation, thereby reducing the transaction costs and scope for quality deterioration/value erosion. As observed by the Eleventh Plan, there is a need to set up an accreditation agency for certified warehouses and warehouse receipts. We recommend that steps should be taken to fully operationalise the provisions of the Warehousing (Development and Regulation) Act, 2005. Suitable policy initiatives should be taken to encourage the private sector and cooperatives to set up godowns and to specify standards for warehouse receipt system.

10.3.04 The introduction of VAT by States from 2005 has addressed the problem of distortions in tax administration to a limited extent. But there are still a number of constraints in the development of a unified common market. The system of VAT is segmented between CENVAT, State VAT Central Service Tax and a number of levies by the States and local bodies and the Central sales tax. There is a need to remove the barriers restricting the smooth flow of goods and services and to put in place a system to ensure a seamless flow of inter-State trade and commerce. The proposed introduction of GST is expected to usher in a common market resulting in the free movement of goods and services without any physical or legal barriers. Purchase tax, cesses, entry tax and octroi which are adversely affecting the free flow of trade are likely to be subsumed under GST. We recommend subsumation of purchase tax cesses and surcharges under the proposed GST with a view to eliminating tax barriers to free trade.

10.3.05 The Central Sales Tax (CST) on inter-State trade is an origin based tax leading to exportation of tax and taxation of non-residents of the State. Designed to regulate inter-State trade CST has emerged as a vehicle for States of origin to shift the tax burden to the residents of other States and given risen to inter-jurisdictional inequity in the sharing of tax bases. More importantly CST has created distortions in the free-flow of trade by denying input credit on inter-State sales and in the location of industry within the country. As a part of the transition to proposed GST tax rate on CST was reduced in phases from 4 per cent to 2 per cent. We recommend abolition of CST as it is a prerequisite for the introduction of GST. Exports from one State to another State should be effectively zero rated such that the revenues on inter-State sales accrue to the destination State.

10.3.06 There is also need to set up a dedicated inter-State dispute resolution mechanism in matters of trade and commerce. The Sarkaria Commission recommended setting up of a permanent authority under Article 307 to bring out reports on inter-State and intra-State trade and commerce and recommend measures for their modification. The NCRWC recommended constitution of a statutory authority under Article 307 for carrying out the objectives of Articles 301, 302, 303 and 304. We are convinced of the need for such an authority and recommend the setting up of a Inter-State Trade and Commerce Commission under Article 307 read with Entry 42 of List-I. This Commission should be vested with both advisory and executive roles with decision making powers. As a Constitutional body, the decisions of the Commission should be final and binding on all States as well as the Union of India. Any party aggrieved with the decision of the Commission may prefer an appeal to the Supreme Court.

10.3.07 At present, check posts at State borders increases journey time of the trucks considerably. Checks are generally conducted by respective States at separate points resulting in more than one detention. The average daily distance covered by a truck in India is 200 km as compared with 550 km in Europe and 700 Km in the USA. We recommend setting up of a common check post manned by the officials of two bordering States instead of multiple check posts.

CHAPTER 11

SUMMARY OF RECOMMENDATIONS

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SUMMARY OF RECOMMENDATIONS

Chapter 5 – Issues in Centre-State Fiscal Relations

3.5.01 The Commission recommends a comprehensive review of all transfers to States with a view to minimizing the component of discretionary transfers, particularly those channeled through CSS.

(para 5.3.01)

3.5.02 As the resources at the command of the States are limited, we recommend higher Central transfers to backward States to enable them to improve their physical and human infrastructure.

(para 5.4.02)

3.5.03 To realize the benefits of past investments in backward regions of the country, we recommend that maintenance of assets already created should form an integral part of planning in these regions.

(para 5.4.03)

3.5.04 We recommend the adoption of a multi-pronged strategy in the backward regions of the country comprising public investment in infrastructure development, proactive policies to attract private investment, higher public expenditure on social sectors, such as health and education and area specific strategy for the growth of agricultural production.

(para 5.4.04)

3.5.05 We recommend that there should be greater focus on the issues of governance in the less developed States of the country.

(para 5.4.05)

3.5.06 Suitable policy initiatives should be taken to improve the C-D ratio of bank credit in the poorer States in a time-bound manner. Efforts should also be made to spread the habit of banking among the poorer sections of society to achieve the objective of financial inclusion.

(para 5.4.06)

3.5.07 All future Central legislations involving States' involvement should provide for cost sharing as in the case of the RTE Act. Existing Central legislations where the States are entrusted with the responsibility of implementation should be suitably amended providing for sharing of costs by the Central Government.

(para 5.5.03)

3.5.08 The proposed enactment for providing food security to the poor should clearly delineate the responsibilities of the Central and State Government in meeting the additional cost of implementing the provisions of the Act.

(para 5.5.04)

3.5.09 The additional expenditure liabilities on States on account of the implementation of Central legislations should be fully borne by the Central Government. An institutional mechanism should be put in place to verify the additional cost and to ensure reimbursement of such additional costs to States. It is recommended that issues giving rise to such liabilities may be included as a part of permanent Terms of Reference of the Finance Commission.

(para 5.5.06)

3.5.10 The ToR of future Finance Commissions should be formulated in such a way that the additional commitments of States on account of pay revision are fully taken into account.

(para 5.6.02)

3.5.11 The royalty rates on major minerals should be revised at least every three years without any delay. States should be properly compensated for any delay in the revision of royalty beyond three years.

(para 5.7.01)

3.5.12 There is a case for reviewing the present arrangement regarding resource sharing between the Centre and the States and giving a share of the offshore royalty to States.

(para 5R.8.01)

3.5.13 A part of the sale proceeds of spectrum should be devolved to States for expenditure on infrastructure projects.

(para 5.8.01)

3.5.14 We endorse fully the recommendation of FC-XII with regard to the sharing of proceeds of service tax in the event of the notification of the 88th amendment to the Constitution.

(para 5.9.02)

3.5.15 With the proposed introduction GST within the next one or two years, States will have concurrent power to tax services. We, therefore, do not see any need to change the status quo with regard to the levy of service tax in the interim period.

(para 5.9.03)

3.5.16 The current ceiling on profession tax should be completely done away with by a Constitutional amendment.

(para 5.10.01)

3.5.17 The scope for raising more revenue from the taxes mentioned in article 268 should be examined afresh. This issue may be either referred to the next Finance Commission or an expert Committee be appointed to look into the matter.

(para 5.11.03)

3.5.18 This 'one-size fits all' approach to fiscal consolidation has constrained fiscally strong States to raise more resources. We, therefore, recommend State-specific targets of fiscal deficit in the FRBM legislations of States. The fiscal correction path may factor in the variations in the initial fiscal situation across States and be made State-specific.

(para 5.12.02)

3.5.19 Quality of fiscal adjustment should be built into the FRBMA targets. We recommend specification of targets with regard to maintaining certain levels of expenditure on social services, maintenance and creation of capital assets in the FRBMA legislations.

(para 5.12.03)

3.5.20 With a view to deriving the full benefits of FRBMA all off-budget liabilities should be brought into fiscal accounting. Suitable adjustments should be made in the deficit reduction targets to reflect changes in accounting practices if any.

(para 5.12.04)

3.5.21 The FRBMA should be amended to clearly specify the circumstances which should warrant deviation from the targets.

(para 5.12.05)

3.5.22 To bring greater accountability all fiscal legislations should provide for an annual assessment by an independent body and the reports of these bodies should be laid in both Houses of Parliament/ State Legislature

(para 5.12.06)

3.5.23 It is necessary that the present system of fixing overall borrowing limits is continued to ensure adherence to FRBM targets.

(para 5.13.02)

3.5.24 Interest relief may be offered on loans from the NSSF by aligning the interest rate on loans from the NSSF to the rate of interest on Government securities. The present repayment period of 25 years in respect of loans from the NSSF may continue.

(para 5.14.02)

3.5.25 It is the considered view of the Commission that direct transfers to implementing agencies should be stopped. It should be ensured that the State Governments pay interest in case of delays in the transfer of funds beyond 15 days of their receipt from the Central Ministries.

(para 5.15.01).

3.5.26 The maintenance of macroeconomic stability is the responsibility of the Union and that States should be properly compensated for any additional expenditure they bear or revenue loss they suffer on account of measures taken by the Union to maintain macroeconomic stability.

(para 5.16.01)

Chapter 6 – Finance Commission Transfers

3.6.01 Considerations specified in the ToR of the Finance Commission should be even handed as between the Centre and the States. There should be an effective mechanism to involve the States in the finalization of the ToR of the Finance Commissions.

(para 6.2.05)

3.6.02 We are concerned about the increase in the revenue collected through cesses and surcharges. We recommend that the Central Government should review all the existing cesses and surcharges with a view to bringing down their share in the gross tax revenue.

(para 6.3.03)

3.6.03 Because of the close linkages between the plan and non-plan expenditure, an Expert Committee may be appointed to look into the issue of distinction between the plan and non-plan expenditure.

(para 6.4.04)

3.6.04 There should be much better coordination between the Finance Commission and the Planning Commission. The synchronization of the periods covered by the Finance Commission and the Five-Year Plan will considerably improve such coordination. We recommend that another attempt be made to synchronize the periods.

(para 6.5.02)

3.6.05 FC-XII recommended that the Finance Commission Division in the Ministry of Finance should be converted into a full-fledged department, serving as the permanent secretariat for the Finance Commissions. We endorse this recommendation of FC-XII.

(para 6.6.01)

3.6.06 We are in favour of Finance Commission adopting more sophisticated methods to assess the needs of backward States and providing them with higher transfers. Performance-linked incentive grants are likely to be more effective in addressing the problems of backward States.

(para 6.7.02)

3.6.07 We are of the view the relative shares of tax devolution and grants should be better left to the judgment of the Finance Commissions

(para 6.7.03)

Chapter 7 – Planning Commission and Plan Formulation

3.7.01 Planning Commission's role in the post-reform period should be that of co-ordination to ensure that the sectoral plans drawn by different ministries are in conformity with the overall objectives of the Plan. This may not require parallel subject matter Divisions in the Planning Commission. The practice of ministries seeking changes in approved projects may be dispensed with as long as sectoral allocations are adhered to

(para 7.2.02)

3.7.02 A case for multi-year budgeting with a firm budget for the first year and provisional for the second and third years assumes importance in the context of shortfall in the realisation of resources envisaged for the Five-Year Plan. The FRBM Act envisages preparation of a Medium Term Fiscal Policy Statement but this cannot serve adequately the purpose a multi-year budgeting. We recommend adoption of multi-year budgeting by the Central and State Governments at the earliest

(para 7.2.03)

3.7.03 While the Planning Commission may finalise the Five-Year Plans in consultation with States to ensure broad correspondence with the national objectives, detailed exercise of approving States' annual plans may not be necessary. The States should be given freedom to plan according to their own needs and priorities within the framework of nationally accepted priorities.

(para 7.2.04)

3.7.04 Plan outlays should be based on realistic estimates of resources and within the FRBM targets.

(para 7.2.05)

3.7.05 Steps should be taken to restore the share of State plan outlays to the previous levels.

(para 7.3.02)

3.7.06 As the Gadgil formula was last revised more than 18 years ago, we recommend its revision in the light of the recent developments. The share of Gadgil formula transfers may be increased in a phased manner so as to restore the preeminence of these transfers.

(para 7.4.04)

3.7.07 The number of CSS should be restricted to flagship programmes of national and regional importance. Accordingly, we recommend reduction in the number of CSS and their funding in a phased manner spread over the next five years. There should also be flexibility in the guidelines governing the implementation of CSS to suit State-specific situations.

(para 7.5.06)

3.7.08 The share of poorer States in EAP has been negligible. Efforts should be taken to enable the poorer States to access the EAP.

(para 7.6.01)

3.7.09 The Second Administrative Reforms Commission, based upon the input received by a cross-section of public opinion and most of the State Governments, has come to the conclusion that the continuance of a 'stand-alone' Ministry with partial responsibility for the North-East region is not in long term interest and have therefore recommended its abolition. The Commission endorses this view.

(para 7.7.04)

3.7.10 The Commission is of the view that in place of multiplicity of institutions that are existing at present to address the problems of the North East, there is a strong case for setting up a single institution. This coordinating and planning role should be undertaken by the Planning Commission which should set up a Regional Unit by subsuming the NEC Secretariat and placing it under a designated Member of the Planning Commission preferably located in North East and having the required empowerment and funds.

(para 7.7.06)

3.7.11 In our opinion, the Planning Commission has a crucial role in the current situation. But its role should be that of coordination rather than of micro managing sectoral plans of the Central Ministries and the States.

(para 7.8.02)

3.7.12 The Planning Commission needs to concentrate on bringing about a system of multi-year budgeting in conjunction with the Ministry of Finance. Planning Commission has an important role in making recommendations over a wide area of public policy along with the Reserve Bank of India, the Economic Advisory Council to the Prime Ministers and other Commissions and think tanks.

(para 7.8.02)

Chapter 8 – Fiscal Domain of Local Bodies

3.8.01 We endorse the recommendation of NCRWC for the synchronization of the periods of the Central Finance Commission and the SFCs. Since the timing of the appointment of the Central Finance Commission is known, SFCs should be appointed in advance so that their reports are available to the Central Finance Commission well in time to ensure their consideration. It should also be ensured that the reference period of the SFCs should match that of the Central Finance Commission.

(para 8.2.09)

3.8.02 We recommend adoption of a uniform approach by the SFCs and as a first step in this direction, the ToR should mandate the SFCs to adopt the common template recommended by FC-XIII.

(para 8.2.10)

3.8.03 This Commission recommends enactment of suitable legislation by all States prescribing qualifications of persons to be appointed to the SFCs.

(para 8.2.11).

3.8.04 The ATRs on the recommendations of the SFCs should be placed in the State Legislature within a period of three months from the date of their submission.

(para 8.2.12)

3.8.05 We are of the opinion that there should be some initiatives in the direction of allowing local bodies to levy and collect certain State taxes and assigning the proceeds of some other. The State Governments should not impose any restrictions on the rates of taxes transferred to local bodies. Such empowerment should be in tandem with recommendations made in volume IV of the Report on time bound devolution of functions and its completion by 2015.

(para 8.3.02)

Chapter 9 – Goods and Services Tax

3.9.01 We recommend the adoption of the dual GST to be levied by the Centre and the States concurrently on a common base with fewer exemptions. Exemptions may be limited to unprocessed food services rendered by the governmental organizations and local bodies. All area based exemptions should be replaced by cash subsidy linked to investment. The aggregate GST base should be large enough to permit lower rates. The EC may work towards building up consensus in this direction

(para 9.4.04)

3.9.02 To address the concerns of States with regard to accentuation of vertical imbalances the revenue neutral rates of GST should be worked out with care. The rates for the Central and State components should be determined taking into account not only the present activities but likely revenue growth of taxes to be subsumed under GST. In

the initial years, it should be ensured that the share of the States in the combined revenue receipts should not be lower than what would have accrued to them in the pre-GST regime

(para 9.5.01)

3.9.03 As the resource base of the States is limited, it would be difficult for them to absorb any revenue loss. We, therefore, recommend that the Centre should compensate the States suffering revenue loss, if any, in the initial years of the introduction of GST.

(para 9.5.01)

3.9.04 Polluting inputs and outputs may be subjected to a special non-rebatable levy by both the Centre and the States. In addition petroleum products alcoholic beverages and tobacco products may also be subjected to a non-rebatable levy.

(para 9.5.02)

3.9.05 The existing machinery for arriving at collective decisions on GST should be institutionalized on a permanent basis. Details with regard to the proposed institutional mechanism may be worked out by consensus.

(para 9.5.03)

3.9.06 We recommend a one-time grant to States for putting in place adequate IT infrastructure preparatory to the introduction of GST.

(para 9.5.04)

Chapter 10 – Unified and Integrated Domestic Market

3.10.01 There should be further reduction in the number of commodities covered under the ECA and uniform liberalization of agricultural trade across States through suitable changes in APMC legislations

(para 10.3.01)

3.10.02 We endorse the suggestion of the Planning Commission that trade and marketing restrictions should be imposed only during exceptional situations of demand-supply dislocations and recommend necessary amendments to the ECA. The number of commodities covered under the Act should also be brought down further

(para 10.3.02)

3.10.03 We recommend that steps should be taken to fully operationalise the provisions of the Warehousing (Development and Regulation) Act, 2005. Suitable policy initiatives should be taken to encourage the private sector and cooperatives to set up godowns and to specify standards for warehouse receipt system.

(para 10.3.03)

3.10.04 We recommend subsumation of purchase tax cesses and surcharges under the proposed GST with a view to eliminating tax barriers to free trade.

(para 10.3.04).

3.10.05 We recommend abolition of CST as it is a pre-requisite for the introduction of GST. Exports from one State to another State should be effectively zero rated such that the revenues on inter-state sales accrue to the destination state.

(para 10.3.05)

3.10.06 We recommend the setting up of a Inter-State Trade and Commerce Commission under Article 307 read with Entry 42 of List-I. This Commission should be vested with both advisory and executive roles with decision making powers. As a Constitutional body, the decisions of the Commission should be final and binding on all States as well as the Union of India. Any party aggrieved with the decision of the Commission may prefer an appeal to the Supreme Court.

(para 10.3.06)

3.10.07 We recommend setting up of a common checkpoint manned by the officials of two bordering States instead of multiple check posts.

(para 10.3.07)

ABBREVIATIONS

APMC Act: Agriculture Produce Market Committee Act.
ATR: Action Taken Report.
CENVAT: Central Value Added Tax.
CSS: Centrally Sponsored Schemes.
CST: Central Sales Tax.
CGST: Central Goods and Services tax.
DCRF: Debt Consolidation and Relief Facility.
DONER: Department for the Development of the North-East Region.
EAP: Externally Aided Projects.
EC: Empowered Committee of State Finance Ministers.
ECA: Essential Commodities Act.
FARC: First Administrative Reforms Commission.
FC-VIII: Eighth Finance Commission.
FC-IX: Ninth Finance Commission.
FC-X: Tenth Finance Commission.
FC-XI: Eleventh Finance Commission.
FC-XII: Twelfth Finance Commission.
FC-XIII: Thirteenth Finance Commission.
FDP: First Discussion Paper on Goods and Services Tax.
FRBMA: Fiscal Responsibility and Budget Management Act.
GBS: Gross Budgetary Support.
GCS: General Category States.
GDP: Gross Domestic Product.
GoI: Government of India.
GSDP: Gross State Domestic Product.
GST: Good and Services Tax.
ISC: Inter State Council.
MODVAT: Modified Value Added Tax.

NCRWC: National Commission to Review the Working the Constitution.

NDC: National Development Council.

NEC: North-East Council.

NEDC: National Economic and Development Council.

NEDFI:

NLCPR: Non-Lapsable Central Pool of Resources.

NEPCO:

NERMAC:

NREGP: National Rural Employment Guarantee Scheme.

RTE Act: Right of Children to Free and Compulsory Education Act 2009.

NSSF: National Small Savings Fund.

Sarkaria Commission: Commission on Centre-State Relations

SARC: Second Administrative Reforms Commission.

SCPC: Sixth Central Pay Commission.

SCs: Scheduled Castes.

SCS: Special Category States.

SFC: State Finance Commission.

SGST: State Goods and Services Tax

SSA: Sarva Siksha Abhiyan.

STs: Scheduled Tribes.

ToR : Terms of Reference

VAT: Value Added Tax

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