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The report of the Tenth Finance Commission

by
S. Guhan

Madras Institute of Development Studies
79, Second Main Road, Gandhi Nagar
Adyar, Chennai 600 020

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AUTHOR'S NAME AND INSTITUTIONAL AFFILIATION

S. Guhan
Madras Institute of Development Studies
79, II Main Road
Gandhinagar Adyar
Madras 600 020

ABSTRACT

The Working Paper contains a critical assessment of the Report of the Tenth Finance Commission. The Report relates to transfers from the Centre to the States during 1995-2000 and was placed in Parliament on 15 March 1995.

Over the previous nine Finance Commissions, whose 'award' periods collectively cover a span of 44 years (1951-95), some general trends have evolved in respect of issues such as plan and non-plan revenue account transfers to the States, 'vertical' shares from the Centre to the States as a whole in the two taxes (viz., personal income taxes and basic duties of Union excise) shareable under the Constitution, the 'horizontal' or inter-se distribution of tax shares among the States and specific deficit grants to States which are left with post-devolution revenue deficits. The Working Paper situates and evaluates the recommendations of the Tenth Finance Commission in this historical framework.

Conceptually, the most interesting part of the Report is the 'Alternative Scheme for Devolution' proposed by the Commission. The Working Paper argues that it is inadequate and flawed. The author has outlined modifications to the Commissions' proposal which can result in a more logical, comprehensive and equitable restructuring of Centre-State fiscal transfers. It is hoped that this will help to stimulate a debate on this important issue.

THE REPORT OF THE TENTH FINANCE COMMISSION

1. INTRODUCTION : THE FISCAL SCENARIO

In keeping with the puranic tradition according to which the tenth incarnation of god (*dasavatar*) takes place in the era of depravity (*kaliyuga*), the Tenth Finance Commission (TFC) has had to undertake its labours under an unprecedentedly grim fiscal scenario at the Centre and in the States. The trends and dimensional magnitudes of fiscal imbalances in Tables 1 to 8 portray the scenario. Table 1 will show that during the award period of the Sixth Finance Commission (1974-79), the revenue accounts at both levels were in surplus.[1] Consequent on a sizable increase in tax transfers to States made by the Seventh Commission, the Centre's revenue account went into a small deficit and that of the States into a surplus in the subsequent quinquennium (1979-84). In the next five years (1984-89), the States as a whole registered a marginal deficit while, on an average, revenue deficits at the Centre rose to more than five times their absolute level in the previous period. In 1989-90, there was a sharp escalation in revenue deficits at both levels, particularly in the States. There has been a serious worsening since then all through 1990-95.

Of particular concern is the fact that the incidence of large revenue deficits have not abated

TABLE 1

Revenue deficits in the Centre & the States : 1974 - 1995

(Rs crores)

Period	Centre	States	Both
1974-79 Annual Average	+ 534	+ 926	+ 1460
1979-84 Annual Average	– 1449	+ 1102	– 347
1984-89 Annual Average	– 7508	– 599	– 8107
1989-90	– 11912	– 3682	– 15594
1990-95 Annual Average1/	– 24085	– 6016	– 30101

1/ : Based on RE 1994-95 for the Centre and RE 1993-94 and BE 1994-95 for the States

Source : R.B.I. Surveys of Centre and State Finances (annual issues)

during 1991-96, a period of so-called 'fiscal consolidation' under the new economic policy initiated in 1991. Table 2 shows that the gross fiscal deficit in the Central budget did get reduced according to target in 1991-92 and 1992-93, but went seriously off track in 1993-94, and is expected to be brought back to the level of 6.6 to 5.5 per cent of GDP in 1994-95 (Revised Estimates) and 1995-96 (Budget Estimates). The revenue deficit has proved to be more intractable than the fiscal deficit. In 1993-94, when the fiscal deficit went out of hand, it was 7.5 par cent of GDP (still below 8.3 per cent in 1990-91) while the revenue deficit at 4.1 per cent went even above the pre-reform 3.5 per cant level in 1990-91. As a proportion of the Centre's fiscal deficit, its revenue deficit has steadily increased from 41.6 per cent in 1990-91 to as high as 61.7 per cent in 1995-96 (BE). The implications of this are clear. First, revenue deficits have remained not only a persistent but an increasingly important contributory cause to fiscal deficits. Second, the proposed reduction of the fiscal deficit to 5.5 per cent of GDP in 1995-96 from 8.3 per cent in the pre-reform year of 1990-91, with no reduction in the revenue deficit between these two points of time, implies that the only option that the Central government has found feasible is to curtail capital expenditures: it has been unable or unwilling to reduce the current account deficit.

TABLE 2

Fiscal Deficits & Revenue Deficits in the Central Budget : 1990-96

(Percentages)

Year	Fiscal Deficit to GDP : Target	Fiscal Deficit to GDP : Actual	Revenue Deficit to Fiscal Deficit
1990-91	NA	– 8.3	41.6
1991-92	– 6.0	– 5.9	44.6
1992-93	– 5.6	– 5.7	46.2
1993-94	– 4.7	– 7.5	54.3
1994-95 RE	– 6.0	– 6.6	56.2
1995-96 BE	– 5.5	NA	61.7

Source : Central Budget documents.

Central transfers in the revenue account include shares in taxes and statutory grants recommended by the Finance Commissions as also plan grants (for State plans and centrally assisted or sponsored schemes) and non-plan grants (such as for the relief of natural calamities). The purpose of Tables 3 and 4 is to bring out the siginificance at both levels of Centre-State revenue transfers and the role of the Finance Commission in mediating them. Table 3 shows that gross central revenue transfers during 1990-95 amounted to about 40 per cent of the Centre's gross revenue receipts (tax and non tax) and to a similar proportion of States' aggregate revenue receipts. Table 4 shows that transfers under the aegis of the Finance Commission have constituted about 60 per cent of such Central transfers.

TABLE 3

Incidence of Gross Revenue Transfers, Centre & States : 1990-95

Year	Gross Revenue Receipts of the Centre (Rs Crores)	Gross Revenue Receipts of the 1/ States (Rs crores)	Gross Revenue Account Transfers from the Centre to the States 2/ (Rs Crores)	Percentage of (4) to (2)	Percentage of (4) to (3)
(1)	(2)	(3)	(4)	(5)	(6)
1990-91	69552	67402	27820	40.0	41.3
1991-92	83322	81299	32837	39.4	40.4
1992-93	94721	91207	38455	40.6	42.1
1993-94 3/	97748	101606	42049	43.0	41.4
1994-95 4/	113613	113621	45262	39.8	39.6
1990-95	458958	455135	186423	40.6	41.0

1/ : Includes gross revenue transfers from the Centre 2/ Includes tax shares and grants on non plan and plan accounts 3/ RE for the States 4/ RE for the Centre and BE for the States

Source : Central Budget documents and RBI Surveys of State Finances (annual issues)

TABLE 4

Channels of Centre-State Gross Revenue Transfers : 1990-95

(Rs. Crores)

Year	Gross Revenue Transfers from the Centre to the States	Via Finance Commission awards	Plan Grants	Non-Statutory non-plan grants
1990-91	27820 (100.0)	16937 (60.9)	9303 (33.4)	1580 (5.7)
1991-92	32837 (100.0)	19311 (58.8)	11719 (35.7)	1807 (5.5)
1992-93	38455 (100.0)	22595 (58.8)	15288 (39.8)	572 (1.4)
1993-94	42049 (100.0)	24028 (57.1)	17536 (41.7)	485 (1.2)
1994-95 RE	45262 (100.0)	26544 (58.6)	18092 (40.0)	626 (1.4)
1990-95	**186423** (100.0)	**109415** (58.7)	**71938** (38.6)	**5070** (2.7)

Figures in brackets are percentages to total gross revenue transfers in each year.

Source : Central Budget documents

Tables 5 and 6 bring out the impact of Finance Commission transfers on the non-plan revenue accounts at the two levels. After effecting these transfers, the Centre's account was in deficit in four out of five years during 1990-95 (Table 5). As far as the States were concerned, their non-plan revenue account registered deficits in all five years (Table 6). The predominant part of Finance Commission transfers are the shares available all States in personal income tax and in basic Union duties of excise. These have remained respectively at 85 per cent and 40 per cent or a little less since 1979. What Table 5 shows is that the Centre is unable to meet its obligations for statutory transfers even at this constrained level. On the other hand, as Table 6 shows, the level of transfers is clearly less than adequate for covering the non-plan revenue deficits of the States. In others words, because of, and despite, stagnant proportions of tax sharing, a persistent disjunction has emerged between the needs of the States and the ability of the Centre to meet them.

TABLE 5

Centre's Revenue Account after Statutory Transfers : 1990-95

(Rs. Crores)

Item	1990-91 Actuals	1991-92 Actuals	1992-93 Actuals	1993-94 Actuals	1994-95 RE
1. Pre-devolution revenue surplus	10995	18123	23798	15936	21349
2. Tax shares to States	14535	17197	20522	22242	24843
3. Finance Commission grants	2402	2114	2073	1786	1701
4. Revenue surplus after statutory transfers (1–2–3)	– 5942	– 1188	+ 1203	– 8092	– 5195

Source : Central Budget documents

TABLE 6

State's Revenue Account after Statutory Transfers : 1990-95

(Rs. Crores)

Item	1990-91 Actuals	1991-92 Actuals	1992-93 Actuals	1993-94 RE	1994-95 BE
1. Pre-devolution revenue surplus	–17813	–21791	–25349	–28699	–30724
2. Tax shares	14242	16848	20580	22422	24529
3. Finance Commission grants	2168	2120	2117	1941	1891
4. Revenue surplus after statutory transfers (1+2+3)	–1403	–2823	–2652	–4336	–4304

Note : Figures in rows 2 and 3 will slightly differ from those in Table 5 because of the difference in sources.

Source : RBI Surveys of State Finances (annual issues)

This is the bleak background in which the TFC has had to frame its scheme for Central transfers for the award period of 1995-2000. The core of its scheme consists of (a) projections, on a broad normative basis, of revenues and expenditures at the two levels so as to bridge the gap between the Centre's capacity and the States' needs (b) the basis for vertical sharing of the shareable taxes between the two levels and (c) the formulae for horizontal sharing of the devolved amount between the States and, consequent to it, the determination of specific revenue gap grants to the States which would remain still in deficit. Other issues dealt with by the Commission include distribution of additional excise duties in lieu of sales taxes, grants in lieu of the repealed tax on railway passenger fares, grants for upgradation of certain services in the States, grants for calamity relief, grants for local bodies and a scheme for debt relief. Most interestingly, the Commission has also presented an 'Alternative Scheme of Devolution' which has the potential for initiating long term reforms in Centre-State fiscal transfers.

In the subsequent sections, we shall evaluate how the Commission has approached these difficult and wide-ranging tasks. Before entering the substantive discussion, it is necessary to comment on an administrative aspect relating to the TFC. In his note of dissent to the Report of the Ninth Finance Commission, Justice A.S.Qureshi regretted 'the extreme casualness on the part of the Union government' towards that Commission citing in this connection delays in the initial appointment of its member-secretary, his replacement at an advanced stage of the Commission's work, and in leaving a member's vacancy unfilled for 10 months. Similar problems have been encountered by the Tenth Commission. Once again, the vacancy created by the resignation of one of its members was kept unfilled for nearly 10 months; the member-secretary was transferred, 10 months prior to the completion of the Report; and a new Economic Adviser to the Commission joined just 5 months before the end. So much for the way in which the Ministry of Finance has dealt with a high Constitutional authority.

2. THE CORE OF THE REPORT

THE SCOPE OF THE REPORT:

The terms of reference for the Commission, issued by the Central government, were sufficiently confused to give rise to doubts about the scope of the Commission's exercise, namely, whether its recommendations ought to cover the entire revenue account of the States (plan and non-plan) or only the non-plan component. On one hand, the Commission was asked to take account of States' requirements for meeting non-plan revenue expenditures and the committed liability on plan schemes completed by 31 March 1995. While these terms of reference implied that the Commission was to focus on the non-plan revenue account, some other guidelines, by requesting the Commission to keep in view the potential for raising additional taxes (which is a resource for meeting plan outlays) and the need for generating surpluses for capital investment, implied that the TFC could ingress into plan financing. The TFC has taken the view that in theory 'there is a clear rationale for the Finance Commission to deal with the revenue account as a whole, and not merely the non-plan revenue expenditure'. However, it has also noted the ambiguity in its terms of reference and the practical difficulties resulting from the fact that its award period (1995-2000) in part overlaps with, and in part extends beyond, the Eighth Plan period (1992-97). In view of the latter, the Commission has confined the scope of its exercise to the non-plan revenue account.

While the Commission's eventual decision on this issue is sound and sensible, its stand that Finance Commissions have a 'clear rationale' for dealing as well with the plan revenue account requires to be challenged in some detail. This assertion, unsupported by any reasoning, ignores not only history and practice but also the logic of the planning process and the role of the Planning Commission in implementing it. By way of historical background, it may be pointed out that while the Constitution specified shareable taxes (under Articles 270 and 272) and grants-in-aid (under Article 275) as the *sources* for the Finance Commission's transfers, it did not delimit the nature of the *needs* — revenue and/or capital, plan and/or non-plan — to which they could be addressed. This was so because the planning process had not been initiated when the Constitution was adopted in 1949. The First Finance Commission (1952-57) made no distinction between plan and non-plan revenue expenditures. The Second Commission (1957-62) was specifically required to cover plan requirements as well. So was the Third Commission (1962-66). However, in deciding on its report the Central government accepted its recommendations only in respect of the non-plan account agreeing in this respect with the dissenting minute of its member-secretary. The Fourth. Commission (1966-69) went into this question on its own and chose not to enter the plan account for the following reasons:

> 'When the provisions regarding Union State financial relations were incorporated into the Constitution, it was not possible for anyone to anticipate the importance and magnitude of our successive five-year plans... It is, however, necessary to note that the importance of planned economic development is so great and its implementation so essential that there should not be any division of responsibility in regard to any element of plan expenditure. The Planning Commission has been specially constituted for advising the Government of India and the State governments in this regard. It would not be appropriate for the Finance Commission to take upon itself the task of dealing with the States' new plan expenditure.[2]

The position arrived at by the Fourth Commission was formalised in the terms of reference to the Fifth (1969-74), Sixth (1974-79), Seventh (1979-84) and Eighth (1984-89) Commissions by requiring them to confine their recommendations to the non-plan revenue account. A consistent practice was thus maintained over two decades. Unfortunately, the Ninth Finance Commission (1989-90, 1990-95) was asked to go into the plan account as well. The unwisdom of this decision was only to be confirmed by the procedures adopted by that Commission. Without any consultation with the Planning Commission, the Ninth Commission arrived at its own estimates for so-called 'minimum plan revenue expenditures', the post-devolution non-plan surplus or deficits in individual States for meeting them and 'plan deficit' grants required to fill the gap. The arbitrary procedures followed by that Commission resulted in a variety of distortions and inequities which I have discussed elsewhere.[3] It is, therefore, welcome that the terms of reference for the Tenth Commission have reverted back — albeit not as explicitly as one would have wished — to earlier practice and that the Commission has accepted this position — albeit only on pragmatic grounds.

There is, in fact, a 'clear rationale' for the Finance Commission *not* dealing with the plan revenue account. Planning is a continuous process entailing annual adjustments to plan allocations. They are best administered by a standing body which is continuously involved in, and knowledgeable about, the plan as a whole at the Centre and among the States. The Finance Commission appears and disappears once in five years; and, such a body has neither the continuity nor the competence to get involved in plan resource allocations.

Having said this, it is important to underline the need for the two Commissions to function in tandem in coordinating resource transfers to States. The pre-condition for this is that award periods and plan periods must be co-terminus so that it will be possible to take a view of resources and requirements, non-plan and plan, at both levels of the federation in an integrated manner. This had been recognized in earlier periods as Table 7 will show. The disjunction between the spans of the two Commissions was corrected in the Third and Fourth Finance Commissions with consistency being maintained in the Fifth and Sixth Commissions. However, the discrepancy reappeared again in the Seventh Commission and was carried over into the Eighth. The problems created by the de-synchronization of the award and plan periods were commented on at some length by the Eighth Commission and it recommended that they should be synchronized in constituting future Finance Commissions.[4] This advice was followed in the case of the Ninth Commission. The two periods were sought to be made congruent again by requiring that Commission to submit two reports, the first for 1989-90 (the final year of the VII Plan) and the second for 1990-95 (the originally scheduled period of the VIII Plan). Since, however, the Eighth Plan actually commenced only in 1992, the TFC's award period (1995-2000) and the plan period (1992-97) have once more fallen out of line.

TABLE 7

Plan periods and Finance Commission award periods : 1951-2000

Year	Plan	Finance Commission
1951-52	First	—
1952-56	First	First
1956-57	Second	First
1957-61	Second	Second
1961-62	Third	Second
1962-66	Third	Third
1966-69	Annual Plans	Fourth
1969-74	Fourth	Fifth
1974-78	Fifth	Sixth
1978-79	Rolling plan	Sixth
1979-80	Rolling plan	Seventh
1980-84	Sixth	Seventh
1984-85	Sixth	Eighth
1985-89	Seventh	Eighth
1989-90	Seventh	Ninth
1990-92	Annual plans	Ninth
1992-95	Eighth	Ninth
1995-97	Eighth	Tenth
1997-2000	Post Eighth	Tenth

The TFC has drawn pointed attention to this issue in the following observations:

> 'We were considerably handicapped in our work by the fact that the period of our Report does not coincide with the period of the plan... We believe it is important to synchronise the period of recommendations of a Finance Commission with that of a Five-Year Plan. In the past, due recognition was given to this factor and up to the Seventh Commission the periods were synchronized. The issue is urgent and should be dealt with while determining the period for the next plan'.[5]

In effect, then, the options now available for re-synchronization are to have a three year plan for 1997-2000 or to terminate the award of the TFC at the end of 1996-97 and constitute the Eleventh Finance Commission for 1997-2002 to coincide with the Ninth Plan period. The latter of the two options could go along with the 'Alternative Scheme' for devolution which the TFC has proposed, an issue which we shall discuss at the end of this paper. Unless one or the other of these options are taken, the disjunction between the two periods will get perpetuated and will seriously jeopardise fiscal coordination between the two levels and, horizontally, between the plan and non-plan accounts. Such coordination, it should be realised, will be particularly important during the process of fiscal consolidation that India has to put through, sooner than later, in the coming years.

ESTIMATION OF RESOURCES AND REQUIREMENTS

As a preliminary to its scheme of transfers, the TFC, like its predecessors, has come out with projections of revenue and expenditures in the non-plan account at both levels. The projections are based in part on (optimistic) expectations and in part on (pious) exhortations, in the process marking up revenues and scaling down expenditures vis-a-vis those forecast by the Centre and the States. In general, the Commission's assumptions relating to real growth in the economy, inflation, tax buoyancies, the impact of inflation on expenditures and the norms it has proposed in respect of interest receipts, returns from irrigation, power, road transport undertakings and public sector enterprises (at both levels) would appear to be realistic if they are understood — as they are meant to be — as reasonable targets to be achieved through greater fiscal discipline on the part of the Centre and the States. While defence estimates have been kept at the GDP percentages forecast by the Centre, the Chapter on 'National Security' contains a number of concrete suggestions to help evolve 'an integrated, cost-effective system of national security'. The Commission has specifically recommended that a High Power Committee should be set up 'to review the entire security scenario — internal and external — and determine the role, organisation, equipment and funding requirements of various agencies; (Let us hope that if and when such a High Power Committee is set up it will also be chaired by the Chairman of the TFC with his rich experience as a former Union Minister of Defence).

In two respects, however, the TFC's assumptions would appear to be prima facie unrealistic. One is that it has not provided for the additional expenditure requirements that will be entailed by the Fifth Pay Commission (now in session) for the Centre or pay revisions that are likely to follow suit in the States. The second is the assumption that aggregate subsidies at the Centre will be kept at their nominal 1994-95 levels and that food subsidies in the States will get completely phased out by 1999-2000.[6] Another point to be underlined is that the interest outgoes projected by the Commission will be realistic only if fiscal adjustment takes place up front in 1995-2000 for otherwise higher levels of borrowings in earlier years will escalate the overall interest estimates.

It is a matter for much disappointment that the TFC, while reviewing the Centre's forecasts, has not referred to the need for better enforcement in the collection of the shareable taxes. High levels of tax evasion in personal income taxes and in excise duties has seriously jeopardised the revenues that the States could expect to get from these two sources. The Tax Reform Committee, under the chairmanship of Dr.Raja Chelliah, had pointed out that not more than 30 to 35 per cent of legally taxable incomes in India are being disclosed for personal income taxation. It has estimated that if a 60 per cent disclosure is enforced and the average effective tax rate is improved from the current 16 per cent to 20 per cent, the yield from income tax would go up to 2.5 times its present level.[7] Similarly, there is clearly much scope for improving excise yields through tackling tax evasion. Given this background, the Commission's silence on the importance of curbing evasion in improving receipts at both levels and the Centre's responsibility in the matter is indeed a serious lapse.

The NFC itself has not been unaware that its forecasts may amount to 'whistling in the dark' to a greater or lesser degree. Vide the following observation:

> 'Our projections of revenue and expenditure for the period 1995-96 to 1999-2000 set out the direction in which policies to restore fiscal balances have to move and provide a picture of what should happen in the five year period if these are undertaken...If in actual practice the picture turns out to be worse than what is being projected, even our conservative assessment of what can realistically be done would have been proved wrong. It is a perpetual battle between hope and experience'.[8]

While sharing the Commission's sentiment that in the perpetual battle hope will triumph over experience, it is necessary to point out that it is experience that has consistently belied the projections of Finance Commissions in the past. Table 8 shows the track record of the Seventh, Eighth and Ninth Commissions. Tables 9 (Centre) and 10 (States) compare in one view the Ninth Commission's projections for 1990-95 and the TFC's estimates for 1995-2000. They show (a) how awry the Ninth Commission's estimates have gone and (b) how a very significant improvement needs to take place if the Tenth Commission's expectations are to be realised. The discrepancy between actuals and projections has in effect resulted in lower plan outlays and/or a much larger proportion of plan outlays getting financed through borrowings at both levels and deficit financing at the Centre. Within non-plan outlays, it has resulted in the crowding out of maintenance and non-salary expenditures given growing liabilities on salaries.

TABLE 8

Projections vis-a-vis Actuals : Seventh, Eighth and Ninth Commissions

Commissions	Projections	Actuals
1. Seventh Commission: Non plan revenue gap for 15 major States	– 5365	– 12829
2. Eighth Commission: Non plan revenue gap for 15 major States	– 10421	– 42299
3. Ninth Commission, 1989-90: Non plan revenue gap for 15 major States	– 5568	– 13080
4. Ninth Commission, 1990-95; Non plan revenue gap for all States1/	– 55866	– 124376
5. Ninth Commission, 1990-95; Revenue surplus or deficit for all States in entire revenue account1/	+ 19871	– 30078

1/ : RE for 1993-94 and BE for 1994-95

Source : Reports of Finance Commissions and RBI Surveys of State Finances (annual issues)

TABLE 9

Centre : Actuals and Projections 1990-95 and Projections 1995-2000

(Rs. Crores)

Item	1990-95 Actuals[1]	Ninth Commission Projection 1990-95	Tenth Commission Projection 1990-2000
1. Pre devolution non plan revenue surplus	90201	149271	268400
2. Tax shares to States	99339	87882	206343
3. Finance Commission grants	10076	18180	20300
4. Revenue surplus after statutory transfers (1-2-3)	– 19214	43209	41757
Memo			
5. Surplus in entire revenue account	– 120426	– 30638	NA

1/ : RE for 1994-95

Source : Reports of Ninth and Tenth Commissions and Central Budget documents.

TABLE 10

States : Actuals and Projections 1990-95 and Projections 1995-2000

(Rs. Crores)

Item	1990-95 Actuals[1]	Ninth Commission Projection 1990-95	Tenth Commission Projection 1990-2000
1. Pre devolution non plan revenue surplus	– 124376	– 55866	– 122325
2. Tax shares to States	98621	87882	206343
3. Finance Commission grants	10237	9154	20300
4. Revenue surplus after statutory transfers (1-2-3)	– 15518	+ 41170	+ 104318

1/ : RE for 1993-94 and BE for 1994-95

Source : Reports of Ninth and Tenth Commissions and RBI Surveys of State Finances (annual issues)

DEVOLUTION OF SHAREABLE TAXES

We can now turn to the nub of the Report which relates to the vertical sharing between the Centre and the States (as a whole) of income tax and basic duties of Union excise and the horizontal distribution of such tax sharing inter-se among the States.

VERTICAL SHARES

Table 11 compares vertical shares recommended by previous Commissions with that recommended by the TFC. During the Eighth and Ninth Commissions, the income tax share for the States was 85 per cent and the excise share was 45 per cent. Of the latter, the Eighth Commission earmarked 5 per cent for the deficit States while the Ninth Commission increased the earmarking to 7.425 per cent. The TFC has reduced the income tax share to 77.5 per cent and has offset the reduction by increasing the excise share to 47.5 per cent. In the net, taking the two taxes together, there is no increase in the States' share. Of the excise share, 7.5 per cent has been earmarked for deficit States.

TABLE 11

Shares to States in the Shareable Taxes

(Rs. Crores)

Finance Commission		Income Tax	Basic Excise Duties
First	(1952-57)	55	40[1]
Second	(1957-62)	60	25[2]
Third	(1962-66)	66.67	20[3]
Fourth	(1966-69)	75	20[4]
Fifth	(1969-74)	75	20[4]
Sixth	(1974-79)	80	20[4]
Seventh	(1979-84)	85	40[4]
Eighth	(1984-89)	85	45[4.5]
Ninth I	(1989-90)	85	45[4.5]
Ninth II	(1990-95)	85	45[4.6]
Tenth	(1995-2000)	77.5	47.5[7]

1. Restricted to excise duties on tobacco, matches and vegetables products.
2. Restricted to excise duties on tobacco, matches, vegetable products, sugar, coffee, tea, paper and vegetable non-essential oils.
3. All commodities yielding Rs.50 lakhs of excise revenue per year except motor spirits.
4. All excisable commodities.
5. 5 per cent earmarked for deficit States
6. 7.425 per cent (16.5 per cent of 45) earmarked for deficit States.
7. 7.5 per cent earmarked for deficit Startes

Source : Reports of Finance Commissions.

The Commission has based its recommendation to reduce the income tax share from 85 to 77.5 per cent with a countervailing 2.5 per cent point increase in the excise share (i.e. from 45 in the Ninth Commission to 47.5) on the consideration that the Centre, being the authority which levies and administers the income tax, 'should have a significant and tangible interest in its yield.' The implication that the Centre has lost Interest in the levy and/or collection of income taxes because such a high proportion of it has to be shared with the States is a sad comment on Centre-State cooperation. Nevertheless, a lesser share to the States could be hoped to be a damper on continual concessions in income tax — as evidenced in the Central budgets of 1993-94, 1994-95 and 1995-96 — and an inducement for stricter enforcement in its collection. In the final analysis, however, income tax yields will improve only when the Centre comes to believe that virtue has to be its own reward.

The States have every reason to be disappointed that the entitlement available to all States (i.e. leaving out the reservation for deficit States) has actually declined with reference to the Seventh Commission's award for as far back as 1979-84. Compared to 85 per cent In income tax and 40 per cent in excise in the Seventh and Eighth Commissions, the percentages became 85 and 37.575 respectively in the Ninth. The TFC has, in net effect, maintained them at levels equivalent to 85 and 37.5. The stagnancy in vertical sharing clearly disregards the growth in the needs of the States over two decades. Although, in the current all-India fiscal scenario, the TFC might not have been able to significantly improve vertical sharing it could have at the very least maintained the shares available to all States during the Seventh and Eighth Commissions. Allowing for the reduction in the income tax share and the earmarking proposed for deficit States, that would have meant 77.5 per cent in income tax and 50 per cent in excise.

The earmarking of a portion of the excise share for post-devolution deficit States is a 'bad practice' begun by the Eighth Commission and continued by the Ninth. It gives a misleading impression of the universal entitlement for all States in excise shares and conceptually confuses the roles of Articles 270 and 272 of the Constitution with that of Article 275. It is unfortunate that the TFC should have persisted with these affronts to transparency and logic.

Two other issues need comment before taking leave of the aspect of vertical sharing. One Is the question of non-shareable surcharges on income tax (Article 271) which have been levied by the Centre for long years although they are meant to meet limited emergencies. The surcharge was levied, in one form or another, continuously for 34 years upto 1984-85. It was reimposed in 1987-88 and removed only in 1994-95. The Seventh Commission observed that 'a surcharge continued indefinitely could well be called an additional Income tax shareable with the rest of the proceeds of the income tax'.[9] The Eighth Commission went further in suggesting that 'with the commencement of the financial year 1985-86, the surcharge be withdrawn and the basic rates of income tax suitably adjusted.'[10] The Sarkaria Commission on Centre-State Relations was 'firmly of the view that the surcharge on income tax should not be levied by the Union Government except for a specified purpose and for a strictly limited period only.'[11] The TFC has also emphasized that' the surcharge on income tax should not be levied except to meet emergent requirements for limited periods'.[12] The Commission could have provided some teeth to this exhortation if It had recommended that the imposition and extension of surcharges should have the approval of the National Development Council or the Inter-State Council if fiscal federalism is to be meaningful. Another Issue on which the States have expressed concern relates to receipts from pre-emptive purchases of immovable properties under the Income Tax Act. Their contention has been that such receipts are in the nature of capital gains and should, accordingly, form part of the shareable income tax pool. Here, the TFC has been content with agreeing with the narrow legalistic stand of the Union Ministry of Finance that these proceeds do not form part of shareable income tax. The point is that in a substantive sense they should qualify for sharing and if, legally, they do not, due amends need to be made by providing grants equivalent to such proceeds.

HORIZONTAL SHARES

Table 12 (for income tax) and 13 (for basic excise duties) compare the criteria for horizontal sharing in the TFC's report with those recommended by its predecessors. The TFC has :

'(i) Adopted the same criteria for income tax and excise. In the process, it has eliminated collections as a factor in income tax sharing.

(ii) The common criterion is based on 20 per cent for population, 60 per cent based on the adjusted distance criterion based on per capita incomes of States,[13] 10 per cent related to tax effort and 5 per cent each for considerations relating to area and infrastructure designed to help States with dispersed populations and poor infrastructure.

In the evolution of Finance Commission awards, the TFC has taken a significant step forward in terms of logic, simplicity and equity in adopting identical criteria for the two shareable taxes. It is worth recalling that the case for sharing the two taxes on the same principle and for eliminating the contribution criterion in income tax sharing was persuasively argued by Prof.Raj Krishna as far back as 1978 in his dissenting note to the Report of the Seventh Commission. Prof.Raj Krishna pointed out: 'From the economic point of view the States are interested in more "vertical justice" in the form of greater devolution from the Centre. And they should be interested in greater 'horizontal justice" In the inter-state allocation of the total transfer. Whether the total transfer comes out of income tax revenue or out of excise revenue is a matter of secondary importance. The important need is only that the total transfer out of both kinds of revenue is adequate and the inter-State distribution of the whole transfer is progressive'. On the contribution criterion in income tax he pointed out that 'any weight given to collection is regressive because a larger collection is invariably associated with a higher level of the State Domestic Product' and that 'it would be pointless to give incentives for Income-tax collections to an agency (the State Government) which has little control over the processes which generate these collections'.[14] While two cheers are due to the TFC for implementing this enlightened rationale, it would have deserved a third if it had shown a decent respect for history by referring to, and acknowledging, the seminal contribution of Prof.Raj Krishna to the debate on this issue.

We can now turn to the components of the Commission's criterion. Justice P.V.Rajamannar, the distinguished Chairman of the Fourth Commission, described the tendency of successive Finance Commissions to choose varying criteria for horizontal distribution as 'a gamble on the personal views of five persons, or a majority of them'.[15] Tables 12 and 13 will show that while the gamble has continued there has also been a discernible convergence over time. If the weights for contribution in income tax and the earmarking for deficit States in excise are left out of consideration, the same criteria have been followed in the Eighth and Ninth Commissions in respect of both shareable taxes. Within them, preponderant emphasis has been given to the distance and inverse criteria both of which are related to per capita incomes in the States. Between these two, the distance criterion has been given more importance. From the Eighth Commission onwards, the weightage for population has also been drastically reduced in both taxes.

The TFC has conformed to this general trend. In the matter of the per capita income related weights, it has preferred the distance criterion to the inverse income formula since the former results in a better graduated and more equitable distribution. How it does that is explained in an interesting technical Appendix (No.4) to the Report. While population (20 per cent) and the distance criterion (60 per cent) together account for 80 per cent in horizontal sharing, three more criteria have been added as tail-pieces to fill up the balance of 20 per cent. These are the criteria related to tax effort (10 per cent), area (5 per cent) and infrastructure (5 per cent). The first of these amounts to a reward for tax effort in the past rather than an incentive for future performance since States have no assurance that successor Commissions will continue with this criterion and the reservation is not significant enough

TABLE 12

Criteria for Sharing of Income Tax

Finance Commissions		Contribution	Population	P.C. income distance criterion	P.C. income inverse criterion	Specific indicators of backwardness	Poverty criterion	Tax effort
First	(1952-57)	20	80					
Second	(1957-62)	10	90					
Third	(1962-66)	20	80					
Fourth	(1966-69)	20	80					
Fifth	(1969-74)	10	90					
Sixth	(1974-79)	10	90					
Seventh	(1979-84)	10	90					
Eighth	(1984-89)	10	22.5	45	22.5			
Ninth I	(1989-90)	10	22.5	45	11.25		11.25	
Ninth II	(1990-95)	10	22.5	45	11.25	11.25		
Tenth	(1995-2000)	–	20	60	–	10	–	10

Source : Reports of Finance Commissions.

TABLE 13

Criteria for sharing Basic Excise Duties

Finance Commissions		Population	P.C. income distance criterion	P.C. income inverse criterion	Revenue equalisation criterion	Specific indicators of backwardness	Poverty criterion	Tax effort	In proportion to post devolution deficits
First	(1952-57)	100							
Second	(1957-62)	90				10			
Third	(1962-66)[1]								
Fourth	(1966-69)	80				20			
Fifth	(1969-74)	80				20			
Sixth	(1974-79)	75	25						
Seventh	(1979-84)	25	25		25[2]		25		
Eighth	(1984-89)	22.22	44.44	22.22					11.11
Ninth I	(1989-90)	22.22	44.44	11.11			11.11		11.11
Ninth II	(1990-95)	25	33.5	12.5		12.5			16.5
Tenth	(1995-2000)	16.84	50.53	–	–	8.42		8.42	15.79

1. Exact proportion not specified but population used as 'major' factor.
2. In effect the revenue equalisation formula was the per capita income distance criterion.

Source : Reports of Finance Commissions.

for enthusing them: the carrot is simply too small and uncertain to be of much interest to the donkey. The area and infrastructure criteria amount to specific indicators of backwardness. The relevant Appendix to the Report (No.5) does not give any clear or precise information on how the infrastructure index has been computed. The inclusion of criteria based on specific indicators of backwardness by the TFC is a retrogression to a practice that was abandoned by the Sixth and Seventh Commissions on good and sufficient grounds. The Sixth Commission pointed out that (a) because of a high degree of correlation among them, the use of specific indicators compounds the effect (b) the use of indicators related to backwardness will prejudice States which, despite a poor resource base, have achieved relatively high levels of attainment in certain sectors and (c) the aggregation of weights given to individual indicators of backwardness was 'an intractable issue'.[16] Their reasoning was fully endorsed by the Seventh Commission.[17] The Eighth Commission also did not adopt any specific indicators of backwardness in its allocation criteria. Given this background, it would have been better if the TFC had resisted the temptation to be original and inventive in adding on these three incompatible sauces to an otherwise satisfying main dish based on population and income.

In horizontal sharing progressivity is a central consideration, i.e. relatively higher shares to States with relatively lower per capita incomes vis-a-vis corresponding shares in population. Table 14 compares progressivity under the TFC's scheme for horizontal sharing under the two shareable taxes with that under earlier Commissions. For convenience, the States have been grouped under broad income categories. Horizontal sharing became progressive only from the Seventh Commission onwards because of a large increase in excise shares which were subject to stronger redistributive criteria in comparison to income taxes. Table 14 will show that compared to its predecessors the Eighth Commission redistributed away from the high income States to the low income States leaving the share of the middle income States about the same. The Ninth Commission's formula was slightly less progressive than that of the Eighth. Progressivity in the Tenth is better than in the Ninth. Compared to the previous Commission's, special category States have been distinctly benefited in the TFC.

The trends brought out in Table 14 also indicate that given stagnant vertical shares horizontal progressivity fluctuates within a narrow band. This is to be expected since, without periodical increases to vertical shares, the scope for redistributive transfers among States in different income groups is bound to get constrained in a context of competitive federalism.

TABLE 14

Horizontal sharing in Sixth to Tenth Commissions

(Per cent)

Income categories[1]	1971 Population Shares			Weighted shares in IT & Basic excise, excluding earmarked shares for deficit States				
	Sixth Commission	Seventh & Eighth Commission	Ninth & Tenth Commission	Sixth Commission	Seventh Commission	Eighth Commission	Ninth Commission	Tenth Commission
1. High Income[2]	18.604	18.596	18.542	18.52	15.600	13.109	13.816	12.871
2. Middle Income[3]	33.192	33.179	33.082	33.19	32.623	32.248	32.751	31.787
3. Low Income[4]	43.242	43.225	43.098	43.40	46.824	49.455	48.335	49.008
4. Special Category[5]	4.962	5.000	5.278	4.89	4.953	5.188	5.098	6.334
	100.000	100.000	100.000	100.000	100.000	100.000	100.000	100.000

1. Follows the classification in the First Report of the Ninth Finance Commission (1988)
2. Gujarat, Haryana, Maharashtra, Punjab.
3. Andhra Pradesh, Karnataka, Kerala, Tamil Nadu, West Bengal
4. Bihar, Madhya Pradesh, Orissa, Rajasthan, Uttar Pradesh.
5. Assam, Himachal Pradesh, J&K, Manipur, Meghalaya, Nagaland, Tripura in Sixth, Sikkim in addition in Seventh and Eighth and Arunachal Pradesh, Goa and Mizoram in addition in the Ninth and Tenth Commissions.

Source : Reports of Finance Commissions.

It is also interesting to separately examine the progressivity in each of the components in the TFC's formula for horizontal sharing. Table 15 gives the decomposition. With reference to bench mark population shares, the distance criterion favours low income States vis-a-vis the high income ones without hurting the middle income States too much. The tax effort criterion helps the middle income States the most. The area criterion helps the special category States the most while the low income States are the particular beneficiaries under the infrastructure criterion. Thus the dominant influence on progressivity of the distance criterion has been tempered by the weight for population and modified in different directions by the other three components. One wonders whether all this fine tuning is really worthwhile: the 'memo' column in Table 15 will show that the TFC could have arrived at more or less the same final result if it had opted for a simple and robust cocktail of 40 per cent for population and 60 per cent for the distance criterion.

TABLE 15

Tenth Commission : Decomposition of individual criteria for horizontal sharing

Income Category[1/]	Population	Distance Criterion	Tax effort Criterion	Area Criterion	Infrast-ructure Criterion	All	**Memo** 40 per cent population & 60 per cent distance
High Income	18.542	9.985	15.900	17.300	14.320	12.871	13.409
Middle Income	33.082	31.538	38.920	20.080	27.020	31.787	32.157
Low Income	43.098	52.972	41.910	36.460	51.840	49.008	49.021
Special Category	5.278	5.505	3.270	26.160	6.820	6.334	5.413
	100.000	100.000	100.000	100.000	100.000	100.000	100.000

1 : As in Table 14

Source : Computed from the Report of the Tenth Finance Commission.

GAP FILLING

To the extent that the devolution of shareable taxes leaves revenue deficits in the non-plan accounts of certain States, the TFC has recommended grants under Art.275 to fill the residual gap. Tables 16 and 17 will be of interest in this connection. Table 16 shows the relative financial status of the major States over the time span of four Finance Commissions. Gujarat, Haryana, Karnataka and Maharashtra have consistently maintained their position as pre-devolution surplus States while Punjab has slipped from this category in the Ninth and Tenth Commissions. At the other end of the spectrum, as might be expected in a scenario of stagnant tax shares, more and more States have regressed into the post-devolution deficit category. They include the low income States of Orissa and Rajasthan in the earlier Commissions and Uttar Pradesh and Bihar in the later ones. Two middle income States, W.Bengal in the Eighth Commission and Andhra Pradesh in the Tenth Commission, have also had this dubious distinction. Apparently, the case of Andhra Pradesh is to be explained by the combination of partial prohibition and large food subsidies. Table 17 shows the break up between tax sharing and deficit financing (via earmarked tax shares and Art 275 grants) under the different Commissions. Compared to the Seventh, tax shares have played a lesser role vis-a-vis deficit financing in the Eighth and especially in the Ninth Commissions. The pattern in the TFC restores the practice in the Eighth.

TABLE 16

Financial Status of Major States: Seventh to Tenth Commissions

Category	Seventh Commission (1979-84)	Eighth Commission (1984-89)	Ninth Commission (1990-95)	Tenth Commission (1995-2000)
1. Pre-devolution surplus States	1. Gujarat 2. Haryana 3. Karnataka 4. Maharashtra 5. Punjab	1. Gujarat 2. Haryana 3. Karnataka 4. Maharashtra 5. Punjab 6. Tamilnadu	1. Gujarat 2. Haryana 3. Karnataka 4. Maharashtra	1. Gujarat 2. Haryana 3. Karnataka 4. Maharashtra
2. Post-devolution deficit States	1. Orissa	1. Rajasthan 2. West Bengal	1. Orissa 2. Rajasthan 3. Uttar Pradesh	1. Andhra Pradesh 2. Bihar 3. Orissa 4. Rajasthan 5. Uttar Pradesh

Source : Reports of Finance Commissions.

TABLE 17

Tax Shares and Deficit financing : Seventh to Tenth Commissions

Source	Seventh Commission (1979-84)	Eighth Commission (1984-89)	Ninth Commission (1990-95)	Tenth Commission (1995-2000)
Tax shares	16139 (93.2)	28977 (85.9)	67238 (81.6)	165242 (86.0)
Deficit financing	**1173** (6.8)	**4764** (14.1)	**15168** (18.4)	**26798** (14.0)
(i) Via tax shares	–	2564 (7.6)	9152 (11.1)	19215 (10.0)
(ii) Through Art. 275 grants	1173 (6.8)	2200 (6.5)	6016 (7.3)	7583 (4.0)
Total	17312 (100.0)	33741 (100.0)	82406 (100.0)	192040 (100.0)

Note : Figures in brackets are percentages to column totals

Source : Reports of Finance Commissions.

There is no reason why deficit States should not be called upon to cover an appropriate part of their deficits through resource mobilisation and expenditure reduction. However, the TFC has not departed from the gap filling approach of its predecessors. Despite being required under one of its terms of reference to take into account the potential for raising additional taxes in the States, the TFC has not attempted to specifically estimate this potential; instead it has been subsumed under the tax buoyancy estimates. The result is that a middle income State like Andhra Pradesh with a per capita income 60 per cent higher than and a per capita own tax revenue 3.4 times that of Bihar gets a per capita deficit grant of Rs.157.8 which is 2.7 times that of Bihar's entitlement of Rs.59.1.[18] In other words, the TFC has failed to sort out the fiscally imprudent (Andhra Pradesh) from the fiscally disadvantaged (Bihar) by filling alike the residual revenue account gaps for both of them. In the process, it has missed the opportunity to operationalise its own exhortations for greater fiscal discipline.

3. OTHER ISSUES

We now turn to the issues which are ancillary or supplementary to the TFC's main scheme for the transfer of resources.

Upgradation grants : One of the terms of reference for the TFC is that it should provide for 'the requirements of States for modernization of administration e.g. computerization of land records and providing faster channels of communication up to and above district level, and for upgrading the standards in non-developmental sectors and services'. The Commission has interpreted this mandate rather widely (wildly?) to propose upgradation grants (for States other than those with pre -devolution surpluses) not only for non-developmental sectors (such as police, fire services, jails, treasuries and record rooms) but also for developmental needs (such as primary schools, upper primary schools and girls' education). Furthermore, it has taken it upon itself to propose grants for so-called 'special problems'. It has assiduously looked for one 'special problem' or another in all the States (including those with pre-devolution surpluses) and has succeeded in finding a bewildering variety of them. 'Special problems' include flood control and irrigation, land improvement, drinking water supply, urban development, slum clearance, medical facilities, the development of backward areas, forests and fishermen, the building of airports, tourist facilities, sports stadia, secretariats and legislative assemblies, training, tax collection and even the conservation of plant genetic resources. Be that as it may, the totality of such grants for upgradation and special problems (Rs.2608.5 crores) accounts for only 1.15 per cent of the TFC's aggregate transfers. In its role as Santa Claus, the Commission has thus given away not 'largesse' but only *baksheesh* — which is to be expected from satisfied tourists to those who have taken good care of them.

Grants for local bodies : Although not required to do so under its specific terms of reference, the TFC has proposed Rs.5380.93 crores (2.4 per cent of overall transfers) as grants to local bodies. This is in the background of the amendment to Art.280 (3), as part of the 73rd and 74th amendments to the Constitution, which call upon Finance Commissions to recommend measures to supplement the resources of panchayats/municipalities in the States: Pending the recommendations of State Finance Commissions for local bodies, the provision for this purpose has had to be an ad hoc one. Nevertheless, the TFC is to be congratulated for going beyond its strict terms of reference in taking this initiative.

Calamity relief : Based on experience during 1983-93, the Commission has updated the Calamity Relief Fund to a total size of Rs.6304.27 crores in 1995-2000. Of this the Central contribution of 75 per cent (Rs.4728.19 crores) has been provided as grants to the States while the States' share (Rs.1576.08 crores) has been included in their expenditure estimates. In addition the Commission has proposed a National Calamity Relief Fund (NCRF) for dealing with calamities of 'rare severity' The size of the NCRF during 1995-2000 is Rs.700 crores to be built up on the basis of 75:25 contributions from the Centre and the States. As a token of national solidarity and inter-State cooperation, the NCRF represents an excellent initiative.

One feature of the Commission's scheme for the main Calamity Relief Fund (CRF) requires comment. This is that the unutilised balances in the fund will be available to the respective States at the end of the fifth year or thereafter. The CRF being in the nature of an insurance fund, it would have been logical to adjust future contributions in the light of past accumulations instead of returning the latter to the contributors. A part of such balances could also have been made available for the NCRF.

Distribution of additional excise duties : The devolution under this head is in the nature of a tax rental arrangement whereby the States are compensated for the sales taxes replaced by additional excise duties on sugar, tobacco, and fabrics (cotton, woolen and man-made). Chapter VI in the TFC's report provides a concise account of the problems faced in this arrangement and of the approaches of earlier Commissions to the sharing of the proceeds. In the absence of reliable State-wise consumption figures, the Eighth and Ninth Commissions had given equal weightage to population and state domestic product (SDP) in the sharing formula. The TFC has slightly modified it as 50:40:10 for population, SDP and State sales tax collections.

Grants in lieu of the repealed tax on railway passenger fares : The amount has been upgraded from Rs.150 crores in the Ninth Commission to Rs.380 crores for 1995-2000 related to the same basis viz., 10.7 per cent of the non-suburban railway passenger earnings.

Debt relief : The nature, growth, magnitudes and ramifications of the State's debt position is a large and complex subject. It is not possible, given the scope of this paper, to contextualize the TFC's recommendations on this topic within that overall framework. As the Commission itself has admitted, the debt relief it has sought to provide is limited and is largely confined to States under 'high fiscal stress' for one reason or another. These include (a) all special category States (b) Orissa, Bihar and Uttar Pradesh being the States in which the average rates of interest payments to revenue expenditures exceeded 17 per cent during 1989-90 to 1993-94 and (c) Punjab in respect of one-third of principal repayments due during 1995-2000 on special term loans for fighting militancy. These specific reliefs add up to Rs.701.14 crores compared to debt relief of Rs.975.62 crores provided by the Ninth and Rs.2285 provided by the Eighth Commissions. The quantum of debt relief is no more than about 6 per cent of aggregate repayments due on Central loans from the States during 1995-2000 and 15.5 per cent of repayments due from the States to which relief has been extended.

The stringency of the TFC in the matter of debt relief has been supplemented by a touch of sophistication. The Commission has evolved a scheme for linking debt relief to improvements in the ratio of revenue receipts to revenue expenditures in the States and another which links debt relief to debts retired through the disinvestment of equity in State Public Enterprises. These are interesting innovations whose actual impact time alone can tell. Meanwhile, the new schemes amount to an invocation to the virtues of self-help on the part of the States. After all, even God helps only those who help themselves!

4. THE ALTERNATIVE SCHEME FOR DEVOLUTION

Conceptually, the most interesting part of the Report is its Chapter XIII entitled 'Devolution: An Alternative Scheme'. The essence of the alternative is that the base for the devolution of taxes from the Centre to the States need not be confined, as at present, to income taxes and excise duties but could include the gross proceeds from all taxes that are, or may be, levied and/or collected by the Centre. The rationale rests on several strong grounds:

(i) If burden - sharing is spread across all its taxes the Centre will not have to part with too high a proportion in a limited number of shareable taxes. This, particularly in income taxes, is proving to be a disincentive. A smaller ratio of sharing on the entire tax base can be expected to provide greater incentives to the Centre in the levy and/or collection of all its taxes.

(ii) The States will benefit from buoyancy across-the-board instead of only in the shareable ones.

(iii) The level of devolution can be more assured and predictable.

(iv) The States themselves have been pressing for the inclusion of the Corporation tax in the divisible pool.

(v) The Centre will have an incentive to exploit the potential for additional taxes under Articles 268 and 269 if these too are included in the base.

The Commission has also drawn support for its proposal from two sources. The first is a recommendation in the Interim Report of the Tax Reforms Committee (1991) that 'with the consent and cooperation of the States the relevant Constitutional provisions could be amended to the effect that 25 per cent of the aggregate tax revenues shall be shared with the States' considering that at present tax devolution constitutes around 24 per cent of the Centre's total gross revenues.[19] The other is 'a suggestion' made to the TFC by the Union Ministry of Finance that the Commission may wish to examine the desirability of tax sharing from the entire tax revenues of the Centre (except Union surcharges) with the proviso that the percentage of such sharing 'may be pitched at 22 to 23 per cent and should remain fixed for 20 years.' The Commission's 'Alternative Scheme' would thus seem to a trial balloon the floating of which has had the informal encouragement of the Union Ministry of Finance.

The Commission's specific proposal is that 29 per cent of aggregate Central tax revenues should be made shareable with the States in terms of a Constitutional amendment and that this proportion should be reviewed once in 15 years. The figure of 29 per cent has been arrived at as follows: (a) Shares in income taxes, basic excise duties and the grant in lieu of the tax on railway passengers fares have together amounted to about 24 per cent of aggregate Central tax receipts during 1979-1995 (b) including the potential from taxes envisaged in Articles 268 and 269, it will be reasonable to mark up this proportion to 26 per cent (c) additional excise duties have amounted to about 3 per cent of aggregate Central taxes during 1979-95. This can be added to the 26 per cent; the tax rental arrangement terminated; and additional excise duties merged with basic excise duties. The Commission has recommended that its 'Alternative Scheme' may be brought into force, after the necessary Constitutional amendments, with effect from 1996-97 leaving intact for the balance of its award period the inter-se shares to the States and the grants recommended by the TFC.

The Commission has not spelled out the exact Constitutional amendments which will be required to effectuate its proposals. It has also been silent on the role of future Finance Commissions.

Presumably, they will still be required to advise on horizontal sharing of the divisible pool, deficit grants, grants-in-aid for other purposes, grants for local bodies and other matters that may be referred to them 'in the interests of sound finance' (Articles 275 and 280). The Constitution, as it stands, assures the States that both vertical and horizontal sharing and supplemental grants-in-aid will be determined by a high level Constitutional authority once in five years. Five years are also the span of development plans with which such a determination will have to be coordinated. If this regimen is to continue, it is not clear why vertical sharing should be entrenched for 15 years as recommended by the TFC or for 20 years as desired by the Ministry of Finance or for all time as proposed by the Tax Reforms Committee. Any proposal for such an extended entrenchment is objectionable on three grounds: (a) it abrogates the Constitutional right of the States for quinquennial sharing (b) de-synchronizes vertical from horizontal sharing ignoring the fact that transfers to the States have to be a product of the two (c) severs the link between statutory transfers and the planning process. It is, therefore, unfortunate that the Commission should have flawed its 'Alternative Scheme' by proposing that vertical shares should be reviewed only every 15 years.

Having said this, it is useful to recognize that the Commission's 'Alternative Scheme' has made a significant contribution in indicating the direction in which Centre-State fiscal transfers can be restructured and in opening up a debate on this issue.

5. CONCLUSION : AN ALTERNATIVE TO THE ALTERNATIVE

As a contribution to progressing this debate, I shall conclude with outlining an alternative that is an improvement in several respects over the one proposed by the Commission. This is the following:

(1) the entire gross tax revenues of the Centre will constitute the divisible pool.

(2) Devolution will cover not only the tax shares, the railway grant and additional excise duties but will also be related to revenue gap and upgradation grants and Central grants which are part of its normal assistance for State plans. Proceeds from Art.268 and Art.269 taxes will also be part of the divisible pool.

(3) Table 18 shows that the transfers proposed in (2) above for devolution have amounted to about 41 per cent of the Centre's gross tax revenues during 1990-95 and to about 43 per cent in 1995-96. It will, accordingly, be reasonable to provide through a Constitutional amendment that:

   (i) *not less than* 40 per cent of the Centre's aggregate gross tax revenues will be shared with the States and

   (ii) that this ratio will be reviewed once in five years.

TABLE 18

Shares in Centre's tax revenues

(Rs Crores)

Year	Tax shares[1]	Art 275 grants	Grants for State plans	Total of (2) to (4)	Centre's gross tax revenues	Percentage of (5) to (6)
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1990-91	14535	2402	4258	21195	57576	36.8
1991-92	17197	2114	6121	25432	67361	37.8
1992-93	20522	2073	8464	31059	74637	41.6
1993-94	22242	1786	10099	34127	75744	45.0
1994-95 RE	24843	1701	11141	37685	89831	42.0
1990-95	**99339**	**10076**	**40083**	**149498**	**365419**	**40.9**
1995-96 BE	29388	5458	9477	44323	103762	42.7

1 : Including additional excise duties.

Source : Central Budget documents

(4) Consequentially :

(i) additional excise duties can be merged with basic duties terminating the tax rental arrangements.

(ii) There need be no separate plan grants for State plans

(iii) Grants for calamity relief and for local bodies will be separately determined in relation to needs assessed from time to time.

(iv) Grants for Central and Centrally sponsored schemes will also be separately provided.

(5) Horizontal sharing criteria will be reviewed once in five years along with (upward) modifications to the stipulated minimum vertical sharing proportion. The domain of vertical and horizontal sharing will cover the non-plan and (State) plan revenue accounts

(6) Horizontal sharing criteria will be broad-based on population, per capita incomes, the poverty ratio and other such factors. The criteria will be approved by the National Development Council. There will be no gap-filling grants or ad hoc grants for upgradation and special problems.

(7) Normal plan assistance to States can, thereafter, be confined to loans and to the capital account. This will enable and encourage the financing of investments in the power, irrigation, infrastructure and urban development sectors to be shifted to all-India development lending institutions. They will be in a better position to link financing to policy reforms in the States and in the entities operating in these sectors.

This version is more logical, comprehensive and equitable than the Commission's scheme. It provides for the States to be Constitutionally assured of a *minimum* share in the aggregate tax revenues of the Centre while retaining the possibility of this share being upgraded in the light of needs and circumstances prevailing in each plan quinquennium at both levels. Likewise, horizontal sharing will be flexible. It is also designed to (a) integrate plan and non-plan financing in the revenue account (b) distinguish between autonomous State plans and Central support for outlays in sectors of national importance (c) delink Central loan assistance for investments from grants for current outlays (d) enforce fiscal discipline by eliminating revenue gap grants and (e) effect horizontal sharing on the basis of transparent and robust redistributive criteria to be approved by the National Development Council

As part of such a restructuring, it will be logical to give the Planning Commission the Constitutional status and mandate to determine both vertical and horizontal sharing for each plan period. Unlike Finance Commissions, which are discrete occurrences, the Planning Commission is a standing body with a permanent secretariat and continuously conversant with finances at both levels through the five year and annual planning processes. Linked as it is to the National Development Council, the Planning Commission will be in a position to develop a long term federal consensus on the extent and pattern of transfers from the Centre to the States and between the States. If that happens, settled policy can replace the quinquennial 'gamble on the personal views of five members.' Provided with a Constitutional status—which is desirable for other reasons as well—the Planning Commission is likely to be no less 'independent' than Finance Commissions: the latter too are appointed by the Central government; guidelined by specific terms of reference; and submit reports which are only recommendations.

To conclude, in the sequence of Finance Commission Reports, the Tenth Commission's is among the outstanding ones. The Commission has had to carry out its remit in a particularly difficult fiscal situation. Its projections of resources and requirements may not, alas, turn out to be realistic. However, they set fair and reasonable goals. The Commission has been stingy in respect of vertical shares and debt relief but in the current fiscal context this is not unforgivable. The adoption of an identical formula, predominantly based on population and the distance criterion, is a reform that is sound and progressive in its economic logic. The grants to local bodies, the establishment of a National Fund for Calamity Relief, and the Chapter on defence expenditures are noteworthy initiatives. The 'Alternative Scheme' — although flawed and inadequate in its present form — may prove to be a historic contribution if it stimulates thought and action on a rational restructuring of federal fiscal transfers. If the restructuring is put through, on the lines argued in this paper, with effect from 1997-98, coinciding with the commencement of the Ninth Plan, the Tenth Commission will also have the distinction of being the last in the series. Should it be felt that the States will be deprived of fiscal advice from Finance Commissions in the future, remember that even the biblical Commandments did not exceed ten.

NOTES

1. Throughout this paper, 'award period' is used as a convenient colloquialism for the period to which the *recommendations* of Finance Commissions relate

2. Report of the Fourth Finance Commission, pp8-9.

3. S.Guhan, 'Flawed Devolution Scheme', Economic and Political Weekly, Bombay, June 9, 1990 pp1269-1274.

4. Report of the Eighth Finance Commission, pp122-123.

5. Report of the Tenth Finance Commission, p.64.

6. Ironically, food subsidies have been significantly increased in Andhra Pradesh and Tamilnadu within weeks prior to the release of the TFC's report. The post devolution non-plan revenue deficit in the Central Budget for 1995-96 is Rs.6211 crores compared to Rs.1768 crores projected by the Commission. (vide Annexure XI.1). The worsening is mainly because Rs.12401 crores has been provided for major subsidies as against Rs.8300 crores projected by the TFC.

7. Interim Report of the Tax Reforms Committee (1991) p.47.

8. Report of the Tenth Finance Commission p.7

9. Report of the Seventh Finance Commission p.82

10. Report of the Eighth Finance Commission p.41

11. Report of the Commission on Centre-State Relations p.275.

12. Report of the Tenth Finance Commission p.21.

13. The adjusted distance criterion gives weights in inverse proportion to the distance of the per capita income of the State, in the reference period, from that of the State with the highest per capita income. Adjustment is made for the highest income State by placing it on par with the second highest. The proportions are weighted by population. For details see paragraph 5.40 at p.23 of the Report of the Tenth Finance Commission.

14. Report of the Seventh Finance Commission pp.150-151.

15. Report of the Fourth Finance Commission pp.92-93.

16. Report of the Sixth Finance Commission p.16.

17. Report of the Seventh Finance Commission p.86.

18. In 1987-90, the per capita NSDP of Andhra Pradesh was Rs.3455 and that of Bihar was Rs.2135. In the same period, the per capita own tax revenue of Andhra Pradesh was Rs.333 and for Bihar it was Rs. 99. With a 1971 population of 43.5 million Andhra Pradesh gets a revenue deficit grant of Rs.686.45 crores while Bihar with a population of 56.35 million gets a deficit grant of Rs.333.08 crores. Vide Annexures V.1, V.3, V.4 and Table 2 at p.51 of the Report of the Tenth Finance Commission.

19. Interim Report of the Tax Reforms Committee (1991) p.45.