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# Centre-State Finances: A Primer

There has been rising interest among market participants over the finances of State governments in India. Financing pattern of State Governments in India is a highly complex arrangement. Apart from its own funds raised from taxes and non-tax resources, States get large share of funds from the Centre as well. Centre provides funds to States based on recommendations from both Finance Commission and Planning Commission. This paper is a primer on this resource transfer of funds from the Central Government to States.

## I. Asymmetric Political and Fiscal Federalism

It is important to begin with a historical perspective on India's political economy. The Constitution of India adopted a two-tier structure of Central and State governments to govern and provide public goods and services to citizens of the country. In a historic move, Constitution Amendment Acts (73rd and 74th in 1992) also allowed the third tier of the government – Rural and Urban local bodies. In this note, we will limit our discussion to fiscal relations between Centre and States only.

The Constitution prepared a list where subjects were divided between the Centre and States. Certain subjects where jurisdiction was difficult to define were kept in the concurrent list which required coordination from both Centre and State governments. Overall Centre has 97 subjects, State has 66 subjects and there are 47 subjects in concurrent list. The key subjects under each of the three lists are:

- Centre: Defence, Foreign Policy, Banking, Railways, Shipping/Ports, National Highways, Airways, etc.
- State: Police, Public Health, Agriculture, Water Supplies etc.
- Concurrent: Bankruptcy, Forests, Wildlife protection, Economic and Social Planning, Education, Electricity, Factories, Newspapers etc.

Another important point to note is that India adopted asymmetrical federalism where Centre was more powerful compared to States. This was required during time of Indian independence as States were not united and there were many princely states. Hence, a strong Centre was needed to unify the country. This was unlike other federal countries like US and Switzerland where States have much larger powers.

This asymmetric political federalism translates into asymmetric fiscal federalism as well. The Constitution gives larger taxation powers to Centre but States have to share higher expenditure where bulk of the public services lies with the Centre. Even as most policies are implemented at the Centre level, they require administration and implementation and administration at the State level. RBI's State Finances Report (2011-12) shows that while States' own revenues constitute 37% of total revenue receipts, their expenditures account for 55% of total government expenditure. Smt. Shyamala Gopinath, former Deputy Governor of RBI, in her speech (29-Jun-09) quoted a report from World Bank which showed Indian States' share in total government expenditure stands higher than in several other countries such as Australia, Denmark, Argentina, USA and Germany

Table 1 summarises the various taxes the two governments are allowed to collect as per the Constitution.

**Table 1: Select Centre and State Taxes**

| Centre Taxes | State Taxes |
|---|---|
| **Direct Taxes**<br>▪ Income Tax other than agricultural income<br>▪ Corporation tax | **Direct Taxes:**<br>▪ Taxes on agricultural income. |
| **Indirect Taxes**<br>▪ Customs Duties<br>▪ Excise Duties on tobacco and other goods except alcohol for human consumption and<br>▪ Service Tax (via constitutional 88th amendment Act, 2003)<br>▪ Taxes on the capital value of the assets<br>▪ Estate duty in respect of property other than agricultural land.<br>▪ Terminal taxes on goods or passengers, carried by railway, sea or air; taxes on railway fares and freights.<br>▪ Taxes on transactions in stock exchanges and futures markets. | **Indirect Taxes:**<br>▪ Duties in respect of succession to agricultural land.<br>▪ Estate duty in respect of agricultural land.<br>▪ Taxes on lands and buildings, mineral rights, vehicle/tolls.<br>▪ Duties of excise on alcohol for human consumption<br>▪ Taxes on the entry of goods into a local area for consumption<br>▪ Taxes on the consumption or sale of electricity.<br>▪ Taxes on goods and passengers carried by road or on inland waterways.<br>▪ Taxes on professions, trades, callings and employments.<br>▪ Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.<br>▪ Rates of stamp duty |

*Source: Constitution of India*

## II. Role of Finance Commission

In order to address this fiscal asymmetry, Constitution mandates formation of Finance Commission (FC) every five years. The Commission provides the basis for sharing Central taxes with States and also provides for certain Grants-in-Aid to States for special purposes. The Commission is appointed by the President and it has a Chairperson and four members. The Commission is appointed for which the devolution of taxes and grants is to be applied. The Commission reviews both the

Centre and State finances and places its recommendations before the Parliament. Broadly the role of Finance Commission is:

- Distribution of taxes between the Union and the States
- Distribution within states
- Distribution to Urban local Bodies and Rural Panchayats
- Principles which should govern the above distribution
- Any other matter referred to the Commission by the President in the interests of sound finance.

As far as any other matters are concerned, the Thirteenth FC was asked to provide a roadmap for fiscal consolidation. Fourteenth FC has been asked to look at pricing of public utility services like drinking water, irrigation, water, power, etc. and ways to make PSUs competitive and markets oriented.

We will now look at how Finance Commissions have over the years recommended share of taxes and provision of grants-in aid to States. We will focus mainly on recommendations of Thirteenth Finance Commission to keep the note contemporary and touch on other Finance Commissions only if required.

## III. Finance Commission - Share of Taxes

In Centre's share of taxes with States, there are two main issues on which Finance Commission gives recommendations – Vertical Transfer and Horizontal transfer.

1. **Vertical transfers:** This provides the basis for transfer of taxes between Centre and States. Table 2 shows how various Finance Commissions have recommended sharing of taxable resources with States. As we can see till Tenth FC, only income tax and basic excise duties were shared with States. Even within excise duties, the number of items/commodities covered has increased from 3 commodities in First FC to All commodities from Fourth FC period onwards.

**Table 2: Finance Commission Recommended Share of Major Divisible Taxes (in %)**

| Finance Commission | Income Tax (%) | Basic Excise Duties (%) | Number of Commodities Covered |
|---|---|---|---|
| First FC (1952-57) | 55 | 40 | 3 |
| Second FC (1957-62) | 60 | 25 | 8 |
| Third FC (1962-66) | 66.6 | 20 | 35 |
| Fourth FC (1966-69) | 75 | 20 | All |
| Fifth FC (1969-74) | 75 | 20 | All |
| Sixth FC (1974-79) | 80 | 20 | All |
| Seventh (1979-84) | 85 | 40 | All |

| | | | |
|---|---|---|---|
| Eighth FC (1984-89) | 85 | 45 | All |
| Ninth FC (1989-95) | 85 | 45 | All |
| Tenth FC (1995-2000) | 77.5 | 47.5 | All |
| All Central Taxes# | | | |
| Eleventh FC (2000-05) | 29.5 | | |
| Twelfth FC (2005-10) | 30.5 | | |
| Thirteenth FC (2010-15) | 32 | | |
| *# All Central taxes does not include cess and surcharges*<br>*Source: RBI* | | | |

From Eleventh FC onwards (2000-05), all the taxable resources (income tax, corporate tax, customs etc.) are shared except for cesses and surcharges levied by the Centre. As per the Constitution, the cesses and surcharges are levied for specific purposes and are not to be shares with States. However, Thirteenth FC reported that share of cesses and surcharges in total Centre's taxes have increased considerably from 3.5% in 2001-02 to 13.6% in 2009-10. States had requested Thirteenth FC to include cesses and surcharges in the divisible pool. However, this would require Constitutional amendment. Hence, the Thirteenth FC recommended that the Centre reduce share of cess and surcharges in the gross tax revenues.

Another issue is sharing of non-tax resources of the Centre with States. Thirteenth FC noted that Non-tax revenues as a percentage of GDP have declined from 2.79% in 2003-04 to 1.81% in 2008-09. However, this share was expected to rise on account of auction of 3-G spectrum, offshore oil and gas reserves etc. However, for sharing non-tax revenues of the Centre will also require a Constitutional amendment.

2. **Horizontal transfers:** This provides the basis for sharing the taxable resources amidst different states. Once, Finance Commission determines the vertical transfer from Centre to States it also need s to arrive at Horizontal transfer which is distribution of States' share within different States. Finance Commissions have looked at different sharing formulas over the years. The Thirteenth FC for instance looks at four criterions for horizontal transfers between States (Table 3).

**Table 3: Horizontal Transfers (in %)**

| **Criteria** | **12th FC** | **13th FC** |
|---|---|---|
| Population in 1971 | 25 | 25 |
| Area | 10 | 10 |
| Income Distance | 50 | 47.5 |
| Fiscal Discipline | 7.5 | 17.5 |
| Tax effort | 7.5 | -- |

*Source: Finance Commission Reports*

- **Population:** The larger population States should get higher share of the tax resource pool. Since the 1971 Census, FCs follow population estimates from the 1971 Census. In the discussions with Thirteenth FC, some states favored using the population figures of 2001 and few States urged the Commission to use 1971 population figures, as mandated in its Terms of Reference. The weights assigned to this criterion varied from 10% to 70%. A few states suggested that suitable weightage be assigned to the SC/ST population which others suggested that population below the poverty line as a criterion.

  In its report, Thirteenth FC continued to use Population as an indicator and used 1971 Census as given in its Terms of Reference. The report said: "Population is an indicator of the expenditure needs of a state. It is a simple, objective and transparent indicator that ensures predictability. The criterion ensures equal per capita transfers to all states, not taking into account cost disabilities across states because of differences in the geographic spread of population."

- **Area:** As per Thirteenth FC report, Area as a criterion in the devolution formula was first introduced by Tenth FC on the grounds that a state with larger area has to incur additional administrative costs to deliver a comparable standard of service to its citizens. The differences in the costs of providing services may increase with the size of a state, but only at a decreasing rate and that, beyond a point incremental costs may become negligible. The Tenth FC further pointed out that states with small areas have to incur certain minimum costs in establishing the framework of government. Taking into account these considerations, the Tenth FC used an adjustment procedure whereby no state received a share higher than 10% at the upper end or less than 2% at the lower end.

  13 FC assigned a weight of 10% to the area criterion. States with less than 2% share in total area were assigned a minimum share of 2%. These States are Goa, Haryana, Himachal Pradesh, Kerala, Manipur, Meghalaya, Mizoram, Nagaland, Punjab, Sikkim, Tripura and Uttarakhand. There was no upper limit on the shares of other states. .

- **Income distance:** Area and Population alone may not help in addressing horizontal imbalances as taxation capacities of States differ highly. Income Distance criterion works as a proxy for the distance between states in tax capacity.

  Before we discuss this criterion further, it is important to distinguish Special Category States from Non-Special category States. In 1969, States were divided into these two categories - Special and Non-Special. Special category States were those which had distinct problems of hilly terrain and turbulent international borders and poor infrastructure as a result. Initially three states were given the

Special status - Assam, Nagaland, and Jammu and Kashmir. This list has since then expanded to eleven states. Eleven Special states include all the seven states of North-east region along with Jammu & Kashmir, Himachal Pradesh, Sikkim and Uttarakhand.

Hence, while calculating income distance Twelfth FC used a single average for both Special and Non-Special States. Thirteenth FC recommended using different average for the two categories of States. In this measure, we first estimate the per capita GSDP of each State and use it to estimate tax to GSDP ratios. Then we estimate the average tax-GSDP ratio for the two groups of States (Special and Non-Special). The group averages are then used to compare with States in the respective groups to estimate the fiscal capacity distance between States.

- **Fiscal discipline:** Fiscal discipline as a criterion for tax devolution was used by Eleventh FC and Twelfth FC to provide an incentive to States managing their finances prudently. Both these Commissions assigned a weight of 7.5 per cent to this criterion. The index of fiscal discipline was arrived at by relating improvement in the ratio of own revenue receipts of a state to its total revenue expenditure to average ratio across all the states. The Twelfth FC used tax-effort as a separate criterion which was dropped by Thirteenth FC as fiscal discipline criteria includes the Tax effort shown by States.

The four criteria in turn help arrive at state-wise sharing of Centre's taxes with States (Table 4). Table 4 shows the horizontal transfer across the Special and Non-Special Category States. It also compares the devolution given by Twelfth FC amidst States. As Service tax is not levied in the state of Jammu & Kashmir, its share as specified in Goods Tax (1.55%) was distributed amidst the remaining 27 states under the same proportion. Hence, States' share of Service Taxes is slightly higher compared to Taxes on Goods.

States like Gujarat, Andhra Pradesh, Tamil Nadu etc get smaller share in Thirteenth FC compared to Twelfth FC. States that have gained share in Thirteenth FC are the Special category states like Mizoram, Nagaland etc. Non-Special states that have gained share are Punjab, Maharashtra, Rajasthan etc. As per Thirteenth FC, Share of Uttar Pradesh remains the largest at 19.71% with share if Sikkim lowest at 0.24%

| Table 4: Horizontal Transfer as per 12 FC & 13FC (in %) | | | | | |
|---|---|---|---|---|---|
| | Thirteenth FC | | | Twelfth FC | Difference All Taxes share between 13 FC and 12 FC |
| | Share of all taxes except Service Tax | Share of Service Tax | All Taxes | All Taxes | |
| **Special Category States** | **9.60** | **8.17** | **9.44** | **8.09** | **1.36** |
| 1. Arunachal Pradesh | 0.33 | 0.33 | 0.33 | 0.29 | 0.04 |
| 2, Assam | 3.63 | 3.69 | 3.63 | 3.24 | 0.39 |
| 3. Himachal Pradesh | 0.78 | 0.79 | 0.78 | 0.52 | 0.26 |
| 4. Jammu & Kashmir | 1.55 | 0.00 | 1.39 | 1.21 | 0.18 |
| 5. Manipur | 0.45 | 0.46 | 0.45 | 0.36 | 0.09 |
| 6. Meghalaya | 0.41 | 0.42 | 0.41 | 0.37 | 0.04 |
| 7. Mizoram | 0.27 | 0.27 | 0.27 | 0.24 | 0.03 |
| 8. Nagaland | 0.31 | 0.32 | 0.31 | 0.26 | 0.05 |
| 9. Sikkim | 0.24 | 0.24 | 0.24 | 0.23 | 0.01 |
| 10. Tripura | 0.51 | 0.52 | 0.51 | 0.43 | 0.08 |
| 11. Uttarakhand | 1.12 | 1.14 | 1.12 | 0.94 | 0.18 |
| | | | | | |
| **Non-Special Category States** | **90.40** | **91.83** | **90.57** | **91.91** | **-1.35** |
| 1. Andhra Pradesh | 6.94 | 7.05 | 6.95 | 7.36 | -0.41 |
| 2. Bihar | 10.92 | 11.09 | 10.93 | 11.04 | -0.11 |
| 3. Chhattisgarh | 2.47 | 2.51 | 2.47 | 2.66 | -0.19 |
| 4. Goa | 0.27 | 0.27 | 0.27 | 0.26 | 0.01 |
| 5. Gujarat | 3.04 | 3.09 | 3.05 | 3.57 | -0.52 |
| 6. Haryana | 1.05 | 1.06 | 1.05 | 1.08 | -0.03 |
| 7. Jharkhand | 2.80 | 2.85 | 2.81 | 3.36 | -0.55 |
| 8. Karnataka | 4.33 | 4.40 | 4.34 | 4.46 | -0.12 |
| 9. Kerala | 2.34 | 2.38 | 2.35 | 2.67 | -0.32 |
| 10. Madhya Pradesh | 7.12 | 7.23 | 7.13 | 6.72 | 0.41 |
| 11. Maharashtra | 5.20 | 5.28 | 5.21 | 5.00 | 0.21 |
| 12. Orissa | 4.78 | 4.86 | 4.79 | 5.17 | -0.38 |
| 13. Punjab | 1.39 | 1.41 | 1.39 | 1.30 | 0.09 |
| 14. Rajasthan | 5.85 | 5.95 | 5.86 | 5.61 | 0.25 |
| 15. Tamil Nadu | 4.97 | 5.05 | 4.98 | 5.31 | -0.33 |
| 16. Uttar Pradesh | 19.68 | 19.99 | 19.71 | 19.28 | 0.43 |
| 17. West Bengal | 7.26 | 7.38 | 7.28 | 7.06 | 0.21 |
| | | | | | |
| **Grand Total - All States** | 100.00 | 100.00 | 100.01 | 100.00 | 0.00 |
| *Source: NIPFP Working Paper (2010) and Finance Commission Reports* | | | | | |

In the Union Budget, Centre shows this devolution in two ways. First, it aggregates all the shareable taxes (minus the Cess and Surcharges) and then keeps the FC recommended share (32% in case of 13 Finance Commission) for States (See Statement 1 in Receipts Budget). Alternatively, it also shows the devolution to States on the basis of each type of tax (corporate tax, income tax etc See Statement 10 in Receipts Budget).

## III. Finance Commission - Share of Grants-in-Aid

Under Article 275 (1) of the Constitution, certain Grants-in-Aid could be given to different States for special purposes like the purpose of promoting the welfare of the Scheduled Tribes in that State or raising the level of administration of the Scheduled Areas. Finance Commission provides basis for both the kind of Grants to be given and the transfer of each of these Grants to different States.

Over the years, these grants have spread across for development areas like education, improvement in justice delivery, Incentive for issuing UIDs, forestry, disaster relief (including capacity building) etc. Table 5 summarises the Grants-in-aid devolved by Thirteenth FC. As the table shows, Special category States get a higher share in grants (29.4%) compared to share in taxes (9.4% shown in Table 4).

**Table 5: Thirteenth FC recommended Grants-in-Aid**

| | In Rs Cr | | | % share | |
|---|---|---|---|---|---|
| | **Special** | **Non-Special** | **Total** | **Special** | **Non-Special** |
| 1. Post Devolution Non Plan Revenue Deficit | 51,800 | 0 | 51,800 | 100.0 | 0.0 |
| 2. Performance Incentive | 1,500 | 0 | 1,500 | 100.0 | 0.0 |
| 3. Local Bodies | 6,776 | 80,743 | 87,519 | 7.7 | 92.3 |
| 4. Disaster Relief (including capacity building) | 4,093 | 22,280 | 26,373 | 15.5 | 84.5 |
| 5. Elementary Education | 1,128 | 22,940 | 24,068 | 4.7 | 95.3 |
| 6. Improvement in justice Delivery | 551 | 4,449 | 5,000 | 11.0 | 89.0 |
| 7. Incentive for Issuing UIDs | 127 | 2,862 | 2,989 | 4.3 | 95.7 |
| 8. District Innovation Fund | 133 | 483 | 616 | 21.6 | 78.4 |
| 9. Improvement of Statistical Systems at State & District Levels | 133 | 483 | 616 | 21.6 | 78.4 |
| 10. Employee & Pension Database | 55 | 170 | 225 | 24.4 | 75.6 |
| 11. Forests | 2,116 | 2,884 | 5,000 | 42.3 | 57.7 |
| 12. Water Sector Management | 360 | 4,640 | 5,000 | 7.2 | 92.8 |
| 13. Maintenance of Roads & Bridges | 2,042 | 17,888 | 19,930 | 10.2 | 89.8 |
| 14. State Specific | 5,251 | 22,694 | 27,945 | 18.8 | 81.2 |
| 15. Total Grants in -aid | 76,064 | 1,82,517 | 2,58,580 | 29.4 | 70.6 |

*Note: Above Grants exclude GST compensation Grant of Rs.50000 crore, Grants for reduction of Infant Mortality Rate of Rs.5000 crore and renewable energy grants of Rs.5000 crore for which state-wise allocation to be done based on implementation*
*Source: Planning Commission*

Table 6 shows the state-wise devolution of Grants-in-Aid. Unlike transfer of Central Taxes, in case of Grants-in Aid calculations differ as nature of Grants are different. Even for transfer within States, there are differences across Grants. As shown in table 5, Special category States get around 35.7% of total transfer from Centre as Grants. The corresponding figure for Non-Special States is just 12.2%. This also explains why

States clamor to get Special category status as they get higher share of grants from Centre. Finance Commission also puts a ceiling on these total transfers from Centre to States. Thirteenth FC capped this total transfer at 39.5% of total gross revenue receipts of the Centre.

**Table 6: State wise comparison of Taxes and Grants (Thirteenth FC period 201-15)**

| | Share of Taxes (in Rs Cr) | Grants (in Rs Cr) | Share of Grants in Total Transfer (in %) |
|---|---|---|---|
| **Special Category** | **1,36,924** | **76,064** | **35.7** |
| 1. Arunachal Pradesh | 4,756 | 4348 | 47.8 |
| 2. Assam | 52,621 | 5,212 | 9 |
| 3. Himachal Pradesh | 11,327 | 10,364 | 47.8 |
| 4. Jammu & Kashmir | 20,183 | 20,256 | 50.1 |
| 5. Manipur | 6,541 | 7,026 | 51.8 |
| 6. Meghalaya | 5,919 | 3,924 | 39.9 |
| 7. Mizoram | 3,901 | 4,904 | 55.7 |
| 8. Nagaland | 4,553 | 9,191 | 66.9 |
| 9. Sikkim | 3,467 | 1,059 | 23.4 |
| 10. Tripura | 7,412 | 5,716 | 43.5 |
| 11. Uttarakhand | 16,245 | 4,063 | 20 |
| **Non-Special Category** | **1,31,1173** | **1,82,517** | **12.2** |
| 1. Andhra Pradesh | 1,00,616 | 13,532 | 11.9 |
| 2. Bihar | 1,58,341 | 14,603 | 8.4 |
| 3. Chhattisgarh | 35,825 | 6,176 | 14.7 |
| 4. Goa | 3,858 | 516 | 11.8 |
| 5. Gujarat | 44,107 | 9,683 | 18 |
| 6. Haryana | 15,200 | 4,271 | 21.9 |
| 7. Jharkhand | 40,640 | 7,238 | 15.1 |
| 8. Karnataka | 62,775 | 11,602 | 15.6 |
| 9. Kerala | 33,954 | 6,372 | 15.8 |
| 10. Madhya Pradesh | 1,03,269 | 13,325 | 11.4 |
| 11. Maharashtra | 75,407 | 16,303 | 17.8 |
| 12. Orissa | 69,316 | 9,659 | 12.2 |
| 13. Punjab | 20,146 | 5,540 | 21.6 |
| 14. Rajasthan | 84,892 | 12,950 | 13.2 |
| 15. Tamil Nadu | 72,070 | 11,367 | 13.6 |
| 16. Uttar Pradesh | 2,85,397 | 26,743 | 8.6 |
| 17. West Bengal | 1,05,359 | 12,639 | 10.7 |
| **Total** | **14,48,096** | **2,58,580** | **15.2** |

*Source: Planning Commission Website*

In the Union Budget these Grants-in-Aid are categorized in Non-Plan Expenditure (Table 7). Within Non-Plan expenditure it is classified as Revenue expenditure. In 2011-12, Centre budgeted higher Grants-in-Aid to states than recommended by Thirteenth FC. However as per Revised Estimates, Centre devolved Grants lower than Thirteenth FC recommendations because of worsening fiscal outlook. Hence, it budgeted a much higher share in 2012-13 trying to make up for the loss of 2011-12.

**Table 7: Grants-in-Aid in Union Budget (in Rs Cr)**

| | 2011-12 (BE) | 2011-12 (RE) | 2012-13 (BE) |
|---|---|---|---|
| Non-Plan Expenditure | 8,16,182 | 8,92,116 | 9,69,900 |
| Non-Plan Revenue Expenditure | 7,33,558 | 8,15,740 | 8,65,596 |
| Grants-in-Aid to States | 49,299 | 47,572 | 58,357 |
| Grants as % of Non-Plan Exp. | 6.0% | 5.3% | 6.0% |
| Grants specified by 13FC | 48,309 | 48,309 | 56,547 |

*Source: Union Budget Documents*

## IV. Role of Planning Commission in State Finances

Apart from Finance Commission mandated transfers, Centre transfers funds to States via other mechanisms as well. Planning Commission plays a central role in this transfer of funds. Planning Commission prepares Five-year plans for the Indian economy showing how various resources are to be deployed to achieve development in the economy. These five year plans are divided into Annual plans and become part of Plan expenditure in each year's Union Budget. As most plan expenditure requires implementation by States, Centre provides resources for both Centre and State Plans.

Basically Centre provides Plan funds for two purposes. In both, the Planning Commission plays a critical role:

1. States' Plan: Centre contributes to financing Plan expenditure of States. Earlier, this assistance used to be provided mainly via loans from Centre. However, Twelfth FC asked Centre to provide most funds in form of Grants and encouraged States to borrow directly from markets. Since then share of loans from Centre has declined and most of plan transfers happens in form of grants. This move also helped in development of State Development Loan market.

2. Centrally Sponsored Schemes (CSS): designed by Centre in consultation with Planning Commission (ICDS, NREGA, NRHM, PMGSY, SSA etc). There is no fix formula for sharing funds and it differs across schemes (50:50, 75:25 etc). Earlier most of CSS were fully Centre sponsored and now States also have to share the financing of these schemes. This has added to further burden on the States and was noted by Thirteenth FC as well.

In Finance Commission recommended transfers, one has clarity on the nature of devolvement to States. In Planning Commission recommended transfers the clarity is relatively less as these are finalized before the Union Budget with Centre and States in the annual National Development Council meeting.

Hence in the Expenditure Budget of the Union Budget, we get an estimate of the total funds given to States for their Plans and CSS. For instance in Union Budget 2012-13, out of total plan expenditure of Rs 5,21,025 Cr, allocation for State Plans was kept at Rs. 1,24,249 Cr and further Rs 41,019 Cr was provided for Central Sponsored Schemes (Table 8).

**Table 8: Centre allocation to State Plan and CSS (in Rs Cr)**

| | 2010-11 (Actual) | 2011-12 (RE) | 2012-13 (BE) |
|---|---|---|---|
| Plan Expenditure | 3,79,029 | 4,26,604 | 5,21,025 |
| State Plan | 88,214 | 1,01,105 | 1,24,249 |
| Grants for implementing CSS | 30,318 | 36,687 | 41,019 |
| Total Centre Financing for Plan Expenditure at State Level | 1,18,532 | 1,34,842 | 1,61,313 |

*Source: Union Budget Documents*

Centre channelizes funds for both State Plan and CSS via various Ministries. Hence, State Plan (and CSS) can be classified into two types: purpose of funds and Funds allotted via various ministries. Table 9 shows the break-up of State Plan devolution across various purposes and shows which Ministries are responsible for channelizing these funds to the required State governments.

**Table 9: State Plan Financing – Purpose and Nodal Ministries (in Rs Cr)**

| | Purpose of State Plan Financing | Nodal Ministries via which funds are allotted | 2011-12 (RE) | 2012-13 (BE) |
|---|---|---|---|---|
| | Central Assistance for State Plans | | 1,01,105 | 1,24,249 |
| 1 | Normal Central Assistance | Ministry of Finance | 21,832 | 25,589 |
| 2 | Special Plan Assistance | Ministry of Finance | 5,500 | 6,005 |
| 3 | Special Central Assistance (untied) | Ministry of Finance | 8,370 | 9,571 |
| 4 | Special Central Assistance, of which | | 4,129 | 4,577 |
| | (a) Hill Areas | Planning Commission | 299 | 300 |
| | (b) Tribal Sub-Plan | Ministry of Tribal Affairs | 1,015 | 1,200 |
| | (c) Grants under Proviso to Article 275(1) | Ministry of Tribal Affairs | 1,111 | 1,317 |
| | (d) Border Area | Ministry of Home Affairs | 1,003 | 990 |
| | (e) North Eastern Council | Ministry of Development of North Eastern Region | 700 | 770 |
| 5 | Control of Shifting Cultivation | Ministry of Agriculture | 50 | ... |
| 6 | MPs Local Area Development Scheme | -- | 2,950 | 3,955 |

| | | | | |
|---|---|---|---|---|
| 7 | Additional Central Assistance for Externally Aided Projects | Ministry of Finance, Department of Economic Affairs | 13,350 | 13,500 |
| 8 | Assistance from Central Pool of Resources for NE & Sikkim | Ministry of Development of North Eastern Region | 800 | 880 |
| 9 | Bodoland Territorial Council | Ministry of Development of North Eastern Region | 50 | 50 |
| 10 | Accelerated Irrigation Benefit Programme (AIBP) and Other Water Resources Programmes | Ministry of Water Resources | 7,460 | 14,242 |
| 11 | Roads & Bridges | Ministry of Road Transport and Highways | 2,159 | 2,267 |
| 12 | National Social Assistance Programme (NSAP) (including Annapurna) | Ministry of Rural Development | 6,608 | 8,382 |
| 13 | National E-Governance Action Plan (NEGAP) | Ministry of Communications and Information Technology | 190 | 190 |
| 14 | Backward Regions Grant Fund (BRGF), of which | | 10,997 | 12,040 |
| | (a) State Component | Ministry of Finance | 7,280 | 6,990 |
| | (b) District Component | Ministry of Panchayati Raj | 3,717 | 5,050 |
| 15 | Jawaharlal Nehru National Urban Renewal Mission, of which | | 7,450 | 12,522 |
| | (i) Sub Mission on Urban Infrastructure and Governance (SMUIG) | Ministry of Urban Development | 4,000 | 5,900 |
| | (ii) Urban Infrastructure Development for Small and Medium Towns (UIDSMT) | Ministry of Urban Development | 1,300 | 2,100 |
| | (iii) Sub Mission on Basic Services to Urban Poor (SM-BSUP) | Ministry of Housing and Urban Poverty Alleviation | 1,350 | 2,100 |
| | (iv) Integrated Housing and Slum Development (IHSDP) | Ministry of Housing and Urban Poverty Alleviation | 700 | 900 |
| | (v) Rajiv Awas Yojana (RAY) | Ministry of Housing and Urban Poverty Alleviation | 100 | 1,522 |
| 16 | Rashtriya Krishi Vikas Yojana (RKVY) | Ministry of Agriculture | 7,811 | 9,217 |
| 17 | Additional Central Assistance (ACA) for desalination Plant at Chennai | Ministry of Finance | 0 | 1 |
| 18 | Additional Central Assistance for Other Projects | Ministry of Finance | 1,400 | 1,261 |

*Source: Union Budget Documents*

For Central Sponsored Schemes also, a similar exercise is conducted. Union Budget 2012-13 shows there are 32 Union Ministries which allocate Rs 41,019 Cr for CSS implementation for various states (see Statement 17 of Expenditure Budget, Union Budget 2012-13).

Just as seen in the case of Finance Commission, there is a need to look at horizontal transfers in these Planning Commission funds as well. Planning Commission follows Gadgil-Mukherjee formula to divide these funds across the twenty-eight States. Some criterions are similar to the one seen in Finance Commission like population, fiscal management etc. However, there are other criterions as well in case of sharing Plan funds like special problems etc.

| Table 10: Gadgil - Mukherjee Criteria for sharing Plan Funds (in %) | |
|---|---|
| Population in 1971 | 60 |
| Per Capita Income | 25 |
| For States lower than National Average | 20 |
| For All States | 5 |
| Performance (Tax effort, fiscal management etc.) | 7.5 |
| Special Problems | 7.5 |
| *Source: Planning Commission* | |

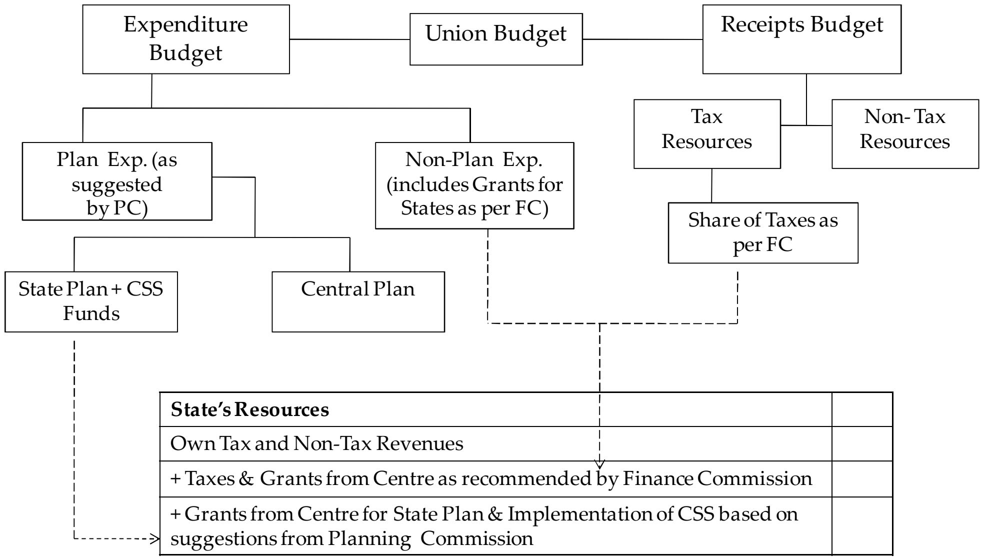
Again, there is clarity over horizontal transfers to States as per Finance Commission recommendations. We do not have similar clarity over horizontal transfers devolved as per Planning Commission recommendations. The Union Budget does not show horizontal transfers for States of Plan funds as it shows for Finance Commission recommended funds.

## V. Summing Up: Centre Transfers to States

We have tried to draw a schema to help understand the overall financial flows from Centre to States (Figure 1). The schema summarises all the flows we have mentioned above and helps one relate the flows to the Union Budget. The schema further divides the flows to both receipts and expenditure to provide conceptual clarity on the matter. It is interesting to note that Finance Commission recommended funds come from both the Budgets - Receipts (Taxable resources) and Expenditure (Grants-in-Aid). In case of Planning Commission recommended funds, the flows come from the Expenditure Budget.

States in turn use the Centre's funds alongwith it own resources (both tax and non-tax) to meet their expenditure needs. The states which still fall short of funds then retort to borrowing from markets via State Development Loans (SDLs). The Constitution specifies that those States which have any outstanding loan to Centre may not issue SDLs without the consent of the Centre Government. Even otherwise, States issue SDLs after discussions with RBI and Planning Commission.

**Figure 1: Flow of Funds from Centre to States**




*Source: STCI PD Research*

Table 11 summarizes the transfer of Centre funds to States via both the channels in recent years. There are some additional grants from Non-Plan account which is mainly Grants for compensation to States for revenue losses due to VAT & CST and for maintenance of Police forces which are provided by Ministry of Home Affairs (see Statement 10 under Expenditure Budget for further details). States get around 48% of total tax revenues of Centre. Out of 48%, around 32% comes from Finance Commission recommendations and around 15% comes from Planning Commission recommendations and other additional grants forming the remaining 1%.

**Table 11: Transfer of Centre Funds to States (in Rs Cr)**

| | 2010-11 (Actual) | 2011-12 (RE) | 2012-20 (BE) |
|---|---|---|---|
| 1. States' share of taxes and Duties | 2,19,303 | 2,55,414 | 3,01,921 |
| 2. Non-Plan Grants | 48,961 | 54,419 | 63,365 |
| i) Grants in Aid as per Finance Commission | 31,514 | 47,572 | 58,357 |
| ii) Other Non-Plan Grants | 17,446 | 6,847 | 5,008 |
| 3. Central Assistance for State Plans | 88,214 | 98,155 | 1,20,294 |
| 4. Assistance for CSS | 30,318 | 36,687 | 41,019 |
| 5 Total Centre Transfer to States | 3,86,796 | 4,44,675 | 5,26,599 |
| i) As per Finance Commission Recommendations (1 + 2 (i)) | 2,50,817 | 3,02,986 | 3,60,278 |
| ii) As per Planning Commission Recommendations (3+4) | 1,18,532 | 1,34,842 | 1,61,313 |
| ii) Others (2ii) | 17,446 | 6,847 | 5,008 |
| 6. Less-Recovery of Loans & Advances | 8,109 | 8,247 | 8,418 |

| | | | |
|---|---|---|---|
| 7. Net Resources transferred to State Governments (5-6) | 3,78,687 | 4,36,428 | 5,18,181 |
| 8. Centre's Total Gross Tax Revenues | 7,93,072 | 9,01,664 | 10,77,612 |
| 9. States share in Centre Gross Tax Revenues (in %) | 48.8 | 49.3 | 48.9 |
| i) As per Finance Commission | 31.6 | 33.6 | 33.4 |
| ii) As per Planning Commission | 14.9 | 15.0 | 15.0 |
| *Source: Union Budget Documents* | | | |

## VI. Conclusion

The above note is an attempt to simplify the flow of funds from the Centre to the States. In a way it also shows the working of India's fiscal union. Fiscal union and its functioning has become a central issue after the Eurozone crisis. Fiscal union implies having a Federal government/Central agency which could transfer funds to needy states in the union. One of the key reasons for deepening of Eurozone crisis is lack of fiscal union in the zone. The periphery economies of Greece, Ireland etc. faced a shock and could not get funds from any such central agency. They could also not devalue their currency as monetary policy role remained with European Central Bank. As a result they had to go for internal devaluation and impose fiscal austerity on their public leading to wide outcry. A fiscal union would have alleviated these financing concerns. Parallels have been drawn with United States where needy States like California and Florida have got share of funds from the Federal government.

India's fiscal union also provides valuable lessons for Eurozone whose leaders are debating on setting a fiscal union of member economies. The above note provides a glimpse of functioning of India's fiscal union. Both Finance Commission and Planning Commission play crucial roles to transfer funds from Centre to States. Given India's asymmetric fiscal federalism, this was clearly needed. Centre also provides funds to States via the National Small Savings Fund which helps financing the fiscal deficit of States (refer our earlier report - Fiscal Deficit and National Small Savings Fund, Oct-11). In case certain States get some asymmetric shocks, one does see Centre stepping into provide financial assistance. However, scholars in the area of federalism and fiscal federalism criticize this Centre intervention in States as excessive. They suggest India should increasingly move towards decentralization of powers and give States (and within States local bodies) a larger say on overall political and financial matters.

Overall, India's fiscal federalism is a very ripe area for economic research. This is more so in the case of States where research is much lesser compared to research on Centre. With the implementation of India's economic reforms moving increasingly into States' domain, time has come for research to focus on States.

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