

Centre State Relations in India

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Week 06: Financial Relations: Allocation of Taxing Power; Distribution of Revenue, Goods and Services Tax, GST Council

Lecture 26: Distribution of Revenue between Centre and States

Greetings to all of you. We are discussing financial relations and in that we have discussed how the development has taken place on an important area of indirect tax with the introduction of goods and services tax in this country. We have also explained and understood that how this GST regime is affecting the Centre State relation, what kind of revenue sharing is happening on the GST matter. Now, in today's session we will be talking about distribution of revenue between Centre and the States that what is the arrangement which the Constitution talks about on this important area. So, we will study distribution of revenue between Centre and the States, what are the theoretical understandings on this important subject and then distribution of revenues and resources, what is the centralization and decentralization argument that is what we will take a look at it and also we will see that what is the constitutional arrangement done on the issues of distribution of revenues in this module, in this lecture. So, now when you look at it how the entire development has taken place on an important area of distribution of revenues, you find that as we have discussed in the previous sessions that on the matter of revenue generation there is a clear demarcation between the Centre and the State before enactment of GST regime.

With the GST regime there is now a concurrent jurisdiction on the issue of indirect taxes. So, now the Constitution talks about apportionment of revenues between the Union and the States wherein it categorically provides for the manner in which revenue allocation should be done among the State and this in a way highlights the issues of fiscal imbalances between the State and the Centre or amongst the States and what kind of design is been provided under the

Constitution to address such fiscal imbalances because when you look at the revenue and when you look at the expenditure you would find that imbalance is very obvious. There is a design given in the Constitution to address the same. So, when fiscal imbalance is a reality when you find that the capacity to generate revenue and the responsibility to spend money for different public servicing, public provisioning, when there are differences on these two then there has to be some arrangement done where transfer of revenue shall be done from one government to another government what you may call it also as an inter-governmental transfer. So, Constitution categorically provides for transfer of revenue from the Central government to the State governments. This is something which is very distinct when it comes to the Indian Constitution where there is a kind of constitutional mandate concerning the distribution of revenue so that across the jurisdictions across the States there has to be development, there has to be improvement of quality of life and that is why when you look at the fiscal structuring of the Indian Constitution and when you look at the provisions you would find that the idea is that regardless of the reason, regardless of the States where individuals are staying at least bare minimum quality of life shall be ensured to every individual.

So, when you find the federal structuring which is there in the Indian Constitution there is a multi-tier governments where each government drawing legitimacy from the Constitution and then there is a provision for mobilization, sharing and utilization of financial resources and when you say mobilization, sharing and utilization of financial resources it is important to take note that exercise should be of such a nature where there shall as far as possible enough resources with every State and with the Centre in order to execute their welfare schemes in order to ensure that developmental activities are being carried out in a very uniformed fashion. Thus this inter-governmental transfers becomes a kind of tricky issues which in a way requires to be addressed with a kind of mature understanding and accommodative approach where the States need to understand those who are generating more revenue that they need to part with their share of revenue with the poor States at the same time Centre with a kind of having a higher hand on the matter of revenue generation they need to be generous and share the revenue with the States.

Now there are two different kinds of systems which are there in financial relations. One is the concurrent system, other is the bifurcated system. When you look at the concurrent system you would find there is a sort of concurrent direction on the sharing of revenue on the point of

borrowings and outlays where both the Centre and the States they do a kind of shared they go for a shared revenue allocation, shared revenue transfers. When you look at the bifurcated system there is a clear division of powers of taxation and borrowings between the Union and the State which was the case before GST at least on certain matters where clearly tax levying power was very clearly divided between the Centre and the States though even with that division there are certain subject matters on which you find that Union levies tax and then the proceeds of such taxes are being distributed amongst the States. So when you look at the Indian position you would find that India falls in the category of bifurcated system with separate legislative heads of taxation to the Union and the States which certainly now has got diluted with the introduction of GST through 101st constitutional amendment which we have discussed in previous session.

Now what is the theoretical understanding of distribution of revenue? We can broadly understand the theoretical underpinning on the area of distribution by looking at these three approaches. One is the welfare gains from decentralization which says that if the local government has been allowed to plan the expenditure then there is a possibility of having better outcome on implementation of the welfare plans. So on this it is been suggested that let the local government make a planning on welfare programs and let the expenditure be the responsibility of the local government. When I say local government obviously I mean the provincial government or the state government. Second is assignment of resources and responsibility between the tiers of the government. So where it is been suggested that there have been clear demarcation on what shall be the responsibility of which layer of the government and what shall be the avenues of resources when it comes to the government. So that is what was the arrangement when you look at 1950 Constitution as I said that no tax related matter was there in the Concurrent List. And then because of very natural situation where there shall be a resource imbalance would be there because every State may not be bestowed with the same natural resources, may not be bestowed with same economic growth or economic development and therefore there is a possibility of having vertical imbalances as well as horizontal imbalances and under the Indian Constitution a constitutional body has been suggested which has got a responsibility to address this imbalances vertical and horizontal which we will be discussing in detail in the next module.

Now there are two kinds of arguments when you look at the centralization and decentralization on the issues of revenue sharing. Look at the argument of decentralization as I said that there is a

possibility of having a better implementation of the welfare plan and schemes if the responsibility of planning such schemes and execution of such a scheme is given to the State government and that is something which has been done by the State government. So that will also be cost effective and at the same time better implementation better, provisioning is to be ensured. Because of the reason that local government or the state government is better equipped to understand the requirement of the people of that region and accordingly they can make the plan and the preferences of citizens can be understood by the local government and considering that the necessary schemes can be put in place necessary allocation of resources can be made by the State. For example when it comes to literacy plan, literacy plan may not be that aggressive in the State of Kerala which is required in some of the northern States for example Bihar.

So if you go for a local requirement understanding the local requirement and accordingly making the expenditure plan then it would be easier for having a kind of resource having a better resource planning. Now when you look at the benefit of the centralization aspect of taxing and distribution then it ensures that there shall be a kind of uniformity in distribution in accordance with the needs and also there is a possibility when the Centre is been entrusted with responsibility it may bring in an efficient system because parochial interest may not be there and local factors may not play a role and there could be a possibility of having a kind of very unbiased implementation of the scheme and the plan. So this is with regard to centralized kind of planning and resource revenue allocation. Distribution of resources and responsibilities as I said this is something which is the task of the constitution where Constitution categorically talks about the responsibilities which when you look at the Indian Constitution you find it is there in the Seventh Schedule where subject matters are clearly enlisted in List I, List II and List III where responsibilities are talked about and then you have tax related entries which talks about resources. So this is what is the arrangement done but at the same time it is been suggested that overall the responsibility shall lie with the Union government to bring in a kind of policies with regard to this addressing the issues of imbalances that is what is required.

So when it comes to subject matters which are of national importance for example, defense, railways or currencies you find that the subject matters are there with the Union and when you look at the issues which are of local importance, sanitation, then public health then you would find that is there with the state and in this background you find that Constitution suggests for a

distribution of revenues so that whatever responsibility is entrusted upon either government that can be effectively discharged with the help of resources available with the governments. Now as I said that fiscal imbalance is a very natural phenomenon. It is something which can be very well understood in a sense that every State is not been blessed with same kind of natural resources. There is a different kind of land escaping, let's say mines and minerals which are there in one of one States which is not in the case with other States or some States are landlocked and they may not have enough industrial establishments. So such kind of imbalance is very obvious and there where what is desirable is that the Centre must step in in order to address that imbalance and that is what is the responsibility of the Union government to allocate the resources to the State government because it is quite obvious that Union government will be in a better position to generate revenue depending upon the subject matters which are there with the Union on tax generation. Now obviously with the 101st constitutional amendment on indirect taxation there is a shared jurisdiction on a good number of subject matters. So this imbalance as the Constitution suggests needs to be rectified with the implementation of transfer of revenue from Union to the State. Such a transfer is of constitutional mandate that is something which Constitution categorically refers to or speaks about it.

So these transfers play a very important role in maintaining a balance creating an equitable relationship between the States and between the Centre and the States. It also mitigates imbalances and it promotes harmonious distribution of financial relations or resources amongst the different layers of the government. Fiscal imbalance can be understood of two kinds one is vertical imbalance the other is horizontal imbalance. When you look at vertical imbalance we are talking about the resource generation capacity of the Centre and connected with the responsibilities which are entrusted to the States. Horizontal imbalance as I said is amongst the States and there the imbalance is largely caused which I highlighted because of the presence of natural resources, industrial development, factors like literacy. So all this can play an important role in in creating this imbalance and which needs to be addressed through the measures or schemes or kind of planning suggested by the Constitution.

So when you look at the vertical fiscal imbalance as I said it arises due to uneven distribution of revenue raising powers and expenditure responsibilities among different levels of government and in such scenario what is desirable is that that the Union shall be willing to part with the

resource collection done, revenue generation done with the States and in that scenario this responsibility lies with the Union to share the surplus with the States what you call as a surplus tier which is connected with the Union and to the deficit tier which is connected with the State.

Horizontal fiscal imbalance where as I said that it relates amongst the States so it focuses on financial inequities amongst the different States and it is connected with economic performance of a State, natural resource endowments, population size among different subnational entities that's something which leads to horizontal fiscal imbalance and that is what we need to address through this role of transfer of revenue which has been done through considering this three broad approaches where internalization of a spillover benefits to other jurisdictions meaning thereby that if there is a surplus it is suggested that let the surplus go to the other jurisdiction so that equitable development takes place, so that overall development is informed. Then fiscal equalization across jurisdictions which says that in a way there has to be a fiscal discipline maintained and there is a possibility of sharing of revenue from one jurisdiction to another jurisdiction and then improved overall tax system so that every government shall try to generate revenue so that the populist major should not become a bottleneck in generating revenue that is what is important to look at it. What are the characteristics of revenue transfer? One is predictability which says that predictive resource flow enables the State to make a plan. So if a State has a kind of understanding that what kind of inflow on income is there then it can make a welfare plan, plan for infrastructure development accordingly. Then characteristics of revenue transfer are also connected with stability which prevents sudden change in the transfer arrangement. Then equitable distribution which says that redirecting funds from resourceful States to the poor States based on the fiscal need and the capacity of the State and effectiveness which says that transfer of revenue from Union maintains a kind of fiscal discipline where Union in a way tries to see that there shall not be any kind of undue expenditure done by the State.

Now when you look at the distribution of revenue arrangement under the Indian Constitution you find that largely it has been taken from the Government of India Act 1935 where there was a provision with regard to sharing of revenue between the federation and the provinces in Section 136 to Section 144 of Chapter I of Part VII of the Act where there was a provision with regard to revenue of federation and revenue of provinces and the provision was also there with regard to levy of taxes like tax on income and corporation tax or salt duties. So clearly division was there

and this is something which has also been taken up in the 1950 Constitution. So under the Indian Constitution you have a dedicated Chapter titled as Distribution of Revenues between the Union and the States which is there under Article 268 to 281 in Part XII of the Constitution. Now this distribution of revenue has seen a kind of transformational change because of 101st constitutional amendment wherein a large pool of subject matter related to indirect taxes has subsumed in a concurrent jurisdiction between the Centre and the States.

So that is the new arrangement which we have already studied in the last session. Now the division of revenue the task is given to the Finance Commission which is a constitutional body and the Commission is constituted by the President. We will be discussing about the power and function of this Commission in the next session. What is the principle on which the division happens? It says that no decentralized government can be established without allocating it to its sufficient financial powers. So in a way when you look at the empowering of the State government, State government can be empowered or ensure better governance only when they have got enough financial resources with them and for that this distribution becomes very important.

Central government appears to be an appropriate authority to levy a tax where uniformity of tax is required across the jurisdiction. So for distribution of revenue under the Constitution Articles 268, 269, 269A, 270 are the important provisions. When you look at it Article 268 talks about duties levied by the Union, but collected and kept by the States. This is again unique modeling under the Indian Constitution because of the nature of the duties it is suggested that let it be levied by the Union, but then collection and retaining of the same is left with the States. Under Article 269 taxes levied and collected by the Union, but assigned to the States it is been distributed among the States. Under Article 269A levy and collection of goods and services in course of inter-State trade and commerce this is a new provision which has come through 101st constitutional amendment and Article 270 which talks about taxes levied and distributed between the Union and the States. You find that this Articles 269 or 270 these are also been made subject to Article 269A which has introduced a new indirect tax regime in our country.

So Article 268 which talks about levying to be done by the Union, but to be retained by the States then it was argued that all duties and taxes should be levied collected and appropriated by

Government of India that is what Mr. Brajeshwar Prasad argued. The provinces should have no power of levying taxes or collecting it or appropriating it. There should be no financial autonomy in this sphere. So what is suggested is that let there be an independent authority at the Centre to allocate funds between different units in accordance with the need which arises in each province.

That is what is his suggestion that let it be entirely under the control of the Government of India and let Government of India take a call that how division shall take place on the subject matter which is there under Article 268 which is a subject matter related to stamp duty. So Article 268 relates to stamp duties and excise duties on medicinal and toilet preparation, where in Union in case of duties leviable with Union Territories and State within which duties are leviable. It is in a way a testimony of a cooperative federal structuring where you find that Union levies the tax, but it is collected by both the Union and the States. In this case of CIT v. K. Srinivasan, has been suggested that Article 268 relates to duties levied by the Union, but collected and appropriated by the States, traces its legislative competency from Articles 245 and 246(1). So that is the source of law making with regard to the subject matter pertaining to levying of stamp duty and excise duties on medicinal and toilet preparations. Article 268A has been added through 88th constitutional amendment in 2003. Now, 88th constitutional amendment has been repealed through 101st constitutional amendment because this is been subsumed under the GST structure. Article 269 talks about taxes on the sale or purchase of goods and taxes on the consignment of goods except goods and service tax on inter-State commerce which shall be levied and collected by the Union, but shall be assigned to the State that is what it says. Now again before this 88th constitutional amendment, Article 269 provided for the list of taxes that can be levied by the Union and assigned to the State which included tax on railways, railway fares, freight, terminal tax on goods and passengers carried on by railways sea or air. So but Article 269 is now made subjected to Article 269A which is on GST.

So and then moving further 270 which talks about levying of tax and distribution between the Union and the States. You find that on this the debate took place that how this distribution of tax should be there between the Union and the State. Mr. Upendranath Barman proposed that there shall be a minimum percentage of revenue and manner of distribution which should be there highlighted in the constitutional provision itself so that later on there should not be any kind of tweaking done. Mr. Shibban Lal Saxena proposed that Parliament should determine the amount

and manner of distribution. Thus, proposing kind of stating that it should be done by the President of the order by the words that it should be done by Parliament.

So that parliamentary supremacy shall be maintained in terms of what shall be what should be levied and how it shall be distributed between the Union and the States. But these amendments were not been accepted because largely it has been left on an independent body called Finance Commission to suggest the same. Article 270(1) talks about the tax and duties referred in the Union List and any cess levied by made by the Parliament and shall be levied and collected by the Union and to be distributed between the Union and the States. So cess is a kind of particular tax on a particular subject matter that is what it says which is generally been levied for undertaking a specific task. For example we paid cess for Swachh Bharat Mission.

There are certain exceptions which are there under Article 270(1) which shall not be brought within this scheme of levying by the Centre and distribution between the Centre and the States duties and taxes which are referred under Articles 268, 269 and 269A and surcharges on taxes and duties under Article 271. Surcharges are always considered to be add on to the tax which is generally been levied on a certain set of people who are there on higher income slab. So Article 270(2) specifies the manner of allocation of taxes between the Union and the States. What is the manner of distribution which is been given under Article 270(2)? It envisages that such percentage as prescribed of the net proceeds of tax or duty and not part of the Consolidated Fund of India in any financial year shall be assigned and Article 270(3) says that it shall be done by the Finance Commission which is to be constituted by the President. It shall be done that what Finance Commission recommends with regard to distribution of revenue between the Centre and the States. So when you read Article 270(2) and so Article 270(3) you find that allocations of taxes are to be done on the basis of recommendation made by the Finance Commission. This is the kind of federal impact is when you look at the distribution of revenue. It is talking about cooperative federalism where the idea is to come together in order to ensure better governance, uniform economic development across the country, in order to ensure that the quality of life is of a minimum threshold across the jurisdictions.

Then it also refers to a kind of balancing relationship between the states amongst the States, so horizontal federalism is also the idea. Then holding together meaning thereby all the States they

need to be partnering together for betterment of the country and then asymmetric federalism in a way that the States which are having a kind of backward communities which are there in a hill areas where the issues of resource constraint is there then other States needs to step in and then it is also talking about competitive federalism where they need to come forward and attract investors so that they can pitch in what is there in their State so that more number of investors should come forward. So when you look at cooperative federalism, it is to be ensured that a kind of balancing shall be done between power and responsibilities between the different layers of the government and both the Union and the State needs to have a kind of work in a close coordination for improving the fiscal strength of the Centre and the States and any kind of differences on the issue of distribution shall be resolved ideally or through a dialogue or through a cooperation. So it is all about shared responsibilities particularly on the issue of social sector, spending where it is all about public welfare on issues like education, health, poverty and elevation, collaborative funding and program implementation between the Union and the States so that is what is the scheme it says.

Then competitive federalism as I said it is more about competing with each other in order to attract better investors in order to see that developmental activities take place in such a way so that they can promise better service to the residents or to the people of their States that's what it talks about competitive federalism. Then asymmetric federalism where it says that apportionment of revenue should be done to rectify fiscal imbalances amongst the States and then it should be done in such a way where the resource as I said resource constraint State should be expecting that resource rich State should come forward and mitigate the imbalances. Holding together where it says that distribution of revenue should manifest in such a way so that they need to come together it is not a case of that one State should be left behind on the developmental graph on the developmental activities and some State should move ahead. So that is what is the idea where it says that the responsibility of the Union lies that revenue should be done in such a way so that everyone moves along and for that the responsibility lies on the Centre to distribute revenue because the States are largely dependent upon the Union for revenue. So, regional autonomy is there, but then at the same time what is important is that national unity and integrity is also to be achieved.

So these are the references for this session. Thank you very much. .