

## *The Marxist*

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COMMUNIST PARTY OF INDIA (MARXIST)

### *Approach Paper On Restructuring of Centre-State Relations*

The Constitution of India is federal in form but is more unitary in character. Strengthening the federal system is necessary for meeting the aspirations of the people who are governed through State Governments and for preserving the unity of India. Therefore, Centre-State relations, i.e. the arrangements between the Union Government and the States in regard to their powers, functions and responsibilities, have always been a crucial issue. The basic structure remains to be one where legislative, administrative and financial powers are disproportionately concentrated in the Union Government with the States having a large number of responsibilities without sufficient autonomy. Alongwith significant socio-economic and political changes occurring in the post-independence period, Centre-State relations have also undergone some changes. The period since 1991, which witnessed a paradigm shift in the economic strategy from planned development to a market-oriented one, has also thrown up new issues and challenges for the federal set-up. These have an important bearing on the functioning of our democracy as well as the well being of our people.

The need for a thorough restructuring of Centre-State relations, in order to correct existing imbalances and strengthen the federal system by empowering the States with genuine autonomy, is therefore being felt strongly. This note is being put forward to initiate a discussion among political parties and organisations that are genuinely committed to federalism and enable the emergence of a common platform to bring about a restructuring of Centre-State relations.

#### BACKGROUND

The CPI (M) has always held that while the state structure in India is federal in name, most powers and resources are concentrated in the hands of the Central government. The repeated use by the Centre of the inherently anti-democratic provisions of Article 356 of the Constitution to dismiss elected State Governments and dissolve the elected state assemblies has been a major instrument for subverting the federal system and the autonomy of States. The constituent States enjoy little power, which makes them dependent on the Central government, restricting their development. The contradictions between the Central government and the States have therefore grown.

The first Left Front Government in West Bengal had adopted a 15-point memorandum in 1977 seeking a realignment of Centre-State relations. Several other political parties in India, since their inception, have also stood for a restructuring of Centre-State relations and greater federal autonomy. The Srinagar Conclave in 1983 brought together parties like the DMK, TDP, Akali Dal, the Republican Party of India, the Assom Jatiyabadi Dal and the J&K National Conference along with the Left Parties. In his note submitted at the Conclave, Chief Minister of West Bengal

Jyoti Basu said, “Contrary to what is generally argued, the devolution of economic powers, resources and decision-making, instead of weakening the Centre, would actually strengthen its base”.

The major areas identified at the Srinagar Conclave, which have been repeatedly endorsed by subsequent conferences of the Chief Ministers, related to the administrative, legislative and financial spheres. In the administrative sphere, the major issues were the abuse of Article 356, the sending of Central forces to the States without their concurrence and the role of Governors. The major issues in the legislative sphere related to intrusions by the Centre into State-list subjects and delays in obtaining assents for important Bills passed by the State Assemblies. In the financial sphere, the major issues related to increasing centralisation of powers in the Union Government in matters like resource mobilisation and allocation and other key areas of economic decision-making like Planning.

With the demand for restructuring Centre-State relations gathering momentum, the Union Government had also set up the Sarkaria Commission in 1983. While this Commission took about five years to submit its report, its recommendations failed to resolve most of the basic issues mentioned above, except for some minor improvements in the financial sphere, such as giving powers to the municipalities to issue tax-free bonds, endorsing the Chief Ministers’ decisions on consignment tax, extending slightly the time frame for overdraft loans etc. It is unfortunate that even these recommendations of the Sarkaria Commission have not been implemented by the Union Government after nearly two decades.

The constitution of the Inter-State Council under Article 263 of the Constitution by the National Front Government in 1990 was a long overdue step taken with the hope of resolving the major issues in Centre-State relations. Since then, ten meetings of the Inter-State Council have been held (the last meeting was held in December 2006) and an equal number of meetings of the Standing Committee of the Council have taken place. But even then, not only have the major problems not been resolved, but new problems have also emerged. Recently, the UPA Government set up a Commission on Centre-State relations in April 2007. However, the States were not consulted prior to the formation of this Commission. Therefore neither the terms of reference nor the composition of the Commission reflect the pressing needs and aspirations of the States. It is in this context that the need has arisen to once again bring the unresolved issues of Centre-State relations to the centre-stage as well as to identify and resolve the new issues that have emerged in the post-liberalization period.

The UPA Government set up a Commission on Centre-State Relations in April 2007 with former Chief Justice MM Punchhi as the Chairperson. The terms of reference of the Commission, however, did not reflect the long-standing demands of the States for greater devolution of financial powers, especially regarding the increase of the States’ share in tax revenue, transfer of Centrally Sponsored Schemes to the States and alleviation of the debt burden of the States. On the other hand the terms of reference included the issue of suo moto interference on law and order and deployment of Central forces, which is an intrusion into the jurisdiction of the States.

#### ISSUES IN THE ADMINISTRATIVE AND LEGISLATIVE SPHERES

##### *Misuse of Articles 356 and 355*

The repeated misuse by the Centre of the provisions of Article 356 of the Constitution to dismiss State Governments and dissolve State Assemblies has been subverting the federal principle and the rights of the States. The demand to restrict the use of Article 356 only to cases where there is a serious threat to national unity or the secular fabric of the country has been raised from various quarters in successive meetings of the Inter-State Council. In view of the Supreme Court

judgement on the S. R. Bommai case, there is an urgent need to build in strong safeguards in Articles 356 and 365 through appropriate amendments of the Constitution. However, no decision has been taken by the Union Government in this regard. There is also a new and alarming proposal for Central deployment of paramilitary forces in the States unilaterally in a situation which the Centre would consider as an 'internal disturbance'. The provenance of Article 355 needs to be clarified. As has been repeatedly stressed by several constituents of the Inter-State Council, the term 'internal disturbance' in Article 355 is related to 'public order', which is the first entry in the State List. The proposal for Central deployment of paramilitary forces in a State in a situation which the Centre would consider as "internal disturbance" without the State's concurrence is unacceptable. Article 355 should be amended on the lines suggested above for Article 356. Apart from external aggression, only a serious threat to national unity or an assault on the secular principle can be taken cognizance of.

#### *Appointment and Role of Governors*

The provision for centrally appointed Governors for the States has remained as an anachronism, which is not in keeping with a federal democratic polity. If the post of Governor has to be retained, then the Governor should be appointed by the President from a list of three eminent persons suggested by the Chief Minister, satisfying the criteria mentioned by the Sarkaria Commission. This has also been repeatedly discussed in the Inter-State Council. None of the major countries of the world with a federal constitution have any provision for a post of the Governor in a State to be appointed by the Centre. There should also be a time limit with regard to Governor's assent to Bills passed by the State Assemblies. Moreover, the requirement of an explicit norm debarring Governors from publicly expressing disagreements or differences with the State Government, also need to be debated. There is also a need to review whether Governors should continue to be ex-officio Chancellors of State Universities.

#### *Central Intrusion into the State List*

Not only have the earlier transfer of State subjects, such as education, to the Concurrent List been left unreversed, but further intrusions have also been made into the State List in terms of proliferation of the so-called Centrally Sponsored Schemes. These Central schemes on the State subjects, which contain rigid guidelines imposed by the Centre, besides having implications in the financial sphere, also impair the autonomy of the States and affect their development priorities. There is an urgent need to review the impact of the transfer of legislative items from the State to the Union/Concurrent List. The Union Government has so far ignored the demand of the States to place at least the residuary powers of legislation in the State List. The residuary power of taxation in the sphere of services is being pre-emptorily used by the Union Government to the total exclusion of the States. Despite discussions in the Inter-State Council, the proposal for a Constitutional amendment to set definite time-limits for receiving the assent of Governors or the President in the case of bills passed by the State Assemblies has so far been ignored. Moreover, there is no formal institutional structure that requires mandatory consultation between the Centre and the States in areas of legislation under the Concurrent List.

#### *Treaty-making Powers*

The present Constitutional scheme with regard to treaty making power being exclusively in the domain of the Union Executive needs to be urgently reviewed. The Constitution should be amended to make legislative sanction mandatory for any international treaty. Besides, several

international treaties like the WTO agreement have serious implications for the States, especially with respect to State subjects like agriculture. In all such cases, consultation with the States and concurrence of the Inter-State Council must also be made mandatory.

### *All-India Services*

The All India Services are under the exclusive domain of the Centre. Some of the powers can be shared with the States. The State Governments should especially have a greater role in the administration of the Rules and Regulations of All India Services.

## FINANCIAL SPHERE: UNRESOLVED ISSUES

Fiscal federalism in India has always been deeply problematic, with vertical and horizontal imbalances not only persisting till date but also getting aggravated in many cases. Resources have always remained centralised in the hands of the Union Government with the States suffering from gross inadequacy of resources in relation to their development needs. The already limited financial and economic decision making powers of the States have got further constrained in the post-liberalization period.

### *Vertical Imbalance*

The basic imbalance in the Indian Constitution in regard to Centre-State relations arises out of the fact that, while the major responsibilities in the sphere of development expenditure (irrigation, roads, power, education, health etc.) and administrative expenditure (law and order, general administration etc.) have been given to the States, the more important powers of revenue-raising have been given to the Centre. In the year 2004-05 for instance, annual development expenditure borne by the States taken together was Rs. 3.62 lakh crore, which was more than one-and-a half times of what was borne by the Centre – Rs. 2.33 lakh crore. (*RBI Handbook of Statistics on Indian Economy, 2005-06*). This also implies that the States undertook around 60.8% of the total development expenditure incurred in 2004-05. It also needs to be noted here that this expenditure was incurred by the States under serious financial constraints, and the actual expenditure that is required to fulfill their responsibilities adequately would be at least twice the amount that was spent. In contrast, the share of the States in total Revenue receipts was merely 38%, with around 62% per going to the Central Government (See Table 1 in Appendix). This vertical imbalance remains the basic problem in Centre-State financial relations.

### *Inadequate Central Transfers*

This mismatch between the greater responsibilities for undertaking development expenditure lying with the States on the one hand, with greater powers of revenue mobilisation lying with the Centre on the other, has not been met through commensurate resource transfers from the Centre to the States. The devolution of Central taxes and grants as was envisaged in Chapter-I of Part XII and Article 275 of the Constitution have remained grossly inadequate. In fact, the share of net Central transfer in terms of devolution of Central taxes and grants (net of interest payment by the States on Centrally imposed loans) as a proportion of total revenue receipts of the Centre has fallen from 32.7% in 1990-91 to 29.5% in 2004-05 (Table 2 in Appendix).

### *Devolution of 50% of Central Taxes to States*

It is essential to work out a fair principle for sharing of Central taxes with the States. The Central taxes net of transfer to the States and the State taxes including States' share in Central taxes should be in proportion to the development expenditures incurred by the Centre and the States respectively. On the basis of this principle and the available data on the trend of existing as well as the required development expenditure of the States, it had been worked out that the State's share of Central tax revenue should be at least 50%. The States, over a long period, have therefore been demanding that 50% of the total pool of collection of Central taxes be devolved to the States. However, this demand has been ignored so far and the States' share of Central taxes currently stands at 30.5% only. This needs to be increased to 50% on an urgent basis.

### *Residual Powers of Taxation*

The States had justifiably demanded the transfer of at least the residual powers of taxation, particularly the power to tax services, to the States. Ignoring this demand, the Centre acquired for itself the entire power of taxing services through a Constitutional amendment. Fairness demands that the States are allowed to tax certain services including some services, which are currently being taxed by the Centre. Central surcharges and cesses do not form a part of the divisible pool, thus denying the States their due share in total revenue receipts. These surcharges and cesses should also be made a part of the divisible pool. There is also a need to evolve a suitable model for the proposed Goods and Services Tax so that the States have a fair share in the revenues especially keeping in mind the interests of the Special Category States.

### *Restrictions on Borrowing by States*

The share of total market borrowing to which the States may be entitled is also dictated by the Centre. While in the 1950s, the shares of market borrowing of the States and the Centre in the total market borrowing by the Government were approximately equal in proportion, the share of market borrowing of the States has now fallen sharply to around 15%, with more than 85% of the market borrowing being cornered by the Centre. Consistent with the development responsibilities of the States, the share of market borrowing of the States should be increased from the absurdly low proportion of about 15% per cent currently to 50%. Moreover, Article 293 of the Constitution should be amended to provide more flexibility and autonomy to the States in regard to market borrowing.

The Reserve Bank of India restrains the State Governments' flexibility in market borrowing in a number of ways. It denies access to the market for resources beyond limits, ranging from 5% to 35% of gross borrowings, depending on the fiscal indicators of the State. The most restrictive condition imposed by the RBI is that market borrowings cannot be used to finance revenue deficits. This ignores the fact that State finances are in doldrums largely on account of high interest-debt from the Central Government. Another perverse condition makes the amount that can be borrowed inversely proportional to the need, i.e. the size of the deficit. Furthermore, the RBI has undermined State Government guarantees by stating that these should not be a key consideration in loans to the public sector. These constraints, which adversely affect the public borrowing of the States, need to be removed.

### *Declining Tax Revenue*

The post-liberalization period witnessed a fall in revenue mobilisation of the Centre, mainly on account of reductions in direct and indirect taxes and the overall weakening of the resource mobilisation effort. Revenue mobilisation by the Central Government declined from 12.17% of GDP in 1990-91 to 10.74% of GDP in 1998-99. States' own revenues, however, remained fairly stable at around 7% during this period. Central transfers to the States also declined from 4.73% of GDP in 1990-91 to 3.79% of GDP in 1999-00. During the reference period of the Eleventh Finance Commission (2000-05), the actual collection of Central taxes fell significantly short of the projected amount. As a result, the actual amount received by the States has also been substantially less, by nearly 19%, from what was recommended by the Commission (Table 3 in Appendix).

### *Tax Concessions*

While there has been some improvement in revenue collection by the Centre in the recent period, the resource mobilisation effort continues to be severely constrained by myriad tax concessions. The latest Budget documents show that revenues worth Rs. 2.78 lakh crore were foregone on account of the various extant direct and indirect tax exemptions in 2007-08, which amounted to 48% of total Central tax collection in that year (Table 4 in Appendix).

These tax concessions, especially the ones on corporate taxes, not only cause enormous revenue losses, but also distort the patterns of investment and growth and aggravate regional imbalances. The experience of mushrooming Special Economic Zones following the passage of the SEZ Act, which grants a ten-year income tax-holiday for the developers and units in the SEZs, is a glaring case in point. This also has major implications for the revenue mobilisation capacity of the States. The competition to attract investment often leads to the States offering exemptions from State taxes and duties and other concessions in a competitive manner, causing revenue losses. There is an urgent need to review the Central tax exemptions and devising mechanisms to compensate the States for the losses and distortions arising out of such tax exemptions. There is also a need for the Centre as well as the States to set some collective limits to tax concessions in order to safeguard against a race to the bottom.

### *Fiscal Crisis of the States*

The post-liberalization period witnessed a sharp deterioration in the fiscal health of the State Governments, with most States facing fiscal crises. An important factor behind the fiscal strain was the Union Government's policy of charging unfairly high rate of interest on the Central loans to the States, particularly for the loans related to small savings (with interest rate exceeding 16%). This compounded the debt burden of the States, as reflected in the sharp increase in the ratio of interest payment to the revenue receipts (Table 5 in Appendix). The impact of the pay revision on the basis of the Centre's decision on the recommendations of the Fifth Central Pay Commission was also quite severe on the States' finances. Confronted with serious fiscal crises, the Chief Ministers and Finance Ministers of all the States had unanimously demanded in the meeting of the National Development Council (February 19, 1999) that the Union Government should bear at least 50% of the additional financial burden of the States on account of pay revision. Following an unprecedented walkout in the NDC meeting, the Centre had agreed to provide that assistance

to the States. However, that assurance was never honoured. With the Sixth Pay Commission already making its recommendations and the Centre initiating the process of implementation, Central assistance to the States for the forthcoming round of pay revision need to be ensured.

### *Imposition of Conditionalities through Finance Commissions*

The Eleventh Finance Commission had failed to recommend any increase in the States' share of Central taxes beyond 29.5% or provide debt relief to the States. Rather, the Commission recommended that the revenue-deficit grants for the States be linked up with the condition that 15% of the States' entitlement of revenue deficit grant would be withheld unless the States had complied with a progressive reduction of the revenue deficit over the period 2000-2005. There were strong protests from the States, and a dissent note was also submitted by a member of the Eleventh Finance Commission (Dr. Amaresh Bagchi) who wrote that the Centre had no business "to withhold even a single paisa of the grants arising out of the needs assessed by the Commission". However, this conditionality was imposed by the Union Government, thereby forcing the States to impose a virtual ban on recruitment that created genuine problems in the delivery of welfare services and development activities of the States. Moreover, this mechanically applied conditionality also started showing signs of design failure. The prescription of a uniform 5% compression of revenue deficit to revenue receipt every year was oblivious to the widely different causes and magnitudes of the revenue deficit to revenue receipts ratio among the States, and it created an anomalous situation in Centre-State relations.

The Twelfth Finance Commission had also imposed several conditionalities on States, one of them being enacting Fiscal Responsibility and Budget Management (FRBM) Act in order to avail of debt relief and restructuring from the Centre. This implied annual reduction targets of revenue and fiscal deficit with the total elimination of revenue deficit by 2008-09. This restrictive conditionality for revenue deficit reduction, which has been imposed without any regard to the initial conditions of the States, suffers from a mechanical and inadequate understanding of the components of revenue expenditure. Grants to the local bodies (panchayats, municipalities etc.), aided schools and colleges, expenditure on account of salaries of doctors, medicines etc., come under revenue expenditure. Efforts to achieve the deficit reduction targets of the FRBM Act would therefore severely constrain the fiscal space for the States and adversely affect development expenditure. Moreover, the restriction of fiscal deficit to 3% of the GSDP will also impinge upon the capital expenditure of the States. The obsession with curbing the size of the fiscal deficit and cutting down upon Government expenditure in order to impose fiscal discipline irrespective of the economic situation is not based upon any sound economic theory.

In keeping with a World Bank recommendation, the Twelfth Finance Commission also suggested the abdication of the Central Government's responsibility in borrowings by the State Governments. Accordingly, the loan component of the Central Assistance to State Plans has been done away with, resulting in a huge disadvantage for backward states. The States are therefore being pushed into negotiating high interest and/or conditionality-linked loans from external agencies like the ADB and the World Bank. Moreover, the Twelfth Finance Commission had also echoed the conditionalities suggested by the RBI, of creating a Guarantee Redemption Fund and a Sinking Fund for amortization of loans outside the consolidated fund of the States and Centre, to avail debt relief. These are meant to subject the States to greater 'market discipline', which will only imply conditionality linked and high interest cost loans for the States and abandonment of projects whose risks are assessed to be too high by the market.

These conditionalities being imposed by the Finance Commission are violative of the principles of fiscal federalism and severely impinge upon the financial autonomy of the States. Debt relief for the States on account of the Central loans must not be tied to any conditionality.

Solutions should be worked out in a State-specific manner, with a component of the relief in terms of writing off a part of loan, and another part in terms of consolidation of past loans with a provision of interest relief. The debt of the Special Category States should be settled in a one-time manner.

A new problem has recently arisen due to the rate of interest on bank deposits becoming much higher than the rate of interest on small saving schemes resulting in erosion of small savings collection. The interest rates on small saving schemes also need to be realigned in order to maintain its attractiveness relative to bank interest rates.

#### *National Small Savings Fund Loan*

The Central loans connected with small savings collection (National Savings Scheme Fund) involved a special burden since the rate of interest charged by the Union Government from the States is significantly higher (often by more than 2%) than the rate of interest paid to the depositors. The States had urged upon the Twelfth Finance Commission to suggest remedial measures. However, none of the major problems of the States were satisfactorily addressed. The debt-relief package recommended by the Commission in respect of Central loans to the States specifically excluded from its purview the NSSF loan extended by the Centre to the States from 1999-2000 onwards, which constitutes the predominant component of the Central loans for several States. Debt relief vis-à-vis the loans from the NSSF should be worked out in a State-specific manner.

#### *Problems with Centrally Sponsored Schemes*

The proliferation of Centrally Sponsored Schemes, whose design and implementation are totally determined by the Centre without adequate consultation with the State Governments, is another serious problem. These excessively centralised and rigid formats of these schemes often make them ill suited for the specific needs of the States. Since the State Governments have to bear a part of the expenditure behind such schemes in most cases, the States find it difficult to make proper allocation of their own resources keeping their own priorities in view. Moreover, conditionalities are often imposed through these schemes, which impinge upon the autonomy of the States.

For instance, the centrally sponsored JNNURM requires the State Governments to bring down the stamp duty rate within five years to a level not exceeding 5% and also impose user charges for various utilities and necessary services. This is a direct intrusion into the power of the States, since with respect to taxes in the State list like the stamp duty, the Legislative Assembly has full powers to prescribe rates. Recently, the Union Government has accepted the recommendations of the Vaidyanathan Committee on revival of the co-operative credit structure. In this case too, the power of the States in regard to the co-operatives has been curtailed and the flow of funds linked up with the acceptance of the attached conditionalities. In some of the schemes, the share of the States' financial burden has also been unilaterally increased. For instance, despite repeated objections by all the Chief Ministers, the share of the States in the Sarva Shiksha Abhiyan will be increased from 25% to reach 50% by the end of the Eleventh Plan period. The inflexibility of the design and the manner of provision of funds for the SSA also leads to significant under-utilisation of funds. Similarly, the rigidity in the schedule of work under the NREGA also precludes its effective implementation in several States.

At the Conference of the Chief Ministers convened by the then Prime Minister on May 4, 1996, it was resolved that all Centrally Sponsored Schemes pertaining to the State subjects would be transferred to the States with funds. Since then, although several exercises have been carried



out in this regard from time to time, there has been no effective resolution of the issue. Rather, more and more Centrally Sponsored Schemes, with attached conditionalities, have been introduced by the Central Government. While Central transfers to the States as a proportion of the Centre's revenue receipt have fallen over the years, the proportion of transfer of funds with conditionalities in the form of Grants-in-Aid has increased from 40.9% in 1980-81 to 49.3% in 2005-06 (Table 6 in Appendix).

All Centrally Sponsored Schemes under the State subject, as well as those under panchayats and municipalities, should be transferred to the States with funds. Broad guidelines can be worked out on the basis of discussions between the Centre and the States and also an appropriately periodic joint Centre-State review. However, the formulation and implementation of the schemes should be left to the States along with transfer of funds. Besides ensuring decentralisation, transfer of the Central schemes to the States would also reduce the cost of programme implementation and save Central resources.

### *Decentralisation, Devolution and Local Self-Governments*

The proliferation of centrally sponsored schemes has also meant an intrusion by the Centre into the functional domain of the panchayats and the municipalities. Direct fiscal provisions are made in some cases to the local bodies from the Centre, bypassing the State Governments. This, in addition to the "capacity building" of members of local bodies by the Centre, amounts to an extremely centralised notion of decentralisation. In such cases the real decisions are made at the Centre rather than being delegated to the States and the local bodies and there is an effort to decide the pattern of decision-making at the local body level from the Centre. This perverse vision of decentralisation should not be promoted and the States should be given the freedom to create an overall context within which local bodies can function. Moreover, a target minimum level of Local Self-Government expenditure to GDP or combined Government expenditure (Centre and States) needs to be set by the Finance Commission. Funds devolved to the local bodies should mandatorily be routed through the State Governments.

There is also a trend towards involving entities like private corporate groups or NGOs, in governance at the local level. These entities, which have no democratic accountability, should have absolutely no role to play in governance. Rather ways and means of improving accountability and transparency in governance through greater participation of common people in policy planning and their implementation should be explored.

### *Special Category States*

In view of their relative backwardness, the problems faced by the Special Category States, especially the North Eastern States and Jammu & Kashmir, should be accorded priority. The differential benefits given to these States in terms of the non-Plan Gap Grant and Normal Central Assistance should continue and adequate resources allocated to these States to meet their development needs. The debt of these State Governments should be settled in a one time manner without any conditionality. The release of funds to the Special Category States under the Centrally Sponsored Schemes should be done in a timely manner without stringent conditions on fund utilization.

### *Other Issues*

There are several other national and inter-State issues, which are important for Centre-State relations. These include major irrigation projects, erosion of major rivers, central investment in

CPSUs, railways, national highways, ports, airports, etc. In each of these issues, the interests of the Centre and States are involved, and it is necessary to ensure inter-State balance in taking decisions. There are also issues like strengthening the PDS, BPL identification and administration of the Essential Commodities Act, which have become very relevant in the backdrop of inflation. The present scheme of the National Calamity Relief Fund needs to be changed in order to increase the corpus of funds for the States. In view of the inter-State competition over mineral resources, there is a need to set some common norms regarding extraction of minerals. The royalty rates on coal and other minerals should be revised more frequently and charged on an ad valorem basis. It is also important to involve the State Governments in the policies of credit disbursement by the banks and financial institutions, particularly to ensure proper allocation of priority sector lending and an inter-State balance in the sphere of the loan disbursement. Effective resolution of these and other issues requires robust institutional arrangements within which Centre-State and inter-State consultations can take place on a regular basis and decisions reached.

#### *Issues Related to Present Institutional Arrangements*

The institutional bodies through which the issues related to Centre-State relations are supposed to be discussed and resolved are the Inter-State Council, National Integration Council, National Development Council, Planning Commission, Finance Commission and the Boards of the Reserve Bank of India and other financial institutions. However, the past record shows that neither have these bodies worked with effective representation of the States, nor have their decisions succeeded in providing a fair deal to the States. In fact, these bodies have functioned ceremonially and almost as an extension of the Union Government, with an implied bias in favour of concentrating power at the Centre. These need to be changed and these institutional arrangements developed into vibrant bodies with appropriate statutory backing.

#### *Inter-State Council*

The functioning of the Inter-State Council, which had gathered some momentum in the earlier years, has once again lost steam. Despite the Council arriving at several decisions regarding implementation of the Sarkaria Commission's recommendations, they have not been implemented by the Union Government. The decisions of the Inter-State Council therefore have to be made binding on the Union Government, through appropriate Constitutional amendment. All major issues involving Centre-State relations, including legislations under the Concurrent List, have to be discussed and decided by the Inter-State Council. The schedule of meetings of the Council as well as the Standing Committee of the Council has to be made mandatory. The Inter-State Council should mandatorily meet twice a year. The Secretariat of the Inter-State Council should have better representation from the States.

#### *NDC and Planning Commission*

The National Development Council has to be developed as an effective instrument for Centre-State co-ordination and should be given, through an appropriate amendment, a Constitutional status as was suggested in the Srinagar Conclave. The meetings of the NDC should be more frequent (at least once in every quarter), and its functioning should not be one of hastily imposing a pre-conceived view of the Centre as a consensus on the States, as is now often practised. Instead, each issue should be discussed seriously with written notes from the Centre and the States, and decisions should be taken democratically and implemented expeditiously. The Planning Commission should act as an executive wing of the NDC. Unlike the present

composition of the Planning Board where members and experts are all nominated by the Centre, there should be adequate representation of the States – both for members as well as experts – with at least one from each region with periodic rotation among the States in a region. The restructured Planning Commission must not act primarily as a representative of the Centre as it is now, but should also represent fairly the interests of the States.

#### *Finance Commission*

A basic problem with the Finance Commission is that the views expressed by the States are never taken into account seriously, while determining the terms of reference of the Commission. All the members of the Finance Commission are nominated by the Centre and representatives of the States are never included. These practices need to be changed. In determining the terms of reference, the views of the States should be taken into account seriously, and if there is any difference of views on the terms of reference, the same should be settled in the Inter-State Council. In the choice of members of the Commission, unlike the present practice, there should be adequate representation of the State Governments.

#### *RBI and Public Institutions*

The States should be involved in the functioning of the Reserve Bank of India as well as national level public financial institutions such as NABARD, IDBI etc. States should have a say in the policies of credit disbursement, particularly to ensure proper allocation of priority sector lending and inter-State balance in loan disbursement. Representatives from the States should be included in their boards, one from each region on a periodically rotational basis. Representation of States in the commodity boards like Tea Board, Coffee Board etc. should also be ensured.

#### SUMMING UP

In the light of the above discussion a set of demands for restructuring of Centre-State relations have been formulated below, on legal, administrative, financial, institutional and other matters. Many of the demands were initially raised by the Srinagar Conference and have not been resolved yet. Some of the demands are new and are being raised on the basis of the experience of the States in the post-liberalization period. We hope that this would initiate a discussion among political parties and organisations and help in the emergence of a common platform to bring about a restructuring of Centre-State relations.

#### *Legal and Administrative Issues*

- 1. Articles 356 and 355:** Articles 356 and 355 of the Constitution should be amended, in order to incorporate safeguards to prevent their misuse.
- 2. Appointment of Governors:** The current process of appointment of Governors by the Central Government should be changed. The Governor should be appointed by the President from a list of three eminent persons suggested by the Chief Minister of a State.
- 3. Legislative Powers for States:** Residuary powers of legislation should be placed in the State List. A process of consultation between the Centre and the States needs to be institutionalised on legislations under the Concurrent list. The Constitution should also be amended to set definite time-limits for receiving the assent of Governors or the President in the case of bills passed by the State Assemblies.

**4. Treaty-making Powers:** The Constitution should be amended to make legislative sanction mandatory for any international treaty. Before signing international treaties, which have implications for the States, consultation with the States and concurrence of the Inter-State Council should also be made mandatory.

**5. All-India Services:** The State Governments should have a greater role in the administration of the Rules and Regulations of All India Services.

#### *Financial Issues*

**1. Devolution of Central Taxes to States:** 50% of the total pool of collection of Central taxes should be devolved to the States.

**2. Residual Powers of Taxation:** The States should be allowed to tax certain services including some services which are currently being taxed by the Centre. Central surcharges and cesses should be made a part of the divisible pool. A suitable model for the proposed Goods and Services Tax should be evolved to ensure a fair share for the States, especially keeping in mind the interests of the Special Category States.

**3. Market Borrowing by States:** Article 293 of the Constitution should be amended to provide more flexibility and autonomy to the States in regard to market borrowing. The share of market borrowing of the States should be increased from about 15% per cent currently to 50%.

**4. Tax Concessions:** Central tax exemptions need to be urgently reviewed and the plethora of exemptions progressively phased out. The Centre should compensate the States for the losses and distortions arising out tax exemptions. The Centre as well as the States should set some collective limits to tax concessions in order to safeguard against a race to the bottom.

**5. Pay Commission Recommendations:** With the Sixth Pay Commission already making its recommendations and the Centre initiating the process of implementation, Central assistance to the States for the forthcoming round of pay revision need to be ensured.

**6. Debt Relief and Conditionalities:** Debt relief for the States on account of the Central loans should not be tied to any conditionality. Conditionalities imposed upon the States like the passage of FRBM Act should be withdrawn. Debt relief should be worked out in a State-specific manner, especially with regard to loans from the NSSF. The debt of the Special category States should be settled in a one time manner.

**7. Centrally Sponsored Schemes:** The formulation and implementation of all Centrally Sponsored Schemes under the State subject should be transferred with funds to the States along with broad guidelines and minimum conditions. The focus should be on outcome indicators rather than process indicators, and States should be provided flexibility in the manner of operating these schemes. Conditionalities like reduction of stamp duties as required under the Schemes like JNNURM should be withdrawn.

**8. Devolution to Local Self-Governments:** A target minimum level of Local Self-Government expenditure to GDP should be set. Funds devolved to the local bodies should mandatorily be routed through the State Governments.

**9. Accountability and Transparency:** Accountability and transparency in governance should be improved through people's participation in policy planning and their implementation. Entities like private corporate groups or NGOs, which have no democratic accountability, should not play any direct role to play in governance.

#### *Institutional and Other Issues*

**1. Inter-State Council:** The Constitution should be amended to make the decisions of the Inter-State Council binding on the Union Government. All major issues involving Centre-State

relations have to be discussed and decided by the Inter-State Council. The Inter-State Council should mandatorily meet twice a year.

**2. NDC and Planning Commission:** The National Development Council should be granted Constitutional status. The Planning Commission should act as an executive wing of the NDC. The Planning Commission should allocate adequate funds for State-level projects having national implications and ensure inter-State balance in Central investments in CPSUs, Railways, National Highways, Ports, Airports etc. The PDS allocations should be in accordance with the needs of the States and not decided unilaterally by the Centre. To ensure all this, adequate representation of the States in the Planning Commission is required – both for members as well as experts – with at least one member from each region with periodic rotation among the States in a region.

**3. Finance Commission:** In determining the terms of reference of the Finance Commission, the views of the States should be taken into account. Any difference of views on the terms of reference should be settled in the Inter-State Council. There should be adequate representation of the States in the Finance Commission.

**4. RBI and Public Institutions:** The States should be involved in the functioning of Reserve Bank of India as well as national level public financial institutions such as NABARD, IDBI and public sector banks. Representation of States in the commodity boards like Tea Board, Coffee Board etc. should also be ensured.

**5. Special Category States:** The differential benefits given to these States in terms of the non-Plan Gap Grant and Normal Central Assistance should continue. The debt of these State Governments should be settled in a one time manner without any conditionality. The release of funds to the Special Category States under the Centrally Sponsored Schemes should be done in a timely manner without stringent conditions on fund utilization.

**6. Mineral Policy:** In view of the inter-State competition over mineral resources, there is a need to set some common norms regarding extraction of minerals. The royalty rates on coal and other minerals should be revised more frequently and charged on an ad valorem basis.

**7. National Calamity Relief Fund:** The present scheme of the National Calamity Relief Fund should be changed in order to increase the corpus of funds for the States.

## APPENDIX

**TABLE 1 Shares of Central Government and State Governments in Total Revenue Receipts of the Country**

Year	Total Revenue Receipts (Rs. Crore)	Share of Centre (%)	Share of States (%)
2004-05	6,21,231	61.90	38.10
2005-06	7,12,552	61.92	38.08

Source: Reserve Bank of India, *Handbook of Statistics on Indian Economy, 2005-06*.

**TABLE 2 Share of Net Central Transfer as a Proportion of Total Revenue Receipts of the Centre**

Year	Total Revenue Receipts of the Centre (Rs. crore)	Net Central Transfer to the States as a proportion of the total Revenue Receipts of the Centre (%)
1990-91	69,196	32.7
2004-05	3,84,564	29.5

Sources: *State Finances*, Reserve Bank of India, Nov., 2006; *Handbook of Statistics on Indian Economy*, Reserve Bank of India, 2005-06; *Handbook of Statistics on State Government Finances*, Reserve Bank of India, 2004

**TABLE 3 States' Share in Central Taxes: 2000-01 to 2004-05**

Year	Amount Recommended by the 11th Finance Commission (Rs. crore)	Actual Amount Received by the States (Rs. crore)	Column (3) as % of Column (2)
[1]	[2]	[3]	[4]
2000-01	54,059	50,734	93.85
2001-02	63,026	52,215	82.85
2002-03	73,493	56,655	77.09
2003-04	85,724	67,079	78.25
2004-05	1,00,013	78,551	78.54
Total	3,76,315	3,05,234	81.11

Sources: Handbook of Statistics on Indian Economy, Reserve Bank of India, 2005-06; Report of the 11<sup>th</sup> Finance Commission, June 2000.

**TABLE 4 Revenue Foregone in Financial Years 2006-07 and 2007-08 (in Rs Crore)**

	2006-07		2007-08	
	Revenue foregone	Revenue foregone as a per cent of aggregate tax collection	Revenue foregone	Revenue foregone as a per cent of aggregate tax collection
Corporate income tax	45034	9.56	58655	10.09
Personal income tax	32143	6.82	42161	7.25
Excise duty	75475	16.02	87992	15.14
Customs duty	137105	29.11	148252	22.51
Total	289757	61.51	337060	58.00
Less export credit related	50045	10.62	58416	10.05
Grand total	239712	50.89	278644	47.94

Notes 1. Aggregate Tax Collection refers to the aggregate of net direct and indirect tax collected by the Central Government.

2. The figure of Aggregate Tax Collection for 2006-07 is based on actuals while that for 2007-08 is based on revised estimates.

Source: Revenue Foregone under the Central Tax System, Receipts Budget, 2008-09

**TABLE 5 Ratio of Interest Payments to Revenue Receipts of the State Governments**

Year	Ratio of Interest Payments to Revenue Receipts of the States
1990-91	13.0%
2003-04	25.8%

Source: State Finances, Reserve Bank of India, November 2006.

**Table 6 Gross Central Transfer in Grants-in-Aid involving Conditionalities as proportion of the Total Revenue Receipts of the Centre**

Year	Gross Central Transfer in Grants-in-Aid involving Conditionalities as proportion of the Total Revenue Receipts of the Centre
1980-81	40.9%
2005-06 (RE)	49.3%

Source: Handbook of Statistics on Indian Economy, Reserve Bank of India, 2005-06.