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SPECIAL CATEGORY STATUS OF HIMACHAL PRADESH AND ITS IMPACT ON THE FISCAL SUSTAINABILITY OF THE STATE

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Abstract

The concept of the Special Category State came into existence when planned economy and normal central assistance was the most dominant method of centre –state funding. Over the years the number of Special Category States has stretched to eleven while their proportion in normal central funds has remained the same. The introduction of economic reforms has transformed the nature of fiscal federalism in India and now states are competing with each other for attracting the investments and industries in their territory. Because of this transformation the reduction in central excise and other tax liabilities has become a very potent mode of attracting industries in the states. Presently, Himachal has gained a lot from the industrial package which gives exemption from central excise taxes and provides capital subsidy to industries investing in Himachal. Creation of NITI AAYOG has ended the old mode of normal central assistance and central assistance for state's plan. The Finance Commission now is allocating larger devolution of resources to states from the divisible pool of centre's income allowing them to create their own plans. Himachal has seen a great amount of increase in its finances due to this new allocation by the Finance Commission. The industrial package is more crucial for the prosperity of Himachal's economy as compared to the funds transferred under the norm of special category state. The Chief Minister of Himachal has requested the Finance Minister of India to extend these tax exemptions at least five years for industries being established in Himachal. The present economic reforms like Goods and Services Tax are pointing towards uniformity of taxation and trade policies and it will demand a great deal of negotiation from the political

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leadership of Himachal to extend this industrial package.

1. Introduction

India came into existence as an indestructible union of destructible states at the time of Independence. The word federal was not even mentioned anywhere in the constitution but with all caveats still intact on 26 the January 1950, India came into existence as a federal system. Federalism is a system which promotes dual form of governance one at the Centre and other at the level of states. Nowadays the local self governance has become the third essential tier of this form of governance. Ideally the distribution of financial and pecuniary powers between tiers of governance should make them self- reliant for their functioning. In a Union not all the states or local self- governing bodies are self reliant with in any political union. Therefore, the transfer of resources from Union to states and local bodies is an essential component of the federal form of governance. If this process of central funding is not adopted then there will always be the danger of creating grave inequalities and imbalances between states or governing bodies. Another important logic behind the central funding for states is that the process of creation of states in India is not based on the criteria of financial viability of these states. Initially states have been formulated on the basis of linguistic identity of a region rather than thinking on its financial viability. Many states and autonomous territorial councils (semi –states) especially in the case of North –East has been created to accommodate the ethnic and tribal identities like Nagas, Mizos, Bodos and Karabi. Government of India has never seen the creation of these states and autonomous territorial councils from the perspective of their financial viability rather the main priority was given to accommodate the potential separatist tendencies within the Indian federation. Creation of states like Himachal Pradesh, Jammu & Kashmir and Uttarakhand was based on the accommodation of distinct ethnic identities within the federal system. Although, it cannot be denied that J&K has its own unique history of joining the Indian federation. Case of Himachal Pradesh, Arunachal, Assam and Uttarakhand has been the successful demand of regions which were culturally, historically and geographically different besides being backward on the scale of development. (All of these states have some of basic similarities of circumstance which makes their financial autonomy more difficult).These are geographically and demographically smaller as compare to the majority of other states which is one of the reasons for their financial dependence on Central assistance. Their terrain is predominately not suitable for industrialization and transportation is both cost and time consuming.

2. Review Of Literature

Bhattacharjee, Govind, 2013, Special Category Status; Will it Actually Benefit Bihar?

The Author illustrates that over the year's resources which are allocated to Special Category States has dwindled. The emergence of Central and Centrally – Sponsored Schemes as the bigger mode of transferring resources form the Centre to the States has further made this status less lucrative for the states. He concludes with the point that there is no dearth of resources for non- special category states and states like Bihar has failed on the administrative level.

Syed Zubair Naqvi, Kapil Patidar and Arvind Subramanian 2017; **A Watershed 14TH Finance Commission.**

This article has pointed out how the 14th Finance Commission has increased the devolution of resources to the states. They also pointed out that with end of Planning Commission funding for state plans and normal central assistance will be in danger. They have pointed out at the non funding nature of NITI AAYOG which puts the special category status in jeopardy due its dependence on the planning commission.

(Singh, Mohinder 2015) **A Comparative Study of Industrial Development in Himachal Pradesh After the Special Industrial Package,** In this paper the Author has tried to understand the overall impact of industrial package on the industrial growth of Himachal Pradesh. The study found that the state registered a significant growth in terms of the number of factories, capital employed , industrial employment , and capital formations during the period from 2003- 04 to 2011-2012 in comparison to other states.

Sharma, Amit Kumar, 2017. **'Impact of Fiscal Incentives on Industrialization in Himachal Pradesh'.** The aim of this paper is to study the impact of incentive package in industrialization of H.P. The researcher concluded that these incentives were responsible for the three fold increase in the number of industrial units within the span of 12 years. This paper also tried to illustrate the various challenges which industries are facing there presently. The BBN area is at the centre of study in this paper. This paper also raises the questions of infrastructure deficit and negative impact on the environment which industrialization brings with it.

Bassi, P & Sharma (2014) **Role of Incentive Package on Industrialization in Himachal Pradesh.** This paper has tried to study the role which an incentive package like relaxation in excise duty and subsidy on capital investment could play in rapid industrialization of an industrially backward area like Himachal Pradesh. This paper has justified the state's intervention in the growth of the industries in backwards regions even after the liberalization and privatization of the economy.

3. Discussion

3.1 Evolution of the Special Category States-

The concept of a special category state was first introduced in 1969 when the 5th Finance Commission sought to provide certain disadvantaged states with preferential treatment in the form of central assistance and tax breaks. Initially three states Assam, Nagaland and Jammu & Kashmir were granted special status but since then eight more have been included (Arunachal Pradesh, Himachal Pradesh, Manipur, Meghalaya, Mizoram, Sikkim, Tripura and Uttarakhand). The rationale for special status is that certain states, because of the inherent features, have low resources and cannot mobilize resources for development. Some of the features required for special status are:1) hilly and difficult terrain ; 2) low population density or sizeable share of the tribal population ;3) strategic location along borders with neighbouring countries; 4) economic infrastructural backwardness ; 5) non –viable nature of state finances. The decision to grant special category status lies with the National Development Council, consisting of the Prime Minster, Union Ministers, Chief Ministers and members of erstwhile Planning Commission, who used to guide and review the work of the Planning Commission.

In India, resources can be transferred from the centre to states in many ways (see figure 1). The Finance Commission and the Planning Commission are the two institutions responsible for centre-state financial relations.

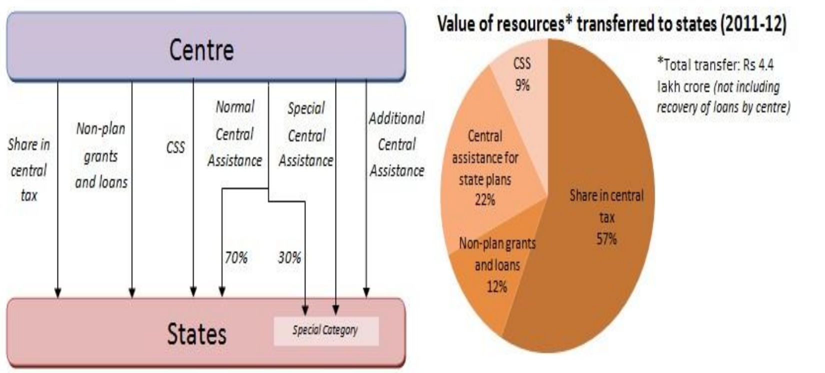

Figure 1: Centre-state transfers (Source: Finance Commission, Planning Commission, Budget documents, PRS)

3.2 Planning Commission and Special Category

Independent India had adopted the path of centralized planned economy which culminated into the creation of the Planning Commission. This institution became the main centre for deciding development agenda and the distribution of funds among the states of the country. It was the planning commission which had evolved different criteria of funding among different states for the developmental work.

The Planning Commission used to allocate funds to states through central assistance for state plans. Central assistance for state can be broadly split into three components; Normal Central Assistance (NCA), Additional Central Assistance (ACA), and Special Central Assistance. Normal Central Assistance (NCA) was the main assistance plan for states, this grant was split to favour the special category states. The 11 states used to get 30% of the total assistance after setting aside funds for externally aided schemes, Special Area Programme and North Eastern Council, while the other states shared the remaining 70%. Normal Central Assistance (NCA) was split into 90% grants and 10 % loans for special category states, while the ratio between grants and loans was 30:70 for other states. For allocation among special category states, there were no explicit criteria for distribution and funds were allocated on the basis of the state's plan size and previous planned expenditures. Special category state also used to receive specific assistance addressing features like hill areas, tribal sub –plans and border areas. Beyond additional plan resources, special category states used to enjoy concessions in excise and custom duties, income tax rates and corporate tax rates as determined by the government. However, as a proportion of total centre –state transfers Normal Central Assistance (NCA) typically accounted for a relatively small portion. As per 2013-14 budget –total central assistance to states was 1.3 lakh crores, of which Normal Central Assistance (NCA) was 27,636 cores and about a third of this money would go to the special category states. This example clearly illustrates that the Normal Central Assistance (NCA) comprises approximately 1/5 of the total centre –states transfers and the Special Category States were allocated only 1/3 of the NCA. That means the eleven Special Category States were consuming approximately the 7 percent of the total Central Assistance. This gives the clear indication that in the context of centre –states fund transfers the status of Special Category State was not making effective tilt in the favor of the these states.ii

Allocation among non special category states was determined by the Gadgil- Mukherjee formula which gave different weight age to different components such as population (60%), per capita income (25%), fiscal performance (7.5%) and special problems (7.5%) in the distribution of funds.

3.3 Centrally Sponsored Schemes

The rise of Centrally Sponsored Schemes emerged as a new powerful method of fund transfer to the states for specific schemes. This kind of fund transfers became more dominant mode of transfer after the initiation of the economic reforms in 1991. These schemes are a politically maneuvered aberration in the Indian financial system which goes against the constitutionally enshrined principal of the fiscal federalism. These schemes are meant to bypass state governments in planning and funding of developmental schemes. The schemes are devised at the central level and implemented by the local governments. Till recently this mode of funding had become one of the most dominant methods of centre –state fund transfers. In the budget of 2013- 2014 the Total Plan expenditure was 4.2 lakh crore for Central and Centrally –Sponsored Schemes, of which Rs 1.4 lakh crores was transferred to states for the implementation of flagship welfare schemes of the Centre. But this type of funding was not done through the budgets of the state governments. In the same year the total Normal Central Assistance (NCS) was 1.3 lakh crores, this clearly depicts the fact that NCS is not the most dominant mode of centre –state funds transfers in Indian federal system. This further clarifies the point that the Special Category State status now has less impact in terms of extracting more funding from the central government.

3.4 The Finance Commission

Finance Commission under the article 280 of the Indian constitution is the constitutionally designated agency which would decide the actual distribution of resources to the states from the central tax pool. In addition to this Finance Commission recommends the principle for extending non-plan grants and loans to states. Under Article 275 of the Constitution, every state is entitled to a share of all central taxes in the union list which are pooled together to form what is known as the divisible pool of central taxes. These are shared between the centre and the states as per the recommendations of the Finance Commission constituted once in five years under Article 280 of the Constitution. Article 275 thus provides a mechanism for automatic devolution of resources of the centre to the states. The Finance Commission also determine the inter se transfer of shares amongst the states depending on a number of factors with the objective of removing inter-regional disparities and promoting better fiscal management. The Finance Commission had been sidelined in the initial decades after the independence due to the dominance of planned development model. The Planning Commission despite being an extra-constitutional body played a far more important role in the distribution of funds from centre to states. The Finance Commission regained its pivotal position in the fiscal federalism after the adoption of economic reforms. The economic reforms transformed centralized planning into the indicative planning and after the deepening of the markets and reforms the Planning Commission has been dissolved. New institution of the NITI AAYOG which has replaced the Planning Commission has been reduced to the status of policy think-tank which does not possess the power of transferring financial resources.

3.5 Vertical and horizontal devolution

The FFC has increased the amount that the Centre has to transfer to the states from the divisible pool of taxes by 10 percentage points i.e. from 32 per cent to 42 per cent. Its radical nature is indicated by the fact that the previous two Finance Commissions (FCs) had increased the share to the states by 1 and 1.5 percentage points, respectively. So, the FFC recommendations represent a ten and six-and-a-half fold increase, respectively relative to the previous two FCs. Had the new share been implemented in 2014-15 (Budget estimates), the Centre's fiscal resources would have shrunk by about 1.20 lakh crore (0.9 per cent of gross domestic product or GDP). If the comparison were to be in terms of overall (tax plus non plan grants) devolution, the increase would be roughly comparable to that in tax devolution.

In addition, the FFC has significantly changed the sharing of resources between the states—what is called horizontal devolution. The FFC has proposed a new formula for the distribution of the divisible tax pool among the states. There are changes both in the variables included/excluded as well as the weights assigned to them. Relative to the Thirteenth Finance Commission, the FFC has incorporated two new variables: Demographic change (Population 2011) and Forest cover, and excluded the fiscal discipline variable. Several other types of transfers have been proposed, including grants to rural and urban local bodies, a performance grant, and grants for disaster relief and reducing the revenue deficit of eleven states. These transfers total approximately 5.3 lakh crore for the period 2015-2020.

3.6 Uniformly large addition to states' resources

The impact of FFC transfers to the states needs to be assessed in two ways: gross and "net". FFC transfers will clearly add to the resources of all the states in absolute terms. They will also increase resources when scaled by states' population, net state domestic product, or own tax revenues, with the latter connoting the addition to fiscal spending power. Implementing the FFC recommendations alone would undermine the centre's fiscal position substantially. The philosophy of the FFC report is that there should be some corresponding reduction in the central assistance to states (CAS, the so-called plan transfers).Thus, greater fiscal autonomy to the states would be achieved both on the revenue side (on account of states now having more resources and more untied resources) and on the expenditure side because of reduced CAS transfers. The exact mechanism for implementation will be discussed in the months ahead but the legally backed schemes as well as flagship schemes that meet core objectives, such as rural livelihoods and poverty alleviation, will be, and need to be, preserved. The net impact on the states will depend not just on the transfers effected via the FFC, but also the consequential alteration of CAS. Under some simple assumptions about how the latter will be distributed, we find that all states will end up better off than before, although there will be some variation amongst the states.

3.7 Increase in progressivity of overall transfers

The FFC transfers will have a more favourable impact on the states that are relatively less developed, which is an indication that they are progressive, that is, states with lower per capita net state domestic product (NSDP) are likely to receive on average much larger transfers per capita. The correlation between per capita NSDP and FFC transfers per capita is -0.72 based on some broad assumptions about FFC transfers. (see chart: FFC transfer...) This indicates that the FFC recommendations do go in the direction of equalizing the income and fiscal disparities between the major states. In contrast, CAS transfers are only mildly progressive: the correlation coefficient with state per capita GDP (over the last three years) is -0.29. This is a consequence of plan transfers moving away from being formula-based (Gadgil- Mukherjee formula) to being more discretionary in the last few years. Greater central discretion evidently reduced progressivity. A corollary is that implementing the FFC recommendations would help address inter-state resource inequality, increase progressive tax transfers would, while discretionary and less progressive plan transfers would decline.

Table 1: Horizontal Devolution Formula in the 13th and 14th Finance Commissions

Population (1971)	25.0	17.5
Fiscal capacity/Income distance	47.5	50.0
Population (2011)	0.0	10.0
Area	10.0	15.0
Forest cover	0.0	7.5
Fiscal discipline	17.5	0.0
Total	**100**	**100**

Sources 13th and 14TH Finance Commissions

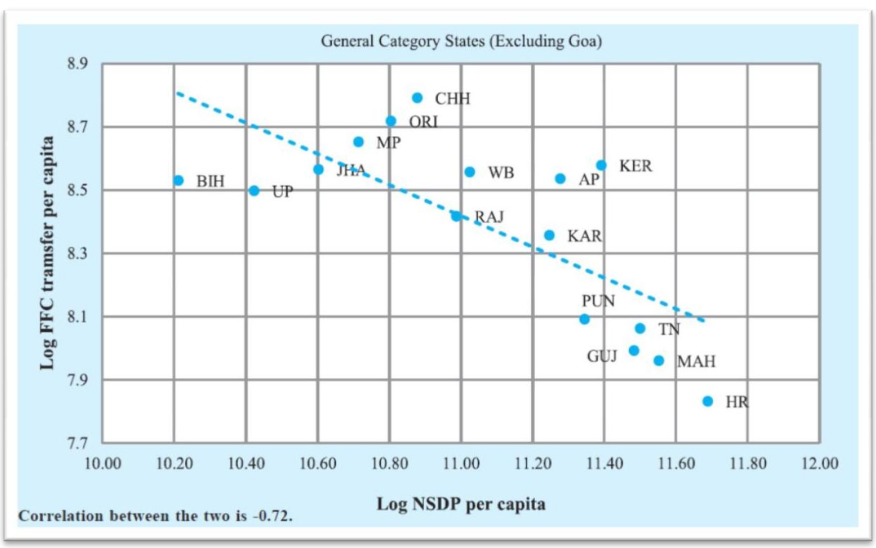

Figure 2: Per Capita NSDP and EFC Transfers

Fiscal discipline and role of NITI AAYOG

Will FFC transfers lead to less fiscal discipline? There are two reasons to be optimistic. First, in the last few years the overall deficit of the states has been about half of that of the Centre: in 2014-15 (Budget estimates) for example, the combined fiscal deficit of the states was estimated at 2.4 per cent of GDP compared to 4.1 per cent for the Centre. So, on average, states, if anything, are more disciplined than the Centre. Based on analysing recent state finances, we find that additional transfers toward the states as a result of the FFC will improve the overall fiscal deficit of the combined central and state governments by about 0.3-0.4 per cent of GDP. Moreover, nearly all the state governments have enacted fiscal responsibility legislations (FRLs), which require them to observe high standards of fiscal discipline such as keeping the deficit low. Further, as part of the new Centre state fiscal relations, for example, under the NITI AAYOG, mechanisms for peer assessments and mutual accountability could be created, and incentives could be provided for maintaining fiscal discipline. This is becoming routine practice in many federal structures where sovereignty is shared between the members. The FFC recommendations and the consequences they entail offer an opportune time for instituting such mechanisms.

The FFC has made far-reaching changes in tax devolution that will move the country toward greater fiscal federalism, conferring more fiscal autonomy on the states. This will be enhanced by the FFC-induced imperative of having to reduce the scale of other central transfers to the states. In other words, states will now have greater autonomy both on the revenue and expenditure fronts. To be sure, there will be transitional challenges, notably how the Centre will meet its multiple objectives given the shrunken fiscal envelope. But there will be offsetting benefits: moving from CAS to FFC transfers will increase the overall progressivity of resource transfers to the states. In sum, it is clear that the far-reaching recommendations of the FFC, along with the creation of the NITI AAYOG, will radically alter Centre-state fiscal relations, and further the government's vision of cooperative and competitive federalism. The necessary, indeed vital, encompassing of cities and other local bodies within the embrace of this new federalism is the next policy challenge, a change that we would like to see.(Syed Zubair Naqvi, Kapil Patidar and Arvind Subramanian)

Formation of Himachal Pradesh and its Fiscal Position

Himachal Pradesh came in to existence as one the Chief Commissioner Provinces on 15 April, 1948 in the Western Himalayas. Gradually it gained the status of a Union territory in 1956 and trifurcation of erstwhile Punjab increased the demographic and geographical composition of Himachal Pradesh in 1966. Himachal became the 18th state of Indian Union on 25 January, 1971. Himachal became the obvious selection for the category of special state due to factors like its geographical topography, boundaries with Tibet and proportion of tribal population. State of Himachal does not historically possess the enough financial resources to create a self reliant administrative unit. Himachal has been dependent on liberal central assistance to keep its finances running like all other hill states. Over the years this status of Special Category State has helped Himachal to gain its finances but with the advent of economic reforms the conception of development has undergone a great change. The transfer of central funds under Special Category became less important in comparison to the reduction in the Central excise duty which would attract modern industries. The industrial package which Himachal gained in 2003 has provided big impetus to the process of industrialization in lower regions of Himachal Pradesh. The industrial package includes relaxation in the central excise taxes on the industries being established in Himachal Pradesh besides providing subsidy on the capital input in these industries.

Brief History of Industrialization in Himachal before 2003

According to the census of 2011, 89.96% of the total population of Himachal Pradesh still resides in the rural area and approximately 90% of its population is engaged in agriculture. The geographic and topographic condition of Himachal Pradesh has not been very conducive for the growth of industrialization.

New Industrial Policy and other concessions for the state of Himachal Pradesh & Uttaranchal - 2003vii

1. Tax and Central Excise concessions to attract investments in the industrial sector will be worked out for the Special Category States including Himachal and Uttaranchal. The industries eligible for such incentives will be environment friendly with potential for local employment generation and use of local resources.'

2. In pursuance of the above announcement, discussion on Strategy and Action Plan for Development of Industries and generation of employment in the states of Uttaranchal and Himachal Pradesh were held with the various related Ministries/agencies on the issue, inter-alia, infrastructure, development, financial concessions and to provide easy market access, The new initiatives would provide the required incentives as well as an enabling environment for industrial development, improve availability of capital and increase market access to provide a fillip to the private investment in the state.

3. Accordingly, it has been decided to provide the following package of incentives for the states of Uttaranchal and Himachal Pradesh

Industrial development in Himachal Pradesh after 2003 the Industrial Package

Till 2003 -2004 there were only about 30839 SSI units and about 211 Large and Medium units employing just 164225 people. As on 31/03/2013 there are 39018 SSI units wherein an investment of Rs. 6156.01 crore is involved and employment opportunities to about 2.16 lakh people have been generated. In Large and Medium Sector, 494 units are set up with an investment of Rs 11009.53 crore having employment of **59143 people**. The government has already developed 42 Industrial Areas and 17 Industrial Estates with all the basic amenities. Maximum numbers of Small Scale Investments exist in Kangra Distict followed by District Solan while in case of Medium and Large Scale enterprises **Solan district leads**. Himachal Pradesh has become a Pharma hub over the years. In Solan District which is considered to be the biggest industrial centre, most of the units belong to Pharmaceuticals sector, followed by electronics, textile, food processing, soaps and cosmetics etc. Most of the enterprise belongs to

Miscellaneous Engineering group and steel units are set up in Sirmour District.

4. Suggestions

1. The special needs of the hill states like Himachal Pradesh, Arunachal Pradesh and Nagaland etc. must be taken into consideration while distributing the resources between the centre and the states.
2. Promotion of environment friendly industries in the hill states must be supported to a greater extent. Promotions of such industries require special kind of facilities to them.
3. Promotion of skill development in various sectors must be supported in the hill states.
4. The promotion of good infrastructure is also the need of the hour.
5. Fiscal federalism demands that hill states should be subsidized for the promotion of their certain essential needs due to their non-viable economy.

5. Conclusion

The end of the planning commission and increase in the devolution of resources from the Finance Commission has transformed the nature of fiscal federalism in India. Planning Commission since the adoption of planned development model has been the most dominant institution of funding to the states and the concept of Special Category States has been the creation of Planning Commission. Presently, Indian federation has moved on the path of fiscal federalism and there has emerged a consensus that states should get a higher share from the divisible pool of taxes. This marks the substantial shift from the centralized planning model and gives states bigger resources to plan their own schemes. The adoption of the 14th Finance Commission award by the Central government is the biggest testimony of this shift. The creation of NITI AAYOG as a policy think tank and not conferring it the role of resource transfers for state's plan is also a step in the direction of the fiscal federalism. The Special Category states have witnessed far more devolution of resources form the Finance Commission this time. The Special Category status has provided the special industrial package for these industrially backward states which has resulted in the establishment of various industrial units in these states. This package has provided the big boost to the growth of industrial units in Himachal Pradesh and has generated employment opportunities for the people of the state. Himachal and other special category states should come together to demand for the extension of this special industrial package till they are able to develop a cost competitive conducive infrastructure in their respective states. This is essential that these states should develop the infrastructure (transportation, cheap power and skilled labour) for making the industries established here cost competitive because once the Goods and Service regime is set then only the cost competitive industries will survive. At present the GST is favouring the industries established here due to the industrial package. The production cost is cheaper but once this industrial package is withdrawn the production costs of the industries are bound to rise. Therefore states like Himachal needs the extension of this package so that they can improve on their infrastructure and make the industries cost competitive without the help of industrial package. The Special Category States should represent the inherent difficulties of their existence (mountainous terrain, small size, border area, substantial tribal population and historically backwardness) to the Finance Commission and NITI AAYOG. This will help them in demanding substantial grants to overcome these historical and geographical hindrances in the path of growth. The state has been the prime agency of development and public investment is the first requirement for the progress of states especially Himachal. The state has been the largest employer other than the primary sector usually this employment is seen as wasteful and a fiscal imbalance. Expenditure incurred on the public resources should be effective but that does not mean to term the every investment of state as wasteful.

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