FISCAL FEDERALISM IN INDIA AFTER THE TWELFTH FINANCE COMMISSION: TRENDS AND ISSUES

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This is to certify that the dissertation entitled "*FISCAL FEDERALISM IN INDIA AFTER THE TWELFTH FINANCE COMMISSION: TRENDS AND ISSUES*" submitted by **ANVITA BHUVAN** in partial fulfillment of the requirements for the award of the degree of **MASTER OF PHILOSOPHY**, of this University, is an original work of her own. This Dissertation has not been submitted for the award of any degree of this or any other University.

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To Apoorva

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ABBREVIATIONS.

I. ACA- Additional Conditional Assistance.

II. APL- Above Poverty Line.

III. ASD- Alternative Scheme of Devolution.

IV. BPL-Below Poverty Line.

V. BRGF- Backward Regions Grant Fund.

VI. CFI- Consolidated Fund of India.

VII. CFS- Consolidated Fund of State.

VIII. CSO- Central Statistical Organization.

IX. CSS- Centrally Sponsored Scheme.

X. CST- Central Sales Tax.

XI. DPC- District Planning Committee.

XII. EFC- Eleventh Finance Commission.

XIII. FC- Finance Commission.

XIV. FDI – Foreign Direct Investment.

XV. FRBM- Fiscal Reforms and Budgetary Management.

XVI. GDI- Gender Development Index.

XVII. GDP- Gross Domestic Product.

XVIII. GM- Governmental Meetings.

XIX. GST- Goods and Services Tax.

XX. HDI- Human Development Index.

XXI. HPI- Human Poverty Index.

XXII. MODVAT- Modified Value Added Tax.

XXIII. NSS- National Sample Survey.

XXIV. PC- Planning Commission.

XXV. PI – Private Investment.

XXVI. PRI- Panchayati Raj Institutions Act.

XXVII. RTI- Right to Information.

XXVIII. SAP- Structural Adjustment Programme.

XXIX. SDP- State Domestic Product.

XXX. SFC- State Finance Commission.

XXXI. TFC- Tenth Finance Commission.

XXXII. TOR- Terms of Reference.

XXXIII. ULB- Urban Local Bodies.

XXXIV. VAT- Value Added Tax.

XXXV. WMA- Ways and Means Advances.

Introduction

"All politics is local", this famous statement made by the former Speaker of the House of Representatives (USA), Thomas O' Neill Jr, carries the spirit of what is to follow in the next 150 pages of this work.

There had been both mainstream and alternative system approaches in the conception of state structures. Amongst the recent classification of the states, names such as Easton (1953),Almond (1956), Eisenstadt(1964), Apter(1974), comes at the forefront in the analyses of the systems(state) approaches. They are involved in the formulation of the idea that the system is composed of various parts that effect and counter affect each other suggesting positions of equilibrium and disequilibrium. Hence there are both external and internal influences that affect a system. Therefore, it is to be seen that all modern nation states have been subjected to contrasting pressures, be it at the international level or at the domestic level.

If one is looking at the abstract domestic level there had been such states that had seen the pressures of centralization of its political structures, while there are others that had been marred by the centrifugal tendencies. My concern here, is to analyze the structure from within. I study these tendencies keeping in view the established Constitutional structure in the country, which provides for the rough division of powers between its constituent units. I shall also take into account, an equally important in the levels of analysis, the powers exercised by the *de jure* organizations and institutions that invariably assert more power and influence over much policy making in the country

Thus taking clue from the arguments forwarded by the above theorists, this work largely aims to study the influences of various kinds of demands and supports that are meted to the system and vice versa, hence would seek to analyze the relative position of equilibrium and disequilibrium.

1. Historical Background

Federalism as a theory of development and governance probably provides the best possible formulation and their execution. Its essence lies in the structuring of power relationships between the state and the civil society on one hand and between the Governments on the other hand[1] . Accepting that federalism is required, for providing the necessary institutional framework for the state to transfer micro details of social responsibility to the society itself. It is also required to transform "initiative" into "opportunity" for sustainable development. Hence particularly in this latter context the concept of federalism assumes particular importance. Where on one hand it delimits the scope of the regulative powers and the authority of the state and on the other hand it promotes the societal perspective of development. Some authors even go beyond this to label to give de bureaucratization and no hierachization of policy making and policy execution as two essential elements of federalism. Federalism, for them provides a space

[1] Singh Ajay Kumar (2004): "Policy governance: Significance of the federal design" as in *Federal India: a design for good governance*, Centre for Federal Studies, Manak Publications, Pg 15.

for social audit of the policies and their governance, and probably is the best possible networking method. Such kind of networking is based on critical adjustment and synthesis of the two principles of management – 'integration' and 'autonomy'.

The theorists who analyze the systems approaches are all likely to understand one thing from the Indian context, and it is that the India is an example of a peculiar mix of unitary and federal features. Where one school of thought may call it a system with strong centralizing tendencies, on the other hand some may call it a system bestowed with the idea of cooperative federalism. Nevertheless, in accordance with what had been it called by the Father of the Indian Constitution Dr B. R. Ambedker, that India is an "indestructible union with the indestructible states", it should be taken to imply broader policy of pluralism, that had been positively embedded in the Indian Constitution.

While it should be noted that federalism as has been defined as reciprocity or mutuality (Proudhon , 1809-65), or as in the writings of Alexander Hamilton(1755-1805) and James Madison(1751-1836) where federalism implies the notion of shared sovereignty, India does not stand as a illustrative example of such classical federations as for example USA, Canada, Belgium etc, it nevertheless stands for an institution that responds to culturally diverse and ethnically heterogeneous traditions of its own country designing its own method of keeping national priorities at the helm. It should be noted here, that the examples forwarded in the name of classical federations are also wrought with problem of assimilation and absorption of ethnic and minority community. As we all are aware of the tendency of centralization that had marked the evolution of federalism in the last century in several such classical federations as in USA, Australia. Likewise there had been a threatening call for disintegration of an overtly centralized federation in Canada, the elaboration on which I shall see shortly.

United States of America, that started initially with the principles of "dual federalism", later in the nineteenth century, gave way to "cooperative federalism", which was based on the growth of the "grants in aid" from the federal Government to the states and the localities. States and the local Government had therefore become increasingly depended on the flow of the federal funds, especially after the upsurge in economic and social programs that occurred under the New Deal in the 1930s initiated at the behest of President Roosevelt. From the mid 1960s however, this "cooperative federalism", based on the partnership of states, was replaced with what some theorists call "coercive federalism", meaning thereby that the federal Government had increasingly brought about the compliance of the states by passing laws that preempt their powers and impose restrictions on the states and the localities in the form of *mandates*.

Similarly, Federalism in Canada, for example, was on the verge of being called a failure had it not taken into account the growing demand for separation of the Francophonic Quebec. Responding to the growth of separatism in the predominantly French speaking Quebec, Canada had been constantly engaged in searching for a Constitutional formula that would reconcile Quebec to the membership of the Constitutional federation. The *Meech Accord of 1987* and the *Charlotte Agreement of 1992* tried to offer one formula after another, finally granting recognition to Quebec (as on 27th November 2006) to be considered a nation within Canada. All the major parties including those of the opposition supported Stephen Harper on the issue. But at least one thing got certain that without giving in to this kind of move, the Government led by Harper could not have averted the crisis.

Almost like the other two, in case of Australian Federation also, the centralization is apparent with the states collecting barely 30% of the total Government revenues, but accounting for about 47% of the total expenditure, signifying a large vertical imbalance (Bagchi, 2002) Hence one could see that the abstract form of federalism exists no where or at the maximum at the level of theory only. . Now it is the balance between centralization and decentralization is what one needs to analyze in the given context of a federal Constitution.

In case of India , though the state of affairs are very much beyond the normative discussions that flow from the debates between the liberalism and communitarianism, yet the polity is definitely passing through the phase what Sunil Khilnani calls the phase of "pure politics"[2]. By this vocabulary he means that the Indian polity remains marred by the struggles over the access, capture and the holding of power which has only intensified over the years. Raw competition for power has weakened the organizing frameworks, initially set up to regulate such competition, and has set up alternative, informal and often opaque patterns that now preside over the political life. In the same vein he iterates his dilemma even about the viability of Constitution itself, he says and I quote. ***Familiarity***

[2] Hasan, Sridharan & Sudarshan(2002): *India's Living Constitution*, Permament Black Publications, pg 63-64.

with the Constitution, always pretty thin beyond a few restricted circles, is today stretched to virtual invisibility. Those who do claim for themselves some knowledge of the Constitution have expressed in the increasingly strident terms the view that it is a relic and an hindrance; a document that has been superseded by history and whose only function today is to serve as a block to the will of the putative majority. Though his ideas are prompted from the actual parliamentary practices, but may actually serve as an effective guide in understanding the façade of India's formal political system that belies its actual externality in relation to the society as a whole. Hence where the forefathers of the Indian Constitution foresaw it as the "document of intensions", intensions commiserating the liberal spirit of the Constitution, the actual working of it proved otherwise, influenced now by several subjective intentions of the parties, politicians, judges and lawyers etc. Therefore though the Constitution envisages liberal spirit of separation of powers and the rule of law and the liberalism that caters to the collective attachments of the people, there have been moments where ruptures have taken place, rendering a few of the theorists to label it a quasi federal Constitution. It is quite interesting to note one of the comment made by one of the important member of the constituent assembly T.T Krishnamachari 'Federalism in case of India is not a definite concept; it has not got any stable meaning. It is a concept the definition of which has been changing from time to time'.

2. Focus of Study

My analysis of Indian federalism will not take a political sociology perspective that seeks to analyze the problem in Indian federalism in terms of problems of caste and ethnicities, or for that matter a region rather it will take the perspective from the political economy specifically revolving around the fiscal relationship amongst the states inter se and between the centre and the states as such. The idea is to look at the concept as it evolved due to the specific effects of the financial relations amongst the centre and the states.

Though, it is to everybody's knowledge that India possesses a federal structure in which a clear distinction is made between the union and the states functions and the sources of revenue. Article 264 to Article 293 explains the Financial Relations between the Union and the States. There have also been separate lists in order to fully demarcate the areas of the Union [with Union List having some 97 items on which the central legislature can make laws] and the States [66 items ,on which the State Legislature can make laws]. In order to provide for the sound federal principle the Constitution also provides for the setting up of Constitutional bodies like Inter State Council under Article 263 and zonal council[3]. Similarly Article 280 provides for the establishment of the FC in order to recommend the distribution of central resources to the states under Article 280 of the

[3] The idea of the creation of the Zonal Council was first mooted by the First Prime Minister , Pandit Jawaharlal Nehru in 1956 when during the course of debate on the report of the state reorganization commission, he suggested that the states proposed to be reorganized may be grouped into four or five zones having an advisory council" to develop cooperative working" amongst these states. This suggestion was made by the prime minister when the recommendation of the Linguistic Reorganization Commission led to the bitterness and hostilities. As the remedy to the situation, it was suggested that a high level advisory committee should be set up so as to minimize the impact of these hostilities and to create a healthy inter state and centre state environment with the view to solving the problem and foster balanced socio economic development of the respective zones. There are five zones in the country namely North, South, East , West and Central.

Constitution. It determines the principles that ought to govern the transfers and any other financial matter which are sought by the Government. There is then, the provision under Article 243(I) that provides for the setting up of the State Financial Commission by the Governor of the State to review the financial position of the Panchayats so that it could make recommendation to the Governor so as to suggest the principles that should govern the distribution between the state and the Panchayats of the net proceeds of taxes leviable by the state also the determine the taxes and duties which may be assigned to and appropriated by the Panchayats. This commission shall like its union counterpart, also recommend, the grants in aid to the Panchayats from the consolidated fund of the state .It is also authorized to suggest measures needed to improve the financial position of the Panchayats and likewise any other matter which is brought before by the Governor. Now the setting up of the two commissions respectively, reflect the very idea of cooperative that ought to flow out of their establishment.

So far Twelve FC's have been constituted. The latest one i.e. the Twelfth FC submitted its report on November 30, 2004 to cover the period 2005-10. On Feb. 2, 2005 the union Government accepted all the recommendations of the 12^{th} FC.

3. Statement of the Problem

It would be my task in the subsequent chapters to analyze the recommendations of the FC's taking into account the dismal situation of the finances of the States, and whether these recommendations have any peculiar effect in influencing the relationship. It had been maintained that through the Development Council and the Planning and FCs, issues of economic development have come to be de linked from the issues of political conflicts that are taken up by the inter state council and the informal institutions such as various conferences. Hence I will study the federal concept via a two level analysis. Though my central concern would be the FC and the effect of its award on the states but I would also look at the role of the other formal institutions such as Planning Commissions, Zonal Commissions, National Development Councils, Interstate Council, Tribunal etc. My second level of analysis would be the informal institutions like Political mediation by the Prime Minister, Federal Conferences, such as Chief Minister's Conference, Governor's Conferences, Inter (Political) Parties' Meetings, Empowered Group of Minister's Meetings etc.

4. Hypothesis of the study

My hypothesis in the dissertation remains as under:

- It is no doubt that the political clout of the states' had been increasing in the Parliament in the form of large number of regional parties, yet the fiscal dependency of the states remains the same. Fiscal dependency has largely become the function of loans from the centre.
- The freedom of choice in terms of revenue raising capacities of the states has been assured only in the limited sense. As the expenditure liabilities go on increasing of the state Governments, there own revenues fall short of the requisite demand. State Governments enjoy right only on inelastic sources of income. It is this

policy that is called by Chelliah and Rao[1991] as "Fiscal Dentistry" where the states with the higher expenditures and low taxes have been awarded, thus ensuring a further dependence on the national Government.

- While the Centre enjoys almost unlimited powers to borrow from internal as well as the external agencies, only the better performing states in terms of infrastructural facilities are able to attract foreign investment.
- FC as a statutory body has been over the years bypassed by such organizations as Planning Commission and Central Ministries. Hence it is still upon the discretion of the National Government to prioritize certain states over and above certain others, according to the political exigencies at that time.

5. Research Questions

Hence, I will deal with the following questions in mind:

- In case of India, the political processes have definitely paved the way to better representation of castes and communities, but have it also equally affected the decision making at the national level. If yes, to what extent?
- Posting a counter factual, I would then argue and question whether the freedom of choice to the sub national Governments have really set in the momentum of granting them this choice in reality?
- How far the informal groups have been meddling with the affairs and shaping the general policy making in the country?

- In the wake of economic reforms pursued since 90s, and the subsequent withdrawal of state from the important areas including that of insurance, retail business and now privatization of profit making PSUs, has it actually led to the regeneration of economy?
- Again how far the reforms carried on so forth(that includes promulgation of FRBM act) affected in the general health of the states ,i.e. has it resulted in the rise of disparities amongst the sub national Governments?
- And last but not the least how far the recommendations made by the latest FC has resulted in assuring the backward states, of support from the national Government?

6. Methodology

The work largely looks at the trends in the fiscal federal relations in the era of globalization and reforms. I have made a case study of the Twelfth Finance Commssion, as it is a constitutional body aimed at devolving centre's fund to the states'. I have looked at the regional inequality across Indian states over the period of two decades, between 1980-90& 1990-2000.But as I already mentioned in accounting for the cross state comparison, there is a likelihood of a misplaced conclusion, for there had been a number of categories that hold good in today's times that were excluded from calculation earlier. Hence I have relied on the data forwarded by Prof. B.B Bhattacharya & Sakhtival. Moreover in ascertaining the regional inequalities, I have taken into account such categories as Poverty ratios, Per Capita GSDP, Level of Infrastructure Development, Approval of Investment Proposals, Human Development Indices. There may be, and definitely are other categories that I may be missing out. Moreover the issues in the Federal Finance are so vast and complicated, that one is almost confounded which ones to exclude and to what degree. In addition the problem with regard to the transfer formula are dealt by certain econometric calculations, while I have just included the general anguish of states' regarding the formula and whether the transfers have had any implications for states to improve their financial situation. Now because the issues in federal finance cannot be studied independently, I have tried to include political processes that have any bearing on the financial matters between the states-directly or indirectly.

7. Survey of Literature

The dissertation basically consists of two separate parts that had been conglomerated under the same roof. I had been tracing the federal-fiscal relations since the establishment of First FC. Likewise I had also been looking at the state of states' finances as a result of such awards from the union. In that I have specifically looked at the Constitutional body and have also been looking at other agencies of the transfer of the states' fund. It is noteworthy that there had been literature on the states' finances, but the literature on the politics behind such awards had been vehemently quite less, at the best in the form of some journalistic Articles.

The most important study for the states' finances had been provided by Prof. B.B. Bhattacharya and S. Sakhtival *'Regional Growth and Disparity in India – comparison of pre and post reform decades'* .I have taken the indices provided by the above authors because the study conducted by the other authors have not taken into account the changing context of our times. According to the authors themselves the earlier work on the subject cannot be taken for comparison over time, for the new SDP/GDP figures , have included a lot many categories that were earlier left out. The analysis done by them happens to be amended likewise to cater to such changes .

Likewise the trends put forth by Govinda Rao in an Article '*Changing Contours in the Federal Fiscal Arrangements in India'* in the book Public Finance edited by Amaresh Bagchi[4], and similarily in his work '*Convergance of incomes across Indian states'*[5] along with such authors as Ric Shand & Kalirajan ,prove wide Inter state differences in the revenue capacity and consequently, per capita expenditures. There are, according to him, some seventeen relatively more homogeneous general category states, but even these have wide differences in size, revenue raising capacities, efforts, expenditure levels and fiscal dependence on the centre. the issue which had been of special relevance to me in my dissertation was with respect to the North Eastern States, where even though the per capita GSDP is higher than other general category states, their revenue raising capacity in terms Tax/GSDP ratios is significantly very low. This is partly because, there is not much production activity and the Government administration is the major determinant of the GSDP. Further the size of their tax base is smaller than what is indicated by the GSDP.

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[4] Bagchi Amaresh(2005), *Readings in Public Finance* , OUP, New Delhi, pp 439-40.
[5] Rao M. Govinda, Ric Shand & K.P. Kalirajan(1999), 'Convergence of Income across states: A divergent view', *Economic and Political Weekly*, March 27-April 2, pg 1022.

In a similar study conducted by Atul Kohli in '*Politics of Economic Growth in India , 1980-2005(Part 1/Part 2')*[6] belie any such concept as Indian state's adoption of pro market strategy has had an effect upon the overall growth across regions. On the contrary, the growth according to him really picked up a "full decade" prior to the liberalizing reforms in 1991. The view is also shared by the following authors like Nagaraj[2000], De Long[2003], Rodrick and Subramanyam[2004] and Arvind Virmani[2004], Jeffrey D Sachs et al[2001] The pro business growth strategy is likely to have adverse distributional and political consequences, they warned.

In a special Article in EPW '*Finance Commission Awards and the fiscal stability in the States'*[7], the authors R Kannan et al examine the efficacy of the FC awards in bringing about financial stability among the states. Their empirical analysis reveals that though the GFD have been reduced in the 90s , yet the problem of borrowings still loom large over the states. Moreover, the authors further reveal that the issue of vertical as well as the horizontal equity still remains a cogent problem. The authors also find wide inter regional disparity in respect to transfers and likewise suggest of a viable criterion that could amend problem of fiscal imbalances across states.

Similarly in an appraisal on *Fifty Years of Fiscal Federalism in India* [8], Amaresh Bagchi acknowledges the virtues of federalism from both the economic angle and the political angle in promoting both efficiency and accountability, through the division of powers

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[6] Kohli Atul(2006), 'Politics of Economic Growth in India , 1980-2005', *Economic and Political Weekly*,16(13), 13th April 2006& 18th April 2006, pp 1251-1252.

[7] Kannan R, Pillai S M, Kausaliya R, Jai Chander (2004), 'FC awards and the fiscal stability of the states', *Economic And Political Weekly*, 39(5) , Jan 31- Feb 6, pg 477.

[8] Bagchi Ameresh(2002), 'Fifty Years of Fiscal Federalism in India:An Appraisal', *Artha Vijana*,44(1),pp 1-46,

between the national and sub national Governments. While analyzing the marked disparities in the incomes across regions, the transfer system should be given a moderate role in accentuating disparities. He quotes Sarkar[1994] who reveal a positive relationship between the plan outlays and development. The reason for the poor states to lag behind others is because their growth depends upon their PID(Physical Infrastructure Development). For this clearly, the transfer system should bear the burden. He also discusses other problem related to the transfer system. To cure its weaknesses, the multiplicity of transfer channels should go. He also suggested mechanism to reform the existing transfer system followed by the FC. But nevertheless he oversimplified things when he said that the changing nature of economy have led to the states competiting for the larger share of central funds, thus this competitive federalism is carrying with itself the seeds of convergence in terms of development. But amongst the reforms that he spells out, relate to the sub national Governments that should be given the power to levy taxes, that provide little scope to tax exportation and likewise do not interfere unduly with internal or international commerce.

8. Organization of Study

The First chapter studies the historiography available in so far the theory on fiscal federalism is available to us both from within the country and without. Under this I shall include perspectives of such thinkers such as Barry Weingast(1997, 1995), Riker(1964), Ackermann(1980), Webbels(200), Musgrave(1959) and Oates(1972) and such Indian authorship on Indian state namely Paul Baran(1996), Sudipto Kaviraj(2001), Akeel Bilgrami(2000), Asish Nandy(1999), Atul Kohli(1998), Doughlas Verny(2002), Partha

Chatterjee(2006) amongst others. I will include thinkers who have specifically dealt on Indian federalism providing nuanced reflection on fiscal relations between the centre and the states that include amongst others people like Amaresh Bagchi(2004), Ahluwalia(2000), Govinda Rao(2006), Pinaki Chakravarthy(2006), B. B. Bhattacharya(2004), Sakhtiwal(2004) to mention here only the very important ones. Hence chapter one would analyze economic theories on Indian federalism and give a vivid account of the same from the angle of scholarship from both the ends.

Chapter Two, on the other hand, looks at the history of the recommendations of the FCs constituted so far and the implications of their recommendations on the backward states. The chapter lucidly looks at the fiscal stress of the state Governments. Though the fiscal situation of the states began to deteriorate much later than the centre, the fiscal stress of the state Government is more acute and an important constrain on their development. And it is this area, which I seek to implore, that has an effect on the centre state relations in India. It should be seen that the revenue account of the states have been continuously in deficit since 1987-88. The deterioration in the revenue account of the states have been more pronounced from the late nineties just to mention the gravity of the problem here, as proportion of GDP, the revenue deficit of the states which increased from 0.3 per cent in 1987-88 to 1.1 per cent in 1996-97 shot up to 2.6 per cent in 2000-01. The deficit continued to remain high till 2001-02. In 2002-03, the deficit declined to 2.2 per cent of the GDP remained there in 2003-04. It showed a positive sign in 2004-05 when it came down most melodramatically to 0.5 per cent (Revised estimates) in 2005-06 according to the Economic survey 2006-2007.

Even though the most recent indicators of the state finances show a distinctly improved picture, the causative factors of future uncertainty still loom large in the minds of the commission and the doubt about the continuation of the improved picture may be thrown to the winds if they are not taken into account. These are interest payments; pension liabilities; losses of the state PSUs ; lack of proper user charges; and lack of buoyancy in taxes have all been the reasons for the dismal state of affairs of the finances of the states.

Chapter Three, hence deals with the Twelfth FC recommendations on the backward states. The recommendations are looked vis a vis the recommendations of the planning commission that has spelt out its most recent approach paper for the Eleventh plan(2007-12), in my fourth chapter.

Likewise in the Fourth Chapter, it becomes increasingly clear that the planning commission with its discretionary powers of granting has overridden the FC in the total volume of the total transfers. Planning Commission as a central Government body is authorized to undertake the work of planning which includes moneys to be allocated to the Centrally Sponsored Schemes and laying down broad parameters of macro economic and micro economic conditions of Indian economy [catering to the fundamentals of the FRBM Act etc] have added to the power and prestige of the centre vis a vis the States. The chapter also looks at the new counters in the fiscal federal literature such as the recent meetings of National Development Council, Inter State Council, India Conclave and Chief Ministers Meeting.

Chapter 1

Theories of Fiscal Federalism and Inter Governmental Transfers In India

1.1 Introduction

Public Economics, also christened as public finance by the later theorists retains its interest since the origin of money economy around the world. We know in case of India the very ancient but inspiring works of Kautilya (approximately 300 BC) and Shudraka(approx 400 AD) provide the minutiae of how state should manage its scarce resources so that distribution could be optimalised and likewise public welfare could be augmented. Now this theory of public choice explores how the expenditures on public goods and the modus of financing them are determined through the political process, applying wherever possible the techniques and principles of economics.

Such a theory of public finance has become important in the last fifty years primarily because of the expansion of the public sector since the Second World War [9]. Such an expansion of the sphere of State had led to the mushrooming of the theory of public choice and therefore public finance assumes such a primary importance in the field of economics as also in political science.

[9] Bagchi Amaresh ed. (2005): *Readings in Public Finance*, Oxford, pg 2-3.

But at the same time a change was slowly seeping into the system that had the effects to radicalize economic and political scene of world. Economic thinkers the world over undertook to explain this dynamism by giving forth theories from both the left and the right be it neoclassical institutionalism (North:p 6)or neo Marxism(Dahl:162). Hence, in contrast to the Darwinian evolutionary theory, the institutionalizes looked at the change in the intentionality of the players,[10] which of course the Marxists were not ready to accept as true. For the latter the perceptions, choices and the intensions are contextual and systemic. Hence the theories in public finance, which needed to cater to the changes at core and at the periphery, gleamed at both sides of the story. Where the debates largely revolved around which kind of Governmental set up would maximize benefits, federalism (for large economies having large geographical areas) was found answering most of the questions. The case of federalism from the political perspective rests on the wider freedom of choice and better representation of the different constituents[11]. The economic case of federalism rests on the principle of market failure argument (which we are taking in the forthcoming pages) as well as the argument that local Governments find it hard to deliver all the national public goods. But the important question was how much of the state intervention were they ready to accept? Keeping in view of the welfare functions of the state, theorists debated on the question of strong central Governmental intervention *vis a vis* decentralized decision making capacity to the local players.

[10] North Doughlas C(2005), *Understanding the Process of Economic Change*, Academic Foundation, Princeton University Press , pp vii-ix.

[11] There are references to various kinds of federalism in vogue among them holding out of federalism(where a whole is broken up into parts for the matters of administrative and Governmental conveniences) in contrast to coming together federalism(where smaller independent entities come together for economic and military purposes).

Hence we see that the study of the repercussion of the theory of public finance on the federal set up, calls for approaching the argument from the political as well as economic side, for here politics and economics are set to mutually reinforce each other, and it becomes misleading to analyze only one category directing the other in its entirety. In a developing society like India, it becomes all the more important, when politics lies so much at the margins of economics, converting the rational science into complete irrationality and throwing every other criterion to the winds.

To begin with, lets cursorily look at the historiography (literature) available on the economic theory on federalism (from the west) that pertains to the moot question as to why state intervention is required at all?

1.2. Economic Theories of Federalism

Federal systems as a matter of definitions, decentralized systems, but so are as a matter of fact, all modern democratic unitary systems; consequently what distinguishes them from the unitary states is not decentralization. The pages here discuss the costs of federalism, vis a vis decentralization, for I have taken to pitch federalism against decentralization. There has been plethora of literature on whether in the modern society and economy; federalism, which in a way promotes, strong central Government is desirable as compared to the decentralized polity and economy. The case for the above rests on the arguments forwarded by hosts of Indian and European comparatvists.

Case for Decentralisation

Of the arguments from the risks factor, to uncertainty, to swathe of recurrent market failures, the thinking by the comparativists called for state intervention in the west. The theorists in this line of thinking such as William Riker[12](the earliest theorists on federalism per se) and Barry Weingast[13] primarily concerned with choosing the Government structure that was best able to promote long term economic interests. These ideas were earlier elaborated by traditional economic thinkers such as Tibout(1956) and Hayek(1979) on account of "information argument" i.e. local Governments have better ideas about the demands and needs of their people as such. Weingast's *"Market Preserving Federalism"* approach stressed the advantage of decentralized control by the sub national Governments; for him by encouraging competition this control was likely to do away with adverse consequences of central Government authoritarianism.[14]

Rikers' [15]concept of federalism defined a federal system as:

- A hierarchy of Governments;
- With each level of Government autonomous in its own sphere of authority and;

[12] Riker as quoted in B. Weingast and Q. Yingi(Autumn 1997) in 'Federalism as a commitment to preserving market incentives' *,Journal of Economic Perspectives*, 11(4) ,pg 84.
[13] See Weingast Barry R(1995), 'The economic Role of Political Institutions: Market Preserving Federalism and Economic Development', *Journal of Law, Economics & Organisation*,11(1)[herein after Weingast, Political Institutions],Barry R. Weingast(1993), 'Constitution as governance structures: The Political Foundations Of Secure Markets', 149 *Journal of Institutional & Theoretical Economics*, 286(1993)[hereafter Weingast , Constitutions]
[14] Rubinfield Daniel L(1997), 'On Federalism And Economic Development', *Virginia Law Review*, 183(7), Symposium: The Allocation of Government Authority, Pg 1581.
[15] See William H Ricker(1964), *Federalism: Origins , Operation, Significance*, Boston: Little, Brown and Company.

- With each Government authority guaranteed

Barry Weingast[16] made a further innovation, adding a couplet only to Riker. He added:

- That the sub national Governments should have the primary responsibility over [their] economies;
- The national Government must ensure the mobility of goods and services
- There should be a limited revenue sharing so that the Governments face a real budget constraint; and
- There should be a durable allocation of authority.

For him the major vice with the central control, relates to the:

- The State Predation Problem[17];
- The Soft Budget Constrain Problem[18];

The essence of such an analysis of federalism feeds on the idea that markets may not be in the position to provide certain goods and services. Hence for the traditional theorists state involvement was definitely called for, if not necessary. Thinkers such as Rodden/ Rose Ackerman(1980) along with Daniel J. Rubinfield(1986) had also been concerned with the risks involved with the central Government intrusion. For such thinkers decentralized federal system appeared more appealing rather than a hyper active central authority. Rubinfield(1996) as a commentary to Market Preserving Hypothesis illustrates

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[16] Douglas North C.(2005), *Understanding the process of Economic Change*, opp cit pg x.

[17] State Predation accrues from the logic that Governments in the developed world tends to bail out failed projects, in other words continue with the sick units which have become white elephants (see more in Douglas North, in *Institutions and Institutional Changes and Economic Performance*. Cambridge , NY,CUP,1990)

[18] Soft Budget Constrain means power of minting money by the state Government(See more in Janos Kornei, in *The Soft Budget Constraint Problem*, Kyklos, 1986, 39.1, 3-30)

lessons from South African Federalism[19] which gives so much credence to decentralization, where the Government at the same time wishes to achieve certain minimum levels of basic public utility services such as sewage, water, electricity, and education. For him in addition, national Governmental intervention only promotes rent seeking and inefficiency at the official bottom level.

But the most common thesis accorded but the first school of thought is that that the importance given to the local public sector or the sub central sector should be actually equated with mature economies. This view appears in the writings of Roy. W- Bahl and Jonnes F. Linn(1992), who argue that the decentralization more likely comes with the higher stage of economic development and that *"threshold level of economic development at which fiscal decentralization becomes attractive"* appears to be quite high"(Bahl and Linn, 1992,p,391)Now, Musgrave(1959) and Oates(1972) considered decentralized system as viable one ,for they thought that the citizenry should be left free to sort out preferences with a particular menu of local public goods[20] .This argument is only carried forward by thinkers such as Isreal(1992) who have argued that a decentralized system can bring choices in the public sector as competitive market brings choices in the private sector. Similarly we see the other view that fiscal decentralization leads to become a factor in the economic growth. De Valk(1990, p5) sees the resurgence in the interest in decentralization as something having less of a political undertone but more concern with the increasing efficiency and effectiveness in the development

[19] For further background on the South African federalist system, see Jeffery Petchey & Daniel Rubinfield , *Inter- Governmental Transfers and Locals Governments in South African* (Nov, 20, 1996(unpublished manuscript , on file with the Virginia Law Review Association)

[20] See more in Qian Yingi & Barry Weingast (1997), 'Federalism As Commitment to Preserving Market Incentives', *Journals of Economic Perspectives*, 11(4), Fall, Pg 83-92.

planning and implementation. Some have upheld decentralization, as it is a means, which allows greater experimentation in the provision of output. Like what Vito Tanzi(1994) have argued that giving greater credence to the local Government will give freer opportunities to make simultaneous experiments. The argument is further explained that in case of a national monopoly, there will be no experimentation, thus anachronistic methods may continue. While the most common arguments, however in favor of the concept of decentralization over and above some kind of monopoly by the national Government are forwarded by Brennan and Buchanan(1980). The argument that local Governments are preferred for they are more accountable, flow from the concept that because they are chosen directly by the electorate, they are also responsible towards it. As Shaw and Quereshi(1994, p, xv) have made it amply clear that accountability is promoted through a clearer and closer linkage of the benefits of the local public services with their costs".

The concept of *"Public Federalism"* seems to be also comfortable with the notion of multi level governance- a perspective of policy governance by structuring the levels of governance in such a manner which harmonizes, though seemed to be contradictory, within the overall national and supra national context, the dualism of centralization from above and regionalization from below. This federal stress on promoting multi level governance as a balanced mixture of different modes of governance has been elaborated by Daniel Elazar (1987, p 244), when he points out that the distribution of powers can be seen as involving differential loadings in the different arenas, occupy its own salience in the fiscal federal discourse. Fernadez Segado, following the Spanish example, has classified different kinds of competences into five different capacities. They are:

- *Integral Competence*: those in which single authority- usually the state- attributed all kinds of public functions regarding a particular matter
- *Exclusive but limited competences*: those in which one authority enjoys full competence but only to a certain extent in a particular matter. Hence it is not the function but the matter that is fragmented;
- *Shared competence*: those in which both the state and the autonomous community are entitled to exercise complimentary parts of the same function over the same matter. This would be case rather frequently- in matters in which the state has reserved for itself the basic legislation, and the autonomous community has taken up legislative development
- *Concurring Competences*: those in which the competences of the state and those of the autonomous community are distinct, but the coverage on the same physical object.
- *Indistinct Competences*: those awarded both to the state and the autonomous community without any sort of distinction and which enable them to deal with the matter in different ways for different purposes. Now it is the ' differential loadings' to respond to specific problems in the different policy fields that the notion of *competence* has assumed .

Arguments against too much of Decentralisation: Case for central Government intrusion

However Erik Webbels(2000) in a rejoinder attributes larger public sectors, higher inflation and larger deficits in developing countries[21] to decentralization. He is joined by the plethora of comparativists like Bind (1986), Fukasako and Hausman(1998), Webb and Zhom(1998).They argue in addition decentralization , in fact delimited the scope of economic reforms or liberalization. Citing that the average expenditure share of Provincial Governments in a Federal System is more than 45%, in contrast, the expenditure share of *sub national Governments* in unitary nations in the developing world is 14.5%.[22]

Moreover arguments in favor of central authority, actually takes into account reasons such as too many levels of decision making actually makes the policy making unnecessary complicated. Moreover it becomes too difficult for the Federal Government to manage too many hands at the decision making level. In addition, with powerful Central Government level it becomes difficult for the local leaders to complicate policies. Recent analyses by Weingast and others talk about the problems related with the Federal Governments as such. These are the following-

- State predation problem.
- Soft budget constraint problem.

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[21] Webbels Erik (2000), 'Federalism and the Politics of Macroeconomic Policy and Performance', *American Journal of Political Science*, 44(4),October, pg 690.
[22] Fukaser, Kichiro &Richardo Hausmann, Ricardo(1998) , *Democracy, Decentralisation and Deficits in Latin America* , Paris, OECD/IDB.

- Increasing transaction cost for the future Government.
- Responsibility on the top public officials.

But this had been the case mostly of the developed economies that increasingly realized that federal Governments with preferential decentralization to certain extent should be right mode. Somewhere the chord is struck between federalism and decentralization wherein federating units or the provinces are not handed over the power to mint money (Hard Budget Constraint Problem) making the top decision makers responsible towards the subordinate ones so that the subordinate is vested with the *"real power"* & the piecemeal erosion of *"principals authority"* could take place. The sole purpose of decentralization as realized by IMF (2002)[23]:

- Financial responsibility or fiscal equivalence- where lower level of Government should be held accountable for all funds including interGovernmental transfers;
- Subsidiarity- to help preserve smaller social groups from encompassing institutions of governance, which deal effectively with the regional differences.
- Equality to address regional disparity and:
- Fiscal autonomy- lower level Government should be made autonomous in their decision-making and executive powers.

[23] I have borrowed this defination from the Thesis of Chanchal Kumar Sharma on *Fiscal Federalism: A survey of Literature*. He had been a student of CPS/SSS, JNU(2001)

With an equal tenor, it is realized that a number of goods cannot be assigned to one Government and one person at the same time. Hence Ehtsham Ahmad[24] et all remarks "For these mixed goods some degree of decentralization coupled with some centralized coordination of policy is both feasible and desirable, owing to the unclear benefits, conflicting goals arise, the analysis of which level should be assigned expenditure responsibility can become quite complicated and subject to normative bias".

1.3. Federalism in case of India

In India, the case was however a unique one. The theorists analyzing the construction of Indian federalism never debated on its alternative presupposing the design as given[25]. Their concern however was entirely different. They looked at the formulation, revisions, resilience and political resources of the Constitutional design of federalization. This "established" federalism was the best institution that India could manage, given the political, cultural and economic climate at the time of independence. Though at the time of inception there were profound cultural and social divisions, which could be seen in the appointment of *Dhar Commission* as early as 1948. The setting of the linguistic

[24] Ehtsham Ahmad , Daniel Hewitt & Edgardo Ruggier ' Assigning Expenditure Resposibilities: Fiscal Federalism in theory and practice', ed Teresa – Minassian (Washington, DC; IMF 1997), pp 25-48. Also refer to Wallace Oates, 'Federalism & Government Finance'; *Modern Public Finance*, eds. John M Quingley and Eugene Smolensky(Cambridge MA; Harvard University Press, 1994), pp 143-147.

[25] Though the narrative does not require us to go into the historicity of the concept; nevertheless for information sake one is remembered of federal administrative elements in the times of Moghuls (beginning with Sher Shah's Land Revenue system and taking shape with Akhbar's division of his empire into 12 Subahs or provinces(Wolsely Haig:40-52).However specific development of the idea of federalism one is called to remember The Government Of India Act 1935.The idea of "*Cooperative Federalism*" can be found out originally from the functioning of the mode of Governments as prevalent in England and the United States and its eventual application as a heuristic paradigm in India(Saez:21)

reorganization commission reflected the woes of the Constitutional forefathers in the later part of the decade itself.

But even then the case could be made that India's bold attempt of combining democratic responsiveness to cultural differences with a federal conciliation of regional community, identity, and autonomy claims and the nationally concerted promotion of regional capability, has tended to ensure a novel mode of multicultural national development. Hence it could be said if not with utmost certainty that literature on federalism never grappled with the questions of state and market as did its likes across the world. The idea of explicitly group-differentiated rights to compliment individual rights was not favored by the makers of the Constitution. The only point of debate was the method of development, one between those of *Nehruvians* , *Gandhians* and *Subhasians* i.e. between those who favored large scale industrialization *vis-a-vis* who favored village republicanism with those who favored straight collectivization. But as it is everyone's guess Nehru's scientism and statism ruled over the other two. The concentration of powers got further strengthened with the adoption of centralized planning in a mixed economy framework with the implementation of an item, *"Economic and Social Planning"*, placed with the concurrent list after 1950s. The appointment of planning commission in 1950 proved last nail. Hence there could nothing be called as the concept of fiscal federalism in India for at least in next 30 years of federal life of the country.

There were to be no issues debated like vertical and horizontal imbalances, no inter jurisdictional competition between the states as such. Hence the central dominance was complete. The Central Government almost acquiesced what was called the commanding heights of the economy. Rule by the same party facilitated the implementation of this programme without any hindrance Going by the statistics, till 1993 the Planning Commission commanded a total staff of more than 5000 persons including a research staff of experts recruited from virtually all fields of development (Dandekar 1994:1459).

Even during Eighth plan (1992-1997), despite several statements in support of liberalization, the commission appeared to control 50% of capital expenditure and nearly a third of total expenditure of the Union Government (ibid: 1457-1458) , motivating political theorists to term Indian case as a case of a quasi federal Constitution. There is no denying to the fact that issues about the regional autonomy had sprung quite often, but again these have been assimilated in a piecemeal fashion. This was what had been called as the context of constructive Constitutionalism. Such a multicultural nation based on democratic foundations and federalizing institutions that made Indian federalism so instructive. Even if we look from the bottoms up approach as did fruitfully by James Manor(1997:p 267) we identify that the problem largely remained at the level of politics, cultural differentiation rather than anything to do with the fiscal. The case studies of the *"troubled states"* such as Andhra, Tamil Nadu, Seven Sisters of the North East not to forget Jammu Kashmir revolved around the ethnic question rather than the development question and even if they mixed financial question that too became the clarion call to say that there is something amiss with the political bargain somewhere.

However the case of India post reforms marks a paradigm shift as far as the conceptualization of fiscal federalism is concerned. The question is all the more interesting especially when the central govt. has to deal with almost contradictory features like welfare state, developmental planning, market economy, and fiscal decentralization having their separate fallouts and repercussions. On the political front the end of the era of single dominant party at the centre and at the level of states, the emergence of coalition parties both at the centre and states made the question of fiscal federalism all the more pertinent .The statutory recognition to rural and local Governments was accorded with the 72^{nd} and 73^{rd} Constitutional amendments in 1992(Rao 2005:439). The important thing here is that the sources were located with the central and state Governments along with the powers subscribed to the Panchayats themselves. This made an important case for fiscal decentralization as such. State Financial Commissions were given powers to recommend tax devolution and grants to the local Governments.

The coming of reforms heralded changes not only in the economic sphere but also in the political and social sphere. The deepening of democracy across the world warranted efforts by the Indian Government to emphasize on development and not only growth, disclosure leading to forced accountability at the official level, and decentralization ensuring maximum authority to the public at large. The distribution of resources which was at the periphery now came at the centre of policy debates. The World Bank sponsored SAP called for equity as well as efficiency at all the levels of Government. The State in a way was to be rolled back so that private players could be given a level playing field at par with the public sector. Though the reforms were sweeping they were not started with one go. There were reforms with stealth from 1980s onward; the financial crises of 1991 only exacerbated its volume and rigor. However what we see today in the form of FRBM bill, RTIs(more so after the inclusion of file notings), FDI's in almost all sector save the core ones , BASEL norms punctuating the traditional banking practices etc is very much in continuance with the legacy. All this and more would bind to have a spiraling effect on relations between the Centre and the States. Hence one could see a plethora of centrally sponsored schemes at the level of States as well as the Centre. At the time of compilation of this chapter, there has been *inter-ministerial* meet at the behest of UPA Govt., initiating the so-called BRGF[26] to address the problem of unequal development at the regional, state and the local levels. The decision to go for decentralized developmental interventions under the BRGF, the numerous Centrally Sponsored Schemes, Employment Guarantee Schemes, the setting up of DPCs asking them to supplement planning done by Municipalities and Panchayats are very much commensurate with the changing counters of Fiscal Federalism.

Theorists from all possible hues discussed the pattern of influence of economic reforms on the federal relations and its possible developmental repercussions in particular. Where in the economic circles the debate loomed large from the supply side meaning thereby from an angle of implications of reforms, political scientists however, looked it from the demand side. What are these newer kinds of demands that are being generated and how, and to what purpose, is it only economic or the result of political churnings .The task before the political economist was more compelling; he had to look at both sides of the story. In the Indian context, issues relating to centre state financial relations centered on

[26] 'Towards Better Fiscal Federalism', *The Hindu*, 20th November 2006.

distribution of power in resource mobilization between the centre and states and sharing the expenditure liabilities. Further he has to devise optimal criterion for federal fiscal transfers to reduce fiscal imbalances across the states. He has to also look at the level of dependence of state Government's dependence affected post reforms. Out of the issues that he has to address is the state of development converging or diverging across the States, which subsequently becomes the single most important issue at hand. And to begin with, let us examine the efficacy of FC awards in bringing about fiscal stability among states, which would reflect the contentious issues around federal debates.

1.4. Framework of Inter Governmental Transfers

The newer debates around federalism relate to the Inter-Governmental finance. The critical aspect of the fiscal transfers is their effect on policy objectives such as allocative efficiency, distributional equity, and macro economic stability[27].

Constitution of India makes a clear division of fiscal powers between the union and the state Governments. Position of states in well defined and such a thing reflects in the no. of items mentioned in the state list, upon which the states have the autonomy to legislate. Although the states have been assigned certain taxes, which are levied and collected by them, they also share in the revenue of certain union taxes, which are levied and collected by the union, but the proceeds of it entirely go to the states. In addition the states receive grants in aid of their revenue, which further increases the amount of transfers between the two levels of Government.

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[27] Kannan R, Pillai S M, Kausaliya R, Jai Chander (2004), 'FC awards and the fiscal stability of the states', *Economic And Political Weekly*, 39(5) , Jan 31- Feb 6, pg 477.

But whatever it is to say, the transfer of resources from the centre to the states remains an essential feature of the present financial system. These are essentially through three channels, viz

- Under the awards of the FC,
- On the recommendation of the planning commission and
- Direct support from the ministries from the Central Government.

The centralization is definitely not embedded in the Constitution but over the years, the working of the democratic processes, has characterized India as a centralized, dysfunctional & anachronistic union system[28].It should be kept in mind that the major chunk of resources from the centre to the states is transferred on the recommendation of the FC. The FC (under Article 280) makes recommendations to the President on:

- The distribution between the union and the states of the net proceeds of taxes which are to be, or, may be divide between them (vertical distribution under chapter 1 of part XII of the Constitution and the allocation among the states of the respective shares of such proceeds (horizontal distribution)
- The principals which should govern grants in aid of the revenue of the state out of the consolidated fund of India and the sums which are to be paid to the states which are in need of the assistance by way of grants in aid of their revenues under Article 275 of the Constitution.

[28] Khan, Rasheduddin, *Federal India: a design for change: Achievements & Challenges* (Washington,D.C:World Bank).

While there had been the 4-fold[29] classification of tax sharing, states find wanting in the tax- resource allocation and hence tended to become increasingly dependent on the Central Government loans, the problem which I would talk at length latter. Such a system has augmented a spree of patron-client relationship keeping states permanently indebted to the centre while increasing their deficits at the same time.

Distribution of revenues between the union and the states take the form of:

- Taxes and duties (Article 268A & Article 268 respectively) levied by the union but collected and appropriated by the States)
- Taxes levied and collected by the union but assigned to the states (Article 269).
- Taxes levied and distributed between the union and the states
- Surcharge on certain duties& taxes for the purposes of the Union[30].

The TORs whom the successive FCs uses determine the magnitude and direction of the resource flow from the Centre to the States. These can be seen under different heads below.

1.5. Recommendations and the Approach of the Successive FCs

I would like to analyze this category, by taking into account recommendations of the FCs on three broad areas which the commissions have been empowered with as part of its statutory obligations. They are as under:

- Central Government taxes; namely Income Tax and Union Excise Duties.

[29] Bakshi, P.M(2006), *Constitution of India* , Universal Law Publishing Company, New Delhi ,pg 232-33
[30] Bakshi P.M., Constitution of India, opp cit , pg 233.

- Grants in aid to the needy states.
- Any other matter that the commission takes *suo moto.*

The first FC in its report stated that: *"...the prosperity of the states must rest on the solid foundations of the reasonably strong centre. Nor need the point be labored that while the states have large and expanding responsibilities for the welfare and development of people. The capacity to make additional resources available is conditioned both by the amount of revenue it can raise and by its own essential needs, which in the ultimate analysis are the need of the country as the whole*"(Chapter I, para 19)

An important reason for giving the transfers arises from the fiscal imbalances or the mismatch between revenues and expenditure of the different governmental units. The vocabulary used by Govinda Rao and Nirvikar Singh[31] in their recent publication, is 'Vertical'[32] and 'Horizontal' fiscal imbalances which require such transfers between the federating units. Hence the transfer of resources from the Centre should be such that it does not bring undue strain, taking into account its own vital responsibilities such as Defence, Communication etc[33]. But even when functions and the revenue powers are efficiently assigned, imbalances are bound to occur. The Central Government has a comparative advantage in raising the revenue, the point that latter becomes the point of its critique too. *Sub National Governments* are better placed to provide public services

[31] Rao Govinda & Singh Nirvikar(2005), *Political Economy of Federalism in India* , OUP, New Delhi, pg 170.

[32] Vertical fiscal imbalance refers to the difference between expenditures and revenues at different levels of government, while Horizontal fiscal imbalances refers to the difference between revenue and expenditure levels within a peculiar level of government.

[33] Vithal B.P.R & Shastry M.L(2001), *Fiscal Federalism in India*, Oxford, pg 60-61.

efficiently corresponding to varying preferences of people of different jurisdictions [*Breton*(1987)& (1995), as quoted in same book].The same thing happens with the grants in aid

- To fill the fiscal gaps;
- Narrow disparities in the availability of the various administrative and social services between the developed and the less developed states;
- Take into account the special burdens cast on the state because of its peculiar circumstances of matters of national concern.

This called for the looking into the financial status of the states, and recommending wherever their condition appeared to grow out of control. The issue such as this has generated enough heat amongst the economists all over the State Universities.

1.6. The Sharing of the Union Taxes

The FC was made to recommend on the two most important items of the shareable central taxes i.e.

1). Taxes on Income, other than Agricultural Income.

2). Union Excise Taxes.

Sharing of Income Tax

It must be taken notice that the FC on the twin principles of distribution. The distribution of available resources vertically[34] and then horizontally[35].

In so far as the vertical distribution of the resources is concerned it was seen right from the inception of first FC that the percentage of the distribution of the net proceeds of income tax remained approx 50% (See Table 1.3). The very first commission has remarked "...a *state in which a tax is not leviable has no right to share at all; and the fact that a prescribed percentage of tax does not form a part of Consolidated Fund of India does not ipso facto make it or any portion of it a part of the consolidated fund of any particular state: and the Constitution does not recognize that any state has the right to the income tax collected or even arising in this area. A state acquires the right to a definite amount of divisible pool only after the President has prescribed the manner of distribution*".

In the second FC it was raised to 60%.However at the time of Third and Fourth FCs a lot of hue and cry was raised for increasing the states' share from 50% to 85-90%. Subsequently it was increased to 66.66% and later by Sixth commission revised to 80%.

[34] With Vertical Distribution I mean- Taxes which are to be or may be divided between the centre and the states as specified in the Articles 270 & 272. They are taxes on income on income other than agricultural income and basic excise duties. Both of these are collected by the centre. It may be taken to notice that the upper limit to sharing of central Government's divisible pool was not explicit in the Constitution of India, but the Eightieth Amendment Act (April 1, 1996) provided for this ceiling. Now the share of the states in net proceeds of the union taxes and duties remains at 29.5%.

[35] By Horizontal Distribution I refer to the share of each state in each of the divisible pool of revenue. The inter se Distribution among the states are based on a certain set of criterion to be followed (different for FC and planning commission which I would be dealing in subsequent pages)

The States again raised almost a like demand before the Eighth Commission. Hence both the Eighth & Ninth FC re-revised the States' share of the divisible pool at 85% in spite of the demand for the enlargement was once again raised. However the share of the income tax graduated to 85% by the 8^{th} and the 9^{th} FC was subsequently reduced by 7.5% to 77.5 %in the 10 FC (see Table 1.3).The case of the 11FC and 12 FC will be discussed in the following chapters hence not touched here. The less amount of proceeds distributed in the 11 FC should not be interpreted as lowering of the states share in the divisible pool rather after the adoption of ASD, the total taxes of the union Government were now to be shared in the like manner. Again it should be noted, that the distribution criterion for the disbursal of Income Tax also could also be elaborated here. While the first FC till the seventh FC gave importance to the population, the eighth FC reduced the emphasis on the criterion dramatically. It rather distributed the share to lot many other criterions for e.g. Distance, inverse income etc (See Table 1.1). Ninth FC further gave recognition to the concept of backwardness; hence there was a tilt towards left as perceptible by such an emphasis.

The Tenth FC gave 60-percentage share to the Distance Criterion, a reduced 20-percentage share to the population criterion. The commission made an interesting intervention in terms of giving due credence to such other factors that were not taken into consideration so far such as area, level of infrastructure development in the state, tax effort and fiscal prudence. Though the emphasis on efficiency and fiscal prudence created a heart burn to some states, it definitely provided alternate view for the backward states to re examine their condition and thus chart their own specific paths of development.

Table 1.1: Distribution criterion of the net proceeds of income tax as per various commissions

(In per cent terms)

F.C.	Distance from Average Population.	Population	Inverse Income	Backwardness	Collection	Assessment	Area Adjusted	Infrastructure	Tax Effort	Fiscal Discipline
1 F.C		80			20					
2 F.C		90			10					
3 F.C		80			20					
4 F.C		80			20					
5 F.C		90				10				
6 F.C		90				10				
7 F.C		90				10				
8 F.C	40	25	25			10				
9 F.C	45	22	11	11	10					
10 F.C	60	20					5	5	10	
11 F.C	62	10					7.5	7.5	5.0	7.5

Source: Kannan R et al, art. cit, pg 483.

Sharing Of Union Excise Duties

Regarding the Centre's Excise Duties, the share of states in the net collection, which in the First FC was fixed as 40% moved down to 25% and further to 20% by the next four commissions. However the Seventh FC raised it back to the position of the First FC. Now with the passage of time the other two commissions increased it and kept it at 45%, only to be increased marginally to 47.5%. Another necessary feature of the whole distribution remained that the buoyancy of the resources depends on the number of exercisable commodities under taxation. The first three commissions had not increased the number of commodities in the divisible pool but the Fourth FC included basic excise duties, Fifth FC extended it to the special excise duties and the Sixth FC expanded it further by including auxiliary excise duties under the bracket[36]. Again quite similar to the Income tax distribution, the first Five FCs(See Table 1.2) actually just gave emphasis on the Population and Backwardness Criterion. It was the Sixth and the likewise the Seventh FC that included Distance and Inverse Income respectively while deciding the share of distribution of the Central Excise Duties.

Table 1.2: Distribution Criterion In Respect Of Union Excise Duties Under Various FCs

Criteria	Distance	Popu- lation	Inverse Income	Backwardness	Non Plan Rev. Deficit	Area Adjusted	Infrastructure	Tax. Effort	Others
1 F.C		100							
2 F.C		90				10			
3F.C		90				10			
4 F.C		80		20					
5 F.C		80		20					
6 F.C	25	75							
7 F.C		25	25	25					25
8 F.C	48.8	24.4	24.4						2.2
9 F.C	33.5	25	12.5	12.5	16.5				
10 F.C	60	20				5	5	10	

Source: Kannan R et al, art. cit pg 483.

All this for the vertical distribution of the revenues by the FC. In so far as the horizontal distribution of the tax revenues are concerned, that is distribution amongst the states as such, the criterion had not been fixed either regarding central taxes or the grants in aid. Well with the planning commission we know that the commission follows the Gadgil formula. With FC the things are a little different. The criterion evolved over the matter of decades, the priority was always given to the population which commanded almost 80% till Fourth FC, raised even higher to 90% in 5th, 6th, 7th FCs. It was however dramatically

[36] Kannan R et al, art. cit ,pg 484.

reduced to 25%, This was owing to the criterion itself becoming more "*shareable*" other factors such as distance, Inverse income, assessment, geographical area, infrastructure, tax effort and fiscal prudence gained a gradual but right importance. With the union excise duties an additional criterion of "assessed deficit" was given importance from the Eighth Commission's recommendations, along with tax effort, fiscal discipline etc.

It must be further noted that with the Eighth FC, there were changes *vis a vis* the method of distribution pertaining to both income tax, and union excise duties. There was a move towards unifying the formula for the inter state distribution of both the income tax and the union excise duties and a portion of the union excise duties was kept aside for the distribution according to the "assessed deficit" of the states after the devolution of central taxes.

Table 1.3: Distribution Criterion Of The Net Proceeds Of Income Tax And Union Excise Duties To States

FCs	Share of income tax assigned to states	Share of union excise assigned to states
FIRST F.C.	55%	40%
SECOND F.C.	60%	25%
THIRD F.C.	66%	20%
FOURTH F.C.	75%	20%
FIFTH F.C.	75%	20%
SIXTH F.C.	80%	20%
SEVENTH F.C.	85%	40%
EIGHTH F.C.	85%	45%
NINTH F.C.	85%	45%
TENTH F.C.	77.5	47%
ELEVENTH F.C.	29.5%	--

Source: Kannan R et al, art. cit., pg 484.

1.7. Sharing of grants- in -aid.

Another important and rather more important is the grants in aid that has the capacity to influence the centre state relations in India .The contributions via this category has come to dominate the resource transfer too much these days.

Grants in aid are intended to fill up the Non Plan Revenue Gap and its share was decreasing on account of the fact that tax effort of states has been given importance in the resource transfer to states by the FCs. For, instance, the Seventh Finance made grants in aid a residuary form of assistance to states. The approach of the Eighth also was so designed in diminishing in every subsequent year on hopes that the tapering revenue gap grants would make states increase their own revenues.

As observed earlier, the variations that we observed regarding the income tax disbursements and likewise Union Excise duties, we almost come across the same with regard to the grants in aid. These variations probably are related to such tendencies as:

- Change in the ratio of tax sharing between the centre and the states (Vertical distribution)
- Revenue buoyancy in the central tax collections
- Fiscal performance of individual states particularly in their placement in the non plan deficit
- Special problems in regard to transfer of grants in aid

Table 1.4: Pattern Of Resource Transfer From The Centre

(Rs cr)

FC	Taxes and duties	Grants in aid	Total transfer
SEVENTH F.C	399(3.8)	10055(96.5)	10454(100)
EIGHTH F.C	35682(90.4)	3769(9.6)	39452(100)
NINTH F.C	87882(82.9)	18153(17.1)	106036(100)
TENTH F.C	206343(91.0)	20300(9.0)	226643(100)
ELEVENTH	376318(86.5)	58587(13.5)	434905(100)

Source: Kannan R et al, art. cit., pg 484.

1.8. Terms of Reference[37]

FIRST FINANCE COMMISSION (1952-57)

- The sharing and allocation of income tax and the union excise duties
- Grants in aid to states in need of assistance, in lieu of their share in export duty on jute and jute products (which had been abolished).

SECOND FINANCE COMMISSION (1957-62)

- Besides recommending the share in taxes
- To decide upon the states which are in need of assistance by way of grants in aid under Article 275(1) and in determining the amount to be paid to the States

THIRD FINANCE COMMISSION (1962-66)

- (References same as second one)

[37] Kannan R et al, art. cit., pg 484.

FOURTH FINANCE COMMISSION (1966-69)

- The revenue resources of those States for five years ending with the financial year 1970-71 on the basis of the levels of taxation likely to be reached in the financial year 1965-66.
- The requirement to meet the committed expenditure on the maintenance and upkeep of the plan schemes completed during the third plan
- Any other expenditure likely to be devolved upon the states to service their debts
- Creation out of the excess if any, over a limit to be specified by the commission of the net proceeds of estate duty on property other than agricultural land accruing to the state in any financial year, for the repayment of the stat's debt to the central Government, and the scope of economy consistent with efficiency which may be effected by the states in their administrative expenditure, and
- To study the combined incidence of sales tax and union excise duties on the production, consumption or export of products or duties which are shareable with the States?

FIFTH FINANCE COMMISSION (1969-74)

- Included for the first time, a reference to the principles that should govern the grants in aid which are broadly 3—the first two related to revenues that would be available at the base year rates of taxation requirements to meet expenditure on revenue and also to have regard to resources of the centre and the demands hereon on account of expenditure on civil administration, defense, debt servicing, etc

- Advance tax collected was also referred to under tax sharing.

SIXTH FINANCE COMMISSION (1974-79)

- Same as the previous commission but as part of its terms of reference had to make revenue projections on the one hand and take into account revenue expenditure commitment on the other
- The Commission was asked specially to take into account the grants in aid for the purpose of upgrading levels of administration in the backward States, provision for emoluments of Government employees,, adequate maintenance and upkeep of assets and plan schemes, the existing practice with regard to determination and distribution of central assistance for financing state plans, and the assessment of non plan capital gap of states for five years ending with 1978-79.
- The Commission was asked to review the policy and arrangement with regard to the financing of relief expenditure of the states affected by natural calamities.

SEVENTH FINANCE COMMISSION (1979-84)

Given the additional guidelines for making recommendations in regard to:

- Resources of the Central Government;
- Central assistance to State plans;

- Revenue resources of the states for five years ending with 1983-84 on the basis of the levels of taxation likely to be reached in the year 1978-79.
- Requirements of the revenue account of the State expenditure and the non plan commitments/ liabilities by taking into account the provision for emoluments of the state employees,
- Maintenance of the capital assets and the plan scheme,
- Upgrading the standards of administration in the non developmental sectors and services of backward States and indicate the manner of monitoring such schemes
- Need for ensuring reasonable returns on the States public sector undertakings including the irrigation works.
- Further, the commission shall adopt 1971 population figures where the population is a determining factor of the devolution of taxes and duties and grants in aid.

EIGHTH FINANCE COMMISSION (1984-89)

The Commission was required to go into the:

- Examine the scope of raising the revenue from taxes and duties mentioned in Article 269 and to enhance revenue from duties mentioned in Article 268.
- Assess the non-plan capital gaps of the states for the years ending 1988-89 and suggest measures to deal with the same having regard to the requirement of the centre.

NINTH FINANCE COMMISSION (1990-95)

- The Commission was required to submit two reports- the first covering the year 1989-90 and second for the subsequent five years (1990-95)
- TOR of the ninth FC did not restrict the scope of the commission to the assessment of the non-plan side of the budget only, but required the scrutiny of the receipts and expenditure on the entire revenue account of the states and the centre.
- For making the assessment, the commission was asked to adopt a normative approach in order to provide adequate incentives for better resource mobilization and financial discipline as a well as effect a closure linking of expenditure and revenue raising decisions
- Emphasis was placed not merely on balancing the receipt and the expenditure on the revenue account but also on generating surplus for capital investment.
- The terms include an examination of the feasibility of the merger of additional excise duties in lieu of state tax with basic duties of excise and examining the possibility of establishing a national insurance fund to meet capital expenditure on natural calamities.

TENTH FINANCE COMMISSION (1995-2000)

The Commission was asked not explicitly required to adopt a normative approach in assessing the receipts and expenditure on the revenue account of the states and centre. The commission was required to consider inter alia the following:

The objective of balancing the receipts and expenditure on the revenue account,

- Generating (revenue) surplus for capital investment,
- Reducing fiscal deficit,
- The tax effort of the states and add the potential for raising
- Additional taxes,
- The maintenance expenditure on plan schemes to be completed by end-March 1995 and the maintenance and upkeep of the capital assets as well as the manner of monitoring such expenditures,
- The requirements of the states for modernization of administration and for upgrading standards in the non-developmental sectors and services,
- The need for ensuring reasonable returns on investment by states in irrigation and power projects, etc. and
- The scope for better fiscal management consistent with efficiency and economy in expenditure.

ELEVENTH FINANCE COMMISSION (2000-05)

- To make recommendations on the sharing of resources between the centre and states the commission,
- To suggest measures for the restructuring of public finances of the union and the state jointly and severally in order to restore budgetary balance and maintain macroeconomic stability,
- To make recommendations on measures needed to augment the consolidated fund of the state to supplement the resources of the Panchayats and municipalities in the states on the basis of recommendations made by the FC of the state concerned.

Further, an additional term of reference was given to the EFC that the commission should draw a monitorable fiscal reforms programme aimed at reduction of revenue deficit of the state and recommended the manner in which the grants to states to cover the assessed deficit in their non-plan Revenue account may be linked to progress in implementing the programme. The EFCs recommendation is important because, unlike the TFC, the EFC was for the first time specifically mandated to study and recommend measure concerning the devolution of the financial resources to the rural and urban local bodies. In examining the various issues raised by the State Governments, the Ministry of Rural Development and the central Government, and in proposing new recommendations, the EFC has taken an approach to the problem of the devolution to the local bodies that merits a close scrutiny.

1.9. Other Forms of Central Governmental Intrusion (between 1950-91)

Between 1950-51 and 1990-91, India's Public sector measured by the ratio of Government expenditure (Centre plus States) to GDP recorded an almost three fold expansion, from 9.9% to about 27%. Much of this growth had taken place in the first three decades. The expenditure ratio has reached 24% in 1980s.expansion of the Government involvement in the economy can also be seen as reflected in the rise of the share of the public sector (taking the undertakings owned and controlled by the Government) from barely 11%of the GDP in the 1960s to almost more than a double. In some sectors like mining and quarrying, the public sector's share increased tremendously. Centralization of economic decision making and heavy reliance on the public sector was as observed by Bagchi and Nair,1994) was driven by two fundamental reasons:

- Exaggerated notions about the external economies of scale on big projects..
- Ignoring the positive effects of administering local initiatives.

There were however, other forms of Governmental interventions too. For sake of understanding, I will elaborate them under the following heads:

- Doing away with the destination principle altogether and introducing an origin based tax system also called the Central Sales Tax (1956)
- Enactment of Essential Commodities Act (1956)
- Enactment of Urban Land Ceiling Act (1976)

The Central Government hence besides the usual FC/ PC transfers intrudes in the affairs of the states and the local bodies by way of central legislation and acts.

Chapter 2

Issues in Fiscal Federalism in India: From the Perspective of, States and the Local Bodies

The discourse on fiscal federalism has undergone serious revision. While proceeding from the Musgravian assumption (which he propounded in his most famous magnum opus ***The Theory of Public Finance*** that the Government decision makers ought to be benevolent, one now needs to take into account the exigencies of the changing times where the Government decision makers are no longer considered to be benevolent, they would rather prefer to be run on self interest principles. In case of India the reality lies somewhere in the middle of the two assumptions. Hence while the state Governments are vying to attract investments from abroad, make correct their fiscal imbalances and show fiscal prudence, they still feel safe to prod the conservative way. There is still a heavy reliance for funds and policy directions from the central Governments, not to mention the Constitutional provisions for the implicit superiority of the centre in certain matters.

The chapter, taking clue from the previous one, would look at the facets of the federal transfers, i.e. the repercussions associated with the transfer mechanism adopted by the successive FCs. Now, taking for granted the given ness of the distribution criterion for the time being, what follows is sensitive issue in central state relations, which demands nuanced reflection. As the most theorists would agree, what resulted after the distribution, (could be classified or rather declassified), as increasing fiscal dependency of the states on the centre and also the increase in inter state disparities. The problems accruing out of the reforms cannot be easily ignored especially in the times of pressing demand upon the centre's and state to restructure their public finances from the top international financial institutions. Moreover with the acceptance of the market liberalization and globalization and the delegation of powers to people or what is gleefully now called civil society organizations[38], the questions of participation, accountability, and autonomy have come to fore. As the 10th plan (2002-2007) document states:

> *..it is expected that the state yields to the market and the civil society in many areas where it, so , far, had a direct but distortionary presence. It also includes the role of the state as the development catalyst where, perhaps civil society has better institutional capacity .At the same time, while the growth of the markets and the presence of the aware and sensitive civil society, many developmental functions as well as the functions that provide stability to the social order have to be performed by the market and the civil society organizations. It means extension of the market and the civil society domain at the expense of the state in some areas [2002:181]*

The critique of the distribution criterion itself would become the area of concern, to be discussed in the later part of the chapter.

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[38] Chandoke Neera(2005) , 'Seeing the state in India' ,*Economic and Political Weekly* , 15(11), March 12-18,.

Taking into account a few analysis on the Fiscal Federalism in context of India, I increasingly realized that there are basically three facets to Federal Finance in India, one is that there is fiscal inequity in fiscal assignments to the state, then there are fiscal imbalances resulting from the fiscal transfers by the FCs which may be due to the grants in aid disbursed to the states for the special reasons and loans disbursed to the states, problem with the transfer formula or for reasons such as states are provided with the elastic tax revenue while those with the centre the sources are more permanent kinds or what we called inelastic sources of revenue. Then another issue (from the point of view of the states) with the FC is the term of reference (that commands it to recommend on the non-plan revenue of states and likewise comment on the non-plan expenditure of these states. Probably that is why one could see that the successive FCs in India were largely concerned with the Non Plan Revenue Deficit of the states' revenue account of the budget. Hence the approach that they have been following is largely gap filling approach.

It was the Ninth FC though (to respite to some states) that called for the "Normative approach", which were to lay out certain yardsticks for the states and likewise for the centre. It looked at the special needs of the centre as also special problems of the states. Tenth FC gave an open mind approach as the motto to be followed henceforth. Hence one finds a gradual evolution both in terms of the principles to be followed by the FC and also ideals cherished in the rapidly changing global context. But despite these changes in the attitude of the FC a large gamut of problems still remain to be answered. Hence in order to look into the problems with the fiscal federalism one needs to look at the problem from these broad perspectives.

Another pointer, that should be mentioned at the outset is that the issues involved in the federal transfers are so vast and complicated, that one is almost confounded which ones to exclude and to what degree. Hence I would be looking at the issues (for these have direct bearing on the fiscal federalism) from the four broad perspectives:

- Financial inequity amongst the States.
- Financial imbalances of the States.
- Fiscal dependency of the States on the centre.
- Level of Fiscal Decentralization; FC and local bodies.

As I discussed in Chapter 1, the rationale of inter-governmental transfers arises from the twin reasons of "vertical" and "horizontal" imbalances. It is believed that the national government has a clear comparative advantage in raising revenues while the state governments have an advantage in spending wherever required according to the economic exigencies or local demands. It must also be mentioned here that the issues in federal finance in India are not just these but more. However the technical problems with the transfer formula which could otherwise not be ignored are dealt in the later part of this chapter. Some other problems that had some bearing on the federal finance but which could not have independently classified and pursued are also taken into cognizance, as I move along with the broad topics mentioned above.

2.1. Fiscal Inequity amongst the States

It is no doubt that the maintenance of fiscal equities had been the area of primary concern to the FCs in the past. As for the first FC "the scheme of distribution should attempt to lessen the inequalities between the states"[39]. Likewise, the second, third, fifth, sixth, seventh and eighth endorsed the same idea. The revenues amongst the states should be equitable so that every state is enabled over time to provide a specified minimum standard of basic public services[40]. But the moot question before us is to look whether the commissions were able to deliver the goods to the states and likewise the public at large.

While one is looking at inter regional disparities, one is not referring to a particular set of criterion followed. Rather it was seen that there had been no consistency in so far as the conceptualization of the term "inter – state" disparities is concerned. For some it could just mean disparities in the per capita income of the states, while for others it refers to the level of Human Development Index as reflected by social indicators such as literacy, infant mortality, and life expectancy. It also sometimes means disparities in basic public services or what is called the PQI (e.g. Education, health, water supply), likewise it may just indicate the level of infrastructural differences, unemployment, and value added and output levels[41].

[39] Government of India(1951), Report of the First Finance Commision,1951,Pg 10
[40] Government of India(1989),Report of the Ninth FC, 1989, Pg 10
[41] Reddy K .N(1994), 'Statutory Transfers and the Inter State Disparities in India : Some suggestions' *as quoted in Journal of Fiscal Economics* , 2(1), July- Dec, pg2-3.

Macroeconomic Income, Poverty And Growth Scenario

If one looks at the macro economic growth scenario at large one may be tempted to say that the condition of Indian public finances must be in good health. For the last quarter century of India's economy the figures put the growth scene nearing 6 per cent on an average. Considering that the India's economy hardly grew in first half of the 20th century, and then following independence, grew at a sluggish Hindu growth rate of 3 to 4 percent, this recent growth projection seems remarkable[42]. However even for this a rejoinder comes from three sides, one school of thought merits the so called rates as only a legacy to incipient or the first phase of liberalization that began in 1974-75(as a response to a crisis of enormous proportions in the economy) and , to this school belongs such political theorists as Baldeev Raj Nayyer(2001), Roddrick and Subramanain(2004), Virmani(2004) and Panagariya(2004).For such theorists there is nothing big about "economic growth" after 1991 since, comparable growth rates were witnessed during the 1980's, prior to the 1991 reforms. The other and the more orthodox school as represented by such thinkers such as Deaton and Dreze (2002) and Sen and Himanshu (2004), for such thinkers, this rapid growth has been accompanied by growing inequalities. Then, there have been some, for whom all these figures are but continuity of eons of delusion, while the reality lies somewhere else (and that this reality is less complicated but more compelling).

[42] Kohli Atul (2006), 'Politics of Economic Growth in India , 1985-90(Part I)', *Economic and Political Weekly*, 16(13),April 1-7, pg 1252.

It's to every body's notice that where the income of the rich have plummeted the incomes of the poor have relatively decreased. In so far as the poverty estimates are concerned the study of various economists suggests dismal position both vis a vis poverty gaps themselves and the construction of these poverty gaps. Over the past years there had been so many hue and cries about the very rationale of the construction of these gaps and deficits. Likewise it had been also found that there had been inconsistencies between official poverty estimates in India and the real poverty figures. Some theorists have even underlined that the concept of poverty line followed for adjudging basic denominators such as APL/BPL ratios, is basically arbitrary.

The studies conducted by Utsa Pattnaik(1998), Dandekar(1999) ,Tendulkar(2002), Geoffery Lancaster(2002) , Ray(2001), Mohan Guruswamy(2005) ,Joseph Abraham(2005)and others have increasingly shown that that how the official poverty lines have flawed the thinking on the performance of the Indian economy . Now this renewed interest in the construction of poverty estimates have taken the debate from poverty "measures" to poverty "line" as such. While poverty line in India, have been constructed taking into account minimum calorie intake by an individual, the very idea had led to innumerable musings if the conceptualization is fair enough from the individual's point of view[43]. Little authorship on the concept has gone to the extent of labeling Poverty line as "starvation line" or "near death line".

[43] **History of the definition of the poverty line**-The Planning Commission's "poverty line" is based on a nutritional norm of 2400 and 2100 calories in rural and urban India respectively [GOI 1979]. Thus people living in rural(urban) India can afford to consume on an average at least 2400(2100)calories of food per day, they are above the poverty line. Likewise the Planning Commission has estimated the total expenditure that would suffice to bring about this nutritional classification. These lines were first estimated 3 decades back. In 1973 prices, the poverty lines for the rural and urban India were Rs 49 and Rs 57 respectively. About 3/4ths of this monthly expenditure was used up in buying the food items, leaving very little for other needs[GOI 1979].Now as of 1999-2000, the poverty lines declared by the planning commission were Rs 327 and Rs 454 respectively for the rural and urban areas. Currently these figures stand at approximately Rs 368 and Rs 559 per person per month.

According to most of them looking at the calorie criterion [a simplistic calorie standard often misses out other nutrients so important for life] is not enough, there are also other non-food basic needs which are equally important. Such a paradigmatic change of hearts amidst social scientists will bound to affect the very notions of growth, development and other important indices that count in the construction of data and figures both at the national and regional levels.

Even the Eleventh Plan DAP as it may be abbreviated, tells us, that the critics of the official estimates of the proportion of the households below the poverty line arrived at on the basis of 55th round of NSS may be right .We now can say with at least some measure of accuracy that the poverty has declined in absolute terms i.e. from 36 per cent in 1993-94 to 28 per cent in 2004-05, a decline of almost 8% over 11 years, this should be seen in terms of the indices of the previous decade when the poverty per cent of households declined even at a faster rate still, (almost twice as rapidly in terms of percentage points per year)[44]. Secondly, using the official nutritional norms, more than 70% of the Indian population would have come under the poorest of the poor category. Thirdly, the rate of unemployment as measured by the current daily status, rose from 5.6% in 1993-94 to 9.0 per cent in 2004 for males and for females the figures lie somewhere between 9.6%- 10% for the same period[45].

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[44] Athreya V.B & Rao Mohan(2006), 'Education and Health in Draft Eleventh Approach Paper', *Social Scientist*, September – October ,pg 21.
[45] Athreya V.B et al, opp. cit pp 22-23.

Regional Disparities in terms of income and growth rates

In the recent period the independent studies, conducted by the host of comparativists see Ahluwalia (2000 and 2002);Nagaraj,Varoudakis and Veganzous (1998); Rao Shan & Kalirajan (1999); Shan & Binde (2000) namely have led to the conclusion that the regional disparities show an upwelling trend, despite the tilt towards equity recommended by the FCs far as till the Eleventh FC. Hence in spite of the bias against the poorer states (as seen in the case of EFC awards, the revenue capacity of these states have remained highly unequal, positing a case for fiscal dependency (which is discussed a little later in this chapter). Where one can see the signs of divergence in terms of growth rates amidst the different states, one cannot just overlook at the enormity of such divergence, the discussion of which I shall take a little later.

I cannot but pause to make a little note on some technical problem that I was struck while looking into the figures that I think one must take into account while handling such things like "comparisons" across states. Studies on comparison between states not only suffer from the problem of being confined only till the period 2002(the recent data is yet to come in public), they also suffered from some technical problems. In a succinct essay in *EPW* (March 2004), Prof B.B Bhattachraya and S. Sakthival have pointed out that the new GDP & SDP figures are incomparable, for the new figures take on the dynamics of the new situation arisen over time, for e.g. the new indices change the base year in terms of price but also revised the boundary line in a number of sectors such as agriculture, real estate and finance. It has also shifted the occupational force database from the census to the NSS and finally it has included some dynamic economic activities such as software etc[46].

Now taking into account almost cursorily the problems accruing from the earlier studies it may be fairly reliable to take the figures constructed from Bhattachraya's study who have compared the growth rates of the 17 major states (also taking into account the newly formed states in 2001).

Table 2.1: Growth Rate of SDP at Constant Prices

(Percent per annum)

States	1980-90	1990-2000	1980-2000
Andhra Pradesh	4.81	5.12	5.05
Assam	3.91	2.47	3.49
Bihar	5.20	3.46	3.85
Goa	5.71	8.23	7.47
Gujrat	5.71	8.28	6.80
Haryana	6.68	6.71	7.80
Himachal Pradesh	6.10	6.91	6.20
Karnataka	6.10	7.07	6.53
Kerala	4.50	6.00	5.97
Madhya Pradesh	5.18	5.45	5.89
Maharashtra	5.98	6.80	6.30
Orissa	5.85	3.60	3.90
Punjab	5.14	4.63	4.70
Rajasthan	7.71	6.46	6.95
Tamil Nadu	6.35	6.65	6.51
Uttar Pradesh	5.88	4.33	5.15
West Bengal	5.20	7.24	6.11
All- India	5.60	6.03	5.66
Coefficient of variation	0.41	0.29	0.22

Source : B B Bhattacharya and S Sakthival , art cit pg 1074.

[46] Bhattarchrya B.B & Sakthivel S, art. cit., pg 1073-74 .

According to him it's an established fact, that the disparities in income across all the states have been widely increasing and that there are no signs of convergence[47], where the data for the states in the 80s show that the regional growth was comparatively balanced [see Table 2.1].

All States except such as AP, Assam, Kerala had recorded an over 5% growth rate per annum. In fact TN, Karnataka, Haryana, HP and Rajasthan recorded one of the highest rates almost over 7%. However the data for 90s show that a few states [Gujrat, Maharashtra, Goa] grew over 8%, only a few others like Karnataka and West Bengal performed with a 7% growth rate. Majority of the others were lagging with 6 % and below some like Assam even touching an ebbing low of 2% in the period between 1990-2000. A remark made by Prof Bhattacharya:

> *"It is interesting to note that West Bengal which is not considered to be a Pro Market State, has not only grown faster than many Pro Reform States such as AP (4.8%) and Punjab(5.1%) ,during the reform era. The poor performance of both Punjab and AP, actually comes as a surprise. While the case with Punjab the lag can be attributed to the stagnating agriculture. AP needs a careful inspection. It appears that the pro reform policies are yet to bear fruits in respect to that State".*

For more poignancy, one looks not merely at the aggregate growth rates but also at the growth of per capita SDP as shown in the Table 2.2.

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[47] The Convergence Theorem postulates that initially when the growth rates increase there is a tendency that some states would grow more than others but after a gap of time the growth rates will fall as a result of the setting in of Law of Diminishing Returns[See more in Barro 1991]

Table 2.2: Growth Rate of Per capita SDP

(Percent per annum)

States	1980-90	1990-2000	1980-2000
Andhra Pradesh	2.56	3.62	3.09
Assam	1.74	0.65	1.38
Bihar	2.97	1.86	1.92
Goa	4.08	6.84	6.01
Gujrat	3.62	6.38	4.85
Haryana	4.12	4.42	5.32
Himachal Pradesh	4.36	5.11	4.29
Karnataka	4.00	5.27	4.63
Kerala	3.04	4.78	4.64
Madhya Pradesh	2.74	3.22	3.08
Maharashtra	3.60	5.04	4.83
Orissa	3.96	2.12	2.15
Punjab	3.19	2.71	2.73
Rajasthan	4.41	4.09	4.20
Tamil Nadu	4.79	5.40	5.10
Uttar Pradesh	3.46	1.98	2.92
West Bengal	2.93	5.41	3.99
All-India	3.36	4.07	3.54
Coefficient of Variation	0.22	0.43	0.34

Source: Bhattacharya and Sakthival, art. cit pg 1075..

Just a case to the pointer, in the 1980's Assam recorded a lowest per capita SDP growth at 1.7% p.a. and TN the highest rate of 4.8%. As against these the regional inequality seems to be more than widening e.g. Assam with a meager 0.7% while the richest state like Goa and Gujarat at 6.84% and 6.38% p.a. respectively. WB managed to grow from 2.93% to 5.40% p.a. In case of Maharashtra and Kerala the growth rates were significantly higher, while just the opposite happened with the states like Assam, Bihar, Orissa, Punjab, Rajasthan and UP.

The inter se distribution of the central resources under the FC awards reveal that the transfer is more in favor of the lower income states both in the share of central taxes and in the disbursements of grants in aid. In case of higher income states, there had been consistent decline both in taxes and grants, while for the middle income states their share had shown a varying proportion under various FC awards. The special category states has been receiving large amounts of grants in aid, while there share had been lower than those of lower, middle and higher income states. This factor shows a large amount of disparities in the financial disbursements by the commission to the states.

Similarly, it could not be ignored that the EFC awards gave to the low income states more in both the categories of distribution, i.e. the low income states received 53.77% of entire taxes and duties disbursed to the high, middle, low and the special category states. In the similar vein Grants in aid amounted to more than 47% going to the special category states. Hence out of the total (taxes and grants in aid) the low income countries got the largest piece in the cake, leaving the high income and the special income states remain dog-eared to pieces.

Human Development Index

Now apart from the usual income and growth rate indices that render regional differentiation across states one needs to take into account of the overall indicies reflecting human development. Human development denotes the sum total of people's level of "freedom". Elucidating on this Human Development Report (1997) states.

Income clearly is only one option that people would like to have an important one. But it is the sum total of lives. Income is also a means with human development as the end.

Ever since the publication of HDR (UNDP)(1990) under the able guidance of Mahbul Haq, efforts have been made to devise and further refine measures of Human Development. Now Human Development has come to mean three things HDI, GDI, HPI. In a recently realized HDI Report places India just a place higher as compared with the earlier year i.e. 126 .It is interesting to note that the period from 1981 to 1990 saw HDI (see Table 2.3) score improve by close to 25%. In the next 10 years the figure has come down to 18.6%. Given the fact the latter period is more or less the post reforms period in India, this is bound to be used up as a strong argument by those opposed to the reforms. However on the positive side, India's gender development index (GDI) rank is 96 out of 177 nations, one of the best in the south Asian region barring Sri Lanka, which is a way ahead at the rank of 68.

As can be gauged from the data below, the performing states like Kerala, Punjab, Maharashtra and Gujarat that need not show a a very remarkable record in terms GDP per capita figures and GDP figures at constant Prices show decently in human development figures. However an inverse relationship could also not be established with certainty for the poor states equally show a bad record in terms of human development figures. And at least this could be said with a greater amount of certainty (See Annexure 2.2).

Table 2.3 HDI Figures over the decades (80s 90s and 2000)

State	Human Development index			HDI Shortfall reduction	Litracy rate(LR)(per cent)			Expectation of life at birth (ELB) (YEARS)			Per capita SDP at 1980-81 Prices(PCI) (Rupees)		
	1981	1991	2001	(1981-2001)	1981	1991	2001	1981-85	1991-95	1992-96	1980-81	1990-91	2000-01
AP	0.298(9)	0.377(9)	0.416(10)	5.6	35.66	44.09	61.11	58.4	61.8	62.0	1380	2060	3069
Assam	0.272(10)	0.348(10)	0.386(14)	6.1	42.05	52.89	64.28	51.9	55.7	56.2	1284	1544	1670
Bihar	0.237(15)	0.308(15)	0.367(15)	10.1	32.05	38.48	47.53	52.9	59.3	59.4	917	1197	1225
Gujrat	0.36(4)	0.431(6)	0.479(6)	3.1	52.21	61.29	66.43	57.6	61.0	61.4	1940	2641	4257
Haryana	0.36(5)	0.443(5)	0.509(5)	7.8	43.88	55.85	68.59	60.3	63.4	63.8	2370	3509	4485
Karnataka	0.346(6)	0.412(7)	0.478(7)	5.7	46.21	56.04	67.04	60.7	62.5	62.5	1520	2039	3590
Kerala	0.50(1)	0.591(1)	0.638(1)	--	81.56	89.81	90.92	68.4	72.8	73.1	1508	1815	2778
MP	0.245(14)	0.328(13)	0.394(12)	12.8	36.63	44.2	64.08	51.6	54.7	55.2	1358	1693	2084
Maharashtra	0.363(3)	0.452(4)	0.523(4)	9.4	55.83	64.87	77.27	60.7	64.8	65.2	2435	3483	5283
Orissa	0.268(11)	0.345(12)	0.404(11)	9.9	40.97	49.09	63.61	53.0	56.5	56.9	1314	1383	1917
Punjab	0.411(2)	0.475(2)	0.537(2)	2.0	48.17	58.51	69.95	63.1	67.2	67.4	2674	3730	4897
Rajasthan	0.256(12)	0.347(11)	0.424(9)	15.3	30.11	38.55	61.03	53.5	59.1	59.5	1222	1942	2412
Tamil Nadu	0.343(7)	0.466(3)	0.531(3)	14.7	54.39	62.66	75.47	56.9	63.3	63.7	1498	2237	3643
UP	0.255(13)	0.314(14)	0.388(13)	9.8	33.35	41.6	57.36	50.0	56.8	57.2	1278	1652	1852
WB	0.305(8)	0.404(8)	0.472(8)	13.0	48.65	57.77	69.22	57.4	62.1	62.4	1773	2145	3745
India	0.302	0.381	0.472	13.6	43.57	52.21	65.2	55.5	60.3	60.7	1630	2223	3234
CV(per cent)	22.5	16.29	16.29	--	28.35	24.18	14.45	8.84	7.78	7.63	31.09	36.01	40.55

Source: Kannan R et al, art.. cit. pg 484.

Infrastructure Development

Growing infrastructural disparities across major states can be gauged. (Annexure 2.3) provides data on consumption of power per capita, registered vehicles per 1000 persons, and road length per 100 sq kms. Of area, telecom lines per 100 persons and percentage of irrigated area to gross cropped area.

Consumption of power per capita is an indicator of the level of energy consumption. The data throws light on the level of the indicator achieved. States such as Punjab, Gujarat, Maharashtra are above the national average of 338 kwh in 1996-97.As against them the backward states such as Uttar Pradesh and Bihar are way behind at 145 kwh and 194 kwh respectively.

State wise number of registered vehicles per 1000 persons is an important indicator, even though it cannot be taken as a comprehensive indicator of the level of transport development including that of roads and railways. Punjab tops the list followed by Gujarat and Haryana.

Trends in investment and financial assistance

A Planning Commission member NJ Kurian in a study indicated that the two thirds of the proposals (69.2%) in the post reform period were concentrated in the forward states and a similar situation prevailed in terms of financial assistance distributed by All India Financial Institutions and State Financial corporations(see Table 2.4) .The All India Financial Institutions viz IDBI, IFCI, ICICI, UTI, LIC,GIC, IRBI and SIDBI disbursed 67.3% of the total financial assistance to the forward states up to March 31 2000.Even among the the forward 9 states , 4 states namely Maharashtra, Gujarat, TN, and AP, were able to appropriate about 51% of the total financial assistance. Even in the case of the SFCs, 70% of the total Financial Assistance was received by the forward states. This process also underlines the case that the reform process has favoured the performing states over and above the weak states. Out of the other explanations such as criminalinality and unstable political atmosphere, the poor socio economic infrastructure level in the state.

Table 2.4: Investment Proposals and Disbursal of Assistance for Investment

States	**% Share of investment proposals (Aug 91-Dec 98)**	**Cumulative share financial assistance disbursed by all India financial institutions (up 31st March 97)**	**Cumulative financial assistance Disbursed by States financial corp(up March 97)**
Forward States			
Punjab	3.4	2.4	3.6
Maharashtra	18.0	21.0	11.5
Haryana	3.6	2.5	4.8
Gujarat	18.7	13.5	9.3
WB	3.3	3.9	2.5
Karnataka	5.6	6.1	15.5
Kerala	1.1	1.7	4.4
TN	7.2	9.0	10.6
AP	8.3	7.2	7.8
Sub Total	69.2	67.3	70.0
Backward states			
MP	7.4	5.1	3.2
Assam	0.7	0.5	0.5
UP	9.4	7.9	11.1
Rajasthan	3.9	4.5	6.1
Orissa	2.2	1.8	3.7
Bihar	1.2	1.4	2.0
Sub-Total	24.8	21.2	26.6
All-India	100.0 (737516)	100.0 (312502)	100.0 (20896)

Note: 1.Figures in brackets indicate totals of Rs.Crores.

2. Data has been arranged according to our classification of Forward and Backward States.

Source: N .J. Kurian(2000), 'Widening Regional disparities in India', *Economic and Political Weekly*, Feb,12-18.

Category wise Central Transfers under the FC

The disbursal of central transfers in India gives us a story similar to that of Keynesianism at work in the west. As can be gauged the direction of the flow of resources from the FC in keeping the spirit of Article of the Constitution. In case of central transfers to the higher income states there had been a perceptual decline both in terms of share in central taxes and in the disbursal of grants in aid, while for the middle-income states the order had been more eclectic. The special category states had been receiving a customary and huge amounts of grants in aid, while their share in taxes was lower than all the three high, middle and low category states (Table 2.5).

Table 2.5: Category wise distribution of central transfers under FC awards

Category of states	**High Income States**	**Middle Income States**	**Lower Income states**	**Special Category states**
A. Taxes and duties				
Eighth	19.19	23.65	16.73	7.58
Ninth	14.81	30.66	41.67	12.86
Tenth	13.13	29.23	44.17	13.45
Eleventh	9.74	29.19	53.77	7.30
B. Grants in aid				
Eighth	7.64	22.22	28.10	46.07
Ninth	9.13	11.89	61.21	22.95
Tenth	12.03	21.48	33.86	32.47
Eleventh	8.43	17.07	20.93	47.29
C. Total				
Eighth	13.20	29.98	42.76	27.53
Ninth	12.54	26.75	45.76	14.96
Tenth	13.05	21.93	43.24	15.16
Eleventh	9.63	27.56	49.33	13.48

High income states : Gujrat, Haryana, Maharashtra,Punjab and Goa

Middle income states: AP, Karnataka, Kerala, TN and WB.

Lower income states: Bihar,MP, Orissa, Rajasthan, UP

Special income states: Arunchal Pradesh,Assam, Himachal Pradesh, J&k ,Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura

Source: Kannan R et al, art. cit., pg 484.

As can be gauged from the Table 2.6 even in the recommendations from the 12 FC emphases is placed on the weak states as compared to the rich or performing states. States like UP, Rajasthan, Orissa HP, Bihar are given preference in the total transfers while the special category states still earn centre's grants in aid as compared to the central share in the taxes and duties.

Table 2.6: Share in total transfers from FC --- Statewise

States	11 FC	12 FC
AP	7.13	7.356
Arunachal Pradesh	0.53	0.288
Assam	3.97	3.235
Bihar*	13.04	11.028
Goa	0.19	0.258
Gujrat	2.76	3.569
Haryana	0.97	1.075
HP	1.72	0.522
J & K	3.78	1.297
Karnataka	4.53	4.459
Kerala	2.83	2.665
MP	8.05	6.711
Maharashtra	4.46	4.997
Manipur	0.74	0.362
Meghalaya	0.68	0.371
Mizoram	0.58	0.239
Nagaland	1.02	0.263
Orissa	4.77	5.161
Punjab	1.25	1.299
Rajasthan	5.42	5.609
Sikkim	0.38	0.227
TN	4.97	5.305
Tripura	1.00	0.428
UP	18.05	19.264
WB	8.10	7.057
Total	100.00	100.00

Source: http// fincomindia.nic.in , compiled from the Chapter on Issues and Approaches of the 12th Finance Commisssion Recommendations.

It needs be given a look that when population was given too much of the emphasis states with abundant population were the main beneficiary. Similarily when the weightage was more to the collection criterion , more advanced states such as Maharashtra, WB, Gujarat & TN received the lions share.Of late there had been a trend to incentivise the performing states hence attention was given to such categories as fiscal discipline, infrastructure, tax effort(as seen in the 11FC transfers). But this trend came under an eye of storm by the not so performing states, Hence the new ideals were soon rolled back , in the 12FC recommendations(see pie chart while I compare the weights of 11FC & 12FC).

Forms and Divergence of the Indian States

The issue whether the ongoing economic liberalization policies based on free market and open economy principles assist the industrial growth of lagging regions within the states and ensure a more balanced development. The reflection on the data tells the picture to the contrary, raising doubts about the validity of the neoclassical conceptualizing of the process of economic growth and balanced development of the regions in the country. It is generally believed even from the authors from the west that the modus operandi of world capitalism precluded any possibility of spontaneous diffusion of capitalist development, of the sort that had happened in the west. Not only established thinkers such as Paul Baran(1957) in his famous magnum opus The Political Economy of Growth stated that the developing countries should have their own agricultural revolutions , looking around the exigencies of the situation, thinkers such as Arthur Lewis(1954), who is seeped in a neo classical tradition was satisfied with the notion the idea of spontaneous diffusion of industrial development is one of delusion and that developing countries should use the state to act as an "entrepreneur".

In case of India almost a similar phenomena could be seen after the reforms were introduced in 90s.Moreover the relative improvement occurred in a few industries did not mean that the process was all encompassing and overarching. Production function estimates reveal that the elasticity of outputs with respect to the inputs was the highest for the materials, while the growth decomposition indicated that it was growth in materials that primarily drove output growth and not in capital, labor or technology. Analysis of the influences of the structural factors indicates that liberalization has not brought about any significant change in terms of diversification of the industrial base, which is marked by the dominance of few local resources based traditional industries. Agricultural based industry linkages as well as the inter linkages between the industries within the manufacturing sector to ensure mutually reinforcing demand for and supply of inputs so as to lead to the inter dependent growth[48].

Moreover the reforms conducted since 1991 have reduced the role for central planning. The shift from the interventionist states to a more market driven state have willy nullied providing for its ebbing in most of the matters. The states have been allowed to borrow as a result of this withdrawal. This has indirectly augmented the borrowings from the central maintaining the stalemate with respect to the fiscal deficit.

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[48] Kumar Ravi(2004) , 'Liberalization and growth-Regional industrial growth under Economic Liberalisation: A Case Study of Selected Issues with reference to the Kerela state[Book Review]',*Economic and Political Weekly*, 39(23), June 5-11, pg 2359.

2.2. Fiscal Imbalances Amongst The States

The problem of imbalances of states could be seen from two perspectives:

- Degree of centralization of revenue collection and the size of "vertical fiscal gap"
- Problem of states regarding deficits including the fiscal, revenue, primary, and the huge problem of internal debt of the states-rational for the "horizontal fiscal gap".

Vertical Imbalances

As must be noted in the earlier chapter, there is centralization of revenue collection, with the states having been capacitated with lesser powers to tax as well to share in the tax resources of the centre. There had been attempts to rationalize this centralization of the revenue collection. Eminent economists' such as Chelliah R.J.(1981, P9) argue " large degree of centralization of revenue reassures is needed not only for economic consideration but also for administrative consideration and also to fulfill the objective of regional equalization". Thus the major justification of centralization had been the prevalence of wide interstate disparities and the responsibility for stabilization and redistribution which rests with the central Government.

But over the years we could see that the resources available to the centre have substantially reduced and the expenditure liabilities of the states have considerably plummeted. The major reason for the existing vertical imbalance is therefore – Constitutional assignment in higher expenditure responsibilities to the states coupled with the relative advantage of the federal Government has in collecting the revenues. (Rao and Sen 1993)

The fiscal imbalances with respect states being able to finance their own current expenditures show a dismal record. The analysis forwarded by Rao & Singh, throw light, when they say that the ability of the states to finance their own current expenditure from their own revenues has declined from 69% to less than 50%[49]. Hence one could see that the states' dependence on centre has increased, as there is an increasing tendency to divert capital receipts of the states to meet their current, where it is interesting to note that states' share of current expenditures as well as current revenue have remained broadly constant, yet their dependence on the union has woefully increased. As pointed out by Rao & Singh, the states do not have much power with regard to the capital receipts, there is a growing amount of vertical fiscal imbalance. In fact as pointed by the same authors, over time there has been a significant erosion of states' control over their expenditure decisions the analysis done by the same authors show that the share of central sector and the CSS in the total of state expenditure has increased particularly after the transfers for the plan purposes are determined by the formula determined by the planning commission(trends in the vertical fiscal imbalance).

[49] Rao Govinda & Singh Nirvikar, opp. cit. pg 171.

Horizontal fiscal Imbalances

Such imbalances refer to the mismatch between the revenues and expenditures of the governmental units within a level of government. In the Indian context they refer to the excess of expenditure over the revenue of the different States. States own public finances can be seen as a reminder to the deterioration of fiscal performance of the states since the mid-1980s and this is reflected through all major indicators including fiscal deficit, revenue deficit and the debt GDP ratio (Annexure 2.4). Fiscal deficit of which the public debt just forms a nominal part, has assumed disturbing proportions in the later part of the 1990's. The combined GFD (Gross Fiscal Deficit) of the states that had been less in the period between 1980s have assumed enormous size of about 4% in some states. And this was compounded with a high inter state disparities amongst the States (see also Annexure 2.5 along with 2.4).Moreover all the above indicators discussed in the fiscal inequity amongst the states for example Per Capita SDP, Poverty ratios, divergences among the units, level of Infrastructure Development, Human Development Indices, Investment Proposals etc,

The resource devolution from the FC was to be looked as enhancing the resource base of the states and thereby helping the states to contain the deficit. The data compiled by the Pillai and Kannan shows almost the similar trends. The data was empirically tested by comparing the states' GFD with and without transfers[50]. In the entire 1980's when the transfer of resources from the centre had been high enough, the GFD of the states on an

[50] Kannan R et al, art cit., pg1074.

average would have almost entirely doubled. This situation has shown a downward trend in the 1990's(See Table 2.7).

However as has been asserted by their studies, the issue of fiscal deficit needs to be addressed by the FC. Between the 1980's and the 1990's resource transfer under the FC had revealed a declining trend from an average of 15.1% to 13.2%. Combined with the declining share of the FC awards and its own tax revenues, the states had to resort to borrowings and this share has been rolling up over the years. It has increased to 52% in the 1990's.

Table 2.7: States Fiscal Deficit and its Financing

(Rs crore)

Period	**GFD**	**Financing (in per centage)**			**Total Outstanding Liabilities**
		Loan from the centre	Market borrowings	Small Savings , PF and Other Liabilities	
1980-81	3713	1567(42.2)	198(5.3)	1948(52.8)	23959(16.6)
1984-85	8199	3580(43.7)	693(8.5)	3926(47.9)	44644(18.1)
1990-91	18787	9978(52.1)	2556(13.6)	6253(33.3	110289(19.4)
1994-95	27687	14760(53.3)	4075(14.7)	8862(32.0)	184527(18.3)
1995-96	31426	14801(47.01)	5888(18.7)	10737(34.2)	212225(18.0)
1996-97	37251	17547(47.1)	6515(17.5)	13189(35.4)	243525(17.9)
1997-98	44200	23676(53.6)	7280(16.5)	13244(30.0)	281207(18.6)
1998-99	74254	31057(41.8)	10467(14.1)	32731(44.1)	341978(19.4)
1999-2000	91481	12408(13.6)	12662(13.8)	39993(43.7)	420132(21.8)
2000-01*	87279	8254(9.5)	12519(14.3)	34802(13.9)	498098(23.9)
2001-02*	106595	13287(12.5)	16074(15.1)	41034(38.5)	589219(25.6)
2002-03*	103736	18548(17.9)	11845(11.4)	35445(34.2)	683169(26.7)

Notes: (1) Figures under the columns 3, 4 and 5 relates to per centage share in the share in the total financing of GFD

(2) Figures under column 6 relates to shares of GDP.

* Provisional

Source: Kannan R et al, art. cit., pg 484.

In absolute terms the outstanding debt of the states increased from the whooping 1,10,289 cr in 1990-91 to 6,94,289 cr in 2002-03.Now it this debt liability which has the spill over impact on the sovereign ratings by the credit rating agencies across the world and in India both. The rising debt (Annexure 2.4) is the reflection of deterioration in the fiscal performance of states and signifies long term mismatch between the growth of revenues and expenditure of states. It is the consequence of persistent increases in the Non Plan Revenue expenditure such as the interest payments, subsidies, salaries and pensions, together with the sluggish growth in the Tax GDP ratios, inadequate returns from public investment and insufficient growth in central transfers.

Large Revenue Deficits have led to larger Fiscal Deficits and spiraling debt, resulting in the emergence of vicious cycle of deficit, debt and debt service payment. The discussion on the debt swap scheme would ensue in the coming chapter, for the scheme was introduced in Sept. 2002 while analyzing the issues pending before the 12^{th} FC.

The public debt of the states comprise of mainly the internal debt which again includes market borrowings, loans from banks and financial institutions, special securities issued to the national small savings fund, provident funds, etc. The FC excludes the short-term component of debt viz. WMA, Reserve Funds and Deposits, in assessing the overall debt position of the state Governments. Although the WMAs and Overdrafts are arranged to overcome temporary liquidity mismatches, they often get rolled over, almost continuously, thereby integrating with the budgetary process to become almost an additional or a regular sources of fiancé. More importantly, these come at a cost –WMA being at the bank rate, while OD (upto 100% of WMA limit) is at the bank rate +3% (more than 100% of the WMA limit) is at bank rate +6%[51].

The loans from the centre may be classified as

- Plan loans
- Non Plan loans

Under Plan loans come the centrally sponsored schemes. It could be mentioned here that the states do not have the facility to withdraw from the external sources. The prerogative still lies with the central Government and the latter's permission is sought or we can put it in this way the external assistance is obtained from the international financial institutions /foreign Governments are passed from the centre to the states Central planned assistance under what is called the ACA. There have been a likewise demand by the central Government (esp. in view of declining interest rates, the state Government should repay the outstanding public loans and incur new public debt in its place at a lower rate of interest. Over the past few years a lot of states have started going in for this technique. Another type of loan to the state Government is provided by the union Government from its own resources from time to time. Interest on these loans should be recalculated on the basis of the weighted average interest of all loans floated by the Union Government during the year when a particular loan was made to the state. Thus recalculated year after year, there is a scope for some relief to the states.

[51] Prasad Abha , Goyal Rajan, Prakash Anupam(2004), 'State debt and debt relief', *Economic and Political Weekly* 39(26), June 26-July 2, pp 2726.

During the past five decades, State Governments have received loans from the foreign Governments and international financial agencies. These have come to the states through the union Government. While there have been soft loans carrying low interest rates and likewise repayable over the long periods the Government of India has charged high interest rates for such loans to the states. The demand had been pending before the FC to recommend that these loans be calculated at the interest rates which the lenders[52] have charged the Union Government.

2.3. Fiscal Dependency of the States

Transfer Formula

The overall mechanism of inter Government transfers suffers two fundamental problems. one is that the scheme of transfers is highly fragmented meaning thereby that the transfers have been handled by not one but three different agencies(discussion in the first chapter).It may be recalled here, the statutory transfers consist of sharing of central tax revenues and grants recommended by the FC. These are supplemented by grants from the PC and Discretionary grants from the Central Ministries.

Transfers under recommendations of FC account for almost 65% of the total transfers. Prior to the enactment of the 80th amendment act 2000, the sharing of the Union Tax Revenues with the States was in accordance with the Articles 270/272 as these stood

[52] Rath Nilkanth(2004) , 'Twelfth FC and the minimum needs', *Economic and Political Weekly*,39(26), June 26- July 2, pg 2668.

then. While Article 270 provided for the compulsory sharing of the net proceeds of the Income Tax (excluding Corporation tax), Article 272 permitted for the sharing of the net proceeds of the union duties of excise (excluding duties of excise on medicinal & toilet preparations), if Parliament by law so provided. Consequently, the principles adopted for revenue sharing differed between the two taxes significantly.

Table 2.8 -Recommended share in Divisible Taxes: First to Eleventh FCs

Commissions	Income Tax (states share in per centage)	Union Excise Duties (states share in per centage)
First	55	40
Second	60	25
Third	66.7	20
Fourth	75	20
Fifth	75	20
Sixth	80	20
Seventh	85	40
Eighth	85	45
Ninth	85	45
Tenth	77.5	47.5
Eleventh	29.5	29.5

Source: http//fincomindia.nic.in ,Compiled from Complete Report No7 "Sharing of Union Tax Revenue"

The Eightieth Amendment of the Constitution altered the pattern of sharing of the union taxes in a fundamental way. Under the amendment, Article 272 was dropped an Article 270 was substantially changed. The new Article 270 provides for the sharing of all the taxes/duties referred to in the union list, except the taxes & duties referred to in the Articles 268 and 269 respectively, surcharges on taxes & duties referred to in Article 271 and any cess levied for specific purpose.

The basic for this change was the ASD recommended by the 10FC. The 11FC was the first to take these changes into account, while recommending the share of the states in the divisible pool.

These fiscal transfers from the state handled thus by multiple agencies are highly desynchronized and unintegrated. It ensures nothing except overlapping roles and wasteful duplication (Chelliah & Bagchi 1995). Hence the FC is not allowed to asses the overall position of the states .The second one and the pertinent for us here is that there had been some technical problems associated with the transfer formula both in terms of vertical distribution and horizontal distribution alike.

Vertical Distribution

At this stage it may be needful for us to take a glance at the historical evolution of the vertical transfers from the Centre to the States. As can be seen from the table(9), over the period covered by the 7^{th} to 11^{th} FC, the award period wise average ratio of total transfers to the central Government gross revenue receipts had remained around 38% during 7-8FC period. It went up to 40% during 9FC period. Thereafter it came down steeply to 35.8% during the 10FC. During the first two years of 11 FC, it has shown a rise of 37.2%. The FC transfers have accounted for about 60-70% of the total central transfers to the states and have also shown a variation over time. The average ratio to the gross revenue receipts of the centre for the Seventh FC was 24.4%. It went down to 22.8%

during the 8 FC. It rose to 24.8% during the 9 FC & declined to 23.8% during the 10 FC period. During the first 2 years of 11FC, however the average ratio was 26.1%.

Table 2.9: Transfers from the centre to the states as % of Gross Revenue Receipts of the centre: FC period averages.

Year	F C Transfers			Others Transfers			Total Transfers (4+7)
	Share in Central Taxes	Grants	Total transfers	Grants through PC	Non Plan Grants (Non Statutory)	Total Others Transfers (5+6)	
1	2	3	4	5	6	7	8
VII FC	22.39	1.96	24.35	12.11	1.66	13.77	38.11
VIII FC	20.25	2.52	22.77	13.56	1.54	15.10	37.86
IX FC	21.37	3.42	24.79	14.48	1.06	15.54	40.33
X FC	21.40	2.34	23.75	10.57	0.63	11.19	35.79
XI FC (First two years)	20.93	5.20	26.13	10.39	0.82	11.21	37.20

Source: http//fincomindia.nic.in in the report of the 12th FC.

In so far as the issues are concerned with the vertical distribution a case has been made on both sides, i.e. from the side of the dependency that could result from a liberal transfer formula and also from the "need more" resources, from the side of the states. The "dependency theorists" argue the transfer mechanism of the central Government tends to overdo sometimes, increasing the dependency of the states on the centre. These awards have only made the states holding a can and have rather disincentivised the performing states. Bihar's revenue capacity , for instance was less than 50% of Punjab's throughout the award period of 2000-05[53][see Annexure 2.6]

[53] Bagchi Amaresh , Chakravarthy Pinaki(2004), 'Towards a Rational system of Revenue Transfers', *Economic and Political Weekly* ,39(5), June 26-July 4, pg 2738.

Table 2.10: Estimated Normative Central Transfers To The States

Rs Lakh

States	1987-88	10 FC period	11 FC period
AP	146242	642269	118520
Bihar	250372	1221903	1920068
Gujrat	48102	148114	354874
Haryana	18036	41011	121004
Karnataka	95483	435626	705617
Kerala	63633	284310	414718
MP	141310	786132	1140961
Maharashtra	78677	94562	365326
Orissa	82829	380995	749069
Punjab	7994	60396	102936
Rajasthan	93468	468291	941053
TN	94237	492449	946938
UP	341996	1746515	2963309
West Bengal	128481	644330	967241
All states	1,590860	74,47301	1,2811634
Normative transfers as % centre's revenue	33.14		

Source: Amaresh Bagchi and Pinaki Chahravarthy, art. cit., pg 2739.

The above table shows how the transfers form the centre represents a significant part of state finances. On the other hand there had been a perverse incentive to for fiscal incentive and tax effort. Between the 1980s and the 1990s, the share of resource transfer under the FC has shown a declining trend from the average of 15.1% to 14.2 % respectively[54]. The gap is being filled by grants by PC and the non-plan grants (CSS and others), which according to Amaresh Bagchi have been increasing over the others. There has been enormous expansion of CSS, which has enabled the centre to expand the scope of discretionary transfers and impose its own priorities on the states. In his own words:

[54] Kannan R et al, art cit. , pg 484.

...While there can be the case for specific purpose transfers to take care of the externalities or to promote objectives of national interest such as Sarva Siksha Abhiyan, proliferation of such grants unavoidably undermines the state's role as fiscally empowered units of responsible Government and creates a dependency syndrome that is scarcely conducive to either true federalism or fiscal discipline. The CSS and the special purpose grants are now assuming large proportions with the Government at the centre embarking on what is called Bharat Nirman pumping in larger funds, reducing the states to mere spending agencies. What is more, a larger part of CSS transfers are flowing from the centre by the states. They are being routed directly to various agencies and local bodies. Again following the recommendations of National Advisory Council of the UPA Govt, a proposal have been mooted by the Planning Commission to set up a "Incentive Fund" or to "incentivise" the states to compete among themselves in good governance by rewarding the good performers. In a democratic system it is the voters and the investors who vote with their feet and the states that do better are rewarded through this process. The idea of the centre rewarding the states that perform better even if based on the judgment of "independent panel" is totally repugnant to the federal idea in which the constituents are supposed to be independent in their spheres.

These development grants by the planning commission tends to create future liabilities for the states (debt services liabilities/infrastructure maintenance& personnel costs)[55]. Further more the planning commission often receives pressures from the centre and the

[55] Ortiz E.H & Rider M(2006), India's Inter Governmental Transfer System & the Fiscal Condition of the States, available at-http//aysps.gsu.edu/publications/2006, last accessed on 15/04/07.

states to accept that the states will be able to generate additional resources. Based on such arguments the Planning Commission then authorizes the states to borrow additional amounts (Rao & Singh, 1998). This has led to the increased dependency of the states on the centre, which has led to increased fiscal deficit of most of the states, and the weakening of the states capacity to generate resources as to sustain itself. The figure related to the debt position of the state presents a dismal picture (See Annexure 4).

Horizontal Distribution

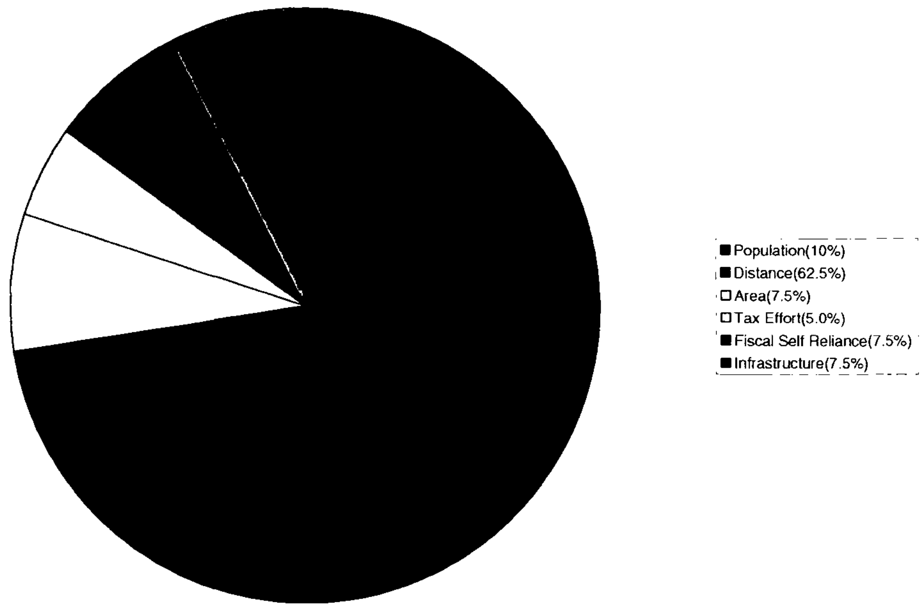
The growing inter states disparity in respect of resources from the centre and its implications for the wider differences in the fiscal performance of the states finds its origin in the various economic criterion adopted by the FC overtime. It should be noted that while the high income states have been declined preferences the maximum number of resources have been driven to the poorer states. The special category sates have been receiving more grants in aid rather than enough resources accruing out of taxes and union excise duties. Further more, the criterion such as the fiscal capacity/ expenditure, Infrastructure and Fiscal self-reliance which have long drawn the interest of the economists itself have also been termed as "self defeating" by others. The former accuse the latter of "harping", on the income per capita category too much so that the states capacity to generate resources takes a back seat. While, the latter term the criterion as generating complacency and status quo deincentivising performing states.

Now as for the data, state wise distribution of the income tax reveals thst when collection was given greater weightage as seen in the First, Second. Third and the Fourth Commissions, more advanced states like Maharashtra, West Bengal, Gujarat and Tamil Nadu received the maximum share, while on the other hand the commissions from the fifth to the Seventh who gave emphasis to the population, states like Utter Pradesh Andhra Pradesh, Kerela , Madhya Pradesh , Karnataka , Rajasthan & Orissa were the major gainers. Under the Eighth FC, need was measured by the inverse of the per capita income due to which states gain in order of their backwardness. The most backward states had been the major beneficiaries[56]. Development in the states has lagged as can be gathered from the data running below whether in case of infrastructure or human development of the population of the states given below.

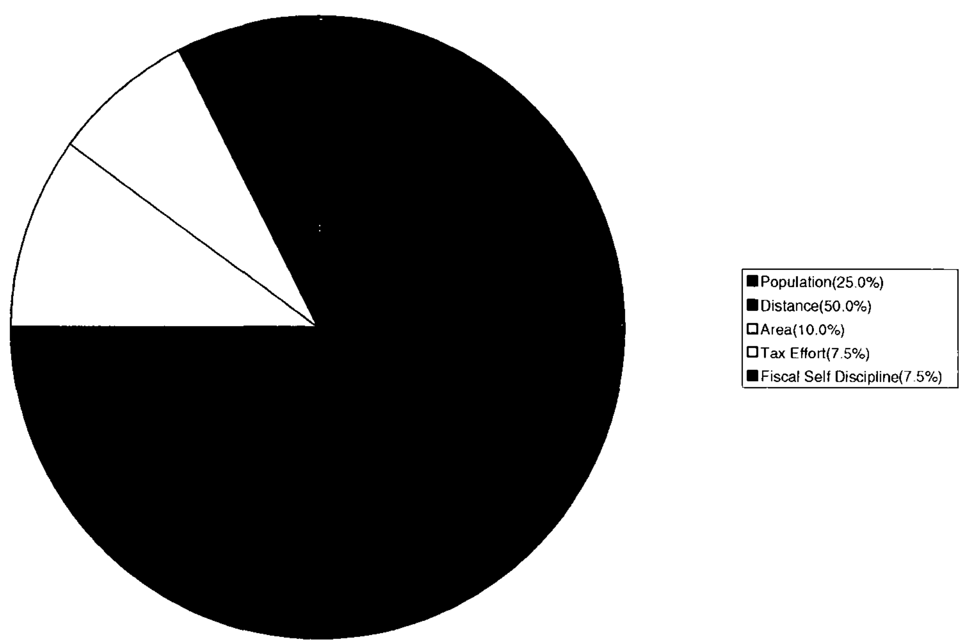
Amongst the physical infrastructure level, the indices have shown large differential levels. If we take an all India average=100. States like Bihar& M.P have been trailing with no's like 77.8 &74.1 respectively. While states like Punjab & Kerala have spectacular results with index figures running to 185.6 &155.4 respectively[57]. This relative infrastructure development index should be understood in terms of new scheme that had been followed by the 12th FC . The new scheme takes away preference given to the infrastructure category, which had earlier been given preference (see pie chart about the weight allotted to the different criterions by the 11FC & 12 FC).

[56] Kannan R et al, art cit , pg 484.
[57] Kannan R et al, art. cit. ,pg 483.

ELEVENTH FINANCE COMMISSION



TWELTH FINANCE COMMISSION



But equally there had been studies by eminent scientists that prove that over the years, non-plan revenue items have been eating away development expenditure of the states. Taking all the major states together, development expenditure as percentage of revenue expenditure fell from 68% in 1990-91 to 54% in 2003-04 for the level of infrastructure development see Annexure (2.3). Such a study made by Govinda Rao and Pinaki Chakravorthy have proved that states like West Bengal and others have cut down on their development expenditure but in spite this their deficits have persisted at a very worrisome levels.

On the scale of social infrastructure that includes human development indices example life expectancy at birth, literacy rate (2001) and mortality rates, the situation has barely improved from 1981 situation. A study conducted by Ahluwalia values states in terms of rank. Where Kerala remains a defending champion and so does Bihar with its lowest 14th rank[58].

Such a scenario calls for an analysis of federal finance and the causes for such lag development. The picture would be clearer if one looks at the revenue and expenditure sides of both the centre and the states, and the corresponding transfer system both plan and non plan for the centre and states separately.

[58] Kannan R et al, art. cit ,pg 484.

Table-2.11 State Level Human Development Indices

STATES	1991	2001
Andhra Pradesh	9	10
Bihar	14	14
Gujrat	6	6
Haryana	5	5
Karnataka	7	7
Kerela	1	1
M.P	12	12
Maharastra	4	4
Orissa	11	11
Punjab	2	2
Rajasthan	10	9
Tamil Nadu	3	3
Uttar Pradesh	13	13
West Bengal	8	8

Source: Planning Commission Report(2002)

2.4. FC and the Local Bodies

When we talk about the moral responsibilities of the Union FC, we are suddenly reminded off the responsibility of the Commission in relation to the financial decentralization of resources. We know that the decentralization process ushered via $73^{rd}/74^{th}$ Constitutional amendments acts, only added a proviso to Article 280 that the task of review the public finances of the PRIs/UCBs now befalls on State FCs. Hence although the primary responsibility regarding the sub state level transfer rests with the State FC, it is only reasonable to assume that the Union FC concerned with the macro public finances of the country has a moral broadly interpreted a Constitutional responsibility to review the public finances of the local bodies even without the "restructuring task".

The additions made to Article under 280 following the 85th amendment to the Constitution are to be seen in the light of the implicit recognition of the organic link between the various tiers in Indian fiscal federalism. Same as in the case with the state level transfers the problem of vertical and horizontal imbalances (here between state and sub state actors) need to be sorted out. As can be gathered from the TORs mentioned in the first chapter, the note made imperative "UCB required serving measures to augment the resources of the local bodies" call for an even development of the richer and poorer areas within a particular region. This cannot be done, unless balanced by central equalization funds and or projects [Crook 2003]. Admittedly the most important rationale for the local governance is the provision of the basic amenities to the people comprising it. No citizen should suffer because of her choice of the location of residence.

The Market-Mediated Growth cannot be trusted to provide for the certain basic services of standard quality. While the horizontal equity at the third tier level is the task of the state FC, the UCB too has a shared responsibility. Hence as suggested by many political economists the union FC has the shared responsibility to fashion the development of the region along with the state FC.

But the figures available with the ministry of finance, in the economic survey and the RBI Bulletins present a dismal picture. It should be noted at outset that there are almost 2.4 lakhs PRIs and 3723 ULBs in the country, almost 94% of the revenue of the PRIs come from the gram panchayats where Assam has no capital expenditure in all the five years and reportedly received no grants in aid from the higher level of governance. Bihar collects no taxes at the panchayat level. In UP, the capital expenditure is five to eight times to revenue expenditure in all the five years (Annexure 2.7).

Again as Ooman put it for 2002-2003, the total expenditure of the local bodies as percentage of the combined expenditure of the union, states and the local bodies works out to be only about 4.7%. . He compares the data with that certain advanced countries, where local Governments normally account for about 20-35% of the total Government expenditure (in Denmark it is as high as 45% and in Finland it is 41%)[UNDP 1993:63].

In the same vein the combined tax revenue of the state and the local Governments is as low as 1.6%. This tax revenue decentralization is actually way below the expenditure decentralization. As a percentage of GDP, the tax revenue of the local bodies is only 0.26% (As percent of the fiscal correction target recommended by the TFC, by 2009-10, the combined Union-State tax-GDP ratio is set at 17.6%). If we take the tax-GDP ratio of the PRIs, it is as low as 0.04%. Clearly despite the tall claims about the political decentralization in India, fiscal decentralization has not made much progress.

Another argument for restructuring for an inclusive restructuring exercise also may be mentioned. The total grants in aid received by the local bodies from state and the central Governments add upto Rs 16230 crore for the year 2002-2003. As the proportion of the total revenue deficits of the central and state Governments for 2002-2003, this works out to be 10%. If we add the major inter Governmental transfers, the total goes up to 16%.

But is this good enough picture for the state of public finances as seen at the level of the local bodies?

2.5. Implications of the Eleventh FC Recommendations on States and Local Bodies

In the approach Paper of 11FC, it was realized that a sound system of inter Governmental transfers constitutes the corner stone of strong and stable federal Government. Hence the two imperatives that it sought to address was to look into the vertical and horizontal imbalances-so that the states and the local bodies may be in the position to provide for the basic social services to their citizens at reasonable level. What marked the striking departure from the past in the TOR was the enlargement of the commission's task by the insertion of Para 4 in the TOR whereby the commission was asked to review the state of finances of the union and the states and suggest ways and means whereby Governments, collectively and severally, may bring about a restructuring of public finances so as to restore the budgetary balance. It was also mandated, that there should be two fold concerns for the commission in question.

- Analyze and recommend upon the menace of unsustainably large deficits in the Government budgets at both the levels of federal governance.
- Reflect on the deterioration in the composition of Government expenditure with the disproportionally large share of receipts getting pre empted by interest payment and unproductive expenditure leaving just too little social sectors and other much needed investments.

Out of the recommendations forwarded by the Eleventh FC, the following important for us are mentioned below:

Definite goals.

Hence realizing that the structuring of public finances pose as the major challenges to the commission, it laid out definite goals in terms of key budget variables i.e. marked level of Revenue/ Exp/and deficit targets to be achieved.

Composition of Govt. Exp. should undergo change.

At the same time the composition of Government expenditure should undergo a change in favor of social sector and capital expenditure. Hence suggested that the revenue capacity of the states and the local bodies should be expanded and this was to be done by reexamining the Tax system. Eleventh FC decided on to follow the ASD in this direction.

All transfers henceforth should be taken in totality.

Another recommendation that the Commission made was to integrate the Plan / Non Plan resources of the central Government. It was increasingly realized when the FC faced practical difficulties in assessing the requirements of Revenue Expenditure under the Plans. The practice of excluding the Plan expenditure was being followed since the third plan. But earlier to answer this lacuna a common member was placed who would bring the desired harmony in the functioning between the FC suggesting that the macro economic picture is not lost sight of, and that the states do not overestimate their resources while asking for larger Plan resources. Now this practice ended with the 10 FC

, thereby closing the avenue whereby effective coordination between the PC/FC could no longer take place.

Augmenting funds of the CFS.

This idea was especially mooted in order to supplement the resources of the panchayats and the urban local bodies on the basis of the reports of the State FC.

Calls for the setting up of ERC.

Though the commission did not make an explicit recommendation for the setting up of Expenditure Reforms Commission yet it agreed to the idea that the setting up of the commission would commensurate task of dealing with the problems of the budgetary deficit.

The period of the 11 FC was over in 2002. There had been some uneasiness to the states regarding the principles followed and the ideas cherished by the erstwhile commission. For example, some states had demanded raising of the tax share to 40 and even 50%, is to name but a few. For a more elaborate discussion, the issues with the 12th FC to suggest recommendations on are to be seen in the next chapter.

Chapter 3

Recommendations of the 12FC and its Implications on the Backward States

3.1. Introduction

The setting up of the twelfth FC has once again drawn attention to the core issues of determining tax devolution and grants. It is not as if the issues are entirely new, but the problem of balancing resources against responsibilities is qualitatively different now when the Government at all levels are nurturing large and rising fiscal deficits with the current trends indicating a continuing deterioration. How these are to be solved remain the core issues to be addressed.

Dr. C. Rangarajan

(Chairman of 12FC)

In a paper on the issues and challenges before the FC, Dr Rangarajan made it aptly clear that the pertinent question that should inform the recommendations of the FC should be fiscal consolidation. Hence, while realizing that the states have different needs and capacities, the FC should now show fiscal prudence. Probably the symbolism meant here made the objective even clearer.

It was this reason that made the recommendations of the 12FC looked sterner as compared to the recommendations forwarded by the earlier FCs. Though the previous commissions have also been following the normative approach for assessing the revenue and expenditure of the states, norms adopted by the 12FC were stiffer.

While I would take the recommendations one by one, the difference imbued in the recommendations of this commission becomes even more apparent. The main objective of this chapter would be to analyze the recommendations of the 12FC for the backward states after briefly examining equity aspects of the overall transfers recommended by it.

3.2. Terms of Reference of 12FC

The terms of reference so forwarded by the Presidential Order, which was placed before the FC made it explicitly, clear that the problem of fiscal deterioration should be kept high on the agenda like the previous one. The main features of the terms of reference are as under:

Fiscal Deterioration should be kept high on the agenda

What was new in the TOR was that apart from the usual suggestions relating to the restoration of the budgetary balance and maintaining macro economic stability, this commission was also given additional burden of recommending mechanisms of debt reduction and thereby suggesting overall equitable growth. But this was not enough apart from balancing, the commission was now expected to generate surplus for capital investment and reducing the fiscal deficit of the centre and likewise of the states.

To Suggest on the Viability of the Capital Assets

Another important aspect besides balancing and surpluses was the emphasis on ensuring the viability of capital assets such as irrigation projects, power projects, departmental undertakings, public sector enterprises etc in the states through various means including the adjustment of user charges and relinquishing of the non priority enterprises through disinvestments.

The Commission shall take the Population Figures of the year 1971 to calculate distribution of Taxes to the states

It should also be kept in mind that while making the recommendations on various matters, the commission will take the population figures as on 1971, in all the cases where population measures as a factor in the subsequent calculations e.g. in the calculation of grants in aid and in the devolution of taxes and duties of the central resources. Moreover apart from making the recommendations on the debt position of the states and aligning it with the macro economies stability of the states, the commission was also asked to comment on the human development and the investment climate of the states concerned.

Review of the Fiscal Reform Facility

In the same order the commission had also been asked to review the fiscal reform facility introduced by the earlier commission and then suggest measures for the effective implementation of its specific objectives. Starting with the Eleventh FC, the efforts had been made so that the states accept the ideals of fiscal reform; this new commission had also been suggested in the like manner. As early as in the Presidential Order of the 11FC, it was made explicitly clear "to draw a moniterable fiscal reforms programme aimed at the reduction of the revenue deficit of the states and recommend the manner in which the grants to states to cover the deficit on their non plan revenue account may be linked to progress in implementing the programme".

Thus the 11FC was asked to look through the ways in which the reforms could be effectively pursued. Now in doing so as we know the centre was not merely seeking a Constitutional validity to a particular kind of fiscal reform, but in a way asking the commission to give the centre the right to use the provision of assistance to cover non plan revenue deficits as an instrument to enforce compliance with such a reform programme. Not surprisingly as Chandrashekhar asserts, the idea had led to huge uproar by the *Left* dominated states esp. Kerala. Now the 12FC had been asked to go even further, to suggest the plan to restructure public finances both of the centre and the states

Review of the present Arrangement on Profit Petroleum & Disaster Management with reference to National Calamity Contingency Fund

In addition to the above issues the commission was also asked to make recommendations on whether the non tax income of the profit petroleum to the union should be shared with the states from where the mineral oils are actually produced, and if so to what extent??

The commission was also asked to review the present arrangements as regards financing of the disaster management with reference to the National Calamity Contingency Fund and the Calamity Relief Fund and make appropriate recommendations thereon.

Assessment of the Debt Position of the states

The Commission may, after making an assessment of the debt position of the States as on the 31st March 2004, suggest such corrective measures, as are deemed necessary, consistent with macro-economic stability and debt sustainability. Such measures recommended will give weightage to the performance of the States in the fields of human development and investment climate.

Table 3.1: Receipts and Disbursements of State Governments

	1990-91	1999-2000	2000-01	2001-02	2002-03	2003-04 (RE)	2004-05# (BE)
			(Rs. crore)				
I. Total receipts(A+B)	91160	310775	349544	373886	425073	542385	552416
A. Revenue receipts (1+2)	66467	207201	237953	255675	280339	329927	374344
1. Tax receipts	44586	146703	168715	180312	198798	228103	263555
of which							
State's own tax revenue	30344	102582	117981	128097	142143	162806	185668
2. Non-tax receipts	21881	60498	69238	75363	81541	101824	110789
of which:							
Interest receipts	2403	9294	11438	9205	9501	10118	12918
B. Capital receipts	24693	103574	111591	118211	144734	212458	178072
of which:							
Recovery of loans & advances	1501	3361	6898	7766	3905	15790	6975
II. Total disbursements(a+b+c)	91088	313889	346971	377311	420462	554056	551368
a) Revenue	71776	260998	291522	314863	335451	402053	418063
b) Capital	13556	37359	43717	50145	70664	128830	118797
c) Loans and advances	5756	15532	11732	12303	14347	23173	14508
III. Revenue deficit	5309	53797	53569	59188	55111	72126	43718
IV. Gross fiscal deficit	18787	91480	89532	95994	102123	141010	111852
			(As per cent of GDP)				
I. Total receipts(A+B)	16.0	16.0	16.7	16.5	17.3	19.7	17.8
A. Revenue receipts (1+2)	11.7	10.7	11.4	11.3	11.4	12.0	12.0
1. Tax receipts	7.8	7.6	8.1	7.9	8.1	8.3	8.5
of which							
State's own tax revenue	5.3	5.3	5.6	5.6	5.8	5.9	6.0
2. Non-tax receipts	3.8	3.1	3.3	3.3	3.3	3.7	3.6
of which:							
Interest receipts	0.4	0.5	0.5	0.4	0.4	0.4	0.4
B. Capital receipts	4.3	5.3	5.3	5.2	5.9	7.7	5.7
of which:							
Recovery of loans & advances	0.3	0.2	0.3	0.3	0.2	0.6	0.2
II. Total disbursements(a+b+c)	16.0	16.2	16.6	16.6	17.1	20.1	17.7
a) Revenue	12.6	13.5	14.0	13.9	13.6	14.6	13.4
b) Capital	2.4	1.9	2.1	2.2	2.9	4.7	3.8
c) Loans and advances	1.0	0.8	0.6	0.5	0.6	0.8	0.5
III. Revenue deficit	0.9	2.8	2.6	2.6	2.2	2.6	1.4
IV. Gross fiscal deficit	3.3	4.7	4.3	4.2	4.1	5.1	3.6

The ratios to GDP for 2004-05 (BE) are based on CSO's Advance Estimates released in February, 2005.

Note : Data are provisional.

Source : Reserve Bank of India.

Source: Economy Survey 2004-2005 website: http://indiabudget.nic.in

3.3. Rangarajan's Explanations for the deterioration of the States' Finances

C Rangarajan himself in the paper on the issues before the 12FC admits the reasons for the deterioration of fiscal indices, some of them he highlights as :

- Erosion of the buoyancy of the central indirect taxes
- Revision of the salaries and pensions in the wake of the recommendations of the 5 pay commission[59] amongst other reasons as high nominal interest rates from 1990s.

Hence taking these questions in view, the design of fiscal transfers required the commission to be guided by certain definitive principles. A good transfer system should hitherto serve both the purposes of equity and efficiency. Equity as earlier in the other chapter discussed can be conceptualized with respect to horizontal as well as vertical transfers, while efficiency should be pitched in the context of welfare and other developmental function without losing the sight of deficits and fiscal consolidation. It had been seen that on an average, the low-income states spend only half of per month expenditure of the high-income states in social services. Similarly the income raising or the revenue earning capacities of these states stand at the lowest ebb possible.

[59] More recently in the Article in Frontline dated Nov 23-Dec 06 2002, CP Chandrashekhar explains the cause of erosion of states resources because of the recommendations of the Fifth Pay Commission. Wherein the states were forced to adopt the recommendations once they were implemented at the level of the centre. The increase in the salaries and wages to the revenue receipts of the states, which had been going down till 1996-97, rose dramatically and almost doubled after 1997-98. Consequently the gross fiscal deficit of the states , which was below 3 % of the GDP during much of 1990s, shot up to more than 5 % by 1999-00

As C. Rangarajan has himself mentioned about the acuteness of the problems, it becomes increasingly clear that the quality of the problems though remain similar to the previous commission the quantity has definitely gravitated. Like in 1988-89, the base year for the Ninth FC, the combined revenue deficit of the centre and the states was nearly 2.9 per cent of the GDP at the current market prices. The combined revenue deficit of the centre and the states for the corresponding base year for the tenth and the eleventh FC were respectively 3.6 per cent of the GDP in 1994-95 and 6.3 per cent 1990-00. In 2001-02, the combined revenue deficit of the centre and the states exceeded 7 per cent age points, and the situation is only becoming grimmer day by day.

Out of the similar issues deliberated by the commission were the sustainability question, the design of fiscal transfers that include suggestions relating to the vertical dimension as well as the horizontal dimension of the fiscal transfers, but the most important among them were the issues commensurating the dismal position of the public finances of both the Centre and the States. Considering the 15-year period from 1986-87 to 200-01 and comparing the three-year averages at both ends that is for 1986-87 to 1998-2001 the following major changes have been recorded. While the tax-GDP ratio fell from the level of about 16 per cent relative to GDP by 1.9 per cent age points during this period, the average tax GDP continues to be just above 14 per cent age in 2002-03 RE. This decline in the Tax- GDP ratio was due to the fall in the indirect taxes, even though the direct taxes showed a relative improvement to the GDP. In the similar vein the non tax Revenue also fell by a margin of 0.3 per cent age to reach an average level of 2.4 per cent age of GDP during 1998-01, the overall ratio of revenue receipts to GDP fell by2.2 per cent age points. In contrast the revenue expenditure of the central and the state relative top the GDP increased by 1.43 per cent age points to reach an average level of 22.9 per cent of GDP during 1998-01. The resulting imbalance led to an increase in the ratio of revenue deficit to GDP by a margin of 3.6 per cent points. The average level of combined revenue deficit to GDP in 1998-01 was 6.4 per cent. It has increased to cross 7 per cent of GDP in 2001-02. Now the fiscal deficit, which was of the high level of 8.8 per cent of GDP in the late 1980s, increased to cross 10 per cent mark in the 2001-02. With this growing dismal position of the public finances, it became necessary for the commission to draw the plan for the optimum amount of fiscal deficit that the economy can sustain taking along the necessities of the growth and development..

Taking cognizance of the Keynesian paradigm as well as the neo liberal paradigm it was almost unanimously thought that fiscal deficit should be just apt so as to service the increased debt.[60] . Accordingly among other considerations and specially the demands from states to increase the shareable pool of transfers from the Eleventh FC's 29.5 per cent to 33 per cent- some states have demanded the increase up to 50 per cent. Now as regards to the overall transfers, the Eleventh FC had fixed it at 37.5 per cent of the gross centre's revenue receipts. The finance ministry had actually requested the 12FC to consider this aspect of the award of the previous commission. Accordingly the FC had to consider all the points of view including the historical trends in devolution.. The 12 FC

[60] It has been argued by the Keynesian theorists that the borrowing by the central Government may be justified till there are unemployed resources in the country. While the neo liberal perspective does not al all sympathize with the concept of fiscal deficit at any level, for them the deficit may result in reduced investment from the private sector[It should be kept in mind that savings always necessarily equals investment and when the Government savings go down this would eventually lead to the decline in the private investment]

found out, about 38 per cent of the centres gross revenue receipts was transferred to the states, partly through the FC awards and partly through the Planning Commission grants and transfers through other resources. The commission also took notice of the UPAs ,NCMP , which while dealing with the subject of centre state relations, had demanded that the share of the sates in the shareable pool of the central Revenues to be enhanced. Keeping these perspective in view, the 12 FC fixed the indicative amount of the overall transfers to the states in the centres gross revenue at 38 per cent- just 0.7 per cent more than the percent fixed by the Eleventh FC.

3.4. States demand: Case study of Himachal Pradesh.

On the vertical side of the fiscal transfers, the demand from the states pointed towards increasing their shareable pool from the existing 29.5% to 33%, while some states going to the extent of increasing their share to 50%

Now as regards to the overall transfers the EFC had fix it at 37.5% of the central gross revenue receipts, the finance ministry had actually requested the 12FC to consider this particular aspect with the nuance attention.

On the horizontal side the demands of the states (performing) related to the increase in the weightage to the tax effort and the fiscal discipline. There were also the concerns of the states especially from the hilly states such as Himachal Pradesh that the revenue receipts of the states have not been adequately supplanted by central Government transfers for example, the Compound Annual Growth Rate of revenue receipts of H.P. over the period over 1991 and 2001 has been 13.3 % while the revenue expenditure has grown at the rate of over 15.7% .Revenue Deficit have been the chronic feature of the state finances since 1988-89. The CM[61] of the state have increasingly realized that apart from the institutional expansion required as part of the states human development initiative, large increase in the salary and pension burden due to Pay Commission Revisions and regularization of the daily paid employees, consequent to the Apex Court Orders, the mix of these and much more have added to the aggravated problem of finances of the state. The state have likewise urged, that the shortfall in the central tax devolution by the 11 FC as compared to the 10 FC have put the state in a dire stress of resources. Hence the state has urged the present FC to bridge the current short fall. Another major or rather interesting problem that the state poses to the FC is that the state is one of having very low population density; hence it gets its awards accordingly. But as spelt out by the CM of the state, this low population density, small and sparsely spread habitations increase the cost of delivery of services.

The Habitation Density (defined as the number of towns and villages per square kilometer) is however high as compared to most other states in the country. Hence a low population density coupled with high habitation density with the low average size of the habitation translates into the higher cost and effort in the delivery of the services. The state is unable to exploit the scale economies in delivering minimum level of services. In addition the state has urged that the commission should not rely on the sole indicator of

[61] The speech delivered by Chief Minister Mr. Virbhadra Singh at the India Conclave, discussed in detail later in chapter Fourth.

Economic Growth such as the Per Capita (where the agriculture is still languishing in the dust), implying whereby that the revenue potential of the state should be moderated. It should rather examine the entire structure of the economy, decomposing the components of economic growth, look at the rural urban population, and assess the availability of markets before coming to any conclusion on the revenue potential of the state. Problem that in considering these demands from the states, the commission had to give due emphasis to both the internationality of the states concerned, at the same time looking at the efficiency aspects, so that the larger goal of the commission doesn't loose its path.

3.5. What's different in this Commission?

While debating on the equity and the efficiency issues of the recommendations of the 12FC public economists such as Indira Rajaraman(2005), G.R Reddy(2006), Amaresh Baghchi(2002,2004), Pinaki Chakravarthy(2004) and Tapas Sen(2006) have all increasingly realized the emphasis on the fiscal prudence by the FC. The other distinguishing features of the transfer system can be summarized as under the following heads:

- *Increase in the share of grants in aid in the total transfers.*
- *Per capita tax devolution grants are highest for the special category states, followed by low income, middle income and high income states, indicating the progressiveness of the transfers.*
- *Debt write off facility to states on central loans due from 2005-10.*
- *Borrowings from the market allowed to the states.*

3.6. Grants in aid as amount of total transfers

Out of the aggregate amount of transfer of Rs7,55,751.62 Cr. The grants in aid stand at Rs 1,42,639.60 Cr to states during 2005-10. This should be seen in the context of Rs 4,40,209.26 Cr from which only Rs 58587.39 constituted the grants in aid to the states by the 11FC. This significantly higher pool of grants marks a progressive departure from the erstwhile commission, which gave little preference to specific maintenance grants [See Table 3.2].

Table 3.2

(Rs. in crore)

Sl. No.	**Purpose of Grant**	**During 2000-05 (11th FC)**	**During 2005-10 (12th FC)**
1	Local Bodies grants	10,000.00	25,000.00
2	Centre's share in Calamity Relief	8,255.69	16,000.00
3	Non-Plan revenue deficit grants	35,359.07	56,855.87
4	Grant for education	Nil	10,171.65
5	Grant for heath	Nil	5,887.08
6	Grant for maintenance of roads and bridges	Nil	15,000.00
7	Grant for maintenance of public buildings	Nil	5,000.00
8	Grant for maintenance of forest.	Nil	1,000.00
9	Grant for heritage conservation.	Nil	625.00
10	Grant for State-specific needs	Nil	7,100.00
11	Upgradation and special problem grants.	4,972.63	Nil
12	Centre's share of Incentive Fund	5303.86	Nil
	Total Non Plan Grants	**63891.25**	**1,42,639.60**

Source: Source: http// fincomindia.nic.in , compiled from the Chapter on Issues and Approaches of the 12th Finance Commisssion Recommendations (2005-10)

The recommendations of the TFC in wake of the non-plan revenue deficit of the states, the states like those of special category and backward states are the beneficiary of this type of grants (see Table 3.3)

Table 3.3

Grant-in-aid for Non-Plan Revenue Deficit (2005-10)

(Rs. in crore)

Sl. No.	STATE	2005-06	2006-07	2007-08	2008-09	2009-10	2005-10 (TOTAL)
1	Arunachal Pradesh	271.84	262.94	293.07	273.92	256.11	1357.88
2	Assam	305.67	Nil	Nil	Nil	Nil	305.67
3	Himachal Pradesh	2164.12	2107.14	2120.96	1991.64	1818.52	10202.38
4	Jammu & Kashmir	2458.56	2446.64	2552.18	2510.64	2385.44	12353.46
5	Kerala	470.37	Nil	Nil	Nil	Nil	470.37
6	Manipur	808.39	841.17	889.10	918.50	934.82	4391.98
7	Meghalaya	376.67	359.02	393.24	355.78	312.15	1796.86
8	Mizoram	537.19	556.52	605.17	634.00	644.91	2977.79
9	Nagaland	993.65	1037.66	1124.44	1168.17	1212.58	5536.50
10	Orissa	488.04	Nil	Nil	Nil	Nil	488.04
11	Punjab	1556.83	922.64	653.20	Nil	Nil	3132.67
12	Sikkim	66.81	47.06	52.86	21.94	Nil	188.67
13	Tripura	1041.91	1064.30	1122.91	1131.90	1133.18	5494.20
14	Uttaranchal	1112.91	1064.30	1115.02	992.02	830.43	5114.68
15	West Bengal	2438.90	605.82	Nil	Nil	Nil	3044.72
	Total States	**15091.86**	**11315.21**	**10922.15**	**9998.51**	**9528.14**	**56855.87**

Source: http// fincomindia.nic.in, compiled from the Chapter on Issues and Approaches of the 12th Finance CommisssionRecommendations(2005-10)

The TFC has indicated that it has preferred specific maintenance grants, as the states have been increasingly neglecting the maintenance of the roads/buildings, forest heritage conservation and the specific needs of the states. While another rewarding aspect of the transfers had been its emphasis on education and health sector which had long been left out of consideration by the erstwhile commission (non plan revenue expenditure).The TFC accordingly has considered it desirable that , pending major institutional reforms, an attempt should be made to reduce the inter state differences in selected services faster than the average level of all services. The selected services are health and education[62][See Table 3.4]

Table 3.4

Grants-in-aid for Education Sector (major head 2202) and Health Sector (major head 2210 & 2211)

(Rs in crore)

State	2005-06	2006-07	2007-08	2008-09	2009-10	2005-10 (TOTAL)
	Education Sector (major head 2202)					
Assam	183.20	200.60	219.66	240.53	263.38	1107.37
Bihar	443.99	486.17	532.36	582.93	638.31	2683.76
Jharkhand	107.82	118.06	129.28	141.56	155.01	651.73
Madhya Pradesh	76.03	83.25	91.16	99.82	109.30	459.56
Orissa	53.49	58.57	64.13	70.22	76.89	323.30
Rajasthan	20.00	20.00	20.00	20.00	20.00	100.00
Uttar Pradesh	736.87	806.87	883.52	967.45	1059.36	4454.07
West Bengal	64.83	70.99	77.73	85.11	93.20	391.86
Total	**1686.23**	**1844.51**	**2017.84**	**2207.62**	**2415.45**	**10171.65**
	Health Sector (major head 2210 & 2211)					
Assam	153.58	171.24	190.93	212.89	237.38	966.02
Bihar	289.30	322.57	359.66	401.02	447.14	1819.69
Jharkhand	57.39	63.99	71.35	79.55	88.70	360.98
Madhya Pradesh	28.88	32.20	35.90	40.03	44.63	181.64
Orissa	31.22	34.81	38.81	43.28	48.25	196.37
Uttar Pradesh	367.63	409.90	457.04	509.60	568.21	2312.38
Uttaranchal	10.00	10.00	10.00	10.00	10.00	50.00
Total	**938.00**	**1044.71**	**1163.69**	**1296.37**	**1444.31**	**5887.08**

Source: http// fincomindia.nic.in , compiled from the Chapter on Issues and Approaches of the 12^{th} Finance Commisssion Recommendations

[62] Srivastava D.K(2006), 'Working Paper on the equalizing health and education: Approach of the TFC', available at www.mse.ac.in as accessed on 18^{th} May 2007.

Table 3.5

Grants-in-aid for Maintenance of Roads & Bridges, Public Buildings and Forest

(Rs. in crore)

Sl. No.	STATE	2005-06	2006-07	2007-08	2008-09	2009-10	2005-10 (TOTAL)
		Maintenance of Roads & Bridges					
1	Andhra Pradesh	0	245.03	245.03	245.03	245.03	980.12
2	Arunachal Pradesh	0	11.09	11.09	11.09	11.09	44.36
3	Assam	0	82.53	82.53	82.53	82.53	330.12
4	Bihar	0	77.34	77.34	77.34	77.34	309.36
5	Chhattisgarh	0	65.60	65.60	65.60	65.60	262.40
6	Goa	0	9.87	9.87	9.87	9.87	39.48
7	Gujarat	0	223.80	223.80	223.80	223.80	895.20
8	Haryana	0	45.68	45.68			

Source: http// fincomindia.nic.in , compiled from the Chapter on Issues and Approaches of the 12th Finance Commisssion Recommendations

The 12FC recommended grants to heath sector for the 7 states. Amongst these 6 states viz Assam, Bihar, Jharkhand, MP, Orissa, UP, have been recommended grants both under education and health sector states receiving one of the two sectoral grants are West Bengal(education) and Uttaranchal (health).

As for the infrastructure front, it is to seen that the performing states are the real beneficiary of the grants so disbursed. States such as Bihar and up, that fail miserably on the infrastructure front are the losers in some senses(see Table 3.5)

The grants are calculated on normatively adjusted existing levels of per capita expenditure on these sectors. States, whose per capita expenditure is lower than their respective group averages, have been selected for grants. The beneficiaries of these grants would be backward states of which West Bengal is a lone exception. However it is noted that these grants are being provided for education and health sectors as additionality, over and above the normal expenditure by the states. But it was envisaged that no further conditionality should be imposed by the commission, nevertheless the commission had put in place two types of conditional ties :-

- Monitory Committee
- Minimum Normal Expenditure thresholds

Hence with the view to achieve the efficiency target the commission has visualized about putting in place a robust monitory mechanism. Hence the commission has recommended that every state should constitute a high level committee for the proper utilization of grants. This committee should be responsible for the achievement of the dual targets, which includes both financial and physical targets, and for ensuring adherence to the specific conditionality applicable. This committee would comprise of chief secretary who will be the head along with the finance secretary and further assisted by secretaries/ heads of departments concerned as members. The meetings as visualized by the commission should take place at least once in every quarter to look through the utilization of funds and likewise issue requisite directions to the department wherever necessary.

The FC has made sure that expenditure on such grants do take place It has suggested that the beneficiary state has to progressively increase expenditure i.e. expenditure on the basis of normal growth and the additionally due to grant. While the additionally above the prescribed growth would come from the recommended grant, the prescribed growth in the expenditure on health and education would come from its own resources. It should be kept in mind that in addition to the grants the states also receive resources from the plan funds, particularly from the schemes like Sarva Siksha Abhiyan, NREGA etc. But nevertheless the recommendations as pointed by eminent economists like D.K. Shrivastava and others are likely to reduce inter state disparities in these two vital services that are also of the nature of merit goods.

The increase in the share of grants in the total scheme of transfers should be also be seen as against the backdrop of the previous commission. While the relative weights and method determining inter se states by the 11FC and 12FC can be gleamed by looking at the pie chart in the previous chapter. However, the table given below, one may say that the present that the present commission has given greater weight to the revenue effort by the state as compared to the previous one. Moreover, the relative share of the deprivation of the state is also enhanced by this commission as compared to the previous one.

Table 3.6 -Relative Weights of 11FC & 12FC

Sl. No.	Criterion	Relative Weight (per cent) 11th FC	12th FC
1	Population	40.0	40.0
2	Geographical area	10.0	10.0
3	Distance from highest per capita Income	20.0	20.0
4	Index of decentralization	20.0	0.0
5	Revenue effort	10.0	20.0
	Of which		
	(a) With respect to own revenue of States		10.0
	(b) With respect to GSDP		10.0
6	Index of deprivation	0.0	10.0

Of the overall transfers that we discussed while we talked has recommended 38% of the central gross revenue receipts as against 37.5% of the gross revenue receipts of the central Government recommended by EFC for 2000-05.

3.7. Tax Devolution

According to the TFC report, the commission had tried to balance the ideals of both equity and efficiency. The population criterion is a pointer towards the need of the actual public goods by the concerned state, the income criterion reflects the differentials in revenue capacity, while the area criterion measures the cost disability of the regions. The remaining two criterions are the reflection of the neo liberal world order which caters to the idea of efficiency as the buzzword for any progress conceived what so ever.

It must be noted that while the neutral factors such as population and area have been given an increased weight age, redistribute factors such as income have been given a go by(down by 12.5% to 50%). On the other side of the coin, the factor such as infrastructure development have been completely done away with[63], the reason sought here was that it was now to be linked to distance criterion and better used in an ordinal way[64]. While the factors such as Tax Effort and Fiscal Discipline remaining same at the commission's index card as compared to the previous one. However the progressive

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[63] It should be well remembered that the criterion of Infrastructure originally introduced by the 10FC with a weight of 5 % was increased to 7.5 % by the 11FC, for it felt that the availability of infrastructure critically influences the location of investment and that the states which are backward in this respect need to be rendered help.

[64] Kumar Ravi T(2004), Tax Devolution and Regional Disparities, *Economic and Political Weekly*, 15(20), May 14-20, pg 2020.

element in the card related to the per capita tax devolution as well as per capita grants which are highest to the special category states, followed by the low income states, and then the middle income states followed finally by the high income states. The state wise distribution of central taxes with and without including the service tax can be seen with the annexure 2 attached. Here one sees that while the backward states benefited from the 12FC commission concluded" We have tried to evolve a formula that balances equity with fiscal efficiency. Fiscal Considerations, however dominate, as they should, in any scheme of federal transfers trying to implement the equalization principle".

3.8. Debt Restructuring

Taking cognizance of the debt burden of the states, the 12FC has recommended a scheme of debt relief, which consists of two broad parts

- The relief that comes from the past debt and rescheduling it, along with the interest rate reduction
- Secondly the debt write off measure, which is linked to the reduction of absolute levels of revenue deficits. Both the reliefs would be available, only if the states enact appropriate legislations to bring down the revenue deficit to zero by 2008-09 and commit to reducing the fiscal deficit in a phased manner[65]

Prescribing to this model approach where once the state adopts the fiscal prudence approach, past loans to it from the centre will be consolidated as a20 year loan (the total

[65] Inaugural Adress by Dr C. Rangarajan Chairman Economic Advisory Council to the Prime Minister at the 16th Bi Annual Conference of the State Finance Secretaries Reserve Bank of India Mumbai On April 8, 2005

of all states comes to Rs 1,28,795 Cr) with a uniform interest of 7.5% and thereafter, for each year up to 2009-10, the annual repayments for that loan will be written off linked to the absolute amount by which the revenue deficit is reduced in each year. If all the states achieve the target (revenue balance) some Rs 32000 cr would be written off in five years. The 12FC has thus tried to blend the objectives of fiscal prudence of the states of the incentive of revenue deficit reduction on a state specific basis and of debt sustainability[66].

3.9. Restructuring Public Finances

In the scheme of restructuring of the public finances, the commission envisages the fiscal deficit to be reduced to 6 % on the combined amount of the centre and the states and the revenue deficit to be reduced to zero by 2008-09.Amongst the other institutional changes the commission has suggested that the states can now decide on their annual borrowing programme keeping in view their fiscal responsibility legislations. And the other and the most important one taking clues from the example of Australian Loan Council, it has suggested that the centre should henceforth restrict its assistance for state plans to only grants and allow freedom to states to access markets for the loan component of the plan[67].

However in this scheme of things the pertinent question is that while the better off states would be able to muster loans from the markets the poorer states would be left holding the can, for their credit worthiness service capacity and the risk perception would be at a much lower scale as compared to their better counterparts. Incidentally there are the

[66] K. Venkataraman , Twelfth FC: The Endless search for solutions , *The Hindu*, May 10, 2005.
[67] Reddy K.N., art. cit pg 2

states that need public investment more As has been pointed by a Reddy, another major issue that have been so far neglected by the analysts, is the maturity pattern of the market loans vis a vis the Central Governmental loans. While the central Government loans are given for the period of 25 years with the moratorium of five years, in, contrast the market loans are given for the period of 10 years with the repayment at the end of the maturity period.

Moreover, it had also been observed that the investments of the scheduled banks in the Government securities have been slowly coming down heralding the changed scenario visualized by the FC.

3.10. Panchayati Raj Institutions and Urban Local Bodies.

Though in the TOR of the TFC , there have been no reference to local self Government, but because the section 5 of the TOR mandates the commission to review the finances of the centre and the states and thereby suggest the plan for the restructure of the public finances so that efficiency and stability could be established. This TOR when comprehensively interpreted cannot leave out local finance in particular[68]. The reasonableness of the argument rests on the concept there may be uneven development at the level of territorial sub units i.e. some units may be more worse off than others and central funds and /or projects are required to maintain the balance in those areas[69].

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[68] Ooman M A(2005) , 'Twelfth FC and Local Bodies', *Economic and Political Weekly*,15(20), May 14-20, pg 2022.

[69] Crook, Richard C (2003): *Decentralization and Poverty Reduction in Africa: The Politics of Local Central Relations*, Public Administration and Development, 23,pg 13 .

The 12FC has recommended a total of Rs 25000 Cr to the local bodies of which the PRIs would receive Rs 20000 Cr and the ULBs would get Rs 5000 Cr . Even at this level of the local bodies the commission has asked to look into the non-plan revenue costs associated with the maintenance of the existing assets. On the other hand at least 50% of the grants provided to each state for the urban local bodies should be allocated for the scheme of solid waste management through public private partnership. The municipalities should concentrate on collection, segregation and transportation of solid waste.

Besides these the local bodies have been asked to specifically look into the ideals of accountability and transparency through the use of modern technology so that the spirit of responsibility as envisaged by the 73rd and 74th amendment Act are fully realized. This could be particularly understood in the context of publication of the state wise data for each level of governance for eight years commiserating between 1990-91 and 1997-98. But the data was soon found unreliable and not worth taking help of. Equally distressing is the fact though they CAG working within its bounds of Constitutional provision have to maintain the records for further survey and conclusions, used by the central Governments or the Governments at the level of the states. But so far not even half of the states of the Indian union had ratified to the proposal of CAG conducting such widespread surveys. Now this unfinished task is taken over again by the 12FC.

3.11. Implications of the Recommendations of the Twelfth FC Awards On Backward states

The very recent Economic survey of 2006-07 puts the case of the States' finances in the right perspective. The effects of the recommendations of the TFC cannot be analyzed without taking into account the state level reforms pursued in wake of the FRBMs, adherence tp the policy of UPA by the Central Government, Planning Commission Transfers and the transfers through CSSs. The revised/Budget estimates ejected out by the Economic Survey of 2006-07, also reflect the move by the states when they fully recognize the need and cogency of fiscal adjustment, resulting in their taking a number of pro active steps including enactment of FRBMAs and an introduction of a monthly cash flow systems aimed at improving their financial postions. As the survey puts it "Even prior the TFC recommending enactment of FRBMAs as a pre requitisite for the states to claim the benefits under the Debt Waiver and Relief Facility (DWRF), a few states have already enacted their FRBMAs. The two stage DWRF as has already been discussed earlier in this chapter, is linked to the states following certain conditionalities:

- Enactment of FRBMAs(required in any case of debt consolidation).
- Reduction of revenue Deficit every year starting from 2004-05, when compared to the average of preceding three years (i.e 2001-02, 2002-03, & 2003-04). In the process, if the revenue deficit is completely eliminated completely by 2008-09, the states get the full benefit of the waiver.
- Containing Fiscal deficit/GSDP ratio at the 2004-05 level in all subsequent years.

Hence, the centre made it increasingly necessary that for the states to avail the debt write off facility, they should reduce their revenue and fiscal deficits. So far 23 states have enacted the FRBMAs and likewise 21 sattes have drawn their "Fiscal Correction Paths".Debt consolidation have been done for 19 states. But out of these 19 states, 6 states namely Assam, Bihar, Kerala, Maharashtra, Tripura and Uttarakhand were found to be in eligible for the debt waiver in 2005-06. in case of 13 states, amount of debt waiver is estimated at Rs 3,856 Cr.

It is for this reason that one could see that the Revenue Deficit(RE) figure for the entire states across, stand at Rs 17,284 Cr, and likewise the Gross Fiscal Defcit(RE) figures stand at Rs113,978 Cr for the period 2005-06.These figures indicate the targets which are achieved especially after the enactment of FRMBAs by the state Governments. In a revised estimates for the same period as above, the Gross Revenue Receipts of the states stand at a loss of almost one per cent age point from the previous year (i.e. from 18.6% in 2004-05 to 17.3%) but there is an improved picture at the side of Tax receipts, (of which the states own Tax Revenue) stand at a gain of one percentage point from the previous year i.e. from 11.9 % to 12.7%. the Budget estimates show a more enthusiastic picture of the tax revenue of the states. Therefore it is clear that states have started charting their own fiscal correction paths and treading on the lines always spelt out by the FC and PC.

Chapter 4

Emerging Trends in Indian Fiscal Federalism

While analyzing the main lines of conflicts and changes in the process of state formation and likewise the idea Of Centre- State-Society relationship, Professor Zoya Hasan (2001, p 24) identifies four broad facets. According to her, there had been the crisis of legitimacy of the state both in respect and credibility in the eyes of people, the breakdown of authority generally and more particularly of the centre in relation to the intermediate and local institutions and the erosion of the autonomy of the state vis a vis civil society and external interests that have lead to the decline in the self reliance and non alignment.

Then the distribution of the benefits of economic development is highly unequal. Then, the ideological pillars of the Indian state, viz., party system and bureaucracies have all been greatly weakened. And lastly there had been severe politicization of the civil services and massive rise of redtapism at the level of Government officials. In the similar vein, the anthology on political thought by Partha Chatterjee (1999: p 209) addresses some of the keys problems that mar the political process of state formation in the country. While he analyze, the planning process in the country just before the commencement of the economic reforms, he rightfully points out the lacunae that stood in the entire planning process What the state thinks as politically necessary or feasible or given to the planner: it is determined by the process of politics that is extraneous to the planning per se. Planning in Toto had not been what has been philosophically called an exercise in instrumental rationality, it had rather been about relative priorities among the socio political objectives or about their political feasibility.

Looking at the fiscal federal relationship, we take on from these generalized notions about the conflicts in the Indian state. Now because the concept of federalism is perceived as autonomy of domain, this type of polity allows social pluralism (especially those that are territorially arranged) to operate within the matrix of self-rule with shared rule[70]. In case of India the deepening of democracy had its impact on federalism. The impact is felt in the arena of crystallizing, regionalization process – a process of coalition making and institutionalization of diversities. But before the critique of the present situation, we need to look at the changes in the federal relationship broadly and fiscal federalism specifically there had been some fundamental changes in policy both at the political level and at the level economy that had the effect to radicalize the fiscal federal set up of the country specially after the 1990s.

4.1. Changes At The Policy Level

When we look at the political front likewise, we find out that the conceptualization of federalism changed in the Indian context due to broadly for the five reasons:

[70] Singh Ajay Kumar(2003), Book Review of the success of India's Democracy, edited by Atul Kohli, *Indian Journal of Federal Studies*,31(5),Jan-June, pg 46.

a) The Passage of the PRIs and ULBs Act; establishment of ADCs in the North East.

The establishment of the Balwant Rai Mehta Committee(1956) and Ashok Mehta Committee(1978), G.V.K Rao(1985), the Singhvi Committee(1987), a sub committee of the Parliamentary consultative committee attached to the ministry of the personnel , public grievances and pensions under the Chairmanship of P.K.Thompson, were infact the earlier attempts in the evolution of the ideas of the local self Government in India. Likewise the 64th Constitutional Amendment Bill (1989) and the 73rd and 74th Constitutional Amendment Bill(1992) made it binding on the part of the State to establish Panchayati Raj Institutions. Further the creation of the three Autonomous Development Councils within the Indian federation provided a new meaning to the emerging concept of Indian federalism. They are Darjeeling Gorkha Hill Autonomous Council(1988), Ladhakh Autonomous Development Council(1995), and the Bodo Autonomous Development Council(1993).

The creation of the ACDs restructured and decentralized our federation, which consisted of the union and the federated units(states). ACDs are basically district level councils created within the district under the traditional district level administration. They are mainly responsible for taking care of the developmental activities within their functional jurisdictions, while the district administration , as a representative of the state, looks after the general administration of the district.[71]

These Autonomous District Councils are formed after taking into account factors like geographical isolation, a distinct regional identity and some special problems that are

[71] Vimal Khawas, Relevance of Autonomy, *Statesman*, 20th April 2005.

different from the mainstream India. They are the result of long-standing ethnic struggle against the hegemonic state structure, wanting to get some measure of political independence. They have been created on the basis of the belief that the decentralization of power would give a boost to the developmental activities and meet the aspirations of the people. The aim of the ACD is thus the socio – economic and cultural advancement of the people of that area.

b) Regional political parties become actors of social change or at least become the catalysts that lead to the maturing of democracy in the country.

Here it is interesting to note that in the recent years, national parties like the Indian National Congress has lost much of its support with the masses while its main rival the Bhartiya Janata Party (BJP) has failed to take its place as the majority parliamentary party in the country. Each party has the support of about a quarter of the voters. The remaining 50% of the electorate vote are further smaller regional parties. Some of these are officially called the National Parties, but others are designated state pasties. The result was that neither of the two large national Parties seems to be in the position to govern except as leaders of the coalition in which the smaller regional parties [play a crucial role in both the Parliament and the Union Cabinet, with the transformation of the party system, changes in the formal institutions of governance have followed. The Rajya Sabha, long the preserve of the National Parties, specially the Indian National Congress may well has become a genuine council of states. The President likewise has come to be recognised as the Head of a unique federation, not just a Parliamentary Head of he State analogous to the Queen in Britain one day, as Douglas Verney has rightly said "the Union Govt.(like the Dominion Government of Canada(may well be restyled as the Federal Govt. of India"

c) Establishment of Inter State Council as recommended by the Sarkaria Commission.

The setting up of ISC finally on 28th May 1990, by the presidential order paved the way for the states getting a more pronounced voice in the consultations with the national government. In order to democratize the council further, the second meeting held by the ISC on 15 October 1996, it recommended the setting up of a Standing Committee for more elaborate voice to the states[72].it was also decided that the meetings of ISC would take place thrice every year. But the working of the council proved to be otherwise. While its first meeting was held on September 1992,there was no meeting for the next six years of the congress rule. It was a kind of the rebuff to the V.P. Singh Govt. that the congress gave not calling for its meeting. Moreover Rao also did not call any meeting of the National Integration Council set up by Nehru in the 1960s. But after the hiatus of nearly more than a half decade, the meeting if ISC was called by the UF government, assuring its commitment for a strong centre- state consulatations[73].

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[72] The functions of the standing committee would include continuous consultation and processing matters for consideration of the council: reviewing and updating the recommendations of the Sarkaria Commission, especially on the vital questions of the devolution of powers from the central government etc.

[73] Saxena Rekha, *Situating Federalism: Mechanisms of Inter Governmental Transfers in Canada & India* , Manohar Publications, New Delhi, pp 293-294.

At the level of economy a perceptible shift away from the centre in the economic policy making took place with the move towards liberalization of the economy initiated in the 1990s[74], with the delicensing of the industries, the powers of the states over the industrial policy were largely restored and they gained their more elbowroom in pursuing their own social and economic policies, changing development compulsions, introduction of the liberal fiscal and monetary policy, assertion on accountability and efficiency on every sphere of the economy, and also growing of the income divide gave a new fillip to the fiscal federal set up of the country .

There were other institutional factors such as the proposals passed at the NDC meetings, disbursement of discretionary grants by the planning commission, deliberations of the empowered group of ministers, various civil society and pressure group movements that had their own effect in influencing the policy making and the larger level on the narrative of the idea of India as a state in itself.

d) Transfers by the Planning commission

Like the FC, the planning commission also uses the formula to ascertain the distribution to the states, so that the regional imbalance amongst the states is checked. Before the

[74] It must be recollected that the impressive growth record of the Indian economy in the first ten years of freedom would seem to provide a vindication of the merits of 'economic federalism' favored by the economists for its accent on efficiency. Factor that eventually led to the slowdown were as Bagchi puts them , the inward looking policies like import substitution, highly protective environment, regime of controls, that made India to dodge on what is called the *Hindu Rate of Growth* . he identifies two ways in which the operation of federalism impacted negatively on the economy in the two decades following the initial years of good growth. One is the inefficiencies created by the centre's attempt to take on too much and manage the economy at the micro level; the other was the failure of the federal system to ensure the smooth functioning of the common market.

Fourth Five Year Plan, there was no certain formula for determining the amount of assistance. A formula was prepared in the Fourth Five Year Plan for this purpose and it was called the Gadgil Formula.This formula provided the basis for the transfer of assistance to the states. According to this formula, the distribution of the total assistance among the states was done on the following basis. It gave population a weightage of 60%, and the per capita income 10%. While it gave tax efforts the value weightage of 10%. And the special development projects again 10%.

This formula was used in the Fourth and the Fifth Five Year Plan for transferring financial assistance to the states. During the discussions on the Fifth Five Year Plan, many chief ministers of the states demanded the revision of the formula. So, the first modification was made in 1990 in which the current projects were associated with the per capita income getting 20% weightage. This modification was applied in the Sixth plan, Seventh Plan and 1990-91 Annual Plans. Then in October 1990 National Development Council re-modified the formula for the second time when it deceased the weighatge of population to 55% . But it did not delineate from the progressivity of distribution. Moreover in what it called the weightage to the financial arrangement it actually decreased the per cent of distribution from the erstwhile 10% to 15%.

The above-modified formula was used only for the annual plans of 1991-92 for giving the assistance to the states by the centre. The planning commission under the leadership of the immediate Vice Chairman of the Commission , Mr. Pranab Mukherjee, constituted a committee for the reconsideration of the modified formula on September 10 1991. The current formula which was adopted by the National Development Council after accepting the modifications suggested by the Mukherjee Committee in the meeting held on Sept 1991 distributed the weightage as follows:

Bases	Weight
1. Population(census of 1971)	60%
2. Per Capita Income	25%
3. Performance	7.5%
(a). Tax Efforts	
(b).Financial Management	
(c). Progress in the form of national objectives	
4. Special Development Programmes	7.5%
5. Total	100%

Now this formula was applied in the Eighth Plan for transferring the central assistance to the states for non-specified heads. For the specified heads, it was decided to continue Modified Gadgil Formula.

e) Loans from the Central Government and RBI to the States.

Another aspect of Fiscal Federal relations in India is the capacity of the states to borrow from the Central Government [Article 292 & 293]. The central Government issues Ways and Means Advances (WMAs) to the states, the facility through which the states can have the quota to the amount of borrowings. The Centre also offers *overdraft facility* (also called Clean Advances) to the states, esp to those that have exhausted its normal WMAs. In a very recent move of the Central Government, the States have been allowed to borrow directly from the international financial institutions without having the central Government intervene on their behalf. Now, the expenditure policies of the States, however came to be influenced heavily by the Centre as they were required to draw up their plans to sub-serve the objective of the central plan and have their five year plans and annual plans approved by the PC. Annual plan approval provided the mechanism foe central control over the state expenditure policies, with the central assistance for the state plans providing the leverage. Over and above plans approved by the PC there are numerous CSSs. The centre has overtime thus made the inroads into the areas that under the Constitution belonged erstwhile to the States. (Bagchi, 2002).

Then there had been many Commissions set up to look into the plethora of issues that have repercussions on the Centre-State and likewise on the state and local bodies. There had also been several Constitutional acts passed by the parliament and state legislature, in the recent political history that have the effect on influencing the Federal scenario of the country. The distinction should also be made between the *plan grants* and the *non-plan grants* (or *statutory grants*) and subsequently discretionary grants. With the non plan grants is meant, grants disbursed by the FC, the plan grants refer to the grants by the PC, while discretionary grants are given by the central Government ministries. Now looking at the table given below, one may see that the significant proportion of the transfers came to be channeled through PC, by passing the FC. Right from the beginning 'Plan Grants' came to constitute 30% or more of the total amount of centre's revenue transferred to the states (Table 4.1). Although the non plan grants still constituted the bulk of the resources transferred to the states, instituted of parallel transfer, not apprehended by the Constitutional forefathers came to stay in a big way:

Table 4.1: Categories of Grants Available to the States

Plan Period		Share in the Central Taxes	Statutory Grants	Total Statutory Transfers	Plan Grants	Discretionary Grants	Total Transfers
1st Five Year Plan	1951-1956	54.43	4.27	58.7	29.27	12.03	100.00
2nd FYP	1956-61	45.85	13.45	59.30	36.99	3.71	100.00
3rd FYP	1961-66	47.84	14.2	62.04	36.40	1.56	100.00
Three Annual Plans	1966-69	48.00	17.63	65.63	33.28	1.09	100.00
4th FYP	1969-74	54.35	9.45	63.80	24.38	11.82	100.00
5th FYP	1974-79	50.24	16.77	67.01	29.35	3.62	100.00
Annual Plans	1979-80	59.80	4.81	64.62	31.68	3.71	100.00
6th FYP	1980-85	56.86	4.92	61.77	34.18	4.05	100.00
7th FYP	1985-90	54.17	6.87	61.04	35.05	3.91	100.00
Two Annual Plans	1990-92	52.33	11.28	63.61	33.46	2.93	100.00
8th FYP	1992-97	56.13	6.90	63.02	35.04	1.94	100.00
9th FYP	1997-2002	56.84	10.27	67.11	30.06	2.88	100.00

Source: Amaresh Bagchi and Pinaki Chahravarthy, art. cit., pg 2740.

Hence one could see that, the states were compulsorily made to depend on the centre by these grants.

4.2. Emerging trends in the fiscal federal relations: New Dynamics

a) Eleventh Plan Approach Paper adopted by NDC on Dec 9th, 2006

And last but not the least, the passage of the Eleventh Plan Approach paper by the NDC[75] and the passage of the budget for 2007-08 should be subjected to careful scrutiny so that a nuanced reflection on the fiscal federal relationship could be made possible. The analysis of the recent Union Budget should begin with the recognition that the budget is only one yet an important one, of the several economic policy instruments available with the Government. Further the policy framework, as often realized by the political economists across, of the Government is constrained and conditioned significantly by the overall structure of the country's political economy in terms of the distribution of productive assets and wealth and the political influence that is closely associated with this[76].

In a recent Article aiming at the analyses of the recent budget, M Govinda Rao[77] maintains that from the budget of 2007-08, it is amply clear that the average rate of growth of GDP in the economy is estimated at 9.2%, coming out on top of 9 % growth observed in the previous years. This has pushed up the average growth rate for the tenth plan to 7.6 %, which is marginally below the targeted 8 %. This has also given the

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[75] The National Development council in its 52nd meeting on Dec 9, 2006 adopted the approach to the Eleventh Plan setting a "faster, more broad based and inclusive" growth at the average annual rate of 9% for the five years starting with 2007-08. This approach paper points out,' requires a substantial increase in the allocation of public resources for the plan programmes in the critical areas', including education, health, agriculture and infrastructure

[76] Little to cheer about, *Frontline*, March 23, 2007, Pg 33

[77] Rao Govinda M(2007), 'Fiscal Adjustment : Rhetoric and reality' ,*Economic and Political Weekly*,17(14),pp 1252-53.

confidence to set the annual growth target for the eleventh plan at 9 %.In a still more recent Article , The Hindu, quotes the recent figures spelt out by the CSO, according to which the revised estimates of the national income reveal a flattering picture of the state of economy. During 2006-07 it registered a 9.4 % growth, the highest since 1988-89 when it grew by 10.5%. And this growth figure goes beyond all other estimates including the Reserve Bank of India's 8.5% and the CSO's own earlier projection of 9.2%. This has been mainly owing to the major two growth drivers of the economy, namely manufacturing and service sector with 12.3 and 11% respectively. However agriculture still lagged behind with meager 2.7 %.

b) Economic Survey (2006-07)and the Budget of 2007

In the similar vein the Economic Survey 2006-07 celebrates the fact of the "high" growth. It identifies the economic policy agenda as consisting of "two issues"- maintaining high growth with moderate inflation and the inclusive nature of growth and likewise spells out three agendas for the Central Government:

- Maintaining and managing high growth
- Bolstering fiscal prudence and high investment
- And improving the effectiveness of the Government in critical areas such as education, health and the support to the needy.

The budget of 2007-08 likewise reiterated the concerns raised by the Economic Survey. Agriculture remained at the top of the agenda where there had been an increase in the allocations of funds. Similarly the various flagship programmes of the central Government were given a boost in the allocation scenario. Schemes such as NREGA have been extended to 130 more districts. Similarly allocations to SSA, Mid Day Meal, Prarmbhik Shiksha and Bharat Nirman have been increased to 450 cr, 7324 cr, 10,393 cr and 24603 Cr respectively.

c) Pensions Reforms and the Chief Ministers Conference (Jan 22, 2007)

Pensions system in India has long awaited reforms. India as the survey puts it incessantly long awaits a pension system which is sustainable, universally acceptable, especially to the uncovered unorganized sector workers on the voluntary basis; low cost, efficient and available through out the country; equitable and pro labour and also which does not inhibit labour mobility and that it should be well regulated to protect the interest of the subscribers. Likewise in August 23, 2003, the Government decided to introduces a well-structured system for the new entrants to the central Government services, except to the armed forces. Subsequently, the new pension system was operationalise as NPS from Jan 1, 2004. It was however as late as in January 22,2007, that the Ministry of Finance convened a conference of Chief Ministers on Jan 22, 2007, wherein it was decided by the State Governments to move towards a fiscally sustainable pension system for the civil servants and the establishment of an old age income security system for all Indians. Following the lead of the Central Government, 17 states have notified a defined contribution pension system for their new employees. In the same conference the states were assured that the PFRDA bill will be amended to provide the option for investing the 100 per cent of the pension funds in the Government Securities, entrusting the job of fund management initially only to the public sector fund managers, etc.

d) National Development Council Meeting held on May 29th, 2007

Hence at a very recent meeting of the national development council held on May 29, 2007, Prime Minister Man Mohan Singh called for very tough decisions and concrete action to achieve at least a level of 4% annual growth in agriculture. Now this 4 % growth requires much greater engagement of States. He asserted the establishment of a sub committee on "agriculture and related issues" under the chairmanship of Union Agriculture Minister Mr. Sharad Pawar. The purpose of the sub committee was to examine in depth the problems facing Indian agriculture and to suggest implement able plans to mitigate the woes of agriculture, which are faced by the weaker and stronger states alike. On the input side, there are issues such as improving water management, harvest and post harvest management, technology fatigue, agriculture research, reforming the cooperative system by implementing the *Vaidyanathan Committee* recommendations and increasing the investment in agriculture.

He also asserted on bridging these gaps required localized, state specific strategies based on local agro climatic conditions of the particular states. State specific plans should be the aggregate of district specific plans formulated for the districts in that state. Prime minister further asserted, "We need to move away from the mechanical implementation of the fragmented schemes towards an integrated approach which is based on the mix of interventions consistent with local requirements". In the same meeting, Union Finance Minister made a similar appeal to states by concentrating on the "yield gaps", and stagnation in the production and likewise declining productivity in agriculture. In some of the interesting observation that the average yield in Punjab and Haryana (stands at 4.2% & 4.0% per hectare respectively) which is significantly higher in Bihar & M.P (only 1.01% and even below). He further made a proposal of devolving additional resources besides the usual FC and PC transfers, through a method of ACA or Additional Central Assistance.

e) India Conclave[78]

In the discussion with the CM in a recently held India Conclave, discussions centreed broadly on six issues:-

1. Matching outlays with outcome.
2. Need for smaller states
3. Choice between free and fair power to farmers.
4. Implementation of VAT.
5. Future of privatization
6. Intertwining of good economics with good politics.

[78] The India Conclave held on April 22,2007 was organized by CII. The participants were both the developed as well as the developing states. It provided a common platform for them to place their grievances and demands.

Even though the most important states were scene not participating, consensus seemed alluding even amongst the developing states. The issues ranged from free power to VAT to water disputes to a firmer time table on the phase out of CST. But as N. K Singh in *Indian Express* has rightly pointed "But there was one consensus amongst all the states—that all of them argued for a case for an improved institutional mechanism for a centre state dialogue". Even the NCMP, has suggested the creation of a new commission on the centre state relations. The existing institutional mechanism on the inter state relations like NDC, Zonal Council and the Inter-State Council(established on the recommendation of Sarkaria Commission) have failed to deliver. As the critiques both at the academic level and at the level of media, have regrettably proclaimed " these mechanisms have degenerated into a mechanical affair where the bored CMs listen to the long written speeches of their colleagues with no interaction between themselves and at the end triumphantly adopt either the five year plan or its medium term review. The structure of these meetings hardly fosters any worth while dialogue amongst its participants".

At the level of economy the introduction of economic reforms, changing development compulsions, deregulation of the Governmental control, introduction of the liberal fiscal and monetary policy, assertion on accountability and efficiency on every sphere of the economy, and also growing of the income divide gave a new fillip to the fiscal federal set up of the country of the Similarly, he had pointed towards the other caveats, where the economy have shown the signs of declining growth. There is a visible decline in the construction and financial and social services. Some of these sectors especially construction, have been witnessing robust growth during the earlier quaters[79]

f) FRBM Act and its Impact on Union and State Finances

As we saw in the introduction itself, the passage of the Fiscal Responsibility and Management Act though had had an impact on the gross fiscal and revenue deficits of both the centre and the states, the situation is still far from contained.

With the ongoing spree of the economic reform programme, which is gradually been extended to most of the sectors of the Indian economy, the entire scope and responsibilities of the sub national Governments have increased to cover new horizons. The sub national Governments are both in need of more resources and optimal utilization of these resources so that the ideals of FRBM act could be realized .As we have already seen that the recommendations of the 12FC have, the objectives of the awards have not been dramatically different from the previous ones, even though the Government have been pressurized to rationalize the tax structure, subsidies, pensions, discuss on the viability of the sick public sector enterprises. Yet the mechanism adopted by the commission caters to the 4 principles identified by IMF(spelt out in the very first chapter itself), that is it has been following the principle of fiscal responsibility or fiscal equivalence, subsidiary, equality to address the problem of regional disparity and at the same time granting the sub national Government autonomy. To reiterate, the twelfth FC raised the share of states in the shareable central taxes from 29.5% to 30.5%. The total

[79] 'Strong Growth with a few caveats', *The Hindu*, 2nd June , 2007.

amount of transfers to the states recommended by the TFC amount to Rs 7,55,752 Cr over the period 2005-10. The total transfers recommended by the TFC are higher by 73.8% over those recommended by the EFC. Within the total transfers, while the share in the central taxes is higher by 62.9%, grants in aid are higher by 143.5 % over those recommended by the EFC. Now as we know that the awards, whether of the planning commission or FC or those of the central Government ministries, have the in built propensity to increase the revenue deficit of the states and thereby the fiscal deficit, the recommendations of the commission is needed to be looked from the perspective of the FRBM act passed by the Lok Sabha in 2003 and which became effective from July 5, 2004. It had mandated the central Government to eliminate the revenue deficit by March 2009 and reduce the fiscal deficit to an amount equivalent to 3% of the GDP by March 2008. Till now that is the period ending on February 2, 2006, 18 states had passed their FRBM acts and likewise 13 states have drawn their fiscal correction paths.

Following the enactment of the FRBM act, the Government constituted the task force headed by Dr. Vijay Kelkar for drawing the medium term framework for fiscal policies to achieve the targets of the FRBM Act. The Task Force submitted its report in July 2002. The recommendations have had had far reaching implications on the direct and indirect taxes in India. Critics have labeled the report as giving in to too much rationalization bid of the Government. For example amongst others, it has sought to recommended reduction of corporate tax to 30% as compared to the current level of 36.75% for the domestic companies, reduction of tax on the income of the foreign companies to 35% as compared to the current level of 40%.. It also recommended, that the customs duties to be reduced to 10% for raw materials, inputs and the intermediate goods and to 20% for the consumer durables. Similar reductions have been sought to be given to such items as coal, crude oil, petroleum etc.

g) VAT and the Federal Relationship

But amongst the major break through, the report (Kelkar Report) recommended a nation wide Value Added Tax[80] and the service tax which should be introduced from April 2003. These decisions were to have a long-term impact on the federal financial relationship. Hence following this as also the collective decision of the Empowered group of State Finance Ministers, 25 states/UTs had introduced VAT to replace the sales tax by Dec 31, 2005. It should be noted that Andaman and Nicobar Islands do not have sales tax. And that Tamil Nadu has introduced VAT from Jan 1, 2007. Now only Uttar Pradesh and Pondicherry had not implemented VAT so far. It is to be noted that the introduction of VAT, have been one of the break through in the area of public finance especially taxation. Though the system has been postponed many times, the introduction of VAT has finally commenced. According to the analysts, VAT is essential in tackling the problem of Tax evasion. A crispy definition of VAT says that it is a Multi point Sales tax levied as a proportion to the value added. It is to be remembered that the sales tax is the subject of state list. The central sales tax is levied on the inter states sales, till the time the modalities regarding a universal GST is finalized. The establishment of GST is to be seen in context of arriving at a national common market where there are no separate or

[80] It should be remembered that a high level committee of experts appointed under the chairmanship of Prof. Raja J Chelliah in 1992 had already recommended the introduction of VAT system t be extended up to manufacturing level

different rates in sales tax, and all such taxes as VAT, CST, MODVAT will merge and form a universal or a single tax. What actually happens is that with a differential level sales tax or VAT or CST in one state affects the domestic trade of another state. This can be explained as say Maharashtra imposes a tax of 10% on a particular good, while UP imposes a tax of 15 % on the same good. The product will be cheap from the side of Maharashtra and this might result in the decline of domestic trade in UP of that product. Hence the revenues of Maharashtra will increase at the cost of UP. Generally it is seen that differential levels of sales tax leads to the poorer states always lagging behind in trade and the performing states or the so called well off states benefit in such an arrangement . In this direction we can see the figures brought out by Ministry Of Finance which says Maharashtra, Tamil Nadu and Andhra Pradesh have earned a total tax revenue of the amount of Rs 18670 Cr, Rs 11858 and Rs 12570 Cr respectively, while the backward states like Orissa , Bihar and Assam have earned only about Rs 2541Cr, Rs 2388 Cr and Rs 1823 Cr in the period between 2005-06.

In so far as the phasing out of CST is concerned, it is to be completed within 2010.The Government is in its Budget of 2007-08 have decreased the CST from 4% to 3%. The Government is also ready for compensation[81] to the worse off states in the mean while or till the time until a single GST is not introduced. Goods and Services Tax (GST) will provide for the common market that was till date impeded by the various kinds of taxes(i.e CST, market/mandi tax, octroi etc).

[81] A formula has been finalized in consultation with the states for providing compensation to them, during the first three years, for any loss on account of introduction of VAT, to the extent of 100% of the loss in the first year 2005-06, 75% of the loss in the second year 2006-07 and 50% of the loss in the third year 2007-08 of the introduction of VAT. Technical And Financial support has also been provided to the states for VAT computerization, publicity and awareness and other related aspects.

h) Other financial flows that can be included in the study of fiscal federalism[82]

Recently some different components of the federal financial flows like the central Government investment in the public sector undertakings and the loans and advances through the financial institutions are also been included in the study of fiscal federalism in India. The reason is that, investments by the central Government in the PSUs can change the sectoral structure of the states and likewise can increase the income and expenditure in them through the Multiplier effect. Moreover they have found favorable comments by many because they are progressive in nature.

[82] I m indebted for this concept from the work of Paritosh Dash(1997) thesis on Centre State Financial Flows. He had been from the Centre for the Study of Regional Development,SSS, JNU

Conclusion

As has been argued in the preceding chapters that a Federal Financial system is a better and an efficient system for a country having wide socio-economic and cultural diversity, for it not only bridges the question of regional equity and balance but also promotes overall growth through efficiency in resource allotment. Hence, the assignment matters that concern the nation as a whole, or where there are externalities or large economies of scale, in that case Government at the Centre combined with the decentralization of responsibility to provide that benefit the smaller segments of the society to the lower tier of Government, indirectly promotes efficiency in the economy. In addition in a federal polity the economy benefits from the operation of Common Market facilitated by the free flow of goods, services and factors of production within the country[83].

But in case of India, the establishment of this type of Federalism, however, created the problem of developing a conceptual framework that can be useful for the study. This problem has been further compounded by the changes in the nature of Federal Systems in India. We have such different versions of analysis made of the kind of Federalism that it exists in India, that a precise conceptual framework of the concept remains only a pipe dream for most of the Indian and foreign authors on the subject[84]. Furthermore, Fiscal Federalism as a conceptual tool in the analysis of the dynamics of Federalism as a whole also had only a limited value. It lies at the margins of a bigger sub set of Democratic

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[83] Bagchi Amaresh(2002), 'Fifty Years of Fiscal Federalism in India : An Appraisal' ,*Artha Vijnana*,44(1), March , pp 1-2.

[84] Arora Balveer(1997), "Federalism and Inter Governmental relations in India: A Bibliographical Essay", in S Bhatnagar and Pradeep Kumar(ed) Some Issues in Contemporary Indian Politics, ESS Publications, New Delhi, pp 43-83.

Federalism, which seems near to my understanding of a kind prevalent in India, though not without its own limitations.

Fiscal Federalism, as we realized in the previous chapters, has slowly inched from being merely *competitive/conflicting* towards both *Participatory* and *Composite*. Though it would be too early to make a conclusion of this kind for an analysis of the Centre-State relations in India cannot be realized by the study of objective situation flowing in from the facts from the GMs(because facts and figures on participation and decentralization have little redemptive value[85]). We also cannot ignore the role of governments, leadership, bureaucracy, new social movements, in augmenting tensions, least forgetting the role of financial institutions, both at the National & International level, in giving it a fillip at some moment or the other.

The setting up of the FC and PC to spell out statutory awards of the revenue collected between the Centre and the States remained the hallmark for a supposed equitable pattern of development. Similarly the Central Ministry's role in devolving the discretionary grants has further opened the scope of Federal Finance in the country. But with all these schemes and formulas of transfer of resources, the regional disparities in India have, if anything accentuated in the last fifty years. While there has been a significant improvement in the income and consumption levels all over the country, the gap between the rich and poor states have actually widened.

[85] It must be pointed out that that the States which are spoken of as states where high level of democratization has occurred eg UP(where a dalit CM has just swore , is grappling with the death of numerous dalit children , TN(similarly the state which is crowning itself to glory for parties such as the DPI and PT have come up in a big way , but equaling the plight of the people in UP, TN also doesn't fare much better on the human rights record)

A study by M. S. Ahluwalia (2000) also concludes that the disparities have accentuated after the economic reforms conducted in 1990s. But he concludes that the main factor underlying disparate growth performance of the states has been the larger flow of PI into the richer states offering better infrastructure and good governance. This neo liberal argument rests on the plea that since liberalization the Centre's hold on the location of investment has almost disappeared, it is for the states to attract private investment into their jurisdictions for which what matters is "labor skills, work culture, good infrastructure and good governance".

On the side of the *left*, and at the *centre*, the critics feel that the cause of the widening of the regional disparities should be solely levied on the reforms and to the withdrawal of Government from the crucial areas of the economy. There is a consensus on at least issue. *The attempt to do away with its functions of welfare or common good is a unilateral decision of the Government elite. The masses have not consented to mortgage the public property and sell the public wealth to the corporations. That the public sector was not efficient and running at a loss and hence privatization is the answer is the prescription of the governing elite that needs to be fought. What we must opt now is not getting rid of the public good and to transfer it to the private hands but to reinvent governance. The idea of less governance can lead to delegitimisation of governance itself*[86] .

Similarly the states complain about the centralizing tendencies of the Central Government and depriving them of their legitimate rights and claims are due to the

[86] Pinto Ambrose(2001), 'Crisis in governance and need to reinvent governance', *Social Action*, 51(1), Jan-March, pg 234-235.

aspirations of the ruling elite at the top decision-making. These elites can be directly from the politics or those who benefit from the politics in some way or the other.

The setting up the 12FC has generated a lot of heat amidst the academic circles as also amongst the political elites across the country. The recommendations should be looked in the context of the UPA Government's commitment to reforms that aims at fiscal prudence through cutting down on revenue and fiscal deficits. 12FC has likewise raised expectations from the states to pursue their respective fiscal responsibility legislations. On its part, with an attempted balance of increased weightage to population appear to somewhat favour the backward states. Its additional grants in aid to the education and health sector also have some measure of progressivity attached to it. Nevertheless, like its earlier two counterparts, the 12FC has moved away from assigning a very heavy weightage to population and income criterion towards tax efforts and fiscal discipline. The debt write off scheme and the reduction in the debt servicing ratio to 7.5% from the earlier contracted per centage of almost 13% is definitely a benign relief to the backward states. But the ceiling on loans and borrowings from centre have raised several eyebrows from the poor states who themselves suffer from a hard budget constraint. The 12 FC has recommended a gradual withdrawal of the plan loan facility and not in one go. This may adversely affect the funding of the remaining two annual plans of the Tenth Plan and thereby affect the macro economic and physical targets of the Tenth Five Year Plan. This is a major issue to be borne by the Government of India, if it has to keep up the spirit of its National Common Minimum Programme. In addition the debt restructuring scheme and the special debt relief scheme recommended by the TFC and accepted by the

Government of India put more burdens on the backward states. As some authors have rightly pointed out, that the National Govt. basks on the notion that the fiscal crisis in the states is mainly due to the faulty practices of the state government, where to some extent the point can be given due credence, the onus should not be entirely shifted to the states. In fact in many cases it is the policies of the Central Government that have created problems for the States.

Moreover, the Federal Financial relationship has also been increasingly shaped by the level of decentralization process carried on after the passage of 73/74 Amendment Acts. But in this case too the legislative action had not proved as a sufficient condition to predicate the political will of any actor, party, or Government structure, a point also illustrated by *Land Reforms Legislation* in the country (Franco & Mathias, 2001).The study conducted by the later thinkers prove that in the Indian context a distinction should be made between decentralization and financial self sufficiency. Where the former refers to the number of functions and activities (according to the Schedule XII) transferred to the domain of the GPs. The latter is related to the capacity of the GPs to raise the financial resources. However some see this phenomenon as good for the economy where the revenue raising capacity is not delegated to the local level but only the expenditure requirements[87]. What ever it is to say, GPs are living off the transfers made from the

[87] The central Govt. in India is still allowed to collect certain select taxes that can internalize the various spill over effects of Public Institutions and at the same time through its revenue expenditure policies and resource transfers can plan for an equitable patter of growth. The later Panchayati acts and ULBs Acts of 1992 changed the situation dramatically. Now , as argued by Brennan and Buchannan in their Leviathan Hypothesis " Total Government intrusion into the economy should be smaller ceteris paribus the greater the extent to which taxes and expenditure are decentralized". But in case of India , the case does not stand tall. The study conducted by Mala Lalwani attempts to test the hypothesis in case of India. And comes to the conclusion that fiscal decentralization has only taken place in terms of devolution of the expenditure liabilities of the central Government. The revenue raising capacity are still not shared by the sub national

centre and the states. There are only two states namely AP and Maharashtra that have actually balanced decentralization and fiscal self-sufficiency. Even the states like West Bengal and Kerala, which are considered as the decentralizing states, fare poorly in self-sufficiency index. Transferring an increasing number of the developmental activities to the GPs does not necessarily make them more self-sufficient. The situation is grimmer if we look at the fiscal situation of the States. In the Chapter 2 when we realize that the states themselves have been incapacitated in generating their own resources, the dependency on the Centre for the PRIs can be easily gauged.

In an Article by Prof Ranbir Singh[88], he unequivocally assert in one voice the enactment of PRIs, establishment of SFC and the creation of DPCs has brought about no real change in the political system at the state and the district levels. *We continue to have the Chief Ministerial system at the level of state and at the level of District.* Besides the talk of representation to the "other" in the Indian society i.e Women and the SC/STs, have only been at the level of ideas only.

Hence analyzing the counters of fiscal federalism both before and after reform period, five basic weaknesses or what can be called lacunas of fiscal federalism as practiced in India can be summed up as follows:

- Faulty design of Inter-Governmental transfers both from the Centre to the States and then from the States to the PRIs / ULBs.

Government, hence the central Government intrusion is compulsory and justified. **Mala Lalvani, Can Decentralization Limit Government Growth? A test of the Leviathan Hypothesis for the India Federation, Publius, vol 32, 2002 Pg 26-27**

[88] Ranbir Singh(2000), A Conceptual Framework For the Study of the Indian Federal System, *Indian Journal of Federal Studies*, 1(1), pp 96.

- Intrusion of the *Informal Organs*[89] and *User Groups*[90] in the decision making process as also in the transfer of resources.
- Inadequate central oversight over the States' borrowings resulting in the problem of sub national debt and deficit. Opening up of the restrictions have actually given a vent to the performing states to attract maximum investments for their own benefit.
- Planning from *bottoms up* or *micro planning* is languishing in lurch with the state PC/FC, DPC have increasingly become white elephants.
- Though there had been this shift in the Union-State relations towards decentralization, there is equally another shift also taken place. Some authors go on to the extent of saying that the debate between the centre- state relations has boiled down to simply power shifting from the Prime Minister – not centre- to the Chief Minister. Even the cabinet seems not the part of the process of decentralization.

I also just want to make a small intervention here with regard to the North- South divide also understandably referred as disparities across regions. A more horrifying situation awaits the backward states in India, where the population growth projections portend a huge rise of the working population by the end of 2026.And this might have a far reaching political consequences too. According to the recently conducted NFHS (2005-

[89] With informal groups I mean, those groups that have acquired the cogency and importance with the passage of time, these include Planning Commission , Office of the Prime Minister & Chief Minister etc

[90] The concept of user groups, I have borrowed from H. Ramchandran (in Reflections on Indian Federalism, Indian Journal of Federal Studies, Vol 4 No 1, 2003), where he realizes that the establishment of various committees/influential people of the village have actually led to the surpassing of the elected officers at the local level. He gives an interesting example. In a village the Panchayat President who is from the SC caste. Now the village is elsewhere dominated by the upper caste. Hence this SC president is slightly by passed by these upper caste user groups, thereby influencing the general policy making at it.

06)the population of the BIMARU[91](the term coined by Ashish Bose) is expected to grow by 44% while in the southern states, the comparable figures is only 21% i.e., the growth rate of the BIMARU states will be more than double than that of the southern states. Hence as a result, if the Parliamentary Seats are determined by the population of the states as per the most recent census, the dominant role of UP in India's national politics will further increase because of its dismal demographic record[92].

[91] It must be noted that Rajasthan and MP have made some progress on the economic front, they continue to be BIMARU as evident from NFHS (3rd round which is conducted in December 2006)

[92] Asish Bose(2007), 'Beyond Population Projections: Growing North – South Disparity', *Economic and Political Weekly*,17(15), April 14-20, pg 1327.

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Annexure for Chapter 2

Annex 2.1

Maximum and Minimum Values for calculating HDI

Indicator	Maximum Value	Minimum Value
Life expectancy at Birth	85	25
Adult Literacy Rate	100	0
Gross Enrolment Ratio	100	0
GDP per capita(PPP $)	40000	100

Performance in each dimension is expressed as a value between 0 and 1 by applying the following formula

$$\text{Dimension Index} = \frac{\text{Actual-Minimum Value}}{\text{Maximum Value-Minimum Value}}$$

HDI is then calculated as the simple average of the dimension indicies.

Source: Dutta R& Sundaram KPM(2006), *Indian Economics*, S Chand Publications, New Delhi,pg 66.

Annex2.2

State Level Human Development Indices

State	**1991**	**2001**
Andhra Pradesh	9	10
Bihar	14	14
Gujrat	6	6
Haryana	5	5
Karnataka	7	7
Kerela	1	1
M.P	12	12
Maharastra	4	4
Orissa	11	11
Punjab	2	2
Rajasthan	10	9
Tamil Nadu	3	3
Uttar Pradesh	13	13
West Bengal	8	8

Source : Planning commission Report(2002)

Annex 2.3

Levels of Infrastructure Development

States	Per Capita Power Consumption 1996-97	Registered vehicles per 100 persons as on 31-3-97	Road length per 100 km of area of the states	Telecom lines per 100 persons as on march 31st 1999	Percentage of irrigated area in gross cropped area94-95	Relative infrastructure development index
	1	2	3	4	5	6
Forward states						
Punjab	790	103.2	113.1	5.34	94.8	191.4
Maharashtra	557	57.2	73.1	4.93	15.3	107.0
Haryana	508	64.6	61.0	3.18	77.2	141.3
Gujarat	686	91.5	55.6	3.75	28.9	122.4
WB	197	19.8	69.9	1.86	28.7	94.2
Karnataka	338	56.5	73.0	3.05	23.9	96.9
Kerala	236	46.5	358.2	4.66	13.6	157.1
TN	469	56.9	157.5	3.84	49.5	144.0
AP	332	42.1	20.7	2.36	39.6	96.1
Backward states						
MP	368	38.8	47.6	1.38	22.3	75.3
Assam	108	19.9	86.7	0.95	15.0	78.0
UP	194	22.7	72.7	1.21	62.6	103.3
Rajasthan	295	45.1	38.0	2.11	29.1	83.0
Orissa	447	22.9	134.8	1.05	25.8	97.0
Bihar	145	16.4	50.6	0.58	43.2	81.1
All- India	338	44.0	91.7	2.55	36.5	100.0

Source : Datta and Sundaram(2006), opp cit pg 475.

Annex 2.4
Debt/GSDP Ratios of states
(Per Cent)

States	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01
Andhra Pradesh	19.0	19.1	20.8	20.8	23.5	25.9
Arunachal Pradesh	53.50	58.0	58.2	56.7	56.7	54.6
Assam	28.1	27.8	27.2	26.7	29.3	33.2
Bihar*	67.7	55.9	59.9	59.7	66.9	73.1
Goa	35.2	32.3	28.6	27.7	28.5	32.7
Gujrat	15.5	14.9	16.6	17.8	21.6	26.6
Haryana	19.4	18.3	19.7	21.8	23.9	24.5
HP	45.4	44.2	44.9	53.4	54.0	60.8
J&K	56.5	55.6	56.9	50.4	55.5	61.5
Karnataka	17.6	17.4	18.1	17.6	19.6	21.0
Kerala	26.1	25.7	26.0	27.9	32.3	34.6
MP*	25.7	25.4	26.7	28.0	30.4	36.2
Maharashtra	11.6	12.3	13.3	14.6	15.9	17.3
Manipur	34.9	31.3	39.0	44.0	44.6	51.2
Meghalaya	21.7	22.0	22.4	24.2	26.5	28.9
Mizoram	44.5	47.2	52.9	58.6	62.7	62.2
Nagaland	51.8	52.5	51.1	57.8	64.5	--
Orissa	35.3	42.1	39.2	44.2	50.5	60.5
Punjab	35.8	34.5	35.3	37.4	37.9	40.7
Rajasthan	25.8	25.4	25.6	28.9	33.3	40.1
Sikkim	57.5	56.6	54.8	44.2	80.6	80.2
TN	16.0	15.8	15.8	37.4	18.7	20.9
Tripura	37.0	35.4	35.4	28.9	39.2	44.8
Uttar Pradesh*	28.2	26.9	29.2	31.5	35.2	36.7
West Bengal	20.8	22.1	22.5	24.8	28.9	33.7
Total	17.9	17.8	18.5	19.6	21.7	23.7

* The states of Bihar , MP, UP include the liabilities of newly formed States viz Jharkhnd , Chhattisgarh & Uttarnchal respectively.

Source: Prasad Abha et al , art. cit pg 2727.

Annex 2.5

State wise Primary Deficit

(Rs Cr)

States	1995-96	1996-97	1997-98	1998-99	1999-00	00-01
1	2	3	4	5	6	7
A.P	888	973	275	3062	1875	3513
Arunachal Pradesh	-3	17	61	-16	-20	89
Assam	165	-486	-497	-182	650	675
Bihar	-97	-526	-555	507	3246	2510
Goa	7	4	7	125	163	201
Gujarat	418	748	1290	3357	3984	4856
Haryana	430	384	307	1243	775	773
HP	236	259	830	1163	-408	1047
J& K	-344	-323	-149	390	494	1322
Karnataka	409	736	216	1495	2264	1832
Kerala	379	439	1128	1566	2584	1620
MP	475	550	161	2292	1773	301
Maharashtra	2095	2506	3539	3789	6823	3751
Manipur	47	102	109	15	524	57
Meghalaya	2	-33	66	78	113	136
Mizoram	36	78	58	59	85	274
Nagaland	152	86	91	107	86	165
Orissa	467	523	511	1431	2508	1038
Punjab	-125	-170	629	1463	558	1560
Rajasthan	1341	953	655	2908	2536	974
Sikkim	11	23	26	94	25	-28
TN	-37	969	358	2655	2671	1952
Tripura	-55	11	76	-22	105	219
UP	1056	1895	2887	6116	4546	2724
WB	1080	1457	1598	4159	7497	5671
NCT Delhi	462	500	412	527	851	893
Total	9493	11675	14087	38380	46309	37830

Notes: 1. '-' represents surplus

2. As the new states of Chhatishgarh,Uttaranchal and Jharkhand were created on different dates during 2000-01, the figures for the financial years are not given.

Source: Prasad Abha et al, art..cit. pg 2728.

Annex 2.6

Per capita Revenue Capacity

(Rs)

States	**2000-01**	**01-02**	**02-03**	**03-04**	**04-05**
Non-Special Category States(NSCS)					
AP	2186	2552	2981	3481	4083
Bihar	1290	1469	1672	1902	2182
Goa	4588	5253	6000	6865	7886
Gujrat	2861	3333	3881	4515	5264
Haryana	2767	3233	3778	4407	5143
Kanataka	2523	2909	3353	3864	4476
Kerala	2686	3121	3621	4194	4869
MP	1762	2003	2279	2596	2970
Maharashtra	2729	3210	3776	4435	5213
Orissa	1656	1791	2114	2320	2678
Punjab	2715	2981	3452	3996	4643
Rjasthan	2007	2158	2423	2790	3228
TN	2812	3259	3776	4374	5095
UP	1419	1567	1803	2072	2388
WB	1789	1960	2188	2456	2854
Total NSCS(Av)	2042	2322	2678	3082	3576
Special category states(SCS)					
Arunachal Pradesh	3973	4167	4360	4568	5025
Assam	1537	1702	1934	2193	2501
HP	3624	3830	4060	4266	4536
J&K	3950	4244	4420	4680	5025
Manipur	2557	2678	2797	2929	3120
Meghalaya	2907	3047	3217	3338	3535
Mizoram	5059	5306	5551	5948	6240
Nagaland	4950	5166	5467	5608	5945
Sikkim	6328	6645	6965	7311	7816
Tripura	2402	2517	2650	2755	2910
Total SCS	2643	2840	3056	3289	3587
90% of Total SCS	2379	2556	2750	2960	3228

Source: Bagchi Amaresh & Pinaki Chakravarty(2004) et al, art. cit., pg 2737.

Annex 2.7

Percentage share of grants in aid to the local bodies as per TFC and EFC recommendations

State	PRIs		UCBs	
	TFC	EFC	TFC	EFC
AP	7.935	9.503	7.480	8.23
Arunachal Pradesh	0.340	0.348	0.060	0.034
Assam	2.630	2.918	1.100	1.077
Bihar	8.120	9.813	2.840	1.100
Chattisgarh	3.075	NIL	1.760	NIL
Goa	0.090	0.116	0.240	0.232
Gujarat	4.655	4.351	8.280	6.626
Haryana	1.941	1.839	1.820	1.832
HP	0.735	0.821	0.160	0.195
J& K	1.405	0.930	0.760	0.783
Jharkhand	2.410	NIL	1.960	NIL
Karnataka	4.444	4.926	6.460	6.241
Kerala	4.925	4.120	2.980	3.762
MP	8.315	8.934	7.22	7.801
Maharashtra	9.915	8.209	15.820	15.813
Manipur	0.230	0.235	0.180	0.220
Meghalaya	0.250	0.320	0.160	1.135
Mizoram	1.100	0.098	0.200	0.192
Nagaland	0.200	0.161	0.120	0.089
Orissa	4.015	4.320	2.080	1.998
Punjab	1.620	1.933	3.420	2.736
Rajasthan	6.150	6.137	4.400	4.971
Sikkim	0.065	0.066	0.020	0.010
TN	4.350	5.826	11.44	9.668
Tripura	0.285	0.356	0.160	0.201
UP	14.640	16.489	10.340	12.582
Uttaranchal	0.810	NIL	0.680	NIL
WB	6.355	7.222	7.860	9.874
Total	100.00	100.00	100.00	100.00

Source: M. A. Ooman, art. cit ,pg 2022.