UNIT 17 FISCAL FEDERALISM IN INDIA

Structure

17.0 OBJECTIVES

This unit is concerned with Union-States financial relations. While going through this unit, you will be able to:

- spell out the principles governing fiscal federalism;
- state the provisions enshrined in Indian Constitution relating to division of financial powers between Union and States;
- appreciate the role of Finance Commission which constitutes a pillar of India's federal structure;
- appraise the role of Finance Commission versus Planning Commission;
- critically examine the various recommendations of 13th Finance Commission; and

- evaluate the dimension and nature of issues involved in contemporary fiscal federalism situation prevailing in the country.

17.1 INTRODUCTION

The framers of the Indian constitution wanted to build a strong united India. India has adopted federalism to actualise and uphold the values of national unity, cultural diversity, democracy, regional autonomy and rapid socio-economic transformation through collective efforts. Any viable and durable federal polity must have its counterpart in a system of efficient and equitable federal fiscal arrangement. The diverse political, economic and juridical aspects of federal fiscal relations have been discussed at length in the *Commission on Centre-State Relations* chaired by Justice R.S. Sarkaria which reported in 1988. The Sarkaria Report observed that from the functional stand-point, such a Constitution is not a static format, but a dynamic process. The very dynamism of the system with all its checks and balances brings in its wake problems and conflicts in the working of Union-State relations.

The country is passing through major economic and political changes and, as a reaction to over-centralisation in the past decades, the States have been asking for greater freedom in the exercise of economic powers. Besides, the current policy of decentralising economic decision making through liberalisation can aggravate regional disparities and here the Centre has an important role to play. At the same time, the less developed States will have to make corrections in their policies to attract investment, otherwise disparities are going to be more.

In the light of this background, it is desirable first to know the constitutional provisions and the role of Finance Commission and Planning Commission in this regard. Let us begin with discussing the principles of Federal Finance.

17.2 PRINCIPLES OF FEDERAL FINANCE

Economic analysis with several layers of government has a long and distinguished tradition in public finance. One of the most significant issues addressed in the literature is that of proper devolution of tax/expenditure authority between different levels of government. Federal fiscal arrangements are a necessary requirement of decentralised government administration, particularly in a large country. At least *five*, generally interrelated parameters define these arrangements:

i) *Expenditure responsibilities*

ii) *Tax assignments*

iii) *Fiscal imbalances, if any*

iv) *Availability of financing alternatives*

v) *Institutional parameters.*

Economic Principles for Designing a Good Federal Fiscal Structure: The major parameters of an intergovernmental fiscal structure can affect the efficiency of allocation of resources in an economy as well as other determinants of its performance. Nowhere are federal fiscal structures designed from scratch (or *denovo*), and economic considerations are not the only factors in their design. Nevertheless, certain economic principles have been developed that can help guide the reform of inter-governmental fiscal structure in any federal country, provided its policy makers are concerned about the *efficiency of resource allocation* and the performance of the economy. Some of these economic principles are:

17.2.1 Expenditure Assignments

Expenditure assignments to different levels of government should be guided by at least three economic principles. *First*, public services that benefit everyone (for example, defence) and whose supply benefits from economies of scale (for example, railways) should be provided by the central government. *Second*, public services whose benefits are localised (for example, law and order) and for which different people can have different preferences (for example, local roads) should be provided by local governments. *Third*, public services whose benefits spill over to jurisdictions other than those where they are actually provided (for example, public education and public health) either should be provided centrally or should be subsidised by the central government, depending on the estaimated value of the spill-over benefit.

17.2.2 Tax Assignments

Tax assignments to different levels of government could be guided by at least three basic principles. *First*, taxes that are levied on: (a) relatively mobile factors of production (for example, *labour and capital*), (b) at progressive rates (for example, *personal incomes*), (c) cyclically sensitive tax bases (for example, *personal incomes and corporates profits*), and (d) tax bases that are unevenly distributed among jurisdictions (for example, *natural resources*) should all be assigned to the central government. *Second*, taxes that are levied on *immobile* tax bases (for example, *land and property*), and whose burden is not exportable to other jurisdictions, should be assigned to local governments. (Neither taxes on the consumption of goods and services, nor the corporate income tax, meet this criterion). *Third*, large revenue yielding taxes that are inherently *buoyant* (for example, personal income tax, enterprise profits tax, broad-based consumption tax) can be assigned to the central government.

17.2.3 Expenditure Assignments should Match Tax Assignments

In order to avoid large fiscal imbalances, expenditure assignments should match the tax assignments at the corresponding levels. If they are unmatched, and lower level governments are likely to face chronic fiscal deficits, 'piggybacking' of the more elastic taxes of central governments (for example, of income taxes and/or value-added tax), or of overlapping assigned taxes, should be allowed. If, despite this strategy, fiscal imbalances continue for lower levels of government, alternative financing methods may have to be considered.

17.2.4 Revenue Sharing

Revenue sharing should relate to any central government tax that (a) is progressive and/or has a large built-in elasticity (for example, personal income tax or enterprise income tax), and (b) is less distortionary and is a large revenue source (for example, value-added tax or excise duties). *No economic principles exist that can help decide the exact proportions of the revenues of these taxes to be transferred to the revenue sharing pool.* Whatever the size of that pool, its distribution among different lower level governments, can be guided by either the '*needs' principle or the 'derivation'* principle. *Tax effort* made by the lower level government could be added as yet another factor in designing the revenue distribution formula. *'Fiscal capacity' and 'fiscal needs' of each jurisdiction must be estimated with a clear, quantifiable, and transparent formula, as far as possible.*

The foregoing principles are primarily derived from economic considerations. However, federal *fiscal relations in no country of the world are based upon economic considerations alone. It is, therefore, quite reasonable to expect that historical, political, social and other noneconomic considerations will continue to play an important role in the design of the federal fiscal structure of the country.* Federal fiscal relations in every country of the world will continue to *remain prisoners of history, traditions, institutions and politics. What can be expected, at best, is only an incremental change from the present reality rather than a very profound and fundamental change. Whatever the extent and form of change, one hopes that it will make the structure transparent, stable and predictable.*

17.3 CONSTITUTIONAL PROVISIONS IN INDIA

The Constitution describes India as a *Union of States*. There are twenty eight States and seven Union Territories making up the Indian Union. According to census of 2011, the total area is 3,280 thousand square kilometers and the total population is 120 crore. The Union Territories are under the administrative responsibility of the *Union Government* (also referred to as Government of India or Central Government). There are also *local authorities* (comprising municipalities, municipal corporations, *ZillaParishads*, Village Panchayats, etc.); these are however created under statute, and are under the administrative supervision of *State Governments*.

Financial relations between the Union and State Governments are governed by Constitutional provisions. There are three lists in the Constitution: *List I* mentions 97 categories of functions to be administered by the Union Government; these in the main, include defence, foreign affairs, banking, currency and coinage, etc. There are 66 categories of functions in *List II* to be administered by State Governments; these include in the main, public order police local government, public health, education, sanitation, agriculture, forests etc. *List III* is the *Concurrent* list; it enumerates 47 categories of functions, including social and economic planning. *Residuary power is reserved for the Union.* The Constitution describes separately the sources of resources (tax and non-tax revenues and borrowed funds) for Union and State Governments needed for discharging the administrative responsibilities entrusted to each.

The basic point of financial relations is the division of tax-sources between the Centre and the States. There should be no overlapping of tax jurisdiction, otherwise it will cause confusion and conflict. The distribution of taxes in India is more logical and thorough than in other federations. *The Concurrent list, does not include any sources of taxation. There is thus, an attempt to avoid all over-lapping.*

17.3.1 Taxing Powers

Article 268 to 281 of the Indian Constitution deal with the distribution of revenue between the Union and the States. In the Seventh Schedule items 82 to 92(a) in the *Union List* and items 45 to 63 in the *State List* refer to sources of taxation.

As regards the division of taxing power, taxes that have an inter-state base are under the legislative jurisdiction of the Union, while those having a local base came under the jurisdiction of the States. *The Union List contains 12 items of taxation. Though they are all in the Union List, it does not mean that the revenues from these accrue to the Union.*

The Constitution (Eightieth Amendment) Act, 2000 has altered the pattern of sharing of Central taxes between the Centre and the States in a fundamental way. Prior to this amendment, Taxes on Income other than agriculture income and Union duties of excise were shared with States under Articles 270 and 272 respectively. The Eightieth Amendment Act has substituted a new article for Article 270 and omitted the old Article 272. The new Article 270 provides as under:

"270(1) All taxes and duties referred to in the Union List, except the duties and taxes referred to in Articles 268 and 269, respectively, surcharge on taxes and duties referred to in Article 271 and any cess levied for specific purposes under any law made by Parliament shall be levied and collected by the Government of India and shall be distributed between the Union and the States."

The Finance Commission is now required to recommend such per centage of taxes or duties referred to in the new Article 270 that may be assigned to the States and also recommend the manner in which these may be distributed among the States. The main changes brought about by this amendment are as follows:

a) All Central taxes and duties, except those referred in Articles 268 and 269 respectively and surcharges and cesses, are to be shared between the Centre and the States.

b) Only States in which these taxes and duties are 'leviable in that year' are entitled to get a share in these taxes and duties.

c) A per centage of "net proceeds" of these taxes and duties as may be prescribed by the President by order after considering the recommendations of the Finance Commission is to be shared by States.

d) The per centage of "net proceeds" of these taxes and duties which is assigned to the States in any financial year shall not form part of the Consolidated Fund of India.

There are 19 items (as against 12 in the Union List) of which the most important are land revenue, duties of excise on alcoholic liquors and narcotic drugs, general sales tax and sales tax on motor spirit, stamps and registration, taxes on motor vehicles, entertainment taxes and electricity duties. Every State levies these taxes by law and collects and appropriate them. *There is no complication about States' taxes. There is no tax item in the Concurrent list, hence no question of common source of taxation. Article 274* of the Constitution protects the interest of the States. The purpose of this Article is to safeguard the financial interests of the States and prevent any possible inroads by the Centre into the revenue preserves of the States, by making it obligatory for the Union Government to take consent of the States through the President.

17.3.2 Grants-in-Aid

However, the Constitution expected that the Union Government would be left with surplus of funds in relation to the duties it had to discharge and the States would be deficient of resources in relation to their responsibilities. Hence, provisions were made for supplementing the resources of State Governments. Under Article 275(1) of the Constitution, such sums as Parliament may by law provide shall be given by the Union Government as grants-in-aid of the revenues of such States as Parliament may determine to be in need of assistance, and different sums may be fixed for different States. Further, such capital and recurring sums are to be paid as grants-in-aid by the Union Government as may be necessary to enable a State to meet the costs of such schemes of development as may be undertaken by the State with the approval of the Government of India for the purpose of promoting the welfare of the Scheduled Tribes in that State or raising the level of administration of the Scheduled Areas therein to that of the administration of the rest of the areas of that State. The actual amount of grants-in-aid payable each year are to be fixed by the Government after considering the recommendations of a *Finance Commission*. *Federalism is not only a unifying but also a levelling up force.* Federal grants-in-aid to the constituent units have been necessary and this exists in all federations. The simple reason behind this is that no system of distribution of financial sources between the federation and the units can possibly meet the needs of national development and social services which are usually the responsibility of the units. *By this device financially weaker States can be assisted in bettering their economic conditions.*The Constitution also allows the Union and State Governments to make *grants* for any public purpose (*Article 282*). Article 282 has been kept outside the purview of the Finance Commission. Presumably, it was meant to be used only in an emergency and not for the purpose of making any regular financial assistance.

17.3.3 Borrowings

Article 292 of the Constitution empowers the Government of India to borrow upon the security of the Consolidated Fund of India, i.e., the resources of the Union, subject only to such limitations as Parliament by law may impose. The Government of India can *borrow internally as well as externally*. States too are empowered to borrow under *Article 293.* According to this Article, a State cannot borrow outside India. The borrowing powers of the States are limited. Furthermore, if a State is indebted to the Union (as every State is now), it may not resort to further borrowing without the prior consent of the Central Government. However, the State Governments do not regard this provision as putting them unduly in the grip of the Union. It does not appear that the working of this Article has been detrimental to the interest of the State.

The scheme of distribution of resources and of functions just described makes the *State Governments inevitably dependent upon the Central financial transfers*, for which the balancing devices have already been provided. The Constitutional provisions have avoided rigidity in these balancing devices by leaving undefined the exact quantum of devolution and its distribution among the States. *Basically, the working of Centre-State financial relations can be seen from the overall result of financial operations on State finances.* The relationship can also be seen in terms of various elements of fiscal federalism such as *sharing of taxes, statutory and discretionary grants-in-aid, Central loans to States, performance under Article 269 and so on.*

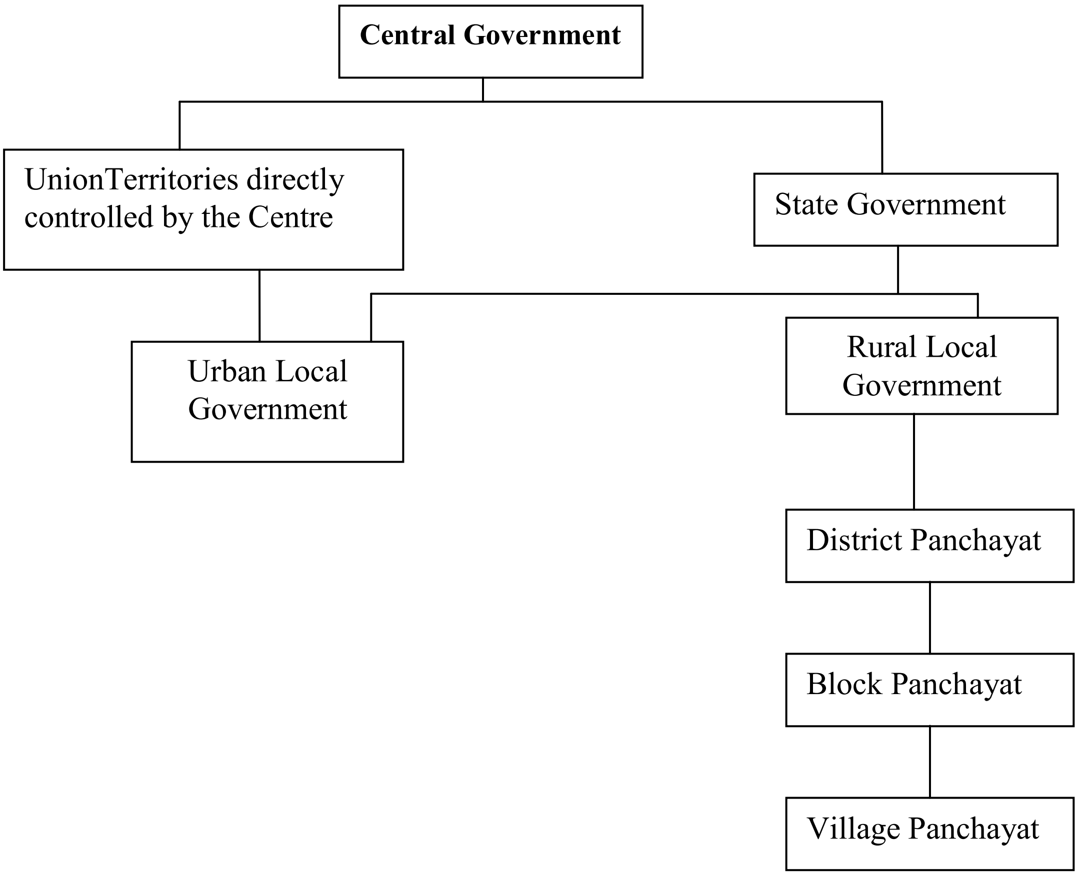
17.3.4 Constitutional Mandates for Local Governments

Of late, there is a swing towards fiscal federalism that promotes *democratic decentralisation*, which ideally should allow for an optimum equilibrium to be reached through effective citizen's engagement in expressing their preferences and local government's efficiency in meeting public demands. From a minuscule number of 4,841 *Lok Sabha, Rajya Sabha and state assembly members* representing the country, following the 73rd/74th Constitutional Amendments (CAs), India has today 2.5 lakh local governments, comprising over three million elected representatives which make the Indian federation the largest democratic country with the biggest representative base in the world. *The 73rd Constitutional Amendment designs a six layered federal polity starting from (i) gram sabha, through the (ii) gram panchayat, (iii) block and (iv) districtpanchayats (v) to the state and (vi) the union which is the apex tier*. The 74th Amendment incorporates the *urban local bodies (ULBs)* into this federal structure. *India is, thus, a multi-level federalism which can be broadly categorised as a functional co-operative federalism*.

Articles 243I and 243Y of the Constitution spell out the tasks of the *State Finance Commission (SFC)*. They are to review the financial position of local governments (LGs). The tasks are strictly patterned on the Union Finance Commission (UFC) as provided for in the Article 280 of the Constitution. Following the 73rd/74th Amendments, two sub-clauses were added to Article 280(3) which require the Union Finance Commission (UFC) to recommend measures needed to augment the consolidated fund of a state to supplement the resources of the Panchayat Raj Institutions (PRIs) and ULBs in the state "on the basis of the recommendations made by the Finance Commission of the State". Each of the State governments was required to pass legislation appointing PRIs and urban local bodies. It was stipulated that election to these local bodies should be held within the stipulated period. A separate list of 29 functions for rural local bodies and 18 items for urban local bodies were placed in schedules and are assigned to local governments to implement concurrently with the states. *The sources of finance were also identified for the local bodies*. Each State government was required to appoint a *State Finance Commission* to recommend tax devolution and grants to the local governments.

Federalism in India is characterised by constitutional demarcation of revenue and expenditure powers among the three levels of government. The institutional structure of multilevel provision of public services is shown in Table 17.1. In addition to *Finance Commission*, the *Planning Commission* also gives assistance to the States based on a formula determined by the National Development Council and *different central ministries* give specific purpose transfers to States. Below the States, there are *over a quarter million local governments*. Of this about 3000 are in urban areas and the remaining in rural areas. Rural local governments again are at three levels – *district*, *Taluk* (block) and *village* levels. The urban local governments consist of municipal corporations in large cities, municipalities in smaller cities and towns and in *notified area committees* in smaller towns. Each of the State governments has devolved powers to levy certain taxes and fees to village panchayats and urban local bodies. The States have also instituted a system of sharing of States' revenues and giving grants to urban and rural local bodies. In addition, a number of Central sector and centrally sponsored schemes are implemented by the local governments and the funds earmarked for the purpose are passed on to them from the State governments for implementation.

Table 17.1: Organisation of multilevel fiscal system in India.



Check Your Progress 1

1) Explain the principles of federal finance.

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2) What are the constitutional provisions relating to Centre-State financial relations.

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3) Explain the multilevel Fiscal System in India.

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17.4 FINANCE COMMISSION

The per centages of tax receipts to be given to the State Governments and the basis of their allocating among States are not specified in the Constitution. All these were left to be decided by a *Finance Commission*.

The Constitution *(Article 280)* provides for the appointment of a Finance Commission at the expiry of every fifth year or at such earlier time as the President considers necessary, to make recommendations to the President as to: (a) the distribution between the Union and States of the *net proceeds of taxes* which are to be, or may be divided between them (under Chapter I of Part XII of the Constitution) and the allocation between the States of the respective shares of such proceeds; (b) the principles which should govern the *grants-in-aid* of the revenues of the States out of the Consolidated Fund of India, and (c) *any other matter* referred to the Commission by the President in the interests of sound finance.

Thus, in terms of the Constitutional provision, a duly appointed *Finance Commission* is entrusted with the task of determining the amounts to be transferred to State Governments and of evolving principles for the distribution of such recommended amounts among State Governments. *The provision for the appointment of an independent body for such purposes is a unique feature of the Indian Constitution.* It is meant to provide a measure of assurance to State Governments that the entire problem of financial relationship between the Union Government and them would be conducted on the basis of a *periodical review and the principles suggested by such an independent body. The element of discretion or arbitrariness in giving financial assistance was meant to be kept under check as a result of this provision*.

The Constitution authorises the Finance Commission to determine their procedure. *The Finance Commission (Miscellaneous Provisions) Act, 1951* has conferred on the Commission all the powers of a Civil Court under the Code of Civil Procedure, 1908. In terms of the 1951 Act, the Commission is to be *headed by a person* selected from those who have had experience in public affairs, and the *four other members* are to be selected from among persons who: (a) are or have been, or are qualified to be appointed as judges of the High Court; or (b) have special knowledge of the finances and accounts of the Government; or (c) have had wide experience in financial matters and in administration; or (d) have special knowledge of economics. Every member of the Commission is to hold office for such period as may be provided for in the Order of the President appointing him but shall be eligible for reappointment.

The First Finance Commission was appointed in November 1951 submitted its report in December 1952 and thirteen Finance Commissions have reported so far. The following Table 17.2 presents details regarding years of establishment and reporting of various Finance Commissions.

Table 17.2: Chronology of Finance Commission.

Five-year Plan Period		Finance Commission and Period of Award	Year of Establishment	Year of Reporting	Name of Chairman
I	1951-56	First: 1952-57	November, 1951	December 1952	Shri.K.C.Neogi
II	1956-61	Second: 1957-62	June, 1956	September 1957	Shri K.Santhanam
III	1961-66	Third: 1962-66	December, 1960	December 1961	Shri. AK.Chanda
	Annual Plan, 1966-69	Fourth: 1966-69	May, 1964	August, 1965	Justice P.V.Rajamannar
IV	1969-74	Fifth: 1969-74	February, 1968	July, 1969	Shri. Mahavir Tyagi
V	1974-79	Sixth: 1974-79	June, 1972	October, 1973	Shri K. Brahmananda Reddi
VI	Annual Plan: 1979-80 1980-85	Seventh: 1979-84	June, 1977	October, 1978	Justice J.M.Shelat
VII	1985-90 Annual Plan: 1989-90	Eighth: 1984-89	June, 1982 First Report for 1989-90	April, 1984	Shri Y.B. Chavan
VIII	Annual Plan: 1990-92	Ninth: 1990-95 (Second Report)	June, 1987	July, 1988 December, 1989	Shri N.K.P. Salve
	1992-97	Tenth: 1995-2000	June, 1992	December, 1994	Shri K.C. Pant
IX	1997-2002	Eleventh: 2000-2005	July, 1998	June, 2000	Dr. A.M. Khusro
X	2002-2007	Twelfth: 2005-2010	November, 2002	November, 2004	Dr. C.Rangarajan
XI	2007-12	Thirteenth 2011-2015	November, 2007	December, 2009	Dr. Vijay Kelkar

Each Commission has taken about one to one and a half years to submit its final report. *The Finance Commission, performs a constitutional function of recommending the distribution of the "divisible pool"* of Union taxes between the Central and state governments. *The challenge is to divide fairly and efficiently.* The former requires an impartial assessment of the needs of a state, while the latter ensures that the commission does not end up perversely rewarding backwardness. *Efficiency also requires rewarding fiscal prudence*. Thus the share is not purely on the basis of tax collection, nor on state GDP, nor on population. *It is a judicious mix of all these factors and more.*

17.5 RECOMMENDATIONS OF THIRTEENTH FINANCE COMMISSION (THFC)

The UFC's task is defined by its terms of reference (TOR), which have been expanding in recent times. Although the primary function of the UFC as envisaged in the Constitution of India is to *correct vertical and horizontal imbalances*, ever-broadening TOR have required it to look into, among other things, the critical issues of macro-economic stability and fiscal restructuring by both the centre and the states. The Thirteenth Finance Commission (THFC), 2010 to 2015, had larger than usual TOR, which required it, apart from carrying out its primary task of resource sharing, to suggest measures for improving the output and outcome of government expenditure; to look into means of tackling climate change and environmental sustainability; and to assess the implications of the proposed *goods and services tax (GST)* on the finances of the centre and the states. The noticeable features of the THFC recommendations areas are follows:

1) Enhancing the vertical share of tax devolution from 30.5 per cent to 32 per cent.

2) A design for the GST and a compensation package linked to adherence to the proposed design.

3) A revised road map for fiscal consolidation and ensuring compliance to it by linking it to transfers.

4) Devolution of a specified share of central taxes to local bodies as grants.

5) A larger number of specific-purpose grants to address the issues defined in the TOR such as climate change, sustainable development, and improving the output and outcome of government expenditure.

One of the most significant recommendations is that on the sharing of resources from the divisible pool of taxes so that local bodies also benefit from the buoyancy of central revenues.

The following are some of the key recommendations of the Thirteenth Finance Commission (Also see Table 17.3 and 17.4).

- The share of States in net proceeds of shareable Central taxes shall be 32 per cent every year for the period of the award.
- Revenue accruing to a State is to be protected to the levels that would have accrued to it had service tax been a part of the shareable Central taxes, if the 88th Amendment to Constitution is notified and followed up by a legislation enabling States to levy service tax.
- Centre is to review the levy of cesses and surcharges with a view to reducing their share in its gross tax revenue.
- The indicative ceiling on overall transfers to States on revenue account may be set at 39.5 per cent of gross revenue receipts of the Centre.
- The Medium Term Fiscal Plan (MTFP) should be a statement of commitment rather than intent.

Table 17.3: Total transfers to States as per Thirteenth Finance Commission (2010-15).

(Rs. Crores)

I. Non-Special Category	**Share in Central Taxes and Duties**	**Total Grants-in-aid**	**Total Transfers**
1. Andhra Pradesh	1,00,616.0	13,532.3	1,14,148.3
2. Bihar	1,58,341.2	14,602.8	1,72,944.1
3. Chhattisgarh	35,825.2	6,175.5	42,999.7
4. Goa	3,857.8	516.2	4,374.0
5. Gujarat	44,107.1	9,682.9	53,789.9
6. Haryana	15,199.5	4,270.8	19,470.3
7. Jharkhand	40,640.3	7,238.4	47,878.6
8. Karnataka	62,774.9	11,601.4	74,376.3
9. Kerala	33,954.3	6,371.5	40,325.8
10. Madhya Pradesh	1,03,268.9	13,324.5	1,16,593.4
11. Maharashtra	75,406.9	16,302.8	91,709.8
12. Orissa	69,316.1	9,658.8	78,974.9
13. Punjab	20,146.4	5,540.3	25,686.6
14. Rajasthan	84,892.2	12,949.8	97,842.0
15. Tamil Nadu	72,070.4	11,366.9	83,437.3
16. Uttar Pradesh	2,85,397.1	26,742.9	3,12,140.0
17. West Bengal	1,05,358.6	12,638.7	1,17,997.2
II. Special Category			
1. Arunachal Pradesh	4,755.6	4,348.2	9,103.8
2. Assam	52,620.6	5,212.1	57,832.7
3. Himachal Pradesh	11,327.3	10,364.4	21,691.6
4. Jammu and Kashmir	20,182.7	20,255.9	40,438.7
5. Manipur	6,541.2	7,026.3	13,567.5
6. Meghalaya	5,918.5	3,923.9	9,842.4
7. Mizoram	3,901.3	4,904.0	8,805.3
8. Nagaland	4,552.9	9,191.3	13,744.2
9. Sikkim	3,466.8	1,058.8	4,525.7
10. Tripura	7,411.5	5,716.1	13,127.6
11. Uttarakhand	16,245.1	4,063.0	20,308.1
Total	**14,48,096.0**	**2,58,581.0**	**17,06,676.0**

Table 17.4 : Inter-se Shares of States

States	Share of all Shareable Taxes* (per cent)	Share of Service Tax (per cent)
Andhra Pradesh	6.937	7.047
Arunachal Pradesh	0.328	0.332
Assam	3.628	3.685
Bihar	10.917	11.089
Chhattisgarh	2.47	2.509
Goa	0.266	0.270
Gujarat	3.041	3.089
Haryana	1.048	1.064
Himachal Pradesh	0.781	0.793
Jammu & Kashmir	1.551	Nil
Jharkhand	2.802	2.846
Karnataka	4.328	4.397
Kerala	2.341	2.378
Madhya Pradesh	7.12	7.232
Maharashtra	5.199	5.281
Manipur	0.451	0.458
Meghalaya	0.408	0.415
Mizoram	0.269	0.273
Nagaland	0.314	0.318
Orissa	4.779	4.855
Punjab	1.389	1.411
Rajasthan	5.853	5.945
Sikkim	0.239	0.243
Tamil Nadu	4.969	5.047
Tripura	0.511	0.519
Uttar Pradesh	19.677	19.987
Uttarakhand	1.12	1.138
West Bengal	7.264	7.379

Source: Report of Thirteenth Finance Commission, Government of India, 2010

Note: Exclusive Service Eax

- New disclosures have been specified for the Budget/MTFP including on tax expenditure, public-private partnership liabilities and the details of variables underlying receipts and expenditure projections.
- The Fiscal Responsibility and Budget Management (FRBM) Act needs to specify the nature of shocks that would require relation of the targets thereunder.

- States are expected to be able to get back to their fiscal correction path by 2011-12 and amend their FRBM Acts to the effect.
- State Governments are to be eligible for the general performance and special area performance grants only if they comply with the prescribed stipulation in terms of grants to local bodies.
- The National Calamity Contingency Fund (NCCF) should be merged with the National Disaster Response Fund (NDRF) and the Calamity Relief Fund (CRF) with the State Disaster Response Funds (SDRFs) of the respective States.
- A total non-plan revenue grant of Rs. 51,800 crore is recommended over the award period for eight States. A performance grant of Rs. 1,500 crore is recommended for three special category States that have graduated from a non-Plan revenue deficit situation.
- An amount of Rs. 19,930 crore has been recommended as grant for maintenance of roads and bridges for four years (2011-12 to 2014-15).
- An amount of Rs. 24,068 crore has been recommended as grant for elementary education.
- An amount of Rs. 27,945 crore has been recommended for State-specific needs.
- Amounts of Rs. 5,000 crore each as forest, renewable energy, and water sector-management grants have been recommended.
- A total sum of Rs. 3,18,581 crore has been recommended for the award period as grants-in-aid to States.

Source: Report of Thirteenth Finance Commission.

17.5.1 Critique of recommendations of the 13th Finance Commission

The 13th Finance Commission (THFC) has broken new ground *by building incentives into the transfer mechanism*. Most of its key recommendations have been accepted by the government. The States stand to get a larger share of central taxes than before. Apart from increasing their share of the divisible pool of tax revenues from 30.5 per cent to 32 per cent, the Commission has proposed an additional 2-2.5 per cent for local bodies. *Grants-in-aid to States are projected at Rs.315,581 crore over the next five years* (2010-15). *The shared taxes and central grants together* will take the overall devolution to *States from 37.6 per cent to 39 per cent of the central divisible tax revenues*. The THFC does not want any inconsistency between the amounts released to the States and the per centage share in the net tax revenues recommended by it. The States have been impressed upon to comply with the norms set by the Commission if they are to avail themselves of the full benefit of certain transfers. *It has called upon the Centre not to lean heavily on surcharges and cesses since collections under these heads are not shared with the States.* The transfer formula, which emphasises fiscal discipline on the part of the States, has been so worked out that non-Plan revenue grants will be made available to fewer States. The system of *incentive-based transfer* seeks to reward States that comply with the norms prescribed by the THFC. However, given the political sensitivity of some of these proposals, the accent is on achieving incremental gains for fiscal federalism.

Dr. M. Govinda Rao holds that the nine-point conditionality package proposed by the TFC for the release of performance grants is the best way to ensure result-based accountability, which, in turn, will lead to vibrant local self-governments. In addition, the commission has also put in place very strong performance incentives. A full 40 per cent of the total grant will be based on state governments fulfilling a set of *nine conditions*. Given the magnitude of our problems, grants from the Thirteenth Finance Commission will make a difference only at the margin. But such grants are a signal to states that if they are willing to redirect their energies in certain desired directions, they will find support from the FC. They are a signal future FCs can build upon as well.

There is no doubt that the THFC's approach has been different from that of earlier UFCs, be it with regard to horizontal distribution, the revised road map for fiscal consolidation, the design of grants to local bodies, or various other specific-purpose transfers. Despite various shortcomings, many of the recommendations, if implemented in the right spirit, will benefit the management of public finances in the country. A major strength is the effort that has been made by the THFC to move towards a more direct measure of fiscal capacity than per capita income and its use in the horizontal distribution formula. However, the large number of specific-purpose transfers tethered to conditionalities recommended by the THFC seriously undermines the very idea of fiscally autonomous lower levels of government in a multi-level fiscal system.

But, as the report of the Thirteenth Finance Commission (THFC) observes, there are three additional challenges: Central revenue now increasingly includes a non-shareable portion (e.g. sale of 3G spectrum, various cesses and surcharges), putting states at a disadvantage; secondly, there is increasing mismatch between fiscal capacity and fiscal needs of various states; and thirdly, with increased urbanisation, the obligations of the third tier of government has been rapidly increasing without any meaningful or automatic devolution to the third tier. The increased salience of the state of local governments in the life of a citizen is obvious, given that the states' share constitutes 60 per cent of the combined expenditure of States and the Centre. The report of the THFC provides a clear articulation of the issues and approach followed, and the consideration that it has used in recommending the fiscal transfers. For example, in determining vertical devolution, it explicitly recognises greater fiscal needs of the states and the need to insure them against regional shocks.

The Commission has earmarked Rs.50,000 crore of central grants to compensate States for any revenue shortfall on account of switching to the Goods and Services Tax. The compensation will be available even if there is no shortfall, provided the State concerned adopts the GST model the THFC has prepared. This, however, is going to prove contentious. The empowered committee of State Finance Ministers has worked out its own model wherein tax rates are higher than in the THFC's version. The States want a much higher share of the divisible tax receipts to be transferred to them. Nor will they be happy that the Commission has remained silent on their long standing demands, namely decision-making powers in respect of centrally-sponsored schemes. The THFC's recommendation to impose a ceiling on total government debt is timely. The government has accepted its suggestion to put a cap on the combined debt of the Centre and the States at 48 per cent of the GDP that is to be achieved by 2014-15.

17.5.2 Recommendations and Local Governments

Unlike its predecessors, the THFC upheld the view that local governments should be supported through a predictable and buoyant source of revenue substantially higher than in the past. Indeed, the most important recommendation of THFC is its decision to relate grants to local governments to a share in the divisible pool of the union tax revenue. In this way, the THFC has made local governments an integral part of the public finance of the country. They are now recognised as entities that are linked to the union tax revenue pool almost like the state governments. Not just that, in absolute as well as relative terms, the local government grant recommended by the THFC could be considered substantial, as is shown in Table 17.5.

Table 17.5: Grant allocation of different Commissions to Local Governments.

Commission	Total Grant (Rs. In crore)	per cent to Divisible Pool
TFC (1995-2000)	5,380.93	1.38
EFC (2000-2005)	10,000	0.78
TWFC (2005-2010)	25,000	1.24
THFC (2010-2015)	87,519	2.28*
*De facto only 1.93 per cent.		

Source: THFC Report

However, the local bodies will be beneficiaries of this recommendation only if its implementation is based on actual revenues of the central government instead of what has been projected in the THFC Report. The increase from the XII FC's Rs. 25,000 crore to the XIII FC's Rs. 87,519 crore is more than 3.5 times. It is important that the THFC goes beyond the usual official pontifications to carry the decentralisation process forward. The local grant recommended by the THFC has two components, a basic component and a performance-based component. The performance grant allocated to each state is subject to them fulfilling a nine-point conditionality package. This should help promote results-based accountability. All of them are important and desirable measures to incentivise the states to carry on and make decentralised governance durable. The THFC vis-à-vis the third tier, despite several sins of commission and omission, seems to have walked somewhat differently from its predecessors. *Local governments are recognised as entities entitled to a share in the union tax pool is something to rejoice about.*

Check Your Progress 2

1) What is Finance Commission?

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2) What is the need for a Finance Commission?

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3) What is the basis for recommendation of the Finance Commissions on transfers?

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17.6 CHALLENGES POSED TO FISCAL FEDERALISM

Fiscal transfers involve sharing of Central taxes and grants with the States. In India, *the key institutional arrangement that has guided fiscal federalism has been the Finance Commission*. Over time, the Indian system has also evolved in a manner which is inconsistent with the principle of equalisation. Taking the transfers done by the 12^{th} and 13^{th} Finance Commissions, it has also been shown that on certain assumptions, 88-90 per cent of the equalisation of fiscal capacity was achieved in the scheme of fiscal transfers. At the central level, there is a need to focus more closely on the primary function, which is to deliver and implement a prudent fiscal policy in consonance with the needs of overall development policy making. In this matter, institutions charged with designing the overall development policy framework of the country particularly, the *Planning Commission*, should reflect on and address these issues. Fiscal interventions to correct against real and perceived disparities generated by the growth process can only address the symptoms and alleviate the consequences of not securing inclusive growth in all its multiple dimensions.

17.6.1 Role of Planning Commission

The Planning Commission is an important body which has an important place in Centre-State financial relations. The *discretionary grants* made under the recommendations of the Planning Commission have been much greater than the grants given under Article 275(1). As the settlement of the amounts of these grants and later their actual issue depended upon detailed discussions between the State Governments, the Planning Commission and the Central departments concerned, *the financial autonomy of the State was being steadily encroached*. Another feature of these grants is that they are available only for the plan period at the end of which they become committed expenditure for which the States are exclusively responsible. Naturally, they approach the Finance Commission and try to get a greater share of revenue and larger grants. This constitutes a vicious circle.

This process was greatly intensified by the *loans* issued by the Centre. But as a matter of fact a considerable portion of these loans have been spent for purposes which do not yield any income, and their burden of interest and repayment fall on the State revenues. From this, it will be clear that *as a result of planning the federal financial relations have become seriously distorted. Dr. P.V. Rajamannar*, Chairman of the Fourth FC, pointed out that *the setting up of the Planning Commission has in practice restricted the scope and functions of the Finance Commission*. It is also suggested that a *permanent Finance Commission is necessary* condition for a satisfactory arrangement, for general transfers to the States. *The scope for discretionary transfers could be minimised if the states are left by the Commissions in a position where they do not have to look to the Centre for help even in trifling matters.* Further, the purview of the Finance Commission should be enlarged to include *all non-Plan financial transfers both on revenue and capital accounts*. By implication, there will be little room for discretionary transfers on non-Plan account. However, the need for *greater co-ordination between the two commissions is also emphasised.*The panel, headed by C. Rangarajan, was set up by the Planning Commission in 2010 to suggest measures for efficient management of public expenditure. The panel has sought abolition of the present system of classifying government expenditure into Plan and non-Plan, saying allocations should be the primary domain of the finance ministry. The Planning Commission in its *Eleventh Five-Year Plan (2007-12)* document had itself suggested doing away with the *'illogical and dysfunctional'* distinction of Plan and non-Plan expenditure. 'Plan' expenditure is spent on productive asset creation through central government-sponsored programmes and flagship schemes, while 'non-Plan' refers to all other expenditures, such as those on defence, subsidies and interest payments, including expenditure on establishment and maintenance activities, such as salaries. The plan body-acting as the government's think-tank should primarily focus on growth prospects and broad economic and policy framework.

Devolution of resources from the union to the states may be placed under *three* categories: (i) transfers based on the recommendations of the *Finance Commission*; (ii) transfers by way of assistance for execution of the plans recommended by the *Planning Commission*, including centrally sponsored schemes; and (iii) others consisting of small savings, loans, assistance for natural calamities, etc., canalised through the *Union Finance Ministry*. Resources flowing from the union government to the states through other channels, principally the Planning Commission, over two-thirds of the revenue received by the states from the centre is still governed by the dispensation of the FC. Bulk of central assistance (grants and loans) is decided according to prescribed criteria, *population being a major criterion, backwardness of the states, other special problems* also being other important criteria. This is done under what is known as the *Gadgil Formula* or *modified Gadgil Formula*. As *Sarkaria Commission* has observed: "It is not humanly possible to derive foolproof formula which would make the totality of central transfers confirm fully to the ideal of automatic and free-from interference devolution. Some amount of flexibility and room for subjective judgement will have to be left to the concerned institutions to deal with the specific situations as they arise. *What is really important is that the institutions involved should function in a fair and non-partisan manner and take decision with due discernment and expertise which are implicitly acceptable to the states*".

17.6.2 Trend towards Decentralisation

In its functioning it is considered to be a quasi-federal system because of the very high concentration of powers with the central government. Recent economic and political events, however, have paved the way for a greater degree of decentralisation. Fiscal decentralisation is only the first step towards achieving better living standards. Its effectiveness can be improved through greater fiscal autonomy to panchayats and public participation to make PRIs' fiscal operations transparent, responsible and accountable. *The PRIs have indeed taken root. But to flourish into strong governments they need substantial nourishment in the form of better institutional capacity, larger resources and, most importantly, higher authority to spend them on improving local services*. In the economic sphere, the transition to a market oriented liberalisation and more open economic environment has necessitated a greater degree of fiscal decentralisation. On the *political front*, factors such as the *end to single party rule*, the emergence of *coalition* of parties in power at the centre and increasing importance of regional parties in the political affairs of the country have provided a favourable environment for decentralised governance. Federal Constitutions everywhere are characterised by an imbalance between the functional responsibilities and the financial powers at different levels of government. Although the shareable pool has been enlarged, the relative revenue accruals of the Centre and the States have not seen any major change. There has been a long-term stability in the shares of the Centre and the States in the combined tax revenues.

17.6.3 Inter-State Disparity

What will be the impact of the proposed *Goods and Services Tax (GST)* on the vertical imbalance? Naturally, this would depend on the pattern and the rate of the GST that will be put in place. The fiscal capacities of the States as measured by the per capita income continue to vary widely even after six decades of federal financial devolution and economic planning. The disparity between the highest and the lowest is in the ratio of four-to-one. As a consequence, there is an uneven provision of public services across different States, including *merit goods* such as education and health services. This inter-State inequality on account of differences in fiscal capacity is further compounded by two factors. The States with low income levels have a large population. It means they have to transfer huge additional resources if there has to be any impact at all. Further, some States have certain *cost disabilities* because of the vastness of the area or other geographical and climatic factors. *An explicit equalisation methodology is yet to be developed to tackle this systemic problem*.

It is a matter of great potential concern that increases in disparities in growth should not lead to demonstrable differences in access to opportunities and public goods. This is not an issue which can be tackled using the limited instruments of inter-governmental public finance available to the *Finance Commission*. It is a wider policy issue on which we feel the institutions charged with designing the overall development policy framework of the country, particularly the *Planning Commission*, should reflect on and address. Fiscal interventions to correct against real and perceived disparities generated by the growth process can only address the symptoms and alleviate the consequences of not securing inclusive growth in all its multiple dimensions.

There is an urgent need for reform of intergovernmental fiscal arrangements for balanced regional development. A number of natural resource-abundant states in India are lagging behind in development because of severe fiscal disabilities which have not been offset by the transfers from the centre. *Intergovernmental transfer systems need to be reformed to correct the regional imbalances in development*. Thus, there is a dire need for coordination between various agencies making transfers from the centre.

Table 17.6 : Transfer of resources from the Centre to the States.

	Receipts of the Central Government				Resources transferred to the States							
Year	Revenue Receipts including States share in taxes	Capital receipts (excld. repay-ment of loans)	Budgetary deficit/ draw down of cash balance of Central Govt.	Total receipts Central Govt. (2+3+4)	Shares of States in Central taxes	Grants from the Centre to States & UTs	Loans (gross) from the Centre to States & UTs	Repayme nt of loans by States & UTs	Gross transfers to States (6+7+8+9)	Net transfers to States (6+7+8+9)	(11) as % of 5	
1	2	3	4	5	6	7	8	9	10	11	12	
1970-71	4097	1124	285	5506	755	612	1028	658	2395	1737	31.5	
1971-72	4972	1207	519	6698	944	891	1209	854	3044	2190	32.7	
1972-73	5645	1240	869	7754	1067	947	1541	655	3555	2900	37.4	(40.6)
1973-74	6247	1504	328	8079	1174	952	1576	969	3702	2733	33.8	
1974-75	7782	1583	721	10086	1224	1060	1093	507	3377	2870	28.5	
1975-76	9674	2662	366	12702	1599	1289	1296	746	4184	3438	27.1	
1976-77	10429	3671	131	14231	1690	1622	1481	656	4793	4137	29.1	
1977-78	11590	2747	933	15270	1798	1961	1956	881	5715	4834	31.7	
1978-79	13197	4203	951	18351	1957	2635	2769	892	7361	6469	35.3	(37.2)
1979-80	14746	3959	2433	21138	3406	2411	2762	844	8579	7735	36.6	
1980-81	16621	6309	2577	25507	3792	2769	3146	917	9734	8817	34.6	
1981-82	19848	7276	1392	28516	4274	2855	3460	1264	10589	9325	32.7	
1982-83	22730	9111	1655	33496	4639	3635	4298	1444	12572	11128	33.2	(36.5)
1983-84	25739	12116	1417	39272	5246	4402	5059	1841	14707	12766	32.5	(33.1)
1984-85	30161	14041	3745	47947	5777	5220	6117	2454	17174	14720	30.7	
1985-86	36698	17441	4937	59076	7491	7067	8473	2739	23031	20292	34.3	(45.1)
1986-87	42730	19215	8261	70206	6476	7744	7695	2909	24115	21206	30.2	
1987-88	48001	22458	5816	76275	9598	9210	9414	3563	28222	24659	32.3	
1988-89	55721	26365	5642	87728	10669	10076	10046	3316	30791	27475	31.3	
1989-90	67196	26630	10592	104420	13232	8713	11311	3356	33256	29900	28.6	
1990-91	71408	34542	11347	117297	14535	13293	14522	4653	42350	37697	32.1	
1991-92	85460	35018	6855	127333	17197	16805	13199	3781	46201	42420	33.3	
1992-93	97092	36088	12312	145492	20522	17943	13335	4639	51800	47161	32.4	
1993-94	100840	54946	10960	166746	22241	20956	15263	5192	58460	53288	31.9	
1994-95	119221	62362	961	182544	24840	20297	18807	4494	63944	59450	32.6	
1995-96	143062	54428	9807	207297	29285	21577	19627	4790	70489	65699	31.7	
1996-97	165532	54004	13154	232690	35061	23545	24031	6459	82637	76178	32.7	
1997-98	190223	7828	66288	264339	43548	30452	14729	7125	88729	81604	30.9	
1998-99	201503	101536	–144	302895	39145	25844	15935	9475	80924	71449	23.6	
1999-2000	242527	121944	–13817	350654	43418	29837	21462	9791	94780	84989	24.2	
2000-01	256859	113359	6911	377129	51945	37684	20490	11691	110110	98428	26.1	
2001-02	274018	82078	62923	419019	53628	42489	24528	14002	120545	106543	25.4	
2002-03	307940	124918	10095	442953	56841	43167	28231	30303	128239	97936	22.1	
2003-04	355212	99852	4796	459860	67366	48430	25449	61179	141245	80066	17.4	
2004-05	400982	161676	63819	626477	80159	53873	24806	59737	158838	99101	15.8	
2005-06	462186	83760	–64850	481096	95887	73677	5654	8799	175218	166419	34.6	
2006-07	571012	104913	–25930	649995	122330	90185	4970	15338	217485	202147	31.1	
2007-08	721116	160586	-310	881392	153600	108377	6706	8290	268683	260393	29.5	
2008-09	724837	185584	–152193	758228	161979	124090	7115	2711	293184	290473	38.3	
2009-10 (R.E.)	774796	461919	9485	1246202	167992	140789	8913	3816	317694	313878	25.2	
2010-11 (B.E.)	**915530**	**421409**	**0**	**1336939**	**212557**	**154605**	**8252**	**4924**	**375414**	**370490**	**27.7**	

Note: 1. Figures in brackets represent the ratios after adding the loans given to the States for clearing their overdrafts/deficits with the R.B.I. to the total receips of the Central Govrnment as well as to the gross transfer to the States.

2. Article 270 of the constitution, was retrospectively amended with effect from 1st April, 1996. Under the provision of the Constitution (80th Amendment) Act, 2000, prescribed share of States in the net proceeds of Central taxes and duties does not form part of the Consolidated Fund of India.

The relative position of transfer of funds from the Centre by Finance Commission and Planning Commission including Union ministries are given in Table 17.6. Column 6 indicate share of States in Central Taxes whereas Column 7 indicates Grants which includes Grants-in-Aid recommended by the Finance Commission as well as the Planning Commission. Column 8 indicates the loans given through Planning Commission to the States and UTs.

The service delivery mechanism of local bodies throughout the country is grossly inadequate. This is due to a gross shortage of funds with urban local bodies. Despite fiscal reforms, there are serious shortcomings in the resource transfer mechanism from the centre to the states. *The states are also not making enough* *of an effort to mobilise their own resources. There is an urgent need for institutional and governance reforms, if the issue of inter-regional inequity is to be seriously addressed.*

Check Your Progress 3

1) Why is Planning Commission considered a distortion in Fiscal Federalism?

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2) Identify the major issues in union-state financial relations.

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3) How are the recommendations of Thirteenth Finance Commission different from the previous one?

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17.7 LET US SUM UP

The Constitution (Eightieth Amendment) Act, 2000 has altered the pattern of sharing of Central taxes between the Centre and the States in a fundamental way. The Finance Commission is now required to recommend such per centage of taxes or duties referred to in the new Article 270 that may be assigned to the States and also recommend the manner in which these may be distributed among the States. It needs to be added that for evolving a satisfactory institutional arrangement to take care of the problem in centre state financial relations, and correcting the deficiencies which have come to notice, one has to look beyond the constitutional provisions as they exist at the moment. *Perhaps the autonomy and independence of the lower levels of government will always be limited, because economic policies designed by the central government often have serious implications for the budgets of provincial and local governments*. The federal fiscal structure must be able to deal with the budgetary consequences of central government policies for the provincial and local governments and vice versa. Therefore, if the institutions which have evolved over the years and come to play an important role in the nation's economic development (like the Planning Commission and the NDC) are found lacking in constitutional sanction, it may not be right to reject all that has been done by them as illegal but to find ways in which their role can be defined with some clarity and regulated by law.

The Finance Commission (FC) constitutes a pillar of India's federal structure, mediating in the sharing of central revenues with the states and the inter se distribution among the constituents of the union. Moreover, the THFC has sought to define the approach needed to address the issues that would help to correct aberrations that have set in the course of time. Though its efforts do not go very far in charting a new path, the report tries to break away from the past in important ways, which may have a profound impact on the finances of the government at all levels in the coming years.

17.8 EXERCISES

1) State in brief the principles of federal finance. How far these principles are adhered to in the Centre-State financial relations in India?
2) What is Finance Commission? How is it different from the Planning Commission? Make an evaluation of the recommendations of the Thirteenth Finance Commission.
3) "States should have their due share in responsibilities as well as rights". In the light of this statement, bring out the important issues in Centre-State relations in India.
4) "The question of Centre-State relations has become the focal point of discussion for a number of reasons". Comment on this statement and point out the reasons for conflict between Centre and States.

17.9 KEY WORDS

Centrally sponsored schemes: Schemes initiated by the Centre but implemented by the States. The extent of Central Assistance to such schemes is normally around 50 per cent of the total outlay. The expenditure on these schemes, in the nature of conditional grants by the centre to the states, has assumed a dimension much beyond that sanctioned by the 1969 National Development Council (NDC) resolution which laid down a ceiling on them of $1/6^{th}$ or $1/7^{th}$ (i.e. 14.17 per cent) of total plan assistance to the States.

Gadgil Formula : A formula of plan assistance to States adopted since the Fourth Plan (1969-74) which provided that distribution of plan assistance to the States should take five elements into account. This is named after Professor D.R. Gadgil, the then Vice-Chairman of the Planning Commission.

Gap-filling Approach : Assistance to States for rectifying imbalances – vertical or horizontal – is essentially in the nature of a device to bridge a budgetary gap. However, the phrase 'gap-filling approach' epitomises the practice of Finance Commissions of recommending grants-in-aid to States on the basis of estimated gap between forecasted expenditure and receipts (inclusive of tax shares) on revenue account.

Horizontal Imbalance, i.e., : The imbalance between the expenditure

Horizontal Federal Fiscal Imbalance requirements and own revenues of different constituent units of a federation mainly on account of differences in fiscal capacities arising out of regional economic disparities. Rectifying horizontal imbalance means promoting regional equalisation.

Inter-State Council : In 1990, the Government took the step of invoking the constitutional provision (Article 263) and forming an Inter-State Council charged with the duty of : "(a) inquiring into and advising upon disputes which may have arisen between States; (b) investigating and discussing subjects in which some or all of the States or the Union and one or more of the States, have a common interest; or (c) making recommendations upon any such subject". The idea is to provide an institutional mechanism through which a more integrated approach to Centre-State relations could emerge. There would be three meetings of council on a regular basis every year, and that all questions coming up for discussion will be decided by consensus. The council will be a recommendatory body.

Statutory Transfer : Transfer of resources from Centre to States under tax devolution and Article 275 grants-in-aid at the recommendations of the Finance Commission.

Tax Effort : Judged from ratio of tax revenue to State income.

Vertical Imbalance, i.e., Vertical Federal Fiscal Imbalance : The non-correspondence between the expenditure requirements of the functions and the extent of revenue raised from the sources assigned to the unit governments as compared to the national government in a federation.

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17.11 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

i) See Section 17.2

ii) See Section 17.3

iii) See Sub-section 17.3.4

Check Your Progress 2

i) See Section 17.4

ii) See Section 17.4 relevant portions

iii) The Finance Commission takes into account various parameters for deciding its awards.

The TFC, for instance, assigned specific weights to population, income distance, poverty, geographic area and tax efforts of the states to decide the quantum of taxes that should be transferred to the states. The previous panel had considered infrastructure development also as one of the parameters. New panels can change the weight assigned to each of the parameter given changes that take place during a five year period of the award.

Check Your Progress 3

i) See Sub-section 17.6.1

ii) See Section 17.6

iii) See Sub-section 17.5.1