EXECUTIVE SUMMARY: ISSUES

ISSUES FOR THE 13TH FINANCE COMMISSION: WELCOME TO THE GREY WORLD OF TRADE OFFS!

- It can be seen that some of **the tasks added to the menu of things to be done by the FCs seem to be of a temporary or ad-hoc/ contingent nature**. Using the same instrumentality for solving multiple problems may be convenient but may lead to problems of coherence and accountability.
- **It is to be recommended that the FCs ought to be set up (in the core sense) for a period of five years and not only give out a one time award but also monitor the performance and dynamically release funds overtime**. The point about 'monitoring' the fiscal reforms program and that of 'linking the grants devolved to implementation' is vital to the success of the translating the recommendations made by the FC into practice.
- **The practice of using the 1971 population was initiated some time ago (4th FC) needs to be changed**. Given that population has been used as an indicator of 'need/ adequacy' of a state, denying resources to the state on this front would lead to a distortion in the allocation pattern. Since use of 1971 population is a part of the TOR of the present Commission, it may not pot possible for the present Commission to go against it and use 2001 population but it is certainly within the purview of the Commission to recommend such a change.
- Some preliminary and general points about the task ahead of 13th FC:
    1. The FC has been asked to estimate the requirements of the Center. **This is crucial and something that has not been attempted *explicitly* by the earlier finance commissions**.
    2. The FC is to look at the ecology and climate change issues. **This is a case where the underlying issue is of great importance however, whether it should be looked at by the FC is a moot point**.
    3. Provision of adequate maintenance grants for committed plan schemes is a very important issue in the TOR. **This again brings into sharp focus the need to review the artificial dichotomies of plan/non-plan and revenue/capital entities.**
    4. As regards the *normative approach* followed by earlier FCs deserves to be commended. However, **it needs to be checked out whether the effort really is worth it in terms of results**. Perhaps even more sophistication in working out these norms is called for.
- Inclusion is rightly underlined in all policy pronouncements. This implies, greater weight needs to be to be given to health and education in a targeted and performance based manner. However, it is crucial that the growth (even when somewhat exclusionary in character) has to be sustained, with the further implication that the design of **any policy strategy must have incentive compatibility meaningfully as its cornerstone.**

- The current political scenario as a biting constraint has to be firmly kept in mind. **The autonomy will perforce be required to be circumscribed by observable 'good conduct' by the states**. The implication is that **the margin of bargain in the non-formula based transfers will be up for grabs and be available on purely party political expediencies.**
- The fiscal situation of the states presents a different (improved) picture as compared to the one that presented itself at the onset of the 12th FC largely due to growth dividend. There are some problems though, **the debt, (outstanding liabilities, to use the RBI nomenclature) has increased by around 9 percentage points from around 31 to around 40%**. This is worrisome and the 13th FC clearly has its work cut out. **The implications (of revenue deficit cap) for expenditures on the crucial sectors of health and education (both essentially state subjects) will require to be watched closely**.
- The spirit of 73rd and 74th Constitutional Amendments required simultaneous transfer of functions as well as empowerment of the local governments. This unfortunately has not happened. It is by now well-known that the State Finance Commissions (SFCs) are set up – as constitutionally mandated – but then the awards are all but forgotten. **The non-synchronic setting up of SFCs and non-uniform treatment by different state governments has meant that they are not useful as providers of inputs to the Central Finance Commissions**. **The trick lies in linking 'agent-purposive' transfers with observable indicators amounting to a sort of administrative arm-twisting**.
- Great level of effective effort at capacity building (training and absorptive capacity) and reforms (process reengineering) are required. But there is good argument in favor of **just devolving funds with implicit faith, that the capacity will be created.** While recognizing the need and the efforts that need to be taken for capacity building, it is not necessary to treat it as an *essential prerequisite*. This would require well funded institution building and financing such a thing will be well worth looking into by the FC.
- The time has come to move from macro-level indicators to **design parameters at micro level**. The quality of expenditure and delivery needs to be vetted through an autonomous well funded agency. Also an effort has to be made to compute the normative need of local bodies just as the earlier FC had done in the case of States. Perhaps the **13th FC needs to facilitate setting up of institutions (monitoring observatories/ data warehouses) afresh or help create them virtually by culling the elements from the existing ones (research institutes/universities).**
- The non-synchronous temporal tenures of the two commissions will lead to several problems and issues. The prevailing practice of treating Plan and Non-Plan requirements of the states by the Planning Commission and the Finance Commission has led to the inability to take a coordinated and holistic view. ***The Finance commission will have to put up a strong fight for the territory that is in danger of being encroached upon***. This is important since, the politically weighted Planning Commission recommendations have implications in the domain of concern of the FC.

- The current economic ethos clearly indicates that efficiency in the form of incentive compatibility (IC) in contracts/relations must assume primacy. **Given the political economy considerations however, it may be more realistic to pursue one sided IC System**, i.e., where we ignore the penal clause. It is important to remember that application of this principle presumes the existence of 'competitive equality' in terms of capacities. A proper policy mix has to be evolved to bring about equalization in the **dynamic sense** (and in terms of both stocks and flows) so that over a period there is a convergence.
- The weight assigned to the **'distance' criterion** needs to be reduced. In order to push for a greater space for efficiency whilst keeping in view equity and adequacy, it may be prudent to get back the recently discarded '**inverse distance**' criterion. A more radical suggestion will be to take the cause of decentralization seriously and treat district as a primary unit for administration, use the **distance criterion at the level of district level income**. This is pertinent since the macro level caps (on say the revenue deficits) lead to less than optimal expenditure on public goods in the poorer parts of the state.
- There is a perception that states and the lower governments are unable to competently discharge the functions assigned to them. This has led to – amongst other things – allocation being altered so as to make the funds for the program directly or on shared basis. Over the past few FCs, the share of transfers as a proportion of the total transfers has shown a monotonic increase. Given that constraints can be imposed only on the transfer component rather than the statutory tax sharing one, it is but natural that this component will increase. **The trick here is to have a self binding commitment in terms of upper bound on the proportion to be so disbursed and then work in as detailed a way to tie the transfers to 'good governance' articulated in observable indicators.**
- In case of GST, the **13th FC has to apply itself seriously and scientifically to study (in a scenario framework) the revenue implications of different reasonable rates at the central and state levels and come up with ceilings and floors (especially for the states). Implications will also have to be worked out about the extent to which the hands of the state governments can be tied (thereby reducing their autonomy).**
- The current growth is essentially driven by urban agglomerations. The FC must also do its bit so that ***an act of omission on its part does not lead to killing the golden goose!*** Such transfers to the local bodies in the areas **must be fully incentive-compatible, and they must meet the rigorous standards of rationalization of user fees, demand recovery and expenditure efficiency.**
- Two of the important issues that should have found an explicit place in the TOR of the 13th FC are the impact of the **Sixth Pay Commission** and **Royalties** payable to the States. **In the name of fairness, it is essential that proper compensation be paid to the States on count of natural resources**.
- Finally, to return to a familiar theme of **governance**, in all that FC does, even more important than the resources, will be the ability to **design transfers within an operational framework of good governance**. 'Once the *wholesale reforms* by way of prerequisites have been accomplished, what is important is to get urgently into the business of reform agenda concerned with the **micro-design**'.

ISSUES FOR THE 13TH FINANCE COMMISSION: WELCOME TO THE GREY WORLD OF TRADE OFFS![ℑ]

Shallow people demand variety, but I have been
writing the same story all my life;
Every time trying to cut nearer the aching nerve.
--- Strindberg

I. Introduction

With the regularity of the proverbial 'rainy season', the Presidential Order constituting the 13th Central Finance Commission has been issued. Whilst the seasons have somewhat lost their regularity – what with ecological and climate change (which is a part of 13th FC's ToR) – it is to the credit of the strength of Indian democracy and the sanctity of her Constitution that its writ is strictly followed. It is also a sign of maturing democracy that it is – along with other events like the Central Budget – not accompanied with much fanfare, but rather treated as a routine affair, as a part of the *process*! The 13th FC has an advantage as well as a challenging task. Advantage, because it is able to stand on the shoulders of the commissions that have gone by, a challenge because it has to measure up to and indeed try to better, especially the twelfth finance commission report, which to my mind is in the nature of *locus classicus*!

This paper has been organized in six sections, including this one. In the next section I will provide a brief backdrop of the ToRs of the earlier finance commissions, in the third section I will argue that the parametric environment presented by the Indian economy and polity has undergone a rather dramatic change. After reproducing the ToR for the 13th FC – for ready reference – in the fourth section, in the fifth section I will flag some issues for consideration of the commission. In the final section I will conclude.

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II. A Brief Review of the TORs of the Earlier Finance Commissions

The TOR of a Finance Commission defines the mandate of the Finance Commission that is binding on the Commission. Hence any critical appraisal of the recommendations made by the FCs should necessarily start with a close look at the TORs of the various FCs. A brief review of the TORs of the earlier Finance Commissions which have made their recommendations, as has been attempted here, would enable us to *put in perspective the recommendations made by these FCs and also enable us to take a more holistic view of the scope of the FCs and the transition it has undergone since when the First Commission* was constituted by an Order dated 22nd November, 1951. The major (core) functions of the Finance Commissions listed under ***Article 280*** of the Constitution are as follows:

(i) ***Distribution between the Union and the States of the net proceeds of taxes*** which are to be may be divided between them and the allocation between the States of the respective shares of such proceeds.

(ii) Listing out the ***principles that should govern the grants-in-a*****id** of the revenues of the States out of the Consolidated Fund of India under **Article 275** of the Constitution.

(iii) The continuance or modification of the terms of any agreement entered into by the Government of India with the Government of any State.

In the interest of sound finance the **First FC** was asked to examine and make recommendations on:

(a) Grants-in-aid to the states of Assam, Bihar, Orissa and West Bengal in lieu of share of the net proceeds in each year of the export duty on jute and jute products to these states in accordance with the provisions of ***Article 273*** of the Constitution.

(b) Grants-in-aid of their revenues to states under ***Article 275*** of the Constitution.

The **2nd FC** while making its recommendations for grants-in-aid under Article 275 was asked to consider

(i) The ***requirements*** of the Second Five Year Plan, and

(ii) The ***efforts*** made by those States to raise additional revenue from the sources available to them.

The FC was also to make recommendations regarding

(1) The principles which should govern the distribution under article 269 of the net proceeds of *estate duty in respect of property other than agricultural land*, levied by the Government of India in the States within which such duty is leviable; and

(2) The modifications, if any, in the *rates of interest and the terms of repayment* of the loans made to the various States by the Government of India between 5th August, 1947 and the 31st March, 1956. The following two matters were added to the terms of reference and the FC was asked to make recommendations regarding:

(3) The principles that should govern the distribution among the states of the ***net proceeds of the additional duty of excise on mill made textiles, sugar and tobacco.*** The right to tax these commodities was surrendered by the states in 1957. The Central Government agreed to levy additional excise duty on this count and distribute it among the states.

(4) The principles that should govern the distribution, under Article 269 of the grants to states in lieu of the repealed ***tax on railway fares.***

In addition to the duties assigned to the first two FCs, the TOR of the **3rd FC** was entrusted with distribution amongst states of the Rs.12.5 crores which the Railways had agreed to pay to the General Revenues every year consequent on the decision taken to merge the tax on Railway Fares with the passenger fares and repeal the Railway Passenger Fares Act, 1957.

The TOR of the **4th FC** listed out in much greater detail the considerations that the FC needed to base its recommendations on. The TOR of the 4th FC for the very first time specified that *efficiency* considerations be given some weight. The FC was asked to consider ***the scope for economy consistent with efficiency, which may be effected by the States in their administrative expenditure.***

The TOR of the **5th FC** in addition to all the previous tasks, also asked the Commission to make recommendations on the problem of unauthorized over-drafts of certain states with the Reserve Bank and the procedure to be observed for avoiding such overdrafts. In keeping with the TOR the previous Commission, this TOR too asked the FC was asked to give consideration to the scope for better fiscal management as also for economy consistent with efficiency which may be effected by the states in their administrative, maintenance and other developmental expenditure. The TOR of this Commission departed from previous ones on two counts. First, it asked the FC to make an interim report and a final one. Second, it explicitly specified the need for transparency as it said that that the final report must indicate the basis on which it had arrived at its findings and make available the relevant documents.

The TOR of the **6th FC** added to the responsibilities of the FC by explicitly asking it to consider the requirements of states which are backward in standards of general administration for upgrading the administration with a view to bringing it to the levels obtaining in the more advanced states over a period of 10 years. It continued the focus on the aspect of fiscal management as well as efficiency that had been initiated in the TOR of the 4th FC.

The TOR of the 6th FC specifically asked the FC to make an assessment of the non-plan capital gap of the States on a uniform and comparable basis for the five years. The Commission could then undertake a general review of the States' debt position and provide relief or suggest corrective measures.

Yet another extension in the scope of the 6th FC was that the TOR stated that the Commission may review the policy and arrangements in regard to the financing of relief expenditure by the States affected by natural calamities and examine the feasibility of establishing a National Fund to which the Central and State Governments may contribute a percentage of their revenue-receipts.

The **7th FC** TOR, in addition to all the requirements spelled out by the previous TORs, made the additional point that the in making its recommendations on the various matters, the Commission should adopt the ***population figures of 1971*** in all cases where population is regarded as a factor for determination of devolution of taxes and duties and grants-in-aid.

The TOR of the **8th FC** made no new changes to the responsibilities and tasks assigned to the FC. It asked for continuation in the use of 1971 population figures.

The TOR of the **9th FC** went off the beaten track and for the first time introduced the concept of adopting a ***'normative approach'***. It stated that in making its recommendations, the Commission should:

(i) Adopt a normative approach in assessing the receipts and expenditures on the revenue account of the States and the Center and, in doing so, keep in view the special problems of each State, if any, and the special requirements of the Center such as defence, security, debt servicing and other committed expenditure or liabilities.

(ii) Have due regard to the need for providing adequate incentives for better resource mobilisation and financial discipline as well as closer linking of expenditure and revenue raising decisions.

(iii) Take into account the need for speed, efficiency and effectiveness of Government functioning and of delivery systems for Government programs and

(iv) Keep in view the objective of not only balancing the receipts and expenditure on revenue account of both the States and the Center, but also generating surpluses for capital investment.

The TOR of the 9th FC was unique in that it enhanced the scope of the FC significantly. It was the very first one to have spoken on the role of FCs to provide 'incentives', to ensure closer linking of revenues and expenditures and in attempting to attain efficiency in the delivery system of government programs.

The TOR of the **10th FC** made the following additions to the considerations that the FC needed to keep in mind while making recommendations:

(i) The requirements of States for modernisation of administration, e.g. computerisation of land records and providing faster channels of communication up to and above district level, and for upgrading the standards in non-developmental sectors and services, and the manner in which such expenditure can be monitored;

(ii) The requirements of the States for meeting the non-Plan revenue expenditure also keeping in view the potential for raising additional taxes.

The TOR of the **11th FC** added the new dimension of entrusting the FC to review the state of the finances of the Union and the States and suggest ways and means by which the governments, could collectively and independently bring about a restructuring of the public finances so as to restore ***budgetary balance*** and maintain ***macro-economic stability***. The FC was asked to keep in mind the need for generating surpluses for capital investment and reduce fiscal deficit. The Commission was also expected keep in mind the requirement of states for up-gradation of standards in non-developmental and social sectors and services, particularly in the backward states. The TOR of the 11th FC for the first time mentioned the need to give significant weight to '***incentives***' for better realization of tax and non-tax revenues.

Since the 11th FC was to be setup after the passage of the 73rd and 74th Constitutional Amendment Acts, which gave local bodies legal status, the TOR of the 11th FC for the first time asked the FC to examine the ***finances of local bodies***. More specifically it said that the FC needed to consider the following:

(a) The measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the State Finance Commission.

(b) Where the State Finance Commissions had not been constituted as yet, or have not submitted their report giving recommendations, the FC was expected to make its own assessment about the manner and extent of augmentation of Consolidated Fund of the State to supplement the resources of the Panchayats and Municipalities in the State.

The TOR also stated that the Commission may make an assessment of the debt position of the States as on 31st March, 1999 and suggest corrective measures keeping in view the ***long term sustainability for both the Center and the States.***

The TOR to the 11th FC assigned the FC the additional task of drawing up ***a monitorable fiscal reforms programme aimed at reduction of revenue deficit of the state and recommend the manner in which the grants to states to states to cover the assessed deficit in their non-plan revenue account may be linked to progress in implementing the programme.***

We now turn to the *TOR of the Twelfth Finance Commission.* Apart from the core issues of determining tax devolution and grants, the TOR of the 12th FC expresses concern about the rapidly deteriorating fiscal scenario.

In keeping with the TOR of the 11th FC, that of the 12th FC also stated that the Commission shall review the state of finances of Union and state governments and suggest a plan to restructure public finances, restore budgetary balance, achieve macroeconomic stability and debt reduction. The TOR of the 12th FC, however, also emphasizes ***'equitable growth'***. The TOR for the first time asks the FC to give weight to ***tax efforts of central and state governments as against targets***, if any, and the ***potential for additional resource mobilization*** in order to improve the tax-GDP and tax-GSDP ratio. The FC has also been asked to review the Fiscal Reform Facility introduced by the central government on the basis of recommendations made by the 11th FC and suggest measures for effective achievement of its objectives.

Like the previous FCs, the 12th FC too has been asked to make an assessment of the debt position of the States, suggest such corrective measures consistent with macro-economic stability and debt sustainability. It has, for the first time, however, elaborated on the factors that need to be given weight to in this context. The FC has been asked to give weight to the performance of the States in the fields of ***human development*** and ***investment climate***. A review of the TORs of the twelve FCs clearly show that over the years **the canvas of operations of the FCs has widened from simply being a body set up every five years with the sole objective of devolving funds to sub-national governments, to that which comprehensively assesses the financial situation (macro-stability) of the economy as a whole and charts out a roadmap for the restructuring the finances. Over the period consideration of efficiency was added quite early on and later – post 73rd and 74th Constitutional Amendments – local bodies came into reckoning, clearly underlining the seriousness of intent vis-à-vis decentralization. It can be seen that some of the tasks added to the menu of things to be done by the FCs seem to be of a temporary or ad-hoc/ contingent nature.** This is not particularly welcome. The aims and objectives of the FCs ought to be sharply focused and hence delimited, which will add value of its awards. ***Using the same instrumentality for solving multiple problems may serve convenience but may***

***lead to problems of coherence and accountability and hence accountability becoming a casualty*.** The example of calamities funds readily comes to mind. This ought to be avoided. The position of the 12th FC on this matter is well articulated and entirely reasonable. Since this matter – as we shall see in the next section – appears in the ToR of the 13th FC, I would suggest that it **could go into a detailed study of the potential likelihood of calamities in an actuarial mode looking at the historical data and modify the scheme somewhat using insurance principles, *complete with the bonus for non-claims*.**

The TOR of the 11th FC marked a crucial departure from its predecessors in the role envisaged for the FCs by asking it to draw up a "monitor-able" fiscal reforms program aimed at reduction in revenue deficits and also the manner in which grants could be linked to implementation of the reform program (acknowledged 'best practice'). This is indeed commendable. However it raises the question of 'who will monitor?'. *It is to be recommended that the FCs ought to be set up for a period of five years and not only give out a one time award but also monitor the performance and dynamically release funds overtime*. The TOR of the 12th FC, however, does not make an explicit mention of this task of the FC. The point about 'monitoring' the fiscal reforms program and that of 'linking the grants devolved to implementation' is, according to us, vital to the success of the translating the recommendations made by the FC into practice. Hence, even though the TOR of a FC does not make explicit mention of it, it is imperative that the FC keeps them in mind while making its recommendations.

The practice of using the 1971 population was initiated so as to not reward the states which failed in population control has continued ever since it was initiated by 4th FC and is specified even in the TOR of the 12th FC. We agree with Kumar and Vemuri (2002) who have rightly pointed out that if the effectiveness of the adopted strategy is to be assessed solely in terms of denying the states with higher rates of population growth the benefit of a larger proportion of resources then the policy of use of 1971 population has been successful. However, given that population has been used as an indicator of 'need/ adequacy' of a state, denying resources to the state on this front would lead to a distortion in the allocation pattern in terms of the actual requirement of resources necessary to cater to the higher levels of population. Further, they have also pointed out that the use of 1971 population by the 11th FC denied a greater share to four of the least developed states viz, U.P, M.P., Bihar, Rajasthan and north-eastern states. Thus, although the mandate of the 12th FC was to use the 1971 population figures, we would have liked the Commission to take a close look at the gainers and losers on account of this provision by computing the allocations under two scenarios, (i) that of using 1971 population and (ii) that using the latest 2001 population figure. It is now hoped that the 13th FC will do the needful. This would be a positive step forward in the working of the entire process of Finance Commission devolutions. Indeed, it is regrettable that the same norm continues to be imposed even in the ToR of the 13th FC. This does not really serve the purpose for which it is supposedly enunciated and indeed goes against the tenets of equity to the extent that it mis-estimates the 'need'. This is akin to the sanctions being imposed on a State leading to punishment being imposed on the vulnerable citizens. After all they too are Indian citizens and as such entitled to the same standard of services. In order to substantiate the point somewhat – without going into detailed exercise – I have presented the relevant data in Appendix III, which clearly indicates the extent to which the pattern of population has undergone a change.

In sum, the review of the ToRs of the earlier Finance Commissions indicate that the tasks have been cumulatively been increasing. To the extent that these are in response to the changes macro-environment and/or management paradigm they are understandable. In this category we would put the influx of the limited concern for incentive compatibility as well as the sense of macro-stability and indeed the concern for decentralization. However, when this is due to contingent and temporary reasons and clearly outside the purview of the core functions of the Finance Commission they only make the work more complex – with multi-objective setting – even at the conceptual level and clearly need to be avoided.

III. Terms of Reference of the Thirteenth Finance Commission & Some Observations

1. The Commission shall make recommendations as to the following matters, namely:-

(i) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under Chapter I Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds;

(ii) the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States which are in need of assistance by way of grants-in-aid of their revenues under article 275 of the Constitution for purposes other than those specified in the provisos to clause (1) of that article; and

(iii) the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.

2. The Commission shall review the state of the finances of the Union and the States, keeping in view, in particular, the operation of the States' Debt Consolidation and Relief Facility 2005-2010 introduced by the Central Government on the basis of the recommendations of the Twelfth Finance Commission, and suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth.

3. In making its recommendations, the Commission shall have regard, among other considerations, to -

(i) The resources of the Central Government, for five years commencing on 1st April 2010, on the basis of levels of taxation and non-tax revenues likely to be reached at the end of 2008-09;

(ii) The demands on the resources of the Central Government, in particular, on account of the projected Gross Budgetary Support to the Central and State Plan, expenditure on civil administration, defence, internal and border security, debt-servicing and other committed expenditure and liabilities;

(iii) The resources of the State Governments, for the five years commencing on 1st April 2010, on the basis of levels of taxation and non-tax revenues likely to be reached at the end of 2008-09;

(iv) The objective of not only balancing the receipts and expenditure on revenue account of all the States and the Union, but also generating surpluses for capital investment;

(v) The taxation efforts of the Central Government and each State Government and the potential for additional resource mobilization to improve the tax-Gross Domestic Product ratio in the case of the Union and tax-Gross State Domestic Product ratio in the case of the States;

(vi) The impact of the proposed implementation of Goods and Services Tax with effect from 1st April, 2010, including its impact on the country's foreign trade;

(vii) The need to improve the quality of public expenditure to obtain better outputs and outcomes;

(viii) The need to manage ecology, environment and climate change consistent with sustainable development;

(ix) The expenditure on the non-salary component of maintenance and upkeep of capital assets and the non-wage related maintenance expenditure on plan schemes to be completed by 31st March, 2010 and the norms on the basis of which specific amounts are recommended for the maintenance of the capital assets and the manner of monitoring such expenditure;

(x) The need for ensuring the commercial viability of irrigation projects, power projects, departmental undertakings and public sector enterprises through various means, including levy of user charges and adoption of measures to promote efficiency.

4. In making its recommendations on various matters, the Commission shall take

the base of population figures as of 1971, in all such cases where population is a factor for determination of devolution of taxes and duties and grants-in-aid.

5. The Commission may review the present arrangements as regards financing of Disaster Management with reference to the National Calamity Contingency Fund and the Calamity Relief Fund and the funds envisaged in the Disaster Management Act, 2005(53 of 2005), and make appropriate recommendations thereon.

6. The Commission shall indicate the basis on which it has arrived at its findings and make available the estimates of receipts and expenditure of the Union and each of the States.

7. The Commission shall make its report available by the 31^{st} day of October, 2009, covering the period of five years commencing on the 1^{st} day of April, 2010.

While the comments and suggestions/ issues arising from the task given to the 13^{th} FC will be found in various places in what follows I would make some preliminary and general points at this stage. The core mandate of the Commission to determine the sharing the tax revenues between Center and the States is a largely settled issue (see, Mythili Bhusnurmath, 2007) and hence not much may be said about it except that given the current conjuncture, the share may be marginally increased. Section 1. (ii) and 1.(iii) are extremely important and will be elaborated later in this paper. In 3 (ii) of the ToR the FC has been asked to estimate the requirements of the Center. **This is crucial and something that has not been attempted *explicitly* by the earlier finance commissions**. This is clearly important in the present context where there will be pressure to increase the states' share in the overall devolution. Section 3 (viii) requires the FC to look at the ecology and climate change issues. ***This is a case where the underlying issue is of great importance however, whether it should be looked at by the FC is a moot point*** (see, EPW, 2007). The issue is of global magnitude and requires a policy environment on which the call has to taken the Central Government at the highest level in consonance with States in a a-party political manner. A separate high powered committee (which includes technical specialists) needs to be appointed to work out such a policy framework and then provide inputs to other agencies to work within broad pre-decided parameters. Also, a great deal of coordination and consonance between the FC recommendations and the Central Policy at large has to be ensured. The example of center's distortionary fuel pricing policy allowing the dismantled administered price framework to work itself back 'in an even more virulent form' hardly fills one with confidence. Loading the FC with this work will deflect from the core issues to the detriment of the quality of report (much the same is true about requiring the FC to work out impact of GST on foreign trade). Section 3 (ix) deals with a very important issue of providing maintenance grants for committed plan schemes. Here, the transfers have to adequate, keeping in view the threshold concept, to neutralize the general tendency (leading to inefficiency) of leaning towards '***ribbon cutting activities***'. This again brings into sharp focus the need to review the somewhat artificial dichotomies of plan/non-plan and revenue/capital entities.

As far as sections 4 and 5 of the ToR are concerned, I see nothing that makes me feel the need to revise the comments in the context of earlier FCs, if anything they hold with greater force. ***Except that in case of 13^th^ FC the use of 2001 figures of population for some purposes should be expanded***. Again, to avoid the gap-filling mandate degenerating into a mere exercise in dentistry, the *normative approach* followed by the 12^{th} FC deserves to be commended. Although introduced by the 9^{th} Finance Commission for the first time, 12^{th} FC has introduced an element of sophistication. However, it needs to be checked out whether the effort really is worth it in terms of results. Perhaps even more sophistication – whilst keeping the underlying principle intact – in working out these norms is called for. A small exercise to check out how reality has panned out vis-à-vis projections clearly indicates (for two years) that the RMSPEs are rather large as may be seen from the following table. ***The notable feature is that for revenues, the growth dividends have helped keep the RMSPE low but for 'Expenditures' – which are the 'control', variable – it is rather large. The 'Deficits' have gone awry***. The state-wise list is presented in Annexure II. There are lessons to be taken away by the 13^{th} FC. Perhaps I may leave this section with a comment – without elaboration – that apart from the North Eastern States (that are not very important in magnitudes) the main *states that seem to be 'different' from the* *average behavior described above and illustrated below in the table are Bihar and West Bengal* (seen in Appendix II).

TABLE: TOTAL 28 States

	Projections of 12th FC		Actuals		RMSPE
	2005-06	2006-07	2005-06	2006-07 (RE)	
Non-Plan Revenue Receipts	244881.35	281867.38	259887.1	312313.24	**8.01**
Total Non-Plan Revenue Expenditure	308764.96	333995.91	366428.5	432289.46	**19.55**
PRE. DEVO. NON-PLAN REV. Deficit/surplus	-63883.64	-52128.51	-106541	-119976.22	**49.00**

IV. The Changed Parametric Environment

The ethos of Indian economy, society and polity have been undergoing a rapid change, thanks to the LPG processes set in motion some two decades ago. The macro-management regimen has undergone significant change in the recent past. The present structure of Indian fiscal federalism was formed at a time when its economy was much less market oriented than today. At any rate it is well recognized that existing inter-governmental arrangements are rarely a product of detailed analytical studies by economists or political scientists, but are the result of historical developments, including historical accidents (see Teresa Minassian 1997). It is thus unlikely that the same arrangements would be chosen if today the countries had the freedom to start from scratch. Some of the specifics that I believe are pertinent and relevant to the work of the 13th Finance Commission. ***Intergovernmental transfers and reforms therein are taking place today in the context of political decentralization, changing as well as shrinking role of the government and recognition of local autonomy, at least for sometime with Central norms and mandates in place (see, Bird,R and C. Wallich 1993)***. These provide points of departure and will need to be borne in mind whilst rendering the mandate given to the FC operational.

IV.1. India Growth Story

India is the flavor of the season. In recent times, the upswing in the secular rate of growth of the Indian economy, wherein it has managed to significantly break away from the 'Hindu rate' has had positive impact on the way in which India is perceived the world over. This feat is especially noteworthy because it has been achieved by a country whose democracy has been often characterized as a *functioning anarchy*. The current growth experience and its impact on the macro-level fiscal and income variables – in terms of the positive growth dividend – must finally put to rest all the anti-growth rhetoric. ***It is amply clear (in the context of growth scenario) that all the good things – in social sphere, in terms of inclusion – can now be realistically afforded by the Indian policy maker, perhaps for the first time!*** It is indeed necessary that we do something here especially given that the 'poor' states have remained 'poor' through this growth episode, with the inescapable conclusion that there is certainly an exclusionary sub-plot to this growth story.

This has two implications, one, for purposes of satisfying the very important tenet of inclusion, greater weight needs to be to be given to health and education in a targeted and performance based manner. Two, it is crucial that the growth (even when somewhat exclusionary in character) has to be sustained, with the further implication that the design of **any policy strategy must have incentive compatibility meaningfully as its cornerstone.**

IV.2. Political Scenario

Although India has a federal structure albeit not in the classical sense (see Roy Ash Narain, 2007), it is essentially a Union with a strong centripetal bias with the constitution ensuring an overwhelming and overriding power to the central government. Yet the political scenario in recent times has been such that more and more ground has had to be yielded to the states. Indeed on every issue it has become necessary to talk to the states. The days of Congress domination are long past and coalitional politics are here to stay. The regional parties with there parochial agendas have been gaining ground for some time now with the strong emergence of TDP, AIDMK and Shiv Sena to name a few. A more recent trend has been emergence of strong local leaders even within the National Parties (witness the so called Mayawati, Modi phenomenon). All of this has meant that the dictat of the Central government will not necessarily be followed. This is quite different from the case of Argentina where macro-stability and other issues were taken care of because, not only was the national government able to set up hard budget constraints but partly also because it had a strong party control of both legislators at the Central level as well as at the level of sub-national governments (see, Dillinger, W and S. Webb (1999). Thus, the specific India political situation brings in a few problems in the context of transfers. ***This is also important because the most important public goods that need to be serviced – such as health and education – are largely provided by States and below. The autonomy will perforce be required to be circumscribed by observable 'good conduct', a phenomenon that had to be earlier encountered only in case of 'rogue' states.*** The continued fractured mandate (as far party political strength is concerned) means that ***the margin of bargain in the non-formula based transfers will be up for grabs and be available on purely party political expediencies*** (see, Indira Rajaraman, 2007). I don't need to elaborate on this given that one of the members of the 13th FC happens to be Professor Indira Rajaramn who is clearly seized with the issue. This situation is potentially problematic and will have to be guarded against in the structure and content of transfer design. More than ever before the 'political feasibility' in a fractured and heterogeneous domain of Indian polity will present a biting constraint. It is perhaps well to remember that nature and politics abhor catastrophic jumps and move in small steps.

IV.3. Fiscal Situation of States

The fiscal situation of the states presents a different picture as compared to the one that presented itself at the onset of the 12th FC. The fiscal situation then was indeed very grim. Vijay Kelkar (2004) noted, 'Despite energetic efforts by a series of governments the revenue deficit worsened from 3.3% of GDP in 1990-91 to 4.4% of GDP by 2003-04'. He further added that 'The baseline projections do not assume that major tax reforms will come about. But they do assume the *pace* in policy and administration, which took place in recent years will be replicated between 2005-09'. The prospect of states hammering down revenue deficits in the wake of the known downward rigidities of revenue expenditure was deemed to be rather dim. Karnik Ajit, (2005) whilst believing the states to be in deep throes of fiscal crisis was even more emphatic, 'Unless changes ushered in 2004-05 are further accelerated and spread across states, the hoped for permanent improvement in state finances may not materialize. We are afraid that the report of 12th FC, while it is critical of current situation of state finances is rather sanguine about future prospects'. Kelkar (2004) clearly believes that it is much better to concentrate on revenue raising effort with its powerful side effect of strengthening state finances which is not the consequence of expenditure cuts.

The growth dividend in the form of tax revenue buoyancy that has been witnessed recently has clearly had good effect on the fiscal situation of the states. It could also have marginally been helped by the simplification, leading to greater compliance as well as some improvement in tax administration. The fiscal situation across the States thus shows a marked improvement (which might be the reason for dropping a clause from the ToR this time around). This evident from the table in Appendix I. The revenue deficit has shown an average drop of 3% points and the overall GFD also shows a reduction. There are some notable 'rogue' exceptions. **Also the debt, (outstanding liabilities, to use the RBI nomenclature) has increased by around 9 percentage points from around 31 to around 40%** (see Appendix I). This is worrisome and the 13th FC clearly has its work cut out. **The revenue buoyancies apart, debt swap scheme and the general softening of interest rates has allowed the interest payments to be held at 18% of revenue expenditures on an average. Whereas the revenue buoyancies can at most be sustained, the fact that the proportion of state debt with the centre has come down from about 50% to around 22% recently thus putting a limit on the debt swaps, and the at the market level the softening of interest rates is not very likely, does not portend well for the future** (for greater details see RBI (2007)). Thus, in *the incremental sense the impact of all these relief factors would be considerably dimmed*. In this context, **the implications of holding the cap of revenue deficit for expenditures on the crucial (and necessary) sectors of health and education (both essential state subjects) will**

require to be watched closely. Much ingenuity – by way of micro-design – in neutralizing the negative impact on the 'good' revenue expenditures in this area will have to be exercised by the 13th FC.

IV.4 Stronger Intent of Decentralization

In a liberalized environment, the role of the government in resource allocation will be smaller, with the relative role of the sub-national governments is set to increase rather than decline (see Govind Rao and Tapas Sen opt cit.). It is recognized that the central government can influence the decentralized delivery of goods and services through the setting of policy guidelines for this delivery, a transfer of resources to go to the sub-national governments to equalize their capacity to meet these mandates; and the ex-post use of the transfers to monitor the level and quality of services provided by lower levels of government (see Teresa Minassian opt cit). It is well known (see Oats, 1972) that decentralized (local) levels of government should rely on taxes on immobile bases (property tax, user fees), middle level government (states) can make use of the incomes and sales to a limited extent but in a harmonized way.

The theoretical efficiency and welfare gains to be made from decentralization are well established for some time now (see e.g. Tiebout, (1961) and Oats, (1972)). However one needs to be mindful of the institutional and administrative capacity constraints among other things that undermine the actual operational aspects of decentralization (see e.g. Tanzi, 1996 and Prud'homme 1995). It then follows that in especially in countries like India that do not face serious macroeconomic crisis, decentralization of revenues and expenditure will require the active engagement of the Central government, both for management reasons as well as directing a concerted and coordinated efforts towards attaining national goals.

In the Indian context, decentralization was 'always around but never invited in'! All this is supposed to have changed with the passage of 73rd and 74th Constitutional Amendments. The spirit of these amendments required simultaneous transfer of functions as well as empowerment of the local governments. This unfortunately has not happened. It is by now well-known that the State Finance Commissions (SFCs) are set up – as constitutionally mandated – but then the awards are all but forgotten, indeed sometimes treated with hostility. The SFCs are set up in a rather casual manner not necessarily keeping in mind the skill sets required to do a competent job. **Thus, the non-synchronic setting up of SFCs (even when they are set up) and non-uniform treatment by different state governments has meant that they are not useful as providers of inputs to the Central Finance Commissions**. At the level of principle, decentralization was seen to be unanimously acceptable, yet at the real ground level the States have not decentralized in the true sense. Being the 'creatures' of the States, the local body governments (both urban and rural) having devolved the functions, have shied away from devolving either the requisite resources in a predictable and certain fashion or indeed enabling the local governments (especially in case of urban bodies) by vesting them with sufficient legislative powers to raise resources and hence strengthen themselves. In trying to get the States to transfer resources along with the functions the discretion with the States (in the use of the word 'may' rather than 'shall' has implied that as an act of omission or deliberate design, the 74th Constitutional Amendment simply does not go far enough. The work of Ministries such as MoPR in trying to directly transferring the resources through treasury and banks is note-worthy; although not likely go down well with the States. Of course, that even within the band of possibilities, the local bodies have by and large not fully exploited the potential has not helped their cause. The finances of local bodies are not in great shape for urban local bodies and indeed are in a pathetic case for the PRIs (rural case) this further creates a problem for delivery of services (both the magnitude and quality). ***The long and tortuous route of Constitutional Amendment apart, the trick lies in linking 'agent-purposive' transfers with observable indicators amounting to a sort of administrative arm-twisting***. I would say this in full realization of the fact that in a typical multi-level hierarchical system, tenet of efficiency demands that the 'supremal' unit must not talk directly to 'infimal' unit. The protocol of linear communication with the adjacent level units within the system, need to be strictly followed. This corrosion of the State autonomy is perhaps worth the price in the wake of possible improvement of the quality of expenditure and service delivery (to be audited by external autonomous agency). There are also, a host of best practices that are common knowledge and documented (see, 12th FC Report, 2005) for the purposes of tying the grant devolution. There is the pre-requisite that the State government must not delay transmission of the resources onwards. There is also the trade off implicit here that the tied devolution will translate into some amount of unpredictability.

Of course, for this to happen, great level of effective effort at capacity building (training and absorptive capacity) and reforms (process reengineering) are required. But there is good argument in favor of just devolving funds with faith, that the capacity will be created. After all, never in history has one found infrastructure being created fully, before the demand for it comes about due to growth. Indeed, it is growth that partly makes the provision of such infrastructure affordable. Thus, while recognizing the need and the efforts that need to be taken for capacity building, it is not necessary to treat it as an *essential prerequisite*. **This would require well funded institution building and financing such a thing will be well worth looking into by the FC.**

The recent finance commissions have also started on the path of performance tied funds (FRBM to name one). **The time has seriously come to move from macro-level indicators to** ***design parameters at micro level*****. The quality of expenditure and delivery needs to be vetted through an autonomous well funded agency (at least on a sample basis). A lot is being done by the NGOs in terms of score cards for delivery thereby creating some capacity to do this. Also the effort has to be made to move from ad-hoc transfer (of say 25,000 crores INR) to** ***compute the normative need of local bodies just as the earlier FC had done in the case of States. I am emboldened to suggest this because one of the Commission members has a great deal of expertise and work in the area (see Indira Rajaraman, 2003). To be sure, this is asking a great deal, especially when the data base in this area even in the financial sphere is in a very bad shape. The issue of data has been discussed ad-nauseum by many scholars and is common knowledge (see e.g., Abhay Pethe and Mala Lalvani 2005) and would be comical if it were not so serious. Perhaps the 13th FC needs to set up institutions (monitoring observatories/ data warehouses) afresh or virtually set them up by culling the elements from the existing ones (research institutes/universities).***

IV. The Trade-offs – Issues facing 13th FC

With twelve commissions having already reported the platform is well set with the obvious constraint that one cannot deviate drastically from what has gone by. At the same time, it is also important that the 13th FC must approach the issues with an open mind (if not with a clean slate) and bearing in mind the changed scenario rather than just tinkering at the fringes. The maturing of issues and our understanding aso means that many of the issues – in the context of the work to be done by the 13th FC, within the parameters set by the given ToR – present themselves as trade-offs. We consider some of these issues in what follows.

V.1. Finance Commission and Planning Commission

In contrast to the Finance Commission which is a child of the Constitution, the Planning Commission is almost an object of faith of politicos. Whilst I believe in the historically contingent character of categories and institutions – and so I am not one to look back in anguish – I cannot but help believe that in the current situation, its *waiting room* character apart, its sell-by date is over! With the changing macro-management ethos, the role of the state as well a review of fiscal federalism becomes necessary (Govinda Rao and Tapas Sen (1996)). As Raja Chelliah (1991) noted, 'Comprehensive central planning involving centralized decision making in relation to product and disposal of resources in the 'national interest' is the negation of true federalism'.

The non-synchronous temporal tenures of the two commissions will lead to several problems and issues. The uncertainty with regard to resources to the states over the entire period is one of them. The prevailing practice of treating Plan and Non-Plan requirements of the states by the Planning Commission and the Finance Commission has led to the inability to take a coordinated and holistic view. Indeed, given that action by either has implications for the other has meant that they (FC and PC) have sometimes worked at cross purposes (see, Govinda Rao and Tapas Sen 1996). It is a happy coincidence that Kelkar (2004) the Chairman of the 13th FC, is on record stating that, '***Plan Vs Non-Plan and Capital Vs Revenue need to be re-examined***'. He will have to undertake the difficult task of recovering the 'lost ground'. It may be worth recalling that there the Chairman of the 4th FC had stated (Govinda Rao and Tapas Sen,

1996) that ‘there is nothing to exclude from its purview, grants for meeting revenue expenditures on Plan schemes, nor explicit bar on grants for Capital purposes’. However hesitancy on the part of FCs traditionally have led to it becoming explicit mandate in the 10^{th} FC. In the ToR of the 13^{th} FC there is direction for the FC to take into account the Gross Budgetary Support to Center and State Plans. This implies a subtle tilt in favor of the Planning Commission and that is a worrisome development for federalism (see, Mythili Bhusnurmath, 2007). ***Such a stipulation may lead to the subservience of the constitutional entity viz., FC to the ‘extra constitutional PC’ with its transfers becoming merely residual in character*** (see G.R. Reddy 2007).

The Finance commission will have to put up a strong fight for the territory that is in grave danger of being encroached upon. This is especially important since, the politically weighted Planning Commission recommendations have implications in the domain of concern of the FC (for example the loan component of the plans give rise to interest payment liabilities, which are part of the non-plan revenue expenditure). The FC correctly mandated to look holistically at the requirements will have a larger part of its transfers ‘blocked’, thereby reducing its degrees of freedom. It is important to note that the Finance Commissions are by and large seen to be fair and rational whereas the plans are representative of the socio-political strategy of the government in office and hence susceptible to electoral cycle (see, N.K. Singh 2007).

V.2. Equity and Efficiency

Economic reform must include substantial changes in the system of inter-governmental fiscal relations, with the ultimate objective of substituting market discipline of State finances for the currently existing Central governmental controls. However in this connection no bailout policy is critical. If such a policy lacks credibility and as a consequence states prove reluctant to push ahead with reform, there would appear to be no alternative but to rely on tight borrowing restrictions combined with cuts in central government transfers as a disciplining mechanism (Hemming, Mates and Potter in Teresa Menasian, 1997). ***The current economic ethos clearly indicates that efficiency in the form of incentive compatibility (IC) in contracts/relations must assume primacy. Given the political economy considerations***

however, it may be more realistic to pursue one sided IC System, i.e., where we ignore the penal clause. There is also the need to consider the fact that we are in an era of 'competitive federalism'. It is however important to remember that application of this principle presumes the existence of 'competitive equality' in terms of initial capacities. If not proper policy mix has to be evolved to bring about equalization in the dynamic sense (especially where infrastructure and skill and revenue capacities are concerned) so that over a period there is a convergence.

The conflict between equity and efficiency arises because over weighting of equity or need (as has been the case in India) creates serious disincentive for the better performing states. So that adequacy or need have to be treated in a normative sense so as to discourage laziness (see, Abhay Pethe and Mala Lalvani, 2003) and instill a level playing field in terms of 'stocks' rather than just flows in the static frame. This can be done by measuring the need in terms of both stocks (infrastructure and capacity backlogs) and flows (income-distance). Similarly in measuring efficiency the dynamic elements (marginal improvement of stocks as well as flows) need to be considered. This way at least one sided incentive compatibility is achieved. That some of this is already being done by the recent commissions is welcome, but more needs to be done here to push efficiency to the center stage. The need of equity considerations is not just a matter of ethico-moral consideration but – even for a rapidly opening economy like India – post-Keyenes, is justified by sturdy economic sense. The power of this argument is enhanced manifold in a country like India when we take into consideration the issue of social harmony. One area where we believe more equitable measurement of equity based on need is in the application of 'distance'. The weight assigned to the **'distance' criterion** needs to be reduced. After all, population, area, as well as distance go to serve the concern of equity. In order to push for a greater space for efficiency whilst keeping in view equity and adequacy, it may be prudent to get back the recently discarded '**inverse distance**' criterion. As is known, such a criterion leads to the 'tragedy of middle classes' but will emphasize the case of both the extreme cases. A more radical suggestion will be to take the cause of decentralization seriously and treat district as a primary unit for administration, use the ***distance criterion at the level of district level income***. By way of illustration, if we consider the case of Maharashtra –

which is a high per capita income state – where about 18 districts fall below the national level average performance in terms of per capita income. Indeed, removal of Mumbai (two districts) from reckoning leads to a drop in the per capita income of around 30%! Given that such high performing (concentrated areas – cities) are always ignored in any transfer on count of need, the aforesaid argument gains even more substance. This is pertinent since the macro level caps (on say the revenue deficits) lead to less than optimal expenditure on public goods in the poorer parts of the state. This is one of the reasons for potentially dangerous, periodic outbursts for separate identities!

Thus, despite a real trade off here, what I would like to see is, one the 'need' to be measured properly and two, a greater weight for efficiency variables (measured both for stocks and flows in static and dynamical frame).

V.3. Autonomy and Tied Transfers

As already mentioned, the Indian Union has a centripetal bias. The fiscal federal structure is kept in place by a web of commissions and councils to form a frame that is workable. There is a perception (not without reason) that states and the lower governments are unable to competently discharge the functions assigned to them. This has led to a number of subjects being shifted to the concurrent list. Also the allocation has been altered so as to make the funds for the program directly or on shared basis. Over the past few FCs, the share of transfers as a proportion of the total transfers has shown a monotonic increase. *From the 7th FC when it was around 7% it has grown to around 18% in the latest FC.* There are heavy pros and cons about this movement that are common knowledge and need not detain us here. The non-formulaic has a greater tendency to be used as a tool of political (not in the best sense) negotiation. This is especially so in the current political landscape that presents itself in India. On the other hand, the need of the hour is to be able to be an *active* rather than a *passive* fund manager. This is required to ensure quality of expenditure and best practices at the State level. Given that such constraints can be imposed only on the transfer component rather than the statutory tax sharing one, it is but natural that this component will increase. Applying an index (admittedly all the indices that I have seen are rather simple, as yet) for quality of governance reveals a surprisingly strong positive correlation between fiscal decentralization and quality of governance (see, Huther Jeff and Anwar Shah, (1998). There is of course the low level of administrative capacity at the lower levels to contend with. ***The trick here is to have a self binding commitment in terms of upper bound on the proportion to be so disbursed and then work in as detailed a way to tie the transfers to 'good governance' articulated in observable indicators.*** This is one more reason why we believe that the FC's job is not of the 'fill it and forget it' variety and hence the ***FC must not be a self dissolving entity but retain its core entity for the entire term of five years***. In doing this there will be encroachment on the autonomy of the States and it will not be easy given the fractured polity of the present. But the FC must try to push limit of possibility outwards. *There is inherent in such an argument that one is willy-nilly creating a Frankenstein. We must then pin our hope on the ever strengthening force of the fourth estate and civil society.*

V.4. Goods and Services Tax (GST)

One of the important issues that the 13^{th} FC has been asked to look at is the impact of GST (since the year of its proposed commencement fall within the time period of its term). Although the reason for looking at its impact on foreign trade is not entirely clear. It is again propitious that Dr. Kelkar (2002) who headed the Task force for Indirect Tax reforms is the Chairman of this Commission. The *grand bargain* has been worked out where all the states will concurrently tax all the goods and services in a dual mode. The rates scenarios too have been suggested. It is argued that the dual GST (which in a sense deemed to be the culmination of tax reforms) will minimize the cost of compliance, with the presumption that the administrative and IT infrastructure will be synchronized and clearing house mechanism will be in place. Detailed empirical analysis (by the Task Force) is said to lead to the conclusion that there will be a substantial increase in the flow of funds to the state (with the pious hope or an expected caveat that this additional expenditure will be spent on Health and Education).

One of the good points about this scheme is that having decided that the taxes will be destination based will remove the complications of tax exportation to a great extent. However there are several conditions that will have to be fulfilled before the stage is set for GST to become realistically implemented (See, Mythili Bhusnurmath

2007). Given that tax reform is about policies, politics and administration, each one of these will provide substantial hurdles of framework, will and capacity. The CMs are in the process of negotiating and seem to be arriving at a consensus yet the messiest part of elimination of all other levies seems to be unresolved (See, Business Standard (edit) 2007). The rates envisaged are also contentious as they seem to be on the higher side when compared with the prevailing prices internationally. More moderate rates around 10% will have to be considered (see, Govinda Rao 2007) with the help of more detailed studies. Also, whether constitutional amendment is required (for unification of cenvat and retail stage cenvat) is a moot point. The states would have to follow the prescribed rates leading to the erosion of their autonomy and yet coordination and creation of common market may require such a prescription. The actual rates not being available the 13th FC Commission will have to take a call in a simulated environment. As pointed out by Govinda Rao (2007), there are likely to be various centre-state and interstate issues (including adjucation) that will arise and hence require resolution through a permanent instrumentality of a 'clearing house' for this purpose. There are many road-blocks to over power as well as miles to traverse even before one can realistically move over to the GST regime (see Srivasta, D.K (2007) amongst others).

Thus, ***the 13th FC has to apply itself seriously and scientifically to study (in a scenario framework) the revenue implications of different reasonable rates at the central and state levels and come up with ceilings and floors (especially for the states). Hopefully, the state CMs committee will reach some consensus before the 13th FC report is submitted! Implications will also have to be worked out about the extent to which the hands of the state governments can be tied (thereby reducing their autonomy). Indeed, the role of the FCs will have to undergo a change in terms of the magnitude and structure of sharing contingent on the pattern of tax revenues accruing.***

V.5. Some Further Issues

Let us now turn to some other issues (not dealt with above) related to design and criteria of devolution amongst other things. The underlying belief here is that the design structure (including the weighting pattern) is important not just for the shares or outcomes at a point of time but also (and perhaps more importantly) for the signals it sends about the underlying intent articulated through the criteria that are used and the possible dynamic impact it will have with changing scenario.

Normally the *quid pro quo* argument does not apply to fiscal federal transfers; indeed it cannot. The nature of current growth, as is known, is such that it is essentially driven by urban agglomerations. These concentrated areas are potent revenue sources for the treasury at the central as well as the state level (see, Abhay Pethe and Mala Lalvani, 2007). In order for the non-homothetic growth to be sustained, at least till such time that it becomes inclusive in terms of sectors and space, it might be prudent for these areas to be compensated. Whilst it is true that there are other instrumentalities for urban infrastructure finance (viability gap funding through JNNURM), the FC must also do its bit so that a***n act of omission on its part does not lead to killing the golden goose!*** Such transfers to the local bodies in the areas **must be fully incentive-compatible, in that, they must meet the rigorous standards of rationalization of user fees, demand recovery and expenditure efficiency in a demonstrable manner.**

Two of the important issues that should have found an explicit place in the ToR of the 13th FC are the impact of the **Sixth Pay Commission** and **Royalties** payable to the States. The first especially since the GST finds a place which will be implemented later in time and the second especially in the context of the dropping of the clause related to the petroleum profits. The experience of the 5th Pay Commission and its impact on the State finances is recent enough to be fresh in the memory of all concerned. The 6th Pay Commission award is on the door step and one can ignore its implication only at one's peril (unless its consideration is to be subsumed under Calamity and Disaster Fund!). **Some estimation of the financial implications has to be worked out in this context so as to provide a realistic backdrop to the design of transfers. Critical events like this can alternatively be treated by keeping the award for subsequent years 'open', as in the Canadian case (see, 12th FC Report, 2005). This further strengthens our argument for having a core FC in existence for five years!**

I have argued fervently for incentives for efficiency so in that context, and **in the name of fairness, it is essential that proper compensation be paid to the States**

on count of natural resources. It is well known that the natural resource rich states are precisely the ones that are economically poor, so that such a tenet also helps taking care of equity concern 'properly'. Further it is common knowledge that the royalty rate paid to the have not increased commensurately with the increase of the prices of these resources. The revenue base of these states can and should be improved through compensation on this count. This will go a long way in satisfying the concerns of equity. To be sure, the 12th FC had done a bit by converting the rates on 'ad-valorem' basis but more need to done in terms of revising the rates themselves. With the help of a proper study, the rates will have to be revised in a fair manner. An effort in this context will go a long way in terms of alleviating the feeling of being 'cheated' by states like Madhya Pradesh, Bihar, Chattisgarh and Jharkhand.

Finally, given that the share of the taxes to be devolved to the states is limited, the increase in magnitude (which is surely required) must come from increasing the tax kitty. Given the general tendency towards softening of tax rates – thanks to supply side philosophy – and the imperative need to expand the tax base I would merely hint at a greater usage of presumptive tax using the 1/6 criterion for this purpose, (an old favorite of my colleague Ajit Karnik) even though it may not strictly fall within the purview of the FC. I will desist mentioning the old ticklish issue of Agricultural Tax (see Chelliah Raja (1993). There is however a potential problem brewing. The emergence as SEZs as a strategy for sustainable growth means – constitutional validity apart – there will be a serious erosion of the ability of the local bodies to raise resources from these areas. This is unfortunate and some way will have to be found to compensate the local bodies within whose geographical areas these SEZs fall, for the forgone opportunity. Otherwise this will be a body blow to the effort of revenue raising efforts of the relevant local bodies.

V. In Conclusion

For all the voluminous literature on the subject of intergovernmental transfers and its role (including changing role) in equalization variously interpreted and despite all the good work done by the Central Finance Commissions, it continues to be true that the transfers are mostly based on broad judgments rather than any objective criteria. Not surprisingly they have also continued to be controversial. The frame of reference has further set to change – e.g., from macro caps via micro design to macro stability – but there is the general feeling – thanks to the work of Buchanan – that has prevailed, that fine tuning can do only that much and the residual violation of equalization will remain. It is also clear that in the changed macro-management ethos and the parametric environment, greater coordination between governments at various levels is called for in the interest of the well being of our polity, economy and society in general, and retaining the strength of the federal character of our union in particular.

Finally, to return to a familiar theme, in all that FC does, even more important than the resources, will be the ability to design transfers within an operational framework of good governance. After all, as Thomas Friedman has said in his justly famous book, 'The World is Flat', 'once the *wholesale reforms* by way of prerequisites have been accomplished, what is important is to get urgently into the business of reform agenda concerned with the **micro-design**' (emphasis added). The successive finance commissions have succeeded in fitting the macro-caps, now the challenge is to cross the 't's and dot the 'i's!

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APPENDIX I

(18 Non-Special Category States)

	2001-02			2006-07		
	Outstanding Liab.	**Revenue Deficit**	**GFD**	**Outstanding Liab.**	**Revenue Deficit**	**GFD**
	As Per cent of GSDP			As Per cent of GSDP		
Andhra Pradesh	27.04	1.83	4.28	42.24	0.02	3.00
Bihar	68.03	4.05	6.94	73.14	1.13	10.40
Chattisgarh	8.67	1.78	3.51	29.00	-3.41	2.90
Goa	36.96	3.22	5.82	39.32	0.23	4.70
Gujarat	29.89	5.45	5.27	36.18	-0.73	2.50
Haryana	25.17	1.66	4.32	26.34	0.60	0.60
Jharkhand	-	-	-	39.83	2.03	9.80
Karnataka	24.94	3.01	5.39	27.84	-1.48	2.80
Kerala	34.83	3.37	4.22	39.95	4.33	6.10
Madhya Pr.	34.94	3.65	4.21	43.94	-1.44	3.70
Maharashtra	19.46	3.02	4.02	31.98	0.63	3.10
Orissa	53.84	6.03	8.44	58.97	-1.06	1.30
Punjab	40.78	4.74	6.22	47.76	1.89	4.80
Rajasthan	39.93	4.14	6.28	51.15	-0.07	3.60
Tamil Nadu	21.93	1.84	3.18	27.94	0.10	2.70
Uttar Pradesh	40.00	3.25	5.20	41.73	-0.82	2.70
West Bengal	37.09	5.64	7.51	46.72	3.20	4.50
TOTAL	**31.07**	**3.41**	**5.07**	**39.08**	**0.34**	**3.46**

APPENDIX II
(Rupees in Lakhs)

		Projections of 12th FC		Actuals		RMSPE
		2005-06	2006-07	2005-06	2006-07 (RE)	
AP	Non-Plan Revenue Receipts	22860.97	26020.4	23898.77	30766.11	**11.33**
	Total Non-Plan Revenue Expenditure	25113.25	27192.08	28433.01	32938.38	**14.84**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-2252.29	-1171.68	-4534.24	-2172.27	**48.24**
Arunachal Pradesh	Non-Plan Revenue Receipts	187.71	212.76	264.07	277.92	**26.32**
	Total Non-Plan Revenue Expenditure	722.92	777.23	943.99	1202.52	**29.99**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-535.21	-564.47	-679.92	-924.6	**31.39**
Assam	Non-Plan Revenue Receipts	4302.75	4824.73	4691.47	5182.04	**7.62**
	Total Non-Plan Revenue Expenditure	7566.6	8181.67	8409.27	12974.47	**27.06**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-3263.86	-3356.94	-3717.8	-7792.43	**41.16**
Bihar	Non-Plan Revenue Receipts	5786.56	6639.58	4083.08	4865.06	**39.19**
	Total Non-Plan Revenue Expenditure	14113.83	15263.3	15324.59	19383.33	**16.03**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-8327.27	-8623.72	-11241.5	-14518.27	**34.06**

		Projections of 12th FC		Actuals		RMSPE
		2005-06	2006-07	2005-06	2006-07 (RE)	
Chattisgarh	Non-Plan Revenue Receipts	4767.89	5302.57	5281.57	6751.36	**16.66**
	Total Non-Plan Revenue Expenditure	4964	5362.71	5448.75	6954.42	**17.36**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-196.11	-60.14	-167.18	-203.06	**51.25**
Goa	Non-Plan Revenue Receipts	1287.3	1517.19	1857.65	2100.42	**29.27**
	Total Non-Plan Revenue Expenditure	1216.54	1321.02	1776.01	2039.12	**33.41**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	70.76	196.17	81.64	61.3	**155.86**
Gujarat	Non-Plan Revenue Receipts	17033.06	19762.08	19051.28	22511.74	**11.43**
	Total Non-Plan Revenue Expenditure	16933.91	18314.83	21544.08	23071.4	**21.01**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	99.15	1447.25	-2492.8	-559.66	**264.01**
Haryana	Non-Plan Revenue Receipts	9830.41	11299.64	11537.21	13537.18	**15.69**
	Total Non-Plan Revenue Expenditure	7657.45	8351.07	10625.09	14021.65	**34.75**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	2172.96	2948.57	912.12	-484.47	**510.51**
Himachal P.	Non-Plan Revenue Receipts	1727.76	2034.22	2186.7	2398.34	**18.32**
	Total Non-Plan Revenue Expenditure	4369.23	4687.86	5282.76	5839.08	**18.54**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-2641.47	-2653.65	-3096.06	-3440.74	**19.22**

		Projections of 12th FC		Actuals		RMSPE
		2005-06	2006-07	2005-06	2005-06 (RE)	
J & K	Non-Plan Revenue Receipts	1940.24	2204.3	2416.78	2506.79	**16.35**
	Total Non-Plan Revenue Expenditure	5516.78	5926.42	8578.71	9272.95	**35.89**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-3576.54	-3722.12	-6161.93	-6766.16	**43.50**
Jharkhand	Non-Plan Revenue Receipts	4310.13	4801	4279.19	4561.66	**3.75**
	Total Non-Plan Revenue Expenditure	4841.25	5258.31	6413.79	7052.52	**24.98**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-531.12	-457.31	-2134.6	-2490.86	**78.45**
Karnataka	Non-Plan Revenue Receipts	19613.79	22990.44	22506.26	28184.69	**15.89**
	Total Non-Plan Revenue Expenditure	17001.1	18472.98	22972.24	26727.4	**28.54**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	2612.7	4517.46	-465.98	1457.29	**490.21**
Kerala	Non-Plan Revenue Receipts	12205.72	13987.51	10715.39	13043.83	**11.09**
	Total Non-Plan Revenue Expenditure	15113.07	16403.2	15208.19	21697.14	**17.26**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-2907.35	-2415.69	-4492.8	-8653.31	**56.75**

		Projections of 12th FC		Actuals		RMSPE
		2005-06	2006-07	2005-06	2005-06 (RE)	
M.P.	Non-Plan Revenue Receipts	11170.83	12710.06	11322.9	12501.73	**1.51**
	Total Non-Plan Revenue Expenditure	13150.41	14173.34	16351	17271.6	**18.77**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-1979.58	-1463.29	-5028.1	-4769.87	**65.12**
Maharashtra	Non-Plan Revenue Receipts	36301.32	41825.79	39475.3	45646.22	**8.21**
	Total Non-Plan Revenue Expenditure	36228.24	39221.78	46974.45	54096.53	**25.29**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	73.08	2604.01	-7499.15	-8450.31	**116.85**
Manipur	Non-Plan Revenue Receipts	183.72	209.79	171.42	275.92	**17.69**
	Total Non-Plan Revenue Expenditure	1323.15	1429.96	1610.89	1739.27	**17.82**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-1139.43	-1220.17	-1439.47	-1463.35	**18.85**
Meghalaya	Non-Plan Revenue Receipts	405.58	455.68	398.66	441.52	**2.58**
	Total Non-Plan Revenue Expenditure	1121.51	1203.11	1182.91	1282.39	**5.71**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-715.93	-747.43	-784.25	-840.87	**9.98**

		Projections of 12th FC		Actuals		RMSPE
		2005-06	2006-07	2005-06	2006-07 (RE)	
Mizoram	**Non-Plan Revenue Receipts**	114.87	131.34	175.15	182.88	**31.45**
	Total Non-Plan Revenue Expenditure	1323.15	1429.96	1610.89	1739.27	**17.82**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-1139.43	-1220.17	-1439.47	-1463.35	**18.85**
Nagaland	**Non-Plan Revenue Receipts**	193.84	219.19	202.34	203.37	**6.25**
	Total Non-Plan Revenue Expenditure	1427.97	1532.18	1784.72	1784.72	**13.50**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-1234.13	-1312.98	-1581.35	-1581.35	**15.57**
Orissa	**Non-Plan Revenue Receipts**	5548.12	6290.15	6534.17	7605.99	**16.23**
	Total Non-Plan Revenue Expenditure	10755.59	11563.12	11490.79	13745.91	**12.11**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-5207.47	-5272.97	-4956.62	-6139.92	**10.61**
Punjab	**Non-Plan Revenue Receipts**	9898.41	11281.51	13525.69	15635.52	**27.34**
	Total Non-Plan Revenue Expenditure	12643.09	13564.1	17247.78	20562.8	**30.59**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-2744.68	-2282.59	-3722.09	-4927.28	**42.25**

		Projections of 12th FC		Actuals		RMSPE
		2005-06	2006-07	2005-06	2005-06 (RE)	
Rajasthan	Non-Plan Revenue Receipts	11162.89	12873.77	12617.89	14498.24	**11.37**
	Total Non-Plan Revenue Expenditure	16261.39	17540.38	18367.67	21418.46	**15.15**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-5098.5	-4666.61	-5749.78	-6920.22	**24.38**
Sikkim	Non-Plan Revenue Receipts	203.89	227	1137.29	1175.5	**81.38**
	Total Non-Plan Revenue Expenditure	478.27	511.71	1473.43	1572.2	**67.50**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-274.39	-284.71	-336.14	-396.7	**23.82**
Tamil Nadu	Non-Plan Revenue Receipts	23047.06	26604.55	25926.77	30946.66	**12.65**
	Total Non-Plan Revenue Expenditure	23833.02	26064.9	26873.21	32622.73	**16.31**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-785.96	539.66	-946.44	-1676.07	**94.24**
Tripura	Non-Plan Revenue Receipts	487.43	557.9	359.7	424.3	**33.56**
	Total Non-Plan Revenue Expenditure	1920.68	2070.26	1979.16	2107.79	**2.44**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-1433.25	-1512.35	-1619.46	-1683.49	**10.85**

		Projections of 12th FC		Actuals		RMSPE
		2005-06	**2006-07**	**2005-06**	**2005-06 (RE)**	
Uttar Pradesh	**Non-Plan Revenue Receipts**	22046.53	25395.88	21788.22	29791.46	**10.47**
	Total Non-Plan Revenue Expenditure	34494.83	37140.59	40172.33	46685.15	**17.57**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-12448.3	-11744.71	-18384.1	-16893.69	**31.40**
Uttaranchal	**Non-Plan Revenue Receipts**	2004.19	2276.52	2434.64	2978.78	**20.84**
	Total Non-Plan Revenue Expenditure	3975.79	4323.92	4214.66	4919.33	**9.45**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-1971.6	-2047.4	-1780.02	-1940.55	**8.55**
West Bengal	**Non-Plan Revenue Receipts**	16258.38	19211.83	11407.19	13742.31	**41.19**
	Total Non-Plan Revenue Expenditure	25150.49	27205.82	26822.72	30226.66	**8.33**
	PRE. DEVO. NON-PLAN REV. Deficit/surplus	-8892.12	-7993.98	-15415.5	-16484.35	**47.14**

APPENDIX III

Population in Thousands

State-wise Decennial Growth of Population by Census in India				
States/UTs	**1971**	**1981**	**1991**	**2001**
India	**548160**	**683329**	**846303**	**1027015**
Andhra Pradesh	43503	53551	66508	75728
Arunachal Pradesh (1)	468	632	865	1091
Assam	14625	18041	22414	26638
Bihar	56353	69915	86374	82879
Chhattisgarh*	-	-	-	20796
Goa	795	1008	1170	1344
Gujarat	26697	34086	41310	50597
Haryana	10036	12922	16464	21083
Himachal Pradesh	3460	4281	5171	6077
Jammu & Kashmir	4617	5987	7719	10070
Jharkhand**	-	-	-	26909
Karnataka	29299	37136	44977	52734
Kerala	21347	25454	29099	31839
Madhya Pradesh	41654	52179	66181	60385
Maharashtra	50412	62783	78937	96752
Manipur	1073	1421	1837	2389
Meghalaya	1012	1336	1775	2306
Mizoram	332	494	690	891
Nagaland	516	775	1210	1989
Orissa	21945	26370	31660	36707
Punjab	13551	16789	20282	24289
Rajasthan	25766	34262	44006	56473
Sikkim	210	316	406	540
Tamil Nadu	41199	48408	55859	62111
Tripura	1556	2053	2757	3191
Uttaranchal***	-	-	-	8480
Uttar Pradesh	88342	110863	139112	166053
West Bengal	44312	54581	68078	80221
Andaman & Nicobar Islands	115	189	281	356
Chandigarh	257	452	642	901
Dadra & Nagar Haveli	74	104	138	220
Daman & Diu	63	79	102	158
Delhi	4066	6220	9421	13783
Lakshadweep	32	40	52	61
Pondicherry	472	604	808	974