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New Approaches to Fiscal Federalism in India

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Dear Friends,

I am greatly honoured by the kind invitation to deliver the Foundation Day Lecture of the MIDS. I am grateful to the Chairman Professor K L Krishna, Director P G Babu and Professor Venkatachalapathy, for giving me this opportunity to visit MIDS again. I had the privilege of interacting with several eminent personalities associated with MIDS starting from Professor Malcom Adhiseshaiah, and including Professor A. Vaidyanathan, Professor Kurien, and of course, my friend S. Guhan. The Institute has built a formidable reputation in applied economics, both in theoretical and empirical research. It has a refreshingly progressive approach with sensitivity to social issues while being pragmatic in its outlook. The depth and breadth of the Foundation Day Lectures in the past stand testimony to the high level of debate that the Institute values.

As a federation, we have two level fiscal system, namely, Union and States. The Constitution assigns revenue raising and expenditure decisions to the two levels. It broadly applies the comparative advantage principle in assigning tax powers and expenditure functions. It also recognises the imbalances that arise as a consequence and provides for a mechanism to resolve the vertical (between Union and State) and horizontal (among the States) mismatch between revenue and

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expenditure assignments. The institutional arrangement is Finance Commission. But, transfers can take place and do take place outside of the Finance Commission also. These had the benefit of advice of Planning Commission then, and more recently, NITI Aayog. Significant literature exists on this subject, including my recent book on the subject. My lecture today focuses on more recent developments in fiscal federalism in India which have led to suggestions for new approaches.

Fiscal Federalism in India has been impacted considerably by several recent events – in particular, the implementation of the award of the XIV Finance Commission, the implementation of the Goods and Services Tax, replacement of the Planning Commission with the NITI Aayog and the Terms of Reference of the XV Finance Commission.

The issues triggered by the recent events may be summarised as follows: (a) The manner in which the recommendations of XIV Finance Commission on vertical and horizontal balances have been diluted, resulting in a widening gap between perception and reality; (b) The effect of changes in the fiscal responsibility framework suggested by FRBM Review Committee on the vertical and horizontal balances envisaged by the XIV Finance Commission; (c) The impact of the implementation of GST on the overall fiscal space available to the States and Centre, relative to the past; (d) The controversies surrounding Terms of Reference of the XV Finance Commission; and (e) The loss of revenue to States due to tax exemptions granted in the Union budget of 2019-20, in addition to the existing infirmities.

In parallel, several eminent economists and policy-makers have floated new approaches to address the perceived problems relating to Fiscal Federalism. These include Arvind Subramanian's exposition in his book "Of Counsel" and Professor Sukhamoy Chakraborty Memorial Lecture titled "Towards India's New Federalism" delivered by Dr. Vijay Kelkar (Chairman XIII Finance Commission) (Kelkar 2019), and common memorandum by select States to the President of India with Professor Isaac, the Finance Minister of Kerala taking a leading role. Dr. Rangarajan made some suggestions in Chennai in an event on 8th March to simplify the whole approach. Dr. Govinda Rao has proposed redesigning of fiscal transfer system in India. Governor Das, among other things, renewed the suggestion to make the Finance Commission a continuing body in the interest of continuity. In brief, there is a search for new approaches to fiscal federalism in India which I propose to analyse.

The concluding part, the way forward, attempts a synthesis of the approaches, while taking account of lessons of experience.

PART ONE: RECENT DEVELOPMENTS

Perception and Reality

The XIV Finance Commission recommended an increase in tax devolution from 32 to 42%. This has been perceived to be substantial with considerable adverse impact on the fiscal space available to the Union. The reality is different from the perception as has been eloquently explained by Professor Govinda Rao. He said: *'First, the XIV FC's recommendation on increasing devolution from 32% to 42% is not as generous as it looks. It must be noted that unlike the previous commissions, the XIV FC was asked to cover the requirements under both Plan and*

Non-Plan accounts which required it to subsume Gadgil formula grants, amounting to 5.5% of the divisible pool in their recommendation. In addition, the XIV FC avoided giving discretionary sectoral grants including environmental grants amounting to 1.5 % of the divisible pool. Thus, the legitimate comparison should be between 39% and 42%.' (Rao, Financial Express, December 5, 2017).

Further, there has been an increase in Cesses and surcharges during the recent years despite the introduction of GST. Since the Cesses and surcharges are not sharable, the States stand to lose the revenue that would have accrued to them if there were taxes.

Moreover, the design of the Centrally Sponsored Schemes has been changed increasing the share of State Governments' contributions from an average of 50% to an average of 60%. In a way, therefore, this has resulted in the erosion in the net benefit available to the State Governments as a result of enhanced devolution.

Under the circumstances, the simplest measure of the vertical balance is the share of aggregate transfers to States in the total gross revenue of the Union Government. The percentage share during four years, 2015-16 to 2018-19 ranged between 47.58 and 44.70, while during 2011-12 to 2014-15, it ranged between 53.70 and 46.00. By this measure, there is decrease and not an increase in the share of States after the acceptance of recommendation of Fourteenth Finance Commission.

Table 1: Total Transfers as percentage of Gross Revenue of the Union Government

*Grants-in-Aid include those on account of recommendations of Finance Commission also.

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18 RE	2018-19 BE
Devolution	20.26	24.84	19.23	23.41	29.65	30.57	30.84	31.32
Grant-in-aid to State Governments*	33.44	24.16	26.77	22.76	17.93	14.12	16.67	16.46
Total	53.70	49.00	46.00	46.17	47.58	44.70	47.51	47.78

2011-12 2012-13 2013-14 2014-15 2015-16 2016-17 2017-18 RE 2018-19 BE

As regards the horizontal balance, there are severe problems of data availability. Hence, conjectures are attempted. The increased share of tax devolution means greater share of formula based transfers. But, the Union Government increased the mandatory share of State Governments in respect of Centrally Sponsored Schemes. This measure could mean that poorer States will have difficulty in putting up counterpart funds resulting in non-utilisation. The change in funding pattern of CSS might have introduced regressive consequences. In brief, the benefit of higher share that poorer States could get due to enhanced devolution has been diluted by the actions of Union Government on non Finance Commission transfers.

Changes in the fiscal responsibility framework

The Union Finance Minister in his budget speech 2017-18 mentioned the recommendations of the FRBM Review Committee and said that it would be the anchor of fiscal policy henceforth. These changes, as will be explained, have the effect of asymmetrical fiscal adjustment paths between Union and States, thus affecting vertical balance. They impact States' access to debt finance in a regressive manner, thus affecting horizontal balance. They dilute the independence of the proposed fiscal council as made by XIV Finance Commission. Some explanation is needed to substantiate these assertions.

Subsequent to the Fourteenth Finance Commission, Government of India had constituted a committee under the Chairmanship of Mr. N.K. Singh (subsequently appointed as Chairman of Fifteenth Finance Commission in 2017) to review the Fiscal Responsibility and Budget Management (FRBM) Act, specifically known as FRBM Review Committee. It submitted its recommendations in 2017. The objective was to align the FRBM framework with current international practices and indicators for fiscal prudence. The main recommendations of the Committee covering debt-deficit dynamics of both Centre and States are summarized below:

Firstly, repealing of existing FRBM Act and enacting of a new Debt and Fiscal Responsibility Act along with formation of an independent fiscal council.

Secondly, debt-GDP ratio on a combined basis for the General Government should be anchored to 60 per cent (from the existing 70 per cent) with Centre's and States' targets as 40 and 20 per cent, respectively.

Thirdly, fiscal deficit to be made the operational target.

Fourthly, within this framework the Committee derived for the Centre, a fiscal roadmap targeting fiscal deficit-GDP ratio at 3 per cent in the period from 2017-18 to 2019-20, 2.8 per cent in 2020-21, 2.6 per cent in 2021-22, and 2.5 per cent in 2022-23. Similarly a glide path to bring down the revenue deficit-GDP ratio from 2.05 per cent in 2017-18 to 0.8 per cent in 2022-23 should be adopted.

Fifthly, deviations from the set fiscal deficit target should not exceed more than 0.5 percentage points. Targets can be exceeded only under certain escape clauses after consultation with the fiscal council. These clauses could be invoked under exceptional circumstances or when there is a decline in real output growth of at least three per cent below the average for the previous four quarters.

Sixthly, the FRBM Committee did not specify State specific deficit paths and instead recommended that the State-wise overall debt and fiscal targets should be assigned to the Fifteenth Finance Commission through a specific ToR. The Committee noted that until such time as the Fifteenth Finance Commission makes its recommendations the status quo inter-se proportions can be maintained.

The Committee said that State debt was currently not significantly higher than the end point anchor (20% of GDP) that was proposed. Therefore, maintaining status quo will not, in its view, significantly impact longer-term recommendations, and will also allow States to consolidate over a eleven–year time frame with the

consolidation path for the first 5 years prescribed by the Fifteenth Finance Commission for individual States."

Currently, there is significant difference in the debt to GSDP ratio across States and access to per-capita debt is highly regressive across States. A differential fiscal adjustment path for States may be needed keeping in view its impact on fiscal space for capital expenditure, especially for poorer States.

The FRBM Review Committee recommended that the operational parameter of fiscal management should be the fiscal deficit consistent with achieving medium-term debt ceiling. This requires bringing down the combined debt to GDP ratio to 60 per cent of GDP by 2025. The Union government is required to bring this ratio to 40 per cent of GDP by 2025 and States together are required to bring this ratio to 20 per cent of GDP.

Table 2: Deficit and Debt Profile of Union Government

(In Per cent)

	2014-15	2015-16	2016-17	2017-18 (RE)	2017-18	2018-19 (BE)	2018-19 (RE)	2019-20 (BE)
Revenue Deficit	2.9	2.5	2.1	2.6	2.6	2.2	2.2	2.2
Effective Revenue Deficit	1.9	1.6	1	1.5	1.5	1.2	1.1	1.3
Fiscal Deficit	4.1	3.9	3.5	3.5	3.5	3.3	3.4	3.4
Primary Deficit	0.9	0.7	0.4	0.4	0.4	0.3	0.2	0.2
Debt to GDP Ratio	50.07%	50.14%	48.75%	0.00%	49.10%	0.00%	48.65%	47.41%

As evident from Table 2, the Union government is having a large fiscal imbalance and its debt to GDP ratio is expected to be 47.71 per cent of GDP in 2019-20 (BE). The debt to GDP ratio of States for the year 2018-19 (BE) is 24.91 per cent of GDP. In other words, the Union government is required to take larger corrections in debt to GDP ratio compared to States to bring this ratio together to

60 per cent of GDP. But, as recommend by the FRBM Committee, in order to achieve this, Union government needs to bring the deficit to 2.5 per cent of GDP by the end of 2025 and States to 1.78 per cent of GDP by 2025. In other words, States will have to undertake larger fiscal correction compared to the Union government despite being fiscally prudent compared to the Union government.

An independent Fiscal Council has been proposed by the FRBM Review Committee which is supposed to be appointed by the Union Finance Ministry and reporting to it. However, it is far less independent than the one proposed by the Fourteenth Finance Commission. The FRBM Review Committee's Fiscal Council will forecast key macro variables like real and nominal GDP growth, tax buoyancy, and commodity prices. Similarly, it will do a monitoring role, besides advising about the use of escape clause and also specify a path of return. It will provide advisory functions to the Ministry.

The Fiscal Council envisaged by the XIV Finance Commission is statutory by an amendment to the FRBM Act, similar to the one that enables the ex-post assessment by the C&AG. The mission of the fiscal council would be to undertake ex-ante assessment of the fiscal policy implications of budget proposals and their consistency with fiscal policy and rules. The assessment made by the fiscal council is meant to be tabled in both Houses of Parliament.

Asymmetric Impact of the implementation of GST:

The implementation of GST is undoubtedly a historic step, but States seem to be disadvantaged in the design and in the implementation.

Firstly, if we consider the pre-GST tax structure, VAT/Sales Tax constituted more than two-thirds of State revenues. While for the Union government, the share of indirect taxes was around 50 per cent of the total tax revenue. Thus, by giving up independence of tax power, relative loss of fiscal autonomy for States is greater than it is for the Union.

Secondly, the GST tax base has been apportioned on a 50:50 basis between Union and States. However, if we review pre-GST discussions/debates, we observe that various Committees, task forces and independent research studies have shown and convincingly established that States' GST rate should be higher. The GST task force appointed by the Thirteenth Finance Commission suggested a 12 per cent GST rates-7 percent as SGST and 5 per cent as CGST. The Committee on RNR chaired by the then Chief Economic Advisor, Arvind Subramanian also recommended a higher rate of GST for States. This is due to the fact that States' tax base subsumed under GST is more than that of Union. Dividing the tax base on a 50:50 basis resulted in accentuation of existing vertical fiscal imbalance between Union and States.

Thirdly, decisions in GST Council have so far been based on consensus between Union and States. In the absence of consensus, voting mechanism will be used to arrive at a decision in the GST Council. In the event of voting, as per the Constitutional amendments, 3/4th majority is required to arrive at a decision in the Council and the Union government has 1/3rd of the vote share. In other words, the Union government has an effective veto power in the Council. This also points to the fact that relative bargaining power of States in the GST Council is much less than that of the Union government.

These three structural issues only highlight that States, in the present GST framework, have agreed to an asymmetric bargain as far as loss of fiscal autonomy is concerned. Though the resource envelope of States is protected for 5 years with a GST compensation, one is unsure as to how the GST would evolve in the medium term and impact State revenue and fiscal autonomy.

The implementation of GST so far does not lend comfort to the States, in some respects. This is best summed up in an article by a public policy analyst, Mr. V. Bhaskar. (Business Standard, March 6, 2019). The concerns relate to recognition of revenue, reporting of revenue and allocation of revenue in respect of revenue from the IGST and compensation for the year 2017-18.

He argues that the GoI is utilising the IGST and Compensation Cess Fund Accounts simultaneously as source of revenue and as a source of ways and means financing. This approach sets up perverse incentives to delay IGST refunds and Compensation Fund payments. The former significantly emasculates exporters, manufacturers and traders, with downstream consequences, while the latter debilitates the fiscal position of State governments.

Controversies:

The Terms of Reference of the XV Finance Commission invited unprecedented controversies. Traditionally, the core functions of the Finance Commission included a reference to providing grants for the States which are in need of assistance. This has been deleted. States genuinely fear that, in the absence of need based revenue deficit grants, discretionary powers will be conferred on the Union contrary to the intent of the Constitution. Secondly, the XV Finance Commission has been

asked to take into account the impact of the "substantial increase in the tax devolution recommended by the XIV Finance Commission". This is the first time that a specific mandate has been given to review the recommendations of the previous Commission. Thirdly, a national development program including New India 2022 representing the programs of the present government have been mentioned as a consideration for the Finance Commission. This gives rise to the fear among the States that the Finance Commission is being asked to support the specific program of the Government of the day. Fourthly, the Commission has been mandated to take into consideration specific factors while giving consent to the borrowings of the State Governments. This is unprecedented and virtually makes the approval of the borrowing program subject to extraneous considerations. The approval of Union Government is required only if the State happens to owe a debt to Union Government and hence the presumptions about the intent of the Constitution. The ToR also lists out nine areas proposing measurable performance-based incentives for States. The States fear that the Union Government is unilaterally deciding on the indicators and thus, policy priorities. The States broadly felt that almost all the changes in the Terms of Reference of the XV Finance Commission are heavily loaded against the States both quantitatively and qualitatively.

The required use of 2011 population figures as the basis by the Finance Commission triggered strong reaction from some of the States. This will lead to about four percentage point drop in the share of Southern States as a group. This is a large drop with implications for devolution of resources as 1971 population had a

weight of 17.5 per cent in the horizontal devolution formula of Fourteenth Finance Commission.

Use of dated population makes assessment of fiscal need of States unrealistic. Thus, use of 2011 population instead of 1971 is an improvement. However, it is to be noted that Fifteenth Finance Commission award period will be 2020-25, and hence even the use of 2011 population would still be a dated one. However, it is a big improvement over the use of 1971 population.

Loss of Revenue

The 2019-20 budget has increased the effective income tax threshold to around Rs. 650,000 annual income (about US $ 9,300), which is about four to five times Indian annual per capita income. The current threshold in the United States, is about US $ 13,500, whose per capita income is around thirty times that of India. In PPP terms, the Indian threshold is now around US $ 33,700. China has a tax threshold of $2800/- after which the tax rate rises progressively from 3% to 45%.

India must be the only major economy in the world where inheritance tax is not levied. The States legitimately feel deprived of their share in such a tax.

The State Governments feel that the Union Government has not fully exploited the tax potential and in the process the States are deprived of the adequate devolution.

In the Indian context, the share of tax-evaded income as a proportion of GDP has been estimated by various studies – the range being 21% to 35-40%. The size

of the tax-evaded economy has an adverse consequence not only for central finances, but also for the states. This has two aspects: first, the divisible pool of the taxes shareable with the states becomes smaller and second, the consequential evasion of state taxes. Given the higher expenditure obligations and limited revenue-raising powers of the states, it adversely impacts the States' intervention capacity more than that of the Centre. Recent initiatives taken by the Government to tackle the evil of unaccounted money should have a beneficial effect, if reflected in tax receipts.

To sum up, the Indian fiscal federalism is under stress, in the sense that the trust in the institutional arrangements and the manner in which they work is under stress. Some of the concerns may be well founded, and others not. As a response some new approaches have been suggested. I propose to place them before you.

PART II: THE NEW APPROACHES

Analytical Framework and Vision:

Dr. Arvind Subramanian (former Chief Economic Adviser, Government of India) in his book "Of Counsel" (2018), has devoted one chapter to a new approach for Fiscal Federalism. The Chapter is titled "Fiscal Federalism in India: An Analytical Framework and Vision".

He makes a reference to the difficult question being faced by the XV Finance Commission, and says: "But the underlying issue is a serious one: how much tax revenue should prosperous states be expected to transfer to less well-off ones?"

While this may be one of the important issues, it is obvious that the framework and the vision for fiscal federalism have to go beyond this issue. Yet, the framework as well as the vision proposed by him needs to be considered in detail since it is in response to the current status of debates.

The framework states that tax sharing in all federal systems has to address three issues, namely, redistribution or equalising transfers; risk sharing in response to shocks and incentives for better performance at the lower tiers of government.

On the first issue of redistribution, Dr. Subramanian proceeds on the assumption that the divisible pool comprises taxes that the Centre is collecting on behalf of the States.

In reality, the Centre collects the taxes on behalf of both Centre and States and the amounts are shared between the two. The Centre's share is credited to Consolidated Fund of the Government of India and the States' share to the respective States. Consequently, there is a simultaneous vertical sharing and horizontal sharing. In fact, the vertical sharing is the controlling factor that decides the outcome of horizontal sharing across States.

On the question of horizontal sharing, Dr. Subramanian argues, "we need to go back to first principles, and restore the primacy of the idea, implied in the Constitution, that the divisible pool comprises taxes that the Centre is collecting on behalf of the states. Accordingly, the default should be to give back to the states the taxes they have generated. Redistribution should then be understood as departures from this benchmark."

In reality, there is no basis to assume that default option is to give back since it is not contemplated or implied in the Constitution. Further, in a common market where the producers get the profits/incomes from the consumers, is it possible to attribute the taxes merely because it is collected there?

On the second issue of risk sharing, Dr. Subramanian feels that the States do not have enough fiscal flexibility to deal with major shocks, and that they will need some help from the Centre. That is true, and this is an issue that impacts both vertical and horizontal balance.

On the third issue, he argues that there is a low equilibrium trap, which is true. He adds: "Consequently, the issue facing the FC is: can it provide credible incentives for second- and third-tier fiscal bodies to improve their own revenue performance, especially direct taxes, in order to facilitate better service delivery?"

It is not clear why improving resource performance of only the 2nd tier and the 3rd tier is mentioned and the Central Government excluded. Moreover, incentives for 3rd tier cannot be built into a mechanism of tax devolution meant to address the fiscal capacity differential across States. As per the Constitutional provisions, the 3rd tier gets funds in the form of grants-in-aid from Union Government on the recommendations of Finance Commission but through the relevant State Government. Entry 5 in the State List of the Seven, the Schedule places the responsibility for the local governments squarely in the domain of the States.

As regards the way forward, Dr. Subramanian's suggestion is that the tax sharing should have four pots. First, a default pot, in which states get back their

due based on their tax base (what might be called true 'devolution'). Second, a redistribution pot that balances the short-run need to equalize without denting the long-run incentives for revenue generation. Third, a risk-sharing pot to deal with both all-India (financial and currency crisis) and state-specific shocks (monsoon and droughts). Fourth, a rewards pot to break the 'low-equilibrium' trap at the lower tiers of government. By way of conclusion, he suggests that a new institution may be needed to implement this vision.

The suggested new framework and vision for tax devolution can be examined from the point of view of Constitutional intent, operational difficulties, lessons of experience, acceptability of outcomes and spillover effects. As already mentioned, paying back to a particular State based on collection of a tax by the Centre is not contemplated in the Constitution. The Constitution recognises the vertical and horizontal imbalances and provides for a periodic Finance Commission with the objective of correcting both the imbalances with reference to constitutionally mandated functions.

There are operational difficulties in estimating a State's share in taxes collected by the Centre by source. There are differences between collection and accrual. In an integrated economy, taxes are paid in places where the returns are filed which may be different from where the income accrues. GSDP may be a proxy to the level of economic output but not tax base. States’ own tax base depends on consumption.

Lessons from the experiences of First to Ninth Finance Commissions for income tax point to the difficulties in giving weights to the collection factor. At that

time, weights varied between 10 and 20%. The X Finance Commission gave its reasons for giving up the practice and they are more relevant now than before. *"The generation of income, especially non-agriculture income, is a spatially interdependent activity. An input being produced in a specific place may be using inputs produced in various other locations. The income generated from the sale of this output also depends on the income of consumers who may be spatially dispersed throughout the country. The country as a whole represents a common economic space and market, and growing interdependence in economic activities has considerably weakened the case of locally originating incomes in the non-agricultural sector."*

The question is "what would the concept of true devolution mean in terms of numbers"? Dr. Chakraborty who has made some calculations in this regard, states:

"If 'true devolution' is introduced, 10 richer States would claim 62.83 per cent and the shares of those at the bottom ladder of per-capita income would be reduced to 37.18 per cent. Even a fraction of tax devolution by way of so called `true devolution' would mean significant erosion of the principle of offsetting revenue disability."

The acceptance of the true devolution concept has spillover effects on grants. Burden of offsetting the disabilities will fall on the grants if the principle of offsetting revenue disabilities is diluted once the principle of true devolution is accepted.

The second pot, namely, the redistribution pot is expected to balance the short-term need to equalise without denting the long-term incentive for revenue generation. Obviously, the incentive for revenue generation requires performance

indicators to be included in the tax devolution criteria. The experience so far is not encouraging in this regard as explained below.

Fiscal Performance Indicators and Tax Devolution: Experience

Till the tenth Finance Commission, performance indicators were not included in the criteria for tax devolution. The Tenth was the first Commission to have assigned a weight of 10 per cent to tax effort in the devolution criteria of both income tax and Union excise duties.

The ToR of the Eleventh Commission made an explicit reference to *'incentives that need to be provided for better utilization of tax and non-tax revenues'.* While continuing with tax effort as a criterion, the Commission reduced its weight to 5 per cent. However, the Commission introduced a new criterion of 'Fiscal Discipline' in the devolution formula. The Commission assigned a weight of 7.5 per cent to the index of fiscal discipline.

The Twelfth Commission made no change except that it raised the weight assigned to tax effort from 5 per cent to 7.5 per cent. The Thirteenth Finance Commission dropped the criterion of tax effort, but felt that there was a strong case to incentivize states following fiscal prudence. The Commission assigned a weight of 17.5 per cent to fiscal discipline. Under this criterion, if all States had improved their respective ratios of own revenue to total revenue expenditure, then the States with relatively higher improvement than the average receive higher transfers. The Fourteenth Finance Commission did not assign any weight to performance indicators.

The issues to be considered in pursuing the idea of incentives for fiscal performance are as follows. First, as the 13th Finance Commission made it clear, forward looking indicators are not feasible, and hence the dispensation is in the nature of a reward for past performance. This does not ensure future performance. Also there is no assurance of reward for performance on a sustained basis. It would depend on the horizontal sharing formula adopted by successive Finance Commissions. Second, there is no empirical evidence that the incentives have worked. Third, it may be better for the Union Government to devise such incentives outside the framework of Finance Commission to ensure continuity and stability in incentive framework.

With regard to the third pot, which is risk sharing, there are several options. But, do they fall in tax sharing or grants? How would it be different from the current arrangements in regard to national calamity fund?

The fourth, rewards pot, is addressed to the lower tiers of the Government. This again cannot be part of sharing of taxes, but will have to be in the part of the Grants-in-Aid. The requirement of Union Government for meeting such demands from grants-in-aid may be taken into account while considering vertical balance.

Dr. Subramanian suggested that, in the absence of Planning Commission, a new institution may be needed to implement this new vision of tax sharing. He expressed the view that GST Council could be such an institution. He stated that, '*Thus far, it has worked very effectively and demonstrated that cooperative federalism can work. It now can build on that experience to take on issues related to resource transfers and any other follow-up and implementation work which*

future fiscal federalism will necessitate.' (page 307). He concludes the chapter by stating that the '*fifteenth Finance Commission has an opportunity to design them as if it were the First.'*

It is not clear how the GST Council as it is constituted can be entrusted with the responsibility of implementing the new vision of tax sharing. Presumably, Dr. Subramanian had in mind a new institution on the lines of GST Council to perform function of erstwhile Planning Commission, by an arrangement to be designed by the XV Finance Commission.

In brief, the vision contemplated by Dr. Arvind Subramanian has to fit into the concept of sharing of taxes as distinct from the Grants-in-Aid. Further, a distinction has to be made between an award which is in the nature of arbitration between the interests of the Union and the States as distinct from the grants from the Union outside the recommendations of the Finance Commission to reflect the policies appropriate from time to time, based on political consensus.

While there are complex issues with the framework and vision, one can agree with the conclusion of Dr. Arvind Subramanian when he says: "India's future lies in cooperative federalism. Increasingly, the Centre and the states must come together to solve problems across the economic landscape. Therefore, its fiscal arrangements must be commensurate with the challenges ahead, and based on a framework and vision that are economically coherent and politically acceptable."

Towards New Fiscal Federalism:

Dr. Vijay Kelkar in his Professor Sukhamoy Chakravarty Memorial Lecture in January 2019 spelt out the parameters of a "new Fiscal Federalism". Firstly, he

expands the federal structure of Union of States from two levels of the Government to a third level and calls it Elected Local Bodies.

Secondly, he expands the scope of the framework of fiscal federalism beyond vertical and horizontal imbalances and introduces a third imbalance, namely, development imbalance. This refers to the increasing inequality among the levels of developments of different States.

Thirdly, he argues that there are two aspects to imbalances, namely, consumption levels and stock of infrastructure. These two warrant two different "policy instruments". He proposes two pillars, namely, Union Finance Commission to take care of the public goods and services part and suggests strengthening of a second pillar for development aspects, namely, NITI Aayog.

Fourthly, Dr. Kelkar seems to suggest that NITI Aayog be provided additional resources to enable it to play a more active role for developmental purposes. In his words, "Given the overall resource constraints what this would mean is that the future Finance Commissions, as against what has been done by the XIV FC, will have to revert to the modest percentages in their devolution formula as was indeed the historical trend." Fifthly, he appears to favour grants, but reformed ones.

"We need to reinvent the central grants by using somewhat different variables and formulae, while being mindful of macro-economic conjuncture and structural needs. These grants can be Capital or Revenue. Equally, these can be either conditional or unconditional transfers."

The framework needs to be analysed as a backdrop to appreciating the four pillars of federalism, without going into the controversies of Tinbergen Rule in a federal set up and the theoretical framework for multi-level policy decision making. Firstly, there is no third level of government independent of the States, as long as local bodies are unambiguously in the State List – 73rd or 74th amendments do not supersede that position. The third tier is governed by individual enactments in each State and such a tier may not exist in a State if the concerned State does not want. The scope and functions are decided by individual Acts of individual States.

Further, the role of the Union Finance Commission is limited when it comes to local governments. The 'Terms of Reference' of the National Finance Commissions requires them only to recommend "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". Thus, the role of State and State Finance Commission is central to decentralisation. The existing constitutional framework does not envisage "one-size fits all" decentralisation designed by the Union Government.

Apart from the questionable merits of a centrally designed democratic decentralisation bypassing the elected bodies at State level, the political sensitivity of the idea should not be ignored.

Secondly, it is important for fiscal federalism to recognize the third imbalance, development imbalance, but addressing it requires several policy actions. It is appropriate that the framework recognises it and brings it under the

purview of reformed NITI Aayog by the Union Government, and not Finance Commission.

Thirdly, the distinction between consumption levels and stock of infrastructure can be translated substantively into revenue and capital expenditure. The two pillars proposed by Dr. Kelkar fit into this assumption.

Fourthly, the framework proposes additional resources for NITI Aayog, which in effect means Union Government in fiscal federal framework. The additional resources are to be met by reverting to the modest percentages in the devolution formula. In effect, the proposal is to reduce the State's share of tax devolution to provide fiscal space to Union to incur expenditure to correct developmental imbalances. It is not clear whether this involves conditional Grants to Union.

As explained in Part I, the aggregate transfers from Union to States have not increased after the recommendation of XIV Finance Commission. They remain at the historic trend.

Fifthly, Dr. Kelkar pleads for reformed grants, conditional or unconditional. This suggestion should be the foundation for the future work of NITI Aayog, recognising the infirmities. Indeed, for future reforms, we need to evaluate the past and explore new options. It is possible that cause of development balance would be better served by replacing current centrally sponsored schemes, (thus eliminating Centre's revenue deficit) with enhanced access to poorer States to borrow for capital expenditures.

Dr. Kelkar proposes Four Pillars for new fiscal federalism; Finance Commission being the First Pillar, NITI Aayog 2.0 will be the Second Pillar of the New Fiscal Federalism.

The first pillar is the Finance Commission and rightly so. The proposal is that Finance Commission should deal with differing levels of per capita consumption of basic public services. Broad approach of Dr. Kelkar is consistent with the position taken by the First Finance Commission. The First Commission made it explicit that it was primarily concerned with the distribution of revenues between the Centre and the States and with the determination of grants and that the capital needs of both the Centre and the States had to be met largely from borrowed funds.

This position was altered by the decision of the Government of India to exclude revenue expenditures under Plan account from the jurisdiction of the Finance Commission. This decision was taken on the basis of the dissent note of the Member Secretary of the 3rd Finance Commission. In other words, bifurcation of revenue expenditure between plan and non-plan reduced the fiscal space for Finance Commission to make resources available for equitable provisioning of basic public services. However, this bifurcation was ended by the XIV Finance Commission by taking into consideration aggregate revenue expenditure while assessing the fiscal needs of States.

A further complication has been introduced with the Government of India incurring revenue deficits since 1980s, requiring borrowed funds to maintain the vertical and horizontal balance on revenue account. Further, a few Finance

Commissions in recent years were recommending capital grants, but that was an exception than a rule.

In brief, therefore, it is possible to operationalise Dr. Kelkar's first pillar provided that the Finance Commission's Terms of Reference restrict themselves to the sharing of taxes and the Grants-in-Aid is restricted to financing the revenue gap of the States. The XIV Finance Commission tried to follow exactly this logic. The binding constraint in implementing Dr. Kelkar's first pillar is the continued incurring of revenue deficit by the Union Government.

The second pillar, namely, NITI Aayog 2.0, an improved version of Planning Commission, is no doubt an appropriate body to consider the issue of development imbalance or Inter-State inequalities. There are three caveats, namely, NITI Aayog 2.0 remit cannot be confined to inter-State disparities, but has to encompass all the developmental aspects – both Union and States. Unlike Finance Commission, it is only an advisory body, and part of Union Government, with tenures of members co-terminus with political cycles.

Thus, at a conceptual level, the first and second pillars proposed by Dr. Kelkar are unexceptionable, and they exist in the current arrangements. But like the first pillar, the second pillar has not been performing as it should.

The empirical evidence so far in regard to flow of funds from multiple channels in the context of development imbalance of States shows that the problem lies with Union Government and not the Finance Commissions.

Empirical Evidence of Flow of Funds

The Finance Commissions have, it can be said, contributed to reduction rather than aggravation of inequalities, though their scope for contribution is circumscribed. Empirical evidence points to tax devolution being progressive; or inversely related to the per capita State Gross Domestic Product. Grants which account for less than twenty per cent of the total transfers recommended by Finance Commissions (except in case of Fourth and Sixth Finance Commissions) were less progressive.

Empirical work shows that the per capita plan outlays were invariably higher in respect of richer States in relation to the poorer States. There are two explanations for this, namely, the poorer States were less savvy in political bargaining or they were handicapped in absorption capacity. This experience is relevant in considering the proposed second pillar of Dr. Kelkar.

Till the eighties with both the Centre and States having surplus on their revenue accounts, borrowings were considered synonymous with capital expenditure. In the beginning of the planned era, allocation of market borrowings largely determined access to debt. In any case, borrowings are subject to approval of Union Government and more recently the fiscal responsibility Legislation.

While the average per capita outstanding liabilities amounted to Rs.47,054 in the top five per capita income States during the period 2013-16, the corresponding figure for the bottom five per capita income States was Rs.13,690. To the extent borrowings finance capital expenditure, poorer States are at a disadvantage in raising resources.

The flow of bank credit seems to favour richer states relative to others for understandable reasons. The average outstanding per capita scheduled bank credit during the years 2013-16 amounted to Rs.94,001 in the top five per capita income States as compared with a meager Rs.14,475 in the bottom five per capita income States.

Studies by National Institute of Public Finance and Policy have shown that the tax concessions, subsidies and direct spending by Union Budgets did not favour the poorer states, relative to others.

Third and Fourth Pillars

The third pillar relates to the strengthening of the fiscal base of the third tier for effective democratic decentralisation through sharing of the GST. The issue of third tier of Government in the Constitution requires a detailed consideration. Since centrality of State governments in deciding the process of decentralisation continues even after the 73rd and 74th Constitutional amendments, changes or suggestions for reforms need to remain sensitive to this aspect.

The fourth pillar of new fiscal federalism relates to the GST arrangements, which is considered to be a weak pillar requiring more reforms. These include inclusion of more products in GST (some argue that if petroleum products were included in the GST basket, the average rate will have to go up and not come down), putting exports at zero rate, bringing real estate into the ambit, reforming IGST, strengthening of secretariat.

Dr. Kelkar has succeeded in his objective; in his words: "I have also suggested innovative reform proposals towards creating Four Pillars-based architecture for India's new Fiscal Federalism. While the final resolution of these matters will be attained through a dialectic that will play out in the domain of realpolitik, it is important that such a process be helped along by evidence based analysis and debate".

Common Memorandum

The Finance Ministers of Andhra Pradesh, Kerala, West Bengal, Punjab, Delhi and Puducherry held a conclave on fiscal federalism and submitted a common memorandum to the President of India on May 17, 2018 expressing their concerns and seeking changes in the Terms of Reference (ToR) of the Fifteenth Finance Commission.

The conclave discussed issues relating to asymmetries in Indian federal system and how the ToR of the Fifteenth Finance Commission go far beyond the Constitutional mandate and impose the ideological and economic agenda of the Union on States. The Finance Ministers have contended that it is not for the Finance Commission to impose its perception of what policies are good for States.

The common memorandum submitted to the President of India sought deletion of certain ToR from the Order constituting the Commission. The memorandum sought deletion of items in the ToR relating to i) whether revenue

deficit grants be provided to States at all, ii) taking into account the impact on the fiscal situation of the Union Government of substantially enhanced tax devolution to States following the recommendations of the XIV Finance Commission, coupled with the continuing imperative of the national development programme including New India-2022, iii) impact of the GST, iv) reference to the examination of the conditions that the GoI may impose on the States while providing consent to States to borrow under Article 293 (3) of the Constitution, v) incentives to States for providing grants to local bodies for basic services and vi) control or lack of it in incurring expenditure on populist measures.

More particularly, the select Finance Ministers have expressed their concern over the explicit mandate given to the Commission to use 2011 population while making its recommendations. The Conclave expressed concerns that this ToR has opened the larger issue of what might happen in the next delimitation. It has been felt that by shifting to 2011 population, too much weightage is given to equity. The Finance Ministers sought replacement of 2011 population by 1971 population in the ToR.

Many of the items sought for deletion are in the nature of considerations and the Commission is not strictly bound by them. When the ToR of the Ninth Commission stipulated the adoption of normative approach, the Commission Chairman assured the Chief Ministers in a letter that the approach would be uniform and equitable both to the Centre and the States. Similarly, when the Thirteenth Commission was asked to take into account the projected gross budgetary support (GBS) to the Central and State Plans while making its recommendations, the

Commission took the stand that taking GBS upfront as a demand on the Centre's resources would reverse the then current practice of arriving at the GBS residually.

Though some of the ToR are in the nature of goading the Commission to act in ways inimical to the interests and autonomy of States, it is hoped that the Fifteenth Finance Commission would be guided by the spirit of the Constitution in discharging its responsibilities and upholding the sanctity of the institution. The Commission may not have such freedom insofar as the use of 2011 population is concerned. Even here, the weight assigned to population can be tweaked suitably to minimize the adverse impact on some States.

On balance, the issue goes beyond the memorandum. For the first time a Finance Commission is disadvantaged in terms of the trust of some of the affected parties. It is also not clear whether there were adequate consultations by the Union with States before finalising the terms of reference, if not the composition. These developments have led to the suggestion to abolish the institution of the Finance Commission.

Ending the Finance Commissions

Dr. C. Rangarajan in a recent talk at the Madras School of Economics (March 8, 2019) has suggested amendments to the Constitution i) fixing the respective shares of the Centre and the States in vertical distribution of divisible pool of taxes including cesses and surcharges in the Constitution itself, thereby doing away with the appointment of the Finance Commission at an interval of every five years or earlier, ii) entrusting the collection of GST to a single agency and iii) enabling States to levy income tax in parallel with the Centre.

Fixing the respective shares of the Centre in the divisible pool of Central taxes can make the vertical sharing of taxes predictable and general revenue division between two levels of governments a Constitutionally determined one on a permanent basis. There is considerable merit in this proposal. The scope for change in the sharing between Centre and State has shrunk. Uncertainty can be removed by such an amendment. Time and effort can be saved. Freezing it at current level will be least controversial. However, its desirability needs to be explored further, as will be explained later.

While the vertical share can be fixed Constitutionally, there is need to have flexibility in regard to horizontal sharing. Firstly, fixing the horizontal share in the Constitution would result in a rigid structure of resource distribution across States and cannot be changed without an amendment to the Constitution. Secondly, fiscal capacity differential across States is a dynamic one and horizontal devolution formula needs to recast itself periodically to reflect these changes. This can only be done by the Finance Commission or a similarly constituted body. Thirdly, no horizontal devolution formula will be able to address the needs of all the States on revenue account. Grants-in-aid are meant precisely to take care of the inherent inadequacies of formula based solutions. Tax devolution cannot be made large or progressive enough to ensure that no State has a post-devolution revenue deficit. An agency similar to Finance Commission will be needed to assess the post-devolution revenue deficits on a normative basis. Discretion will creep in, if such a function is left to the Union.

It is possible to argue that if a Commission is inevitable for horizontal balance, why should the flexibility in vertical balance be given up. More important,

there may be merit in taking an integrated view of vertical and horizontal balance, to meet changing circumstances.

The second issue raised by Dr. Rangarajan is entrusting the collection of GST to a single agency, i.e., the Centre. Though such an arrangement will simplify tax collection, it has the adverse impact of further skewing the vertical imbalances. The Centre presently collects 65 per cent of the combined revenue receipts. Entrusting the collection of GST entirely to the Centre will be counter to cooperative federalism. In the interests of tax harmonization, States have extended their unstinted support to the Union in the introduction of GST. While GST has subsumed around 31 per cent of the gross tax revenue of the Centre, it has subsumed even larger proportion of States' tax revenue of around 50 per cent. The only major source of tax revenue to the States, namely, VAT has been subsumed under GST. Even after Union excise duties and services tax are subsumed under GST, the Centre is still left with buoyant sources of revenue like income tax, corporation tax and duties on customs.

The third issue relates to empowering States to collect income tax parallel with the Centre. Currently, income tax collected by the Centre is part of the divisible pool. The question is whether income tax could form part of the divisible pool once the States start levying it along with the Centre.

Redesigning Fiscal Transfer System In India

Dr. M. Govinda Rao in a recent paper (2019) highlighted the rationale for intergovernmental transfers and the need for redesigning them in the context of the

evolving changes in Indian fiscal federalism. In many ways, the core of the fiscal federalism is inter-governmental transfers.

Dr. Rao observes that following the recommendations of the XIV Finance Commission, a clear distinction has emerged between general purpose and specific purpose transfers. All the general purpose transfers are now recommended by the Finance Commission and the special purpose transfers by the Central Ministries. While there was no change in the total transfers to the States in 2015-16, the first year of the award period of XIV over 2014-15, the share of general purpose transfers rose significantly from 55.5 per cent to 71 per cent.

Dr. Rao recalled Dr. Kelkar's suggestion that Finance Commission and erstwhile Planning Commission had different objectives; the former allocating resources for the provision of basic services and the latter allocating resources to create physical and social infrastructure. Dr. Kelkar had also suggested that NITI Aayog should be given adequate resources for allocation to States to ensure balanced regional development by mitigating infrastructure differences in low income States.

Dr. Rao expressed his reservations about this argument mainly on the ground that creation of infrastructure and its equitable spread requires capital expenditure and that this should be addressed through borrowings and not through current transfers. The other reservations expressed by Rao relate to conditional transfers by Central Ministries not being given for capital creation and the plan transfers not being related to infrastructure deficiencies.

Dr. Rao observed that given the large variations in fiscal disabilities in Indian States, it becomes difficult to design general purpose transfers to fully offset the revenue and cost disabilities. Thus, specific purpose transfers are necessary. But the specific purpose transfers in India suffer from a number of infirmities. They are not as equalizing as the general purpose transfers recommended by the Finance Commissions are. Further, they are i) not linked to service outcomes, ii) there are too many schemes resulting in the spread of resources too thinly, iii) releases falling short of allocations, iv) States burdened with matching contributions and v) lack of flexibility to States in the implementation of schemes.

He has suggested rationalization of CSS, funding them adequately to make a difference to the service levels and linking the schemes to shortfall in specified services so that overall objective of achieving minimum standards is achieved. He made out a case for having differential matching requirements with a State's contribution increasing as the shortfall in services reduces.

In brief, Dr. Rao's view is that the current problem of India's fiscal federalism is best addressed by recognising the scope and limits of inter-governmental transfers distinct from devolution or tax sharing; and designing an optimal mix of general purpose and specific purpose transfers. Operationally, rationalisation of Centrally Sponsored Schemes is the crux of the problem.

As the discussion in Part I of the lecture has shown, tax devolution and deficit grants were less controversial.

Finance Commission as a Permanent Body

Shri Shaktikanta Das, Governor, Reserve Bank of India, shared some of his own personal thoughts on fiscal federalism in a speech on 19th March 2019. He referred to the need to strengthen local bodies; to the possibility for "GST Council expanding its scope and agreeing to work on other areas of reforms to generate national consensus"; to derive annual fiscal deficit targets from the fiscal path of FRBM Review Committee; and most importantly, to the future of the Finance Commission.

Two sentences are significant in regard to future of Finance Commissions. "While at one level there has to be a framework for innovative thinking by every Finance Commission, at another level there is need to ensure broad consistency between the recommendations of the Finance Commissions. Increasingly, therefore, it is felt that there is need to give permanent status to the Finance Commission which can function as leaner entity in the intervening period till the next Finance Commission is set up in a full-fledged manner. Such an entity during the intervening period can also address issues arising from implementation of the recommendations of the Finance Commission."

The terms of reference of the XV Finance Commission contain many tasks that would require continuity. Therefore, there will be a temptation for XV Finance Commission to recommend that it be made permanent. It could then potentially become sole agency responsible for all transfers, in addition to recommending tax sharing periodically.

It is good to recall that a case was made out in the past also for a permanent Finance Commission, by merging the functions of Planning Commission and Finance Commission.

First, the argument in favour of a permanent Finance Commission was that since it was a Constitutional body all transfers to the States should be the mandate of the Finance Commission only.

A second argument was that the functions of Finance and Planning Commissions were overlapping and there was duplication. Hence, that should be avoided.

In fact, the Third Finance Commission deliberated on this subject and argued that as Non-Finance Commission transfers are discretionary, the role of the Finance Commission be expanded to encompass all aspects of transfers including loans given to the States. Recommendations of the Third Finance Commission were not accepted by the Government.

Mr. K. K. Venugopal, in his presentation to the Ninth Finance Commission stated, "There is nothing in the Constitution which precludes or prohibits a Finance Commission continuing for a period of five years and then replaced by another Finance Commission. Article 280 says that there shall be a Finance Commission for a period of every five years or for such period as may be fixed by the Government." (NIPFP, 1993. PP. 232-233).

Sarkaria Commission which considered the issue was also opposed to the idea. It recommended that "Finance Commission is essentially an expert recommendatory body and cannot be expected to participate in active

determination of the transfers on annual basis corresponding to changes in the economic situation. Indeed, the very scheduling of such exercises in an annual setting may be quite cumbersome and reopen a whole host of issues for consideration every year. Secondly, a measure of stability is desirable in the transfers and frequent changes may be very unsettling and counter-productive, giving rise to avoidable friction in Union-State financial relations. We are, therefore, of the view that there is no need for a permanent Finance Commission."

More recently, the Fourteenth Finance Commission also opined on the issue. It argued that entrusting the Finance Commission with responsibilities relating to all transfers from the Union to the States was not advisable. In fact, it recommended then fiscal space for programmes and schemes reflecting national priorities and externalities be left with the Union government for implementation based on a new institutional arrangement of 'cooperative federalism' involving both the Union and States. The parameters for such a new institutional arrangement have been indicated by the XIV Finance Commission (vide Para 12.28).

The proposal for making Finance Commission a continuous body, which is not in violation of the Constitution position, can evolve in two ways. First, the Union Government would abdicate its discretion currently available in designing and implementing the specific purpose transfers. Second, it would dilute the neutrality of Finance Commission between Union and States through a process of continuous association with Union Government. There is a serious danger that the second situation will prevail.

In my view, there is considerable merit in having one apolitical body that provides stability, predictability primarily to sharing of taxes that ensures fiscal balances; and another forum for transfers involving continuous political bargaining with broader mandate.

My view in this regard is reflected in the recent book in connection with NITI Aayog:

"NITI Aayog suffers from a wide mandate and diffused focus. The organisation should ideally be the focal point for all transfers from the Centre to States outside the recommendations of the Finance Commission. As a continuing body, it could also ensure implementation of the Finance Commissions' recommendations. In order to achieve this, it requires significant technical support from experts and, at the same time, substantial political support. The latter requires an institutional arrangement, and this should ideally be in the ambit of the ISC (Inter State Council)." [page 264].

PART III: WAY FORWARD

Recent developments are, no doubt, significant, but there is considerable misunderstanding of their implications. This has resulted in an increase in the trust deficit between Union and States. Any framework of federal fiscal relationship cannot be successful unless it is based on a relationship of trust. In India, a stable federal fiscal relationship over the years has evolved and provided stability, predictability and to an extent progressivity in sharing and transfer mechanisms. This role has primarily been played by successive Finance Commissions. There is no

major controversy so far on the recommendations of the Finance Commissions. This is only a reflection of trust among all the stakeholders. This needs to be preserved.

However, there is a perception that the XIV Finance Commission has been too generous with the State Governments. The data shows that there has been no increase in the overall transfers though one component, namely, tax devolution has been somewhat in favour of the States. The actions of the Union Government in this regard raised distrust among the States. Similarly, the report of the FRBM Review Committee has given rise to doubts about the asymmetrical treatment of Union and States in regard to the path of fiscal consolidation.

The GST Council is a valuable addition to the institutional architecture of federalism in our country, but in the implementation, the State Governments feel that they are being treated unfairly. Controversies have risen about the Terms of Reference of the XV Finance Commission because of the detailing of the considerations. In brief, most of the concerns are in the nature of mistrust between Union and States, and to some extent, lack of transparency, if not misunderstanding.

Reactions to recent developments have unfortunately been structural and extreme. One view is to abolish the Finance Commission. The other view is to make it permanent. Some other proposals relate to a new framework, a new vision, new pillars, etc.

Way Forward, it is necessary to understand the existing institutional framework and the manner in which the institutions and instruments of policy have been working. Firstly, the Finance Commission is the bedrock of fiscal federalism of

India. The major task of the Finance Commission is tax sharing between the Centre and the States. By and large, there have been no serious issues in regard to vertical balance till the terms of reference of the XV Finance Commission. Further, it is necessary to strengthen the hands of the Finance Commission to give an award that is fair and acceptable to both Union and States in a symmetrical manner. The Finance Commission also gives Grants-in-Aid, but these have constituted on an average less than 15% of the amount of the award. A large part of the Grants-in-Aid relates to deficit grants to the States. These are meant to arrive at vertical and horizontal balance even when some States are not adequately compensated by the formula for tax sharing. There can be no controversy on this issue. The Grants-in-Aid for other purposes could certainly be examined primarily with a view to excluding those which do not have inter-state significance. In other words, restoring the mandate of the Finance Commission to the core Terms of Reference should be the way forward.

There has also been a suggestion to fix the vertical share through constitutional amendments. This may ensure greater predictability but can introduce rigidity in the transfers. Operationalising this also does not make the Finance Commission redundant. The role of Finance Commission then would be restricted to horizontal allocation of resources. Also, this approach is static in nature and cannot take into consideration changes in the resource and expenditure envelopes of both the levels of government and corresponding adjustment needed in vertical share. Since the mechanism of Finance Commission has worked reasonably well, it is prudent to continue with the existing constitutional provision, which is flexible yet stable and predictable over the medium term.

Secondly, the flow of resources from Centre to States outside the recommendations of the Finance Commission has been a contentious issue. The legitimacy of the Planning Commission, the adoption of Gadgil formula, the modifications to such a formula, the increasing role of discretionary grants and the magnitude of the complexity of the centrally sponsored schemes have been a matter of concern and a source of tension between the Union and the States. In terms of magnitudes, the flow of resources through this route accounts for an overwhelming part of the transfers by way of grants (and loans in the past). Despite several suggestions in this regard, including by the XIV Finance Commission, there has been surprising and inexplicable lack of focus on this real problem of the fiscal federalism. Way Forward requires attention to institutional arrangements in this regard. In addition, the redesign of transfers as recommended by Professor Govinda Rao should be the priority.

Thirdly, the proposal to have continuity in Finance Commission has a potential for merging the functions of sharing of taxes and Grants-in-Aid too closely for comfort. There is a need for an appropriate mix of stability and predictability on one hand, and flexibility and political bargaining on the other. The present arrangement of Constitutionally determining stability and predictability through Finance Commissions periodically and leaving flexibility and continuity to the elected Government appears theoretically sound and proven to be successful. The real issue now relates to institutional vacuum as far as the transfers outside the Finance Commission are concerned.

Fourthly, there is an avoidable diversion into the transfers to local bodies in the discussion on fiscal federalism. Structurally, the Constitution assigns

responsibilities and resources to States and the Centre, and local bodies are squarely in the domain of States. The local bodies are created or not created by the State Governments. Therefore, economists and public intellectuals should approach the State Governments and convince them to strengthen local bodies rather than address their concerns to the Union Government or Finance Commissions. Further, attempts to use the Finance Commission to foster decentralisation with conditionalities has a tendency to erode the trust of the States in the role of the Finance Commission as an arbitrator between the Union and the States. Finally, the extent of decentralisation by different States is a reflection of the sensitive political process and not a matter in which the Finance Commission can claim expertise.

It is necessary to distinguish between fiscal and developmental imbalances. Fiscal imbalances on revenue account should be the concern as per original design and current practice. If equal weight is given to efficiency and equity in devolution, with equal respect to Dr. Kelkar and Dr. Subramanian, they may neutralise each other. Balancing the competing considerations is the name of the game and Finance Commissions till now have done it well and in a progressive manner. The record of transfers outside the Finance Commission by the Union Government in the past has been regressive and with questionable success. These are the transfers that deserve attention. The transfers outside the Finance Commission's recommendations could play a legitimate role in regard to development dimension provided appropriate fiscal space could be identified for the purpose without adversely affecting the States and an appropriate institutional arrangement is made for such transfers.

To conclude, the Way Forward is best summed up in a recent book on Indian Fiscal Federalism.

In brief, wisdom lies in refocusing the scope of the Finance Commission to maintain the trust of all stakeholders in the institution as a pillar of fiscal federalism. To fill the existing institutional vacuum for other Central transfers to States and related matters, it is necessary to reinvent NITI Aayog. This organisation should be endowed with appropriate stature and expertise and have the benefit of Constitutional legitimacy, possibly by linking it to the ISC.

It should be recognised that the dominant objective of federal transfers is moderating the fiscal-capacity differential across States to provide comparable levels of public services at comparable levels of taxation. The complex issue of reducing inequalities in development among States should be addressed by the cooperative efforts of both Union and the States on several policy fronts as this should be a matter of national concern.[pp. 165 of Indian Fiscal Federalism].

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