# Chapter 3

# Issues and Approach

## Introduction

3.1 The overall task of the Finance Commission is to discharge the mandate laid down in articles 270, 275 and 280 of the Constitution, consistent with the principles of federal finance, taking into account the current and likely future macroeconomic and fiscal scenarios, so as to secure fiscal stability and adequate resource availability for the Centre, the states and the local bodies.

3.2 The Presidential orders that provide the Terms of Reference (ToR) for the Thirteenth Finance Commission can be viewed as setting the Commission three different types of tasks. The first or 'core' task of the Commission is to recommend distribution, between the Union and the states, of the net proceeds of taxes to be divided between them under Chapter I, Part XII of the Constitution of India, commonly termed as the 'divisible pool'. Second, the Commission has also to recommend the allocation between the states of such proceeds. Under Article 275 of the Constitution the Commission may provide general purpose grants to states which are 'in need of assistance' and other specific purpose grants. Third, the Commission has been asked to recommend measures to supplement the resources of the panchayats and municipalities in different states by augmenting the consolidated funds of individual states, taking into account the recommendations of the respective State Finance Commissions (SFCs).

3.3 Every Commission is required by its Terms of Reference to keep specific policy considerations in mind while undertaking its core task. Thus, the Thirteenth Finance Commission has to take account of:

i) The need to balance the receipts and expenditure on revenue account of all the states and the Union and generating surpluses for capital investment.

ii) The impact of the proposed implementation of the Goods and Services Tax (GST) from 1 April 2010, including its impact on the country's foreign trade.

iii) The need to improve the quality of public expenditure.

iv) The need to manage ecology, environment and climate change consistent with sustainable development.

v) The need to ensure commercial viability of public sector and departmental undertakings, as also of irrigation and power projects.

vi) The taxation efforts of the Central Government and each State Government and the potential for additional resource mobilisation to improve the tax-Gross State Domestic Product/Gross Domestic Product ratio.

3.4 These specific considerations are taken account of by the Commission in the assessment of the financial needs of the Centre and the states and in the design of specific purpose grants.

3.5 The ToR assign FC-XIII a specific 'macro policy task', which is to review the state of the finances of the Union and the states and the operation of the states' Debt Consolidation and Relief Facility (DCRF) 2005-10 and suggest measures to maintain a stable fiscal environment, consonant with equitable growth. A subsequent addition to our ToR mandates us to review the roadmap for fiscal adjustment and suggest a suitably revised roadmap that would maintain the gains of fiscal consolidation through 2010-15.

3.6 The issues that we have to consider, therefore, directly emanate from the ToR of this Commission. In this chapter we will outline the broad considerations that inform the Commission's approach to its core and policy tasks. We also discuss the main issues and our proposed approach.

3.7 The overall approach of the Commission is to foster 'inclusive and green growth promoting fiscal federalism'. This is the vision underlying the Commission's recommendations on inter-governmental fiscal arrangements and on the roadmap for fiscal adjustment. This vision has to be given effect within the overall structure of inter-governmental fiscal arrangements, whose contours are Constitutionally specified.

3.8 The federalist development State is a domain for evolutionary policymaking, responsive to internal and external policy imperatives such as political integration and globalisation, with sovereign powers to fulfil its mandate. These powers are, however, not absolute. The development project of the state is enabled by evolutionary policy making, while circumscribed by the laws that mandate the exercise of its sovereignty in the formulation and implementation of policy.

3.9 Kautilya argued for a social contract defined by laws, principles and doctrines in *Dharmasastra* and *Arthasastra*, delimiting the Constitutional metes and bounds of Monarch and State. The Indian Constitution can, thus, be seen from a variety of perspectives, as providing a regulatory framework within which the developmental federalist State undertakes its project. The structure of the inter-governmental fiscal framework has to serve the purposes of the contemporary development project, while at the same time, ensuring that it functions within the regulatory framework defined, in our time, by the Constitution of India.

3.10 Inclusive growth is the cornerstone of India's development project. India's recent economic growth performance has, indeed, been creditable. However, such growth must make a demonstrable difference to the lives of the poorest and most vulnerable citizens. On this, as reflected in the Millennium Development Goals (MDGs) there is global consensus, of which our nation is a part. India has the potential and the means to secure such a future for its citizens. The stress laid on inclusive growth in the Eleventh Plan has meant that such growth has been accompanied by a concerted effort, by all levels of government, to invest in the delivery of public services, particularly those which promote progress in achievement of the MDGs. But, to achieve this potential, it is necessary that resources be mobilised and deployed in such a manner that the recent high rates of growth are maintained and even increased. Thus, sustainable and inclusive growth are prerequisites for achieving the MDGs.

3.11 Inclusivity informs our recommendations in every sphere. In our formula for horizontal devolution, the highest weightage amongst all the variables is for correcting the fiscal disability of a state vis-a-vis those of the top-ranked states. Further, we also recognise the fiscal disability of the special category states by computing their fiscal distance from the top-ranked states after setting their tax effort at the average for the special category alone, in place of an all-state average. Inclusivity is justified, not merely to ensure equal treatment of citizens by governments, but also for long term economic efficiency reasons, so as to minimise the burden of fiscally-induced migration on high-income states. It also underlies our attempt to prescribe a fiscal roadmap targeting elimination of the revenue deficit so that net new borrowing is directed towards creation of public infrastructure which would benefit all. It also underlies many of our grant provisions, for instance, maintenance for the new village connectivity roads financed under Pradhan Mantri Gram Sadak Yojana (PMGSY). And finally, inclusivity underlies our substantially enhanced grant for local bodies, including those of the Schedule V and VI areas, so as to enable provision of sanitation and other public goods.

3.12 Fiscal consolidation promotes growth. By fiscal consolidation we do not mean a reduction in the role of the State. In a complex and developing economy like India, the government will continue to mobilise and deploy a significant proportion of resources to promote public welfare. Rather, fiscal consolidation refers to measures to improve the quality and effectiveness of the processes of public expenditure and resource mobilisation. We are of the view that there are feasible pathways for fiscal consolidation with high growth, as a study by the NIPFP for this Commission shows analytically. In the present context, this also means providing the fiscal space to promote both public and private investment, so as to secure the highest possible sustainable, green and inclusive rate of growth for the Indian economy. For the Commission, this involves proposing ways to incentivise such consolidation within the mandate and instruments at our disposal. We have been particularly mindful of this challenge in our recommendations with respect to the future fiscal roadmap.

3.13 For achieving a greener and more inclusive growth path we need a fiscally strong Centre, fiscally strong states and fiscally strong local bodies, or the third tier of government. Therefore, we are proposing the strategy of 'expansionary fiscal consolidation' with no compression of development expenditures. Such a fiscal strategy will provide a more propitious environment for increasing both public and private investments, as well as for better handling of adverse economic shocks that we may face due to external developments. In other words, the proposed fiscal strategy will also improve our country's economic security.

3.14 A high growth economy minimises the risk of 'crowding out' of the private sector, by allowing the government to increase fiscal space for public investment consistent with fiscal prudence. In fact, in such an environment, the private sector becomes a valuable actor. Better targeted public good delivery systems can be used to engage the private sector in the provision of key public goods, particularly infrastructure. Effective fiscal consolidation ensures that the government gets the best value for money from such engagement. In assessing the resources available for overall transfers the Commission has also taken into account the total resources available, including potential inflows from disinvestment.

3.15 Green growth involves rethinking growth strategies with regard to their impact on environmental sustainability and the environmental resources available to poor and vulnerable groups. It is significant to note that many stimulus packages announced globally to combat recession incorporated a green component. International experience is that green growth promotes inclusivity. Further, the renewable energy sector is relatively labour intensive, with the potential for generating more jobs than the oil and gas industries.

3.16 Securing the environment is critical for India's future generations and not just a matter of international commitment. A degraded environment reduces the quality of life for all citizens, but the impact is particularly pronounced on the poor and vulnerable groups, as it is they who suffer the most from degraded access to clean water, air and sanitation, as well as from climate shocks. It is for this reason that, despite the fact that India's per capita greenhouse gas emissions are much below the world average and far lower than the average of developed countries, we have pursued policies which complement efforts towards mitigation of climate change. It is, therefore, important to incentivise fiscal policies that promote measures for energy conservation, renewable energy, soil conservation, afforestation and more effective and affordable access to clean water at different levels of government. This would impact all levels of government, including local bodies, which face mounting challenges in delivering better access to clean water, better solid waste management and enhanced, but green local infrastructure. Our grant proposals are supportive of such an approach.

3.17 In India, Finance Commissions have had to face three important challenges. First, there has been a historically high degree of vertical imbalance between the Centre and the states, as will be shown in Chapter 4. Recently, there has also been an increase in the size of the non-shareable portion of central revenue receipts. Second, there is spatial inequality in the fiscal capacity and fiscal needs of different states. The reasons underlying this spatial inequality vary considerably, depending on the state in question. Further, different states are at different stages of the development transformation, so their fiscal needs also vary over time. The Constitution provides general guidance on addressing the needs of the states and the Centre as well as taking account of state-specific needs, but does not provide the prescriptive framework for Finance Commissions. Third, it is a fact that recent decentralisation initiatives and the increasing pace of urbanisation have considerably increased the fiscal obligations of the third tier of government, but not the devolution of human and financial resources to discharge these obligations. This has increasingly become an important dimension of the work of every Finance Commission. Thus, the work of every Commission is multi-dimensional in nature.

3.18 Added to this are the new domestic challenges that have emerged. The imperatives of urbanisation, empowerment of India's villages and improved information flows have collectively increased the expectation and demand for public and merit goods. In meeting this demand the challenge of sustainable development has to be kept firmly in mind, so that present generations do not diminish the lives and capabilities of future generations. Further, India has one of the world's youngest populations. This is a one-time demographic dividend which needs to be harnessed through appropriate investments in human development, particularly in education and public health, so that the country, having undertaken its long term development transformation, is then able to cater to the long term challenge that this dividend poses—that of an ageing population. In making its awards the Commission has to be mindful of the short and long term implications that these challenges pose for the public finances of India and the need to foster the appropriate fiscal incentives to address these challenges.

3.19 An important challenge faced by our Commission was that the assessment of the resource position of the Centre and the states has had to be made in the face of more than normal uncertainties, given the developments in the global economy and the consequent need for resources to be devoted to stabilisation and countercyclical measures by the Centre as well as the states. The Commission's recommendations for vertical and horizontal devolution have to be consistent with the requirement that the Commission '.... suggest a suitably revised roadmap with a view to maintaining the gains of fiscal consolidation through 2010 to 2015'. The impact of countercyclical measures on the absolute and relative finances of Central and State Governments will affect the future fiscal roadmap. This, in turn, has to be taken into account in preparing the forecasts necessary to calculate consistent and appropriate vertical and horizontal devolutions.

3.20 All Commissions have to approach their tasks, recognising that the data base for many important economic variables (e.g., taxable capacity) is less than perfect and may require approximations and normative corrections. We are well aware that it is desirable to make the fiscal awards more incentive-compatible and better targeted to securing the different objectives enjoined on the Commission in its terms of reference. This requires the Commission to identify and use reliable and widely acceptable data which is regularly available, easily understood and does not require interpretation or normative assessment by any agency during the Commissions' award period. Data limitations, thus, act as a reality check on our aspirations in this direction, as does the fact that Finance Commissions have to take account of the limits and constraints of political economy that any country faces in working out inter-governmental/jurisdictional fiscal transfers.

3.21 As mentioned in Chapter 2, we commissioned several external and in-house studies to inform deliberations and assist in developing our approach. The Commission was very keen that its work be knowledge based and, to this end, interacted continuously with the scholars and institutions commissioned to carry out applied research. These studies, as well as our consultations with the national and international professional and policy community, have greatly contributed to our endeavour to present evidence and research based arguments in support of our recommendations.

## Approach to Fiscal Consolidation

3.22 Despite the commendable correction achieved by the Centre and states through implementation of the Fiscal Responsibility and Budget Management (FRBM) legislation across the 2005-10 period, the closing debt-GDP ratio for 2009-10 is estimated at 82 per cent, well above the FC-XII target of 75 per cent. Our starting point was to determine the feasible target for the debt-GDP ratio, consolidated across the Centre and the states, by 2014-15. A major task, then, before this Commission was to determine the extent to which fiscal consolidation could reduce the medium term combined debt-GDP ratio over the time horizon 2010-15, based on our projection of the medium term macro-economic situation. We are proposing a target of 68 per cent for a combined Centre and state debt to GDP ratio to be achieved by the year 2014-15 and 45 per cent for the Central Government debt-GDP ratio. We then specified a time path, whereby the Centre and specify would be able to return to the process of fiscal adjustment, in the aftermath of the deviation necessitated by the events of 2008-09. These developments also signalled the need to specify more closely the circumstances under which such deviations were to be triggered and a more desirable distribution of the burden of incidence of stabilisation and counter-recessionary measures.

3.23 We have taken elimination of the revenue deficit as the long term and permanent target for both the Centre and the states. We are of the view that there is a general consensus on this issue and further, that such a target is enjoined on us by our Terms of Reference, given the need to generate surpluses for public investment. Our prescribed fiscal consolidation path for the Central Government entails a decline in the revenue deficit from 4.8 per cent of GDP as projected for the fiscal year 2009-10, to a revenue surplus of 0.5 per cent of GDP by 2014-15. This allows for acceleration in capital expenditure to 3.5 per cent of GDP; more if there are disinvestment receipts. This projected scenario would be one that places Central Government finances on a sound footing in the long term, consistent with the requirements of inclusive growth.

3.24 The second round of Fiscal Responsibility Legislation (FRL) by states, prescribed by us in accordance with our additional term of reference, takes up from where FC-XII left off. The fiscal consolidation path promotes growth-expansionary fiscal consolidation, by incentivising elimination of revenue deficit thereby ensuring that net public borrowing is directed exclusively towards growth-enhancing public investment. At the same time, we recognise the adjustment period required for exit from the fiscal loosening permitted to states in 2008-09 and 2009-10, as part of the national fiscal stimulus to contain the adverse impact of the international growth meltdown. Accordingly, we allow 2010-11 as a year of adjustment and begin our fiscal consolidation path only from 2011-12. For those states which begin the process from a more adverse fiscal situation than others, a longer period is granted for conforming to the mainstream. Thus, our prescriptions explicitly recognise that one size does not fit all. Although public investment is growth-promoting, its quantum in any single year has to be subjected to an overall fiscal deficit cap. This ensures that public claims on financial savings do not crowd out private investment. It also ensures avoidance of the kind of bunching of repayment obligations that can happen when public borrowing is not paced uniformly across years and permits the kind of pre-planning and judicious choice of projects necessary if public investment is to have maximal impact. These are the multiple considerations that have gone into our configuration of the roadmap for fiscal adjustment over the horizon 2010-15.

3.25 We have also carried forward the practice, introduced by FC-XII, of incentivising fiscal consolidation by states. The intent is not to restrict the discretionary latitude of states with respect to their fiscal domain, but to secure commitment by all states to the national fiscal consolidation required for achievement of macroeconomic stability. Our projections of revenues of states into 2010-15 enjoin greater tax effort on the part of states with a poor revenue collection record, thus implicitly rewarding states with higher levels of past achievement. Our projections of state expenditures are based on norms by type of expenditure, thus indicating the directions open to states for expenditure reform. Equally, the proposed expansionary fiscal consolidation path for the Union will promote inclusive growth.

3.26 We have sought to design grants with a view to incentivising improvements in accountability of, transparency in and innovation at, the cutting edge of the public goods delivery process. Thus, the Commission's approach is geared to advancing the fiscal reforms agenda in all these three dimensions.

3.27 Expenditure reforms are an important driver of the Commission's approach to the fiscal roadmap for the future. Two game-changing tax reforms, namely GST and the new Direct Tax Code, will give considerable impetus to revenue growth. Expenditure reforms at all levels of the government have a strategic role in the Commission's approach towards fiscal consolidation. A major thrust of the proposed expenditure reforms is to improve the supply of public goods which is also inclusive by reducing existing untargeted and regressive subsidies. Other reforms are aimed at improving the productivity of public expenditure. These include: (i) performance-linked incentives to states and local bodies; (ii) measures to improve transparency and accountability, e.g., stricter audit procedures; (iii) 'institutional deepening' for better expenditure management, e.g., creation of the local body ombudsman, fiscal council and independent evaluation organisations; (iv) promotion of innovations and their diffusion so as to reduce cost as well as to improve quality of public services and (v) larger fiscal transfers to the local bodies, to encourage speedier implementation of the 73$^{rd}$ and 74$^{th}$ Constitutional amendments regarding the transfer of functions and functionaries in consonance with the subsidiarity principle.

## Considerations in Recommending the Design of Fiscal Transfers

3.28 The approach to designing fiscal transfers by this Commission is, in its basics, consistent with the approach of recent Commissions. The availability of resources and expenditure requirements of the Centre and the states has been assessed on the basis of certain norms. Having estimated these, the vertical and horizontal devolution of taxes is determined. Grants are then allocated to states, based on certain criteria. However, these are not to be understood as linear stages in the Commission's working. A calibrated normative approach, is followed, where the assessment of resources available and expenditure commitments forecast by different government entities is undertaken, bearing in mind the overall resource envelope available to the general government, viz. gross revenue receipts of the Government of India and the State Governments, as well as the desired roadmap for fiscal consolidation. An iterative process with application of careful judgment and appreciation of the evolutionary nature of past trends helped us to determine the vertical sharing of resources between the Union and the states. Our endeavour has been to make this process transparent in our explanation of the logic underlying the Commission's recommendations on vertical and horizontal devolution and the principles governing the award of grants-in-aid to the states and local bodies.

3.29 Table 3.1 gives the share of each state in total FC transfers and the deviation from the mean share across Commissions. This analysis has been carried out for all Commissions. We have, as far as possible, tried to keep the boundaries of the states across two consecutive FCs same, so as to enable proper comparison. For example, in the case of FC-XII the share of Jharkhand has been added to that of divided Bihar to get the share of undivided Bihar for comparison with the Bihar of FC-XI. Our analysis indicates that differences exceeding 1 per cent are very rare; the largest difference, of 3.31 per cent, happening but once in the case of the Eleventh Commission, relative to the Tenth Commission, for Bihar. By and large, *inter se* changes in tax devolution shares tend not to exceed half a percentage point. Differences tend to be larger in the case of grants; and even so, differences exceeding 3 per cent are fairly rare. In some cases, (e.g., Nagaland and Jammu & Kashmir in the case of the last two Commissions), the large differences reflect the provision or expiry of a major specific purpose grant. It can, therefore, be concluded that, in general, the *inter se* shares of Finance Commission transfers have not varied widely over the various Commissions. This is an important feature of the political economy of India's fiscal federalism.

3.30 This remarkable stability across time and over a variety of circumstances, (for instance, covering the years of fiscal squeeze as well as the relative fiscal abundance of recent years) has meant that the structure of inter-governmental fiscal relations has not been 'shocked' by changes in macro-fiscal circumstances and has, in turn, not caused structural shocks to the macro-fiscal situation in the Indian economy. Thus, there is a marked tendency towards stability in the relative share of the Centre and states in respect of aggregate transfers.

3.31 The overall approach of the Commission has taken account of the following issues in the design of fiscal transfers:

*i*) *Symmetry between the Centre and states:* It is commonly understood that the intent of setting up a Constitutional body such as the Finance Commission is to ensure that all levels of government are accorded similar treatment. In making projections of revenue and expenditure we have applied a normative discipline for both the Centre and states.

*ii*) *Equal treatment:* There are two contexts in which this proposition may be understood. First, there is no automatic priority accorded to any level of government, or to any two units at the same level of government within the framework of inter-governmental relations, in the Commission's award. Second, the Commission is concerned with equalisation, not equity. This proposition needs to be understood in a citizen-centered, rather than government-centric fashion, namely, that all citizens of India should expect to receive a comparable standard of public services, irrespective of where they reside within the Republic of India. The intent is to ensure that the states and local bodies have the fiscal potential to provide comparable levels of public services, at reasonably comparable levels of taxation. Clearly, this does not mean that per capita expenditure on such provision will be even across the country; conversely, it means that one of the requirements of equal treatment is to address differences in fiscal needs and cost disabilities for providing a similar level of public services, which may be higher or lower than the average. Thus, the principle does not guarantee uniformity in public services across the country, but addresses the fiscal requirements of each jurisdiction to enable such uniformity.

**Table 3.1: State-wise Share in Total Transfers (Tax devolution + Grants) as Recommended by Different FCs and its Deviation from the Mean Share**

(*per cent*)

| State | First | Second | Third | Fourth | Fifth | Sixth | Seventh | Eighth | Ninth (1) | Ninth (2) | Tenth | Eleventh | Twelfth | Mean |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Andhra Pradesh | 4.16 | 8.58 | 9.31 | 8.05 | 7.77 | 8.08 | 7.30 | 7.34 | 6.60 | 6.83 | 7.98 | 7.13 | 6.66 | **7.37** |
| | (-3.21) | (1.21) | (1.95) | (0.68) | (0.4) | (0.71) | (-0.07) | (-0.03) | (-0.77) | (-0.54) | (0.61) | (-0.24) | (-0.71) | |
| Arunachal Pradesh | | | | | | | | | 1.11 | 0.79 | 0.78 | 0.53 | 0.47 | **0.73** |
| | | | | | | | | | (0.37) | (0.05) | (0.05) | (-0.2) | (-0.27) | |
| Assam | 4.60 | 4.33 | 4.47 | 5.04 | 3.65 | 4.58 | 2.49 | 4.07 | 4.12 | 3.73 | 3.67 | 3.05 | 3.22 | **3.92** |
| | (0.67) | (0.4) | (0.55) | (1.12) | (-0.27) | (0.65) | (-1.44) | (0.15) | (0.19) | (-0.19) | (-0.25) | (-0.87) | (-0.71) | |
| Bihar | 11.78 | 9.09 | 7.83 | 6.91 | 9.57 | 8.79 | 10.62 | 10.70 | 10.65 | 10.54 | 10.88 | 13.04 | 13.14 | **10.27** |
| | (1.51) | (-1.18) | (-2.44) | (-3.36) | (-0.7) | (-1.48) | (0.35) | (0.43) | (0.38) | (0.27) | (0.61) | (2.77) | (2.87) | |
| Chhattisgarh | | | | | | | | | | | | | 2.42 | |
| Goa | | | | | | | | | 0.34 | 0.48 | 0.27 | 0.19 | 0.23 | **0.30** |
| | | | | | | | | | (0.04) | (0.18) | (-0.03) | (-0.11) | (-0.07) | |
| Gujarat | | 3.41 | 6.50 | 4.23 | 4.34 | 3.84 | 4.62 | 3.77 | 3.19 | 3.50 | 3.92 | 2.76 | 3.39 | **3.96** |
| | | (-0.54) | (2.54) | (0.27) | (0.39) | (-0.12) | (0.67) | (-0.18) | (-0.76) | (-0.45) | (-0.04) | (-1.2) | (-0.57) | |
| Haryana | | | | 1.19 | 1.42 | 1.26 | 1.48 | 1.11 | 1.21 | 1.13 | 1.23 | 0.97 | 1.06 | **1.21** |
| | | | | (-0.01) | (0.21) | (0.05) | (0.28) | (-0.09) | (0) | (-0.08) | (0.03) | (-0.24) | (-0.14) | |
| Himachal Pradesh | | | | | 0.94 | 2.12 | 1.56 | 1.96 | 1.86 | 1.75 | 2.10 | 1.72 | 1.91 | **1.77** |
| | | | | | (-0.83) | (0.35) | (-0.21) | (0.19) | (0.09) | (-0.02) | (0.33) | (-0.06) | (0.14) | |
| Jammu & Kashmir | | 2.34 | 1.66 | 2.27 | 2.17 | 2.42 | 1.81 | 2.84 | 3.48 | 3.17 | 3.23 | 3.78 | 2.76 | **2.66** |
| | | (-0.32) | (-1) | (-0.39) | (-0.49) | (-0.24) | (-0.85) | (0.18) | (0.82) | (0.51) | (0.57) | (1.12) | (0.1) | |
| Jharkhand | | | | | | | | | | | | 0.00 | 3.13 | |
| Karnataka | 1.42 | 7.01 | 6.19 | 7.48 | 4.65 | 3.99 | 4.82 | 4.38 | 4.22 | 3.83 | 4.64 | 4.53 | 4.16 | **4.72** |
| | (-3.3) | (2.29) | (1.48) | (2.77) | (-0.07) | (-0.72) | (0.1) | (-0.34) | (-0.5) | (-0.89) | (-0.08) | (-0.19) | (-0.56) | |
| Kerala | 0.85 | 3.62 | 5.23 | 6.51 | 4.38 | 4.99 | 3.70 | 3.27 | 3.01 | 3.25 | 3.41 | 2.83 | 2.59 | **3.66** |
| | (-2.81) | (-0.04) | (1.56) | (2.85) | (0.71) | (1.33) | (0.03) | (-0.4) | (-0.66) | (-0.41) | (-0.26) | (-0.83) | (-1.07) | |
| Madhya Pradesh | 5.84 | 6.81 | 6.62 | 5.60 | 6.45 | 5.66 | 7.66 | 7.50 | 6.99 | 7.40 | 7.10 | 8.05 | 8.55 | **6.94** |
| | (-1.1) | (-0.13) | (-0.32) | (-1.34) | (-0.49) | (-1.28) | (0.72) | (0.56) | (0.04) | (0.46) | (0.16) | (1.11) | (1.61) | |
| Maharashtra | 16.35 | 10.47 | 9.12 | 9.01 | 9.16 | 7.40 | 8.22 | 6.68 | 6.71 | 5.85 | 6.05 | 4.46 | 4.79 | **8.02** |
| | (8.33) | (2.45) | (1.1) | (0.99) | (1.14) | (-0.62) | (0.2) | (-1.34) | (-1.31) | (-2.17) | (-1.97) | (-3.56) | (-3.23) | |

| State | First | Second | Third | Fourth | Fifth | Sixth | Seventh | Eighth | Ninth (1) | Ninth (2) | Tenth | Eleventh | Twelfth | Mean |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Manipur | | | | | 0.50 | 1.33 | 0.93 | 1.19 | 1.09 | 1.02 | 0.94 | 0.74 | 0.91 | **0.96** |
| | | | | | (-0.46) | (0.37) | (-0.03) | (0.23) | (0.13) | (0.06) | (-0.02) | (-0.22) | (-0.05) | |
| Meghalaya | | | | | 0.35 | 0.91 | 0.64 | 0.97 | 0.82 | 0.78 | 0.83 | 0.68 | 0.58 | **0.73** |
| | | | | | (-0.38) | (0.18) | (-0.09) | (0.24) | (0.09) | (0.05) | (0.1) | (-0.05) | (-0.15) | |
| Mizoram | | | | | | | | | 1.25 | 0.96 | 0.80 | 0.58 | 0.62 | **0.84** |
| | | | | | | | | | (0.41) | (0.12) | (-0.05) | (-0.26) | (-0.22) | |
| Nagaland | | | 0.05 | 2.01 | 1.53 | 1.41 | 1.15 | 1.34 | 1.25 | 1.17 | 1.23 | 1.02 | 0.99 | **1.20** |
| | | | (-1.14) | (0.81) | (0.34) | (0.21) | (-0.04) | (0.14) | (0.06) | (-0.02) | (0.04) | (-0.17) | (-0.21) | |
| Orissa | 5.06 | 4.51 | 7.72 | 8.03 | 5.41 | 6.01 | 4.72 | 4.84 | 4.53 | 5.21 | 4.28 | 4.77 | 4.89 | **5.38** |
| | (-0.32) | (-0.87) | (2.34) | (2.65) | (0.02) | (0.62) | (-0.66) | (-0.54) | (-0.85) | (-0.17) | (-1.1) | (-0.61) | (-0.49) | |
| Punjab | 5.09 | 4.95 | 4.50 | 2.22 | 2.13 | 1.76 | 2.01 | 1.64 | 2.04 | 1.58 | 1.58 | 1.25 | 1.70 | **2.50** |
| | (2.59) | (2.45) | (2) | (-0.27) | (-0.37) | (-0.74) | (-0.48) | (-0.86) | (-0.46) | (-0.92) | (-0.91) | (-1.25) | (-0.79) | |
| Rajasthan | 5.35 | 4.57 | 5.36 | 4.52 | 4.99 | 5.87 | 4.33 | 4.25 | 4.77 | 6.15 | 5.03 | 5.42 | 5.17 | **5.06** |
| | (0.29) | (-0.48) | (0.3) | (-0.54) | (-0.07) | (0.81) | (-0.73) | (-0.81) | (-0.29) | (1.09) | (-0.03) | (0.36) | (0.11) | |
| Sikkim | | | | | | | 0.18 | 0.26 | 0.23 | 0.24 | 0.31 | 0.38 | 0.24 | **0.26** |
| | | | | | | | (-0.09) | (0) | (-0.03) | (-0.02) | (0.05) | (0.11) | (-0.02) | |
| Tamil Nadu | 9.87 | 6.95 | 7.00 | 7.17 | 6.98 | 5.60 | 7.21 | 6.25 | 6.38 | 5.85 | 5.89 | 4.97 | 4.85 | **6.54** |
| | (3.33) | (0.41) | (0.47) | (0.63) | (0.44) | (-0.93) | (0.68) | (-0.29) | (-0.15) | (-0.69) | (-0.64) | (-1.57) | (-1.68) | |
| Tripura | | | | | 0.63 | 1.38 | 0.96 | 1.42 | 1.34 | 1.35 | 1.27 | 1.00 | 1.11 | **1.16** |
| | | | | | (-0.53) | (0.21) | (-0.2) | (0.26) | (0.18) | (0.19) | (0.1) | (-0.16) | (-0.05) | |
| Uttar Pradesh | 16.30 | 13.51 | 11.29 | 12.96 | 14.53 | 14.04 | 15.90 | 15.47 | 15.83 | 16.46 | 15.95 | 18.05 | 19.27 | **15.35** |
| | (0.94) | (-1.85) | (-4.06) | (-2.39) | (-0.82) | (-1.31) | (0.55) | (0.12) | (0.48) | (1.1) | (0.6) | (2.7) | (3.92) | |
| Uttarakhand | | | | | | | | | | | | | 1.61 | |
| West Bengal | 13.35 | 9.85 | 7.15 | 6.78 | 8.44 | 8.57 | 7.66 | 8.74 | 6.99 | 6.99 | 6.61 | 8.10 | 6.73 | **8.15** |
| | (5.2) | (1.69) | (-1) | (-1.37) | (0.29) | (0.41) | (-0.49) | (0.59) | (-1.16) | (-1.16) | (-1.54) | (-0.05) | (-1.42) | |

Note: Figures in parentheses indicate deviation from the mean across Commissions.
The FC-XII figures of UP, MP and Bihar are for the undivided state (i.e., it includes respectively figures of Uttarakhand, Chhattisgarh & Jharkhand).

*iii*) *Predictability:* The ability of governments to provide timely and need-based public services should not be negatively impacted by uncertainties and/or volatilities regarding resource flows. In the Indian context, where resource flows across inter-governmental units are sizeable in magnitude, close attention needs to be paid to this aspect in the design of the fiscal framework. In India the Centre collects important sources of revenue, which are then devolved to the states. The Centre, states and local authorities, all have a role to play in financing the delivery of key public services within their respective jurisdictions. It is important to ensure that the medium term framework for inter-governmental resource allocation allows all tiers of government to be reasonably certain about the resources at their disposal, in order to undertake their respective expenditure assignments.[1]

*iv) Incentives:* Finance Commission awards are but one part of the complex set of institutions that constitute the framework of inter-governmental arrangements in India. On the fiscal side, institutions like the Planning Commission, the finance departments and planning boards of different states, state Finance Commissions, the judiciary and the legislature, all play a role in determining the mobilisation and allocation of public resources. In this context the Finance Commission can play an important role in incentivising different tiers of government to undertake fiscal measures. A sterling example of this was the fiscal consolidation process undertaken in the period 2005-10. The role played by the previous Finance Commission was not that of leading or implementing the process; instead, it was that of incentivising the Central and State Governments to act on their resolve to reform the public finances of India, by recommending appropriate fiscal and other policy measures that could serve as a roadmap, together with a framework of positive incentives for its implementation. In our view the facilitating role of the Finance Commission in designing such incentives is as critical as, if not more critical than, the process of determining the criteria for inter-governmental awards. Our Commission has, therefore, tried to play its part in designing incentives consistent with the Terms of Reference. We have sought to maintain the incentive component within the devolution formula, while also seeking to provide grants to incentivise improvements in governance and the environment. We have, further, maintained time consistency of incentives across recent Commissions in order to improve the impact of such incentives.

3.32 Like our predecessors, this Commission's recommended award has to take a very large number of variables into consideration, given the terms of reference and the multi dimensional balancing required to arrive at consistent vertical and horizontal transfers. In our approach we have tried to ensure that:

i) The normative annual needs of the Centre and the states are addressed at a level that is largely acceptable to both, consistent with the requirements of fiscal consolidation.

ii) The requirements of different elements in the terms of reference of the Commissions are addressed in a manner that is fully compatible with the Constitutional requirement to recommend an award that takes account of the needs of the Centre as well as those of the states.

iii) The design of vertical and horizontal devolution as well as that of grants-in-aid supports, rather than detracts from, efforts to maintain a 'hard budget constraint'.

iv) The design enables individual states to access resources for their overall development needs, through appropriate *inter se* formulae for tax devolution, by a

[1]Indira Rajaraman (2008), 'The Political Economy of the Indian Fiscal Federation' in Barry Bosworth, Suman Bery and Arvind Panagariya (ed.), *India Policy Forum 2007-08* (Brookings and NCAER), Volume 4; 1-35

normatively forecasted non-plan revenue deficit for those states that continue to display a forecasted fiscal gap following the Commission's normative assessment of their fiscal position for the 2010-15 period, and through the provision of general and state-specific grants.

v) Adequate attention is paid to the low resource base and the cost disabilities of special category states due to their physical geography, sparse terrain, remoteness and historical circumstances.

3.33. We are required to consider the impact of the proposed implementation of the goods and services tax with effect from 1 April 2010, including its impact on the country's foreign trade. GST, with its revenue and growth effects, influences three other items in our ToR. These include the reference to estimation of the resources of the Central and State Governments, the reference to the potential to improve the tax-GDP ratio of the Centre and the states, the reference to the need to balance the receipts and expenditure on the revenue account and to generate surpluses for investment. We have, therefore, attempted to be holistic in our consideration of GST as this is, indeed, a 'game-changing' reform to create India as a vibrant common market. Our approach seeks to define the contours of the present debate on GST and outline the framework for a Model GST. A National Council of Applied Economic Research (NCAER) study sponsored by the Commission explains why implementation of such a Model GST will be a positive sum game and will bring considerable economic benefits for the whole country, with reduced transaction costs, revenue neutrality and substantially lower tax rates. This study also suggests that implementation of the model GST will lead to better environmental outcomes. We seek to propose a 'Grand Bargain' through which such a GST can be implemented and which incorporates assurances on compliance by all parties. We have also addressed the concerns voiced by some states on possible negative impacts.

3.34. There has been significant advancement since the Government of India announced its intention, in February 2007, to move to a GST by April 2010. The Empowered Committee of state Finance Ministers has released two significant documents–'The Model and Road Map for Goods and Services Tax in India' in April 2008 and the 'First Discussion Paper on Goods and Services Tax in India' in November 2009. These documents, while reflecting the commitment of the State Governments to implement GST, indicate the present stage of the agreement reached on the GST model and its implementation modalities. The Discussion Paper suggests the possibility of different rates for goods and services and different tax thresholds for the Central GST and the State GST, while exempting a number of items. It has yet to take a final view on the Revenue Neutral Rate to be adopted and the treatment of some goods. A number of State Governments and industry associations have independently expressed their concerns to the Commission on the framework of the GST. We have, therefore, attempted to move this debate forward by defining the contours of a Model GST and incentivising State Governments to adopt it.

## Vertical Devolution: Issues and Approach

3.35 A key economic feature of a nation State is the existence of an internal common market. An important objective of economic policy should be to make sure that this market functions as efficiently as possible. This happens when resources and commodities move from one region to another without impediments or distortions caused by policy. While differences in local cost conditions may exist, their mitigation is a legitimate objective of policy making. However, distortions caused by faulty policy design are undesirable. In a decentralised tax system differences in tax structures across jurisdictions can cause undesirable distortions. In addition, there are fixed administrative costs associated with collecting different taxes which can be mitigated by a joint collection mechanism. Thus, according to our Constitution, many direct taxes like Income Tax are levied and collected by the Centre, but the proceeds are shared with the states. Similarly, the principle of equal treatment, irrespective of jurisdiction, is an important part of the political settlement in India. Thus, the principle that underpins both vertical and horizontal devolution is that equality of access should be enabled, but cannot ensure that common standards in quality or outcomes in public services are actually achieved. For that to happen it is necessary that the average cross-state level of tax effort assumed actually prevails in the states and that efficiency of delivery is not below the cross-state average. At the same time, we recognise that the Central Government can play a role in incentivising improved levels of public service delivery across the country.

3.36 Vertical transfers can be justified on four principal grounds. First, transfers may be responses to the extant asymmetric decentralisation of expenditure responsibility and revenue-raising authority. Second, they may be used to equalise the fiscal capacity of the regions to avoid inefficient migration of persons and businesses among regions and to foster horizontal equity across the country. Third, these may also be used in conditional forms to neutralise fiscal externalities imposed by regional governments on other regions, as well as to achieve national standards in social programmes and to induce efficiency in the internal economic union. Finally, these may be used as instruments for insuring regions against shocks to their fiscal capacities (though this is mainly done through grants-in-aid). Each of these reasons informs our assessment of vertical devolution. Given the background of the ongoing economic recession it is clear that it is both efficient and desirable for the Centre to institute countercyclical measures to fulfil the key function of economic stabilisation. At the same time, the symmetric decentralisation of expenditure commitments and resource mobilisation powers requires redressal through vertical devolution. In addition, devolution must be adequate with regard to the requirements of fiscal consolidation and reform that the Commission recommends.

3.37 The Constitution specifies the taxing powers of the Centre and states with respect to different sources of tax revenue. It can be argued that there is a vertical imbalance in the distribution of these taxing powers which has worsened over time, as pointed out in Para 3.17. While in the total revenue expenditure there has been long term stability in the relative shares of the Centre and the states after implementation of the transfers recommended by the Finance Commission, the buoyancy of central taxes has been higher than those of the states and such a trend is expected to continue, given the nature of tax assignment to the Centre and states. Rangarajan & Srivastava (2008)[2] have shown that to maintain constancy in the share of states in post-devolution total tax revenue, this share would need to increase by the margin by which the buoyancy of central tax revenue exceeds the buoyancy of combined tax revenue. The argument for using post-devolution tax shares to maintain consistency, as against altering tax assignments, is based on the premise that most schemes of assigning resources in different country settings tend to be biased in favour of the Centre in assignment of tax collection powers on efficiency grounds.

3.38 On the expenditure side it can also be argued that the states have higher 'fixed costs' than the Centre, as reflected in their higher share of committed expenditure in total non-plan expenditure relative to the Centre. In addition, states have restrictions placed on their borrowing powers. These features exacerbate the fiscal pressure on the states when, as is the case at present, an economic slowdown occurs. The discretionary fiscal space available to states to maintain fiscal prudence in the face of falling revenue buoyancy is less than that of the Centre. In addition, over the period

[2] C. Rangarajan & D.K. Srivastava (2008) : 'Reforming India's Fiscal Transfer System : Resolving Vertical & Horizontal Imbalances' : EPW Volume 43.

2010-15, there is the added fiscal burden posed by the states' pay awards, following that of the Sixth Central Pay Commission (CPC). The fiscal burden of the latest round of pay awards is much higher for the states in absolute as well as relative terms. Another issue that has been kept in mind is the increased tendency to expand the share of the non-divisible pool of resources available to the Centre, including cesses and surcharges, relative to the divisible pool. These important issues have informed the Commission's reflections on the appropriate vertical devolution.

3.39 The Commission has explicitly recognised the risks and uncertainties inherent in the current macroeconomic situation. We have been mindful that our economy will continue to face such, particularly due to external shocks. Keeping this in mind, we have been somewhat cautious in projecting growth rates, for both GDP and for revenues. In the case of GDP, our projected growth rates are lower than those given to us by the Planning Commission. For projecting revenues of the Centre, the revenue buoyancy estimate that we have adopted is lower than that of the Ministry of Finance. Similarly, for the states' revenue projections, we have adopted relatively more cautious revenue buoyancy parameters. Equally, whether for the Union or for the states, our fiscal correction targets are not overly ambitious, and are more likely to lead to a situation where performance is better than the promise. Such a development will only enhance the confidence of the markets, particularly the capital markets. This is, perhaps, a better way to build the country's reputational capital and will, thus, bring many long term benefits to the Central as well as State Governments.

3.40 In the case of the Centre, as well as of the states, we have viewed the first year of the award period, namely 2010-11, as a year for adjustment and recovery. We recognise the impact of exogenous price shocks on key fiscal parameters. These shocks make predictability difficult. Thus, the proposed Central FRBM legislation incorporates a terms of trade band, beyond which the targets may be readjusted in a transparent manner. Similarly, we recommend a mechanism whereby, in such cases, the states are absolved from the task of taking on macro-economic adjustment and stabilisation. This task of macroeconomic stabilisation is a function which should be entirely assumed by the Central Government. This is reflected in our recommended design of the future fiscal roadmap.

3.41 In the design of a prudent fiscal regime there is a choice between delivery of public goods and services and provision of subsidies for private goods. While it is undoubtedly true that well directed subsidies can improve the access of target groups to merit goods, the extent to which this is true depends on what is subsidised and how. From the academic and policy literature on the subject and based on studies prepared for the Finance Commission, we are of the view that the impact of many central subsidies–including tax expenditures–is, on balance, regressive. Per capita subsidies flowing to the poorer states from the three major subsidies, viz. food, fertiliser and petroleum, were found to be far lower than the national average. The reasons for this may vary across the subsidies. Food subsidies are determined *inter alia* by efficiency of administrative arrangements in the respective states, as well as by their fiscal capacity to provide additional subsidies. The use of fertilisers is directly linked to irrigation facilities created and the size of land holdings. Consumption of petroleum products is directly proportional to the purchasing power of citizens. We have no persuasive evidence that price subsidies on foodgrains, power and irrigation–constituting the bulk of subsidies at the state level–are effective. In fact, in our consultations and state visits we found several examples of regressive incidence of these subsidies, largely on account of leakages and highly imperfect targeting systems. This is a cause for concern.

3.42 Given that inclusive growth is the overriding objective of public policy, regressive untargeted subsidies that reduce fiscal space for key growth-promoting public investments and delivery of public goods to enhance inclusiveness are, today, a fiscal obstacle to the acceleration of India's development transformation. We have also noted that the preceding Finance Commissions took a very similar view in their normative assessments of central and state finances. Hence, this Commission, in its normative approach and recommendations with respect to the future fiscal roadmap, has recommended a fiscal path wherein subsidies are closely targeted. We have sought to discourage public spending on subsidies that detract from inclusive growth and, so, reduce fiscal space.

## Horizontal Devolution: Issues and Approach

3.43 In determining horizontal devolution, the reports of previous Commissions and the professional literature identify four issues that need to be addressed:

*i) Fiscal need:* In a diverse country like India it is common for the fiscal needs of different states to vary. The drivers of such differences also vary. The Commission has to balance the need for equal treatment with the need to be sensitive to the requirements of states in different stages of the development transformation. It is in this context that purpose- and state-specific grants assume great importance. This is particularly the case since, as represented to us by many states, fiscal need is not adequately captured by state level development indicators. There are also important intra-state disparities which, quite legitimately, require deployment of resources to address their fiscal needs. While lack of adequate district level data has not allowed the Commission to address this issue as directly as we would have liked, we have been mindful that differences in fiscal need cannot be addressed simplistically.

*ii) Fiscal capacity:* The core task of all states in the Union of India is to provide those public goods and services that their Constitutional responsibility mandates. However, the fiscal capacity–measured by the revenue base available to each state–varies. The considerations that determine the *inter se* share of an individual state in the divisible pool need to factor in a state's fiscal capacity. If all states had equal fiscal capacity, then this would be done simply by dividing such a pool on the basis of fiscal need. However, recognising the differences in the tax base of different states, this is not an approach that has historically been followed.

*iii) Costs of providing similar levels of public goods and services:* Such differences arise due to feature-based or historical circumstances, adverse physical geography, sparse terrain, or geopolitical constraints to development. To some extent, the definition of some states as 'special category states' addresses this issue. However, adequate attention will need to be paid to such factors, given the Commission's terms of reference with respect to disaster management and the attention we seek to give to green growth.

*iv) Rewarding efficiency in public management, fiscal effort and outcomes:* The adoption of fiscal responsibility legislation and the general improvement in the fiscal health of many states has been one of the most positive features of the period following the report of FC-XII. We are mindful of the need to sustain and build upon this effort and this requires incentivising improved efficiency in public expenditure management and revenue effort.

3.44 We commissioned a joint study by the Institute of Economic Growth (IEG) and India Development Foundation (IDF) to evaluate the impact of fiscal transfers. The IEG-IDF study constructed a multi-regional Computable General Equilibrium (CGE) model where the Indian economy was stylised as an economy comprising three regions, viz. high income, middle income and low income regions. The IEG-IDF study has provided valuable insights. This shows that well-designed fiscal transfers from high income to low income regions of India have net positive welfare implications for all three regions. This is essentially due to the deep economic interdependence of the three regions and this impact will be even higher if such transfers are utilised for increased expenditure on basic needs and on capital formation. We have taken this into account in our approach to both horizontal devolution and grant design.

3.45 With regard to the criteria and weights for horizontal devolution, it is difficult to map a one-to-one correspondence between individual criteria and one or more of the issues raised above. For instance, higher population and/or area indicate the need to spend more in absolute terms to provide the same level of public goods and services. Equally, for similar levels of Gross State Domestic Product (GSDP), a state with higher population would, *ceteris paribus*, have greater fiscal capacity. A larger area, *ceteris paribus,* implies larger factor endowment and therefore, positively impacts fiscal capacity. For this reason, this Commission has not attempted to explicitly assign specific criteria as measures of fiscal capacity or fiscal need. In the case of cost disabilities, the distinction between the general and special category states provides a macro-level recognition of this factor in the normative assessment as well as in the allocation of general and state-specific grants.

3.46 Since the Commission is concerned with equalisation, not equity, it is both feasible and possible to address efficiency and fiscal equalisation, using both instruments available to the Commission, viz. grants and devolution. In the case of efficiency and performance, we have made a special effort to address the concerns of some states regarding the possibility of perverse incentives. The lack of adequate data to design forward-looking indicators has, perhaps, been the greatest challenge in this endeavour. Despite this constraint the Commission has sought to explicitly recognise and give due weight to considerations of efficiency and performance in its overall design. It should be pointed out that the wider the differences over time in the response to incentives to secure fiscal discipline, the less likely will be the stability in *inter se* shares of the different states. Equally, states that respond to incentives to maintain and enhance fiscal discipline will, *ceteris paribus,* have the possibility of improving their *inter se* shares.

## Principles Governing the Design of Grants

3.47 Generally, the amount of grants-in-aid provided to the states by different Finance Commissions since the First Finance Commission have been under the Constitutional obligation of the Union Government as per articles 273 (1) and 275 (1). In addition, other kinds of grants have been given to the states to: (i) reduce disparities in the availability of various administrative and social services across states; (ii) allow particular states to meet special financial burdens emerging as a result of their peculiar circumstances; and (iii) to provide resources for specific activities considered to be national priorities. Further, grants such as the Debt Consolidation and Relief Facility of the Twelfth Finance Commission mean foregone revenues for the Centre.

3.48 It has been argued that Non-Plan Revenue Deficit (NPRD) grants risk moral hazard by providing an incentive to states to run non-plan revenue deficits. Our analysis of the incidence of such grants does not seem to indicate that this is true in the case of general category states. Only one state has received an NPRD grant from each and every Finance Commission, which, however, has been declining absolutely and sharply in real terms since the award of FC-IX. While it is true that some states have received significant grants from specific Commissions, there is no pattern showing increased inter-temporal recourse to such grants by general category states. In the case of special category states, cost disabilities are such as to require the use of this instrument to address fiscal equalisation, on a case-by-case basis, much as envisaged by the Constitution, with the need for such consideration diminishing as the development payback from special attention to these states kicks in over time. In this Commission's award there has been a significant reduction in the volume and state-wise incidence of NPRD grants, which is to be expected, given the structural improvements in the fiscal position of many states, including special category states. In the latter case, in recognition of the effort made to exit NPRD, we have, in fact, deemed it appropriate to acknowledge such achievement with a performance incentive. In our view, therefore, the need for NPRD grants diminishes as structural fiscal reforms are implemented and economic performance improves and we expect this welcome trend to continue.

3.49 An important issue that arises when considering the appropriate design of horizontal distribution is whether to reward states for past performance or incentivise states to improve performance during the award period. It pertains more to criteria that seek to capture fiscal discipline and fiscal effort. Of course, if criteria that reward are more or less consistent over time, then these serve as incentives. For example, if it is known that fiscal discipline will be: (i) given due weight and (ii) measured roughly in the same way over the next three Commission award periods, then this acts as a built-in incentive to states to design policies so as to accord with such incentives.

3.50 The major constraint in designing forward-looking incentives is the availability of real time data on which to judge performance. The other constraint is the lack of an institutional 'home' within which assessments of improvements in performance can be judged and awards accordingly made. In the case of FRBM this task was performed by the Ministry of Finance, Government of India. The task was relatively simple, given that the data on adherence to benchmarks was fiscal in nature and available expeditiously from the annual budgetary process. Milestones often involved discrete actions, such as passing a specific legislation or setting up a specific fund. We have retained the forward-looking element in our design of grants and have sought to extend such, where feasible, to areas beyond the FRBM.

3.51 Our recommendations regarding the principles for disbursement of different grants have a conditionality element. We have taken the utmost care not to have intrusive conditionalities; i.e., not be intrusive in the domain of decision making by the State Governments and local bodies. Our approach to setting conditionalities is informed by three objectives:

*i) To ensure additionality of resources:* Mindful of the fungibility of resources, our objective is to discourage the use of grants to substitute what a State Government is already spending on the purpose for which the grant is being given. Thus, the overall result of the grant should be to reduce the deficit in resources to provide public goods.

*ii) To improve transparency and accountability, thus enabling a 'feedback' route in improving policy formulation and implementation*: If grants were to incentivise greater transparency and accountability in public spending, then they would improve the effectiveness of public expenditure and targeting of public goods. Thus, the conditionalities should be viewed as incentives to act and to improve the effectiveness of public expenditure. There is a general consensus in policy literature on Indian public expenditure that there exists huge scope for doing this. Our approach, by improving accountability and outcome delivery consistent with our Terms of Reference, will empower citizens as well as their elected representatives, including those at the municipal and panchayat levels.

*iii) To assist in better monitoring of expenditure*: In designing the conditionalities/performance-based incentives for various grants we have taken sufficient care to not to be intrusive vis-à-vis the administrative domain of the State Governments. As these grants flow from the public exchequer, the touchstone for the proposed performance-based incentives/conditionalities is their potential for contributing towards better prudential monitoring of these expenditures.

3.52 We have sought to incentivise different levels of government to adopt and undertake green policy actions. Our approach has been to use the grant instrument to foster such incentives. In addition, we have also sought to discourage policy actions that distract from sustainable development, such as the fertiliser subsidy in the case of the Centre and power subsidies in the case of the states.

3.53 Our environmental grants both reward past actions and incentivise future actions. The forest grant that we recommend is essentially a reward for contributing to the ecology and bio-diversity of India, as well as a compensation to states for the opportunity loss on account of keeping areas under forest.

3.54 A quantum increase in the supply of electricity is a critical requirement for future sustainable growth. It is desirable that this growth takes place in the greenest possible fashion, with the maximum reduction in carbon intensity. We have, therefore, provided forward looking grants as an incentive to increase the share of electricity generated from renewable sources.

3.55 During our visits to the states and to local bodies it became apparent to us that improved management of India's water resources was an imperative for sustainable, inclusive development. With this in mind, another of our environmental grants incentivises the states to establish an independent regulatory framework for the water sector. We also expect a substantial increase in our grants to local bodies to be used by them to mitigate their environmental challenges in areas such as water and solid waste management.

3.56 There is a general consensus that India's main development challenge is to improve governance and effectiveness of public institutions. In responding to considerations in this area specified by the ToR, we have used grants to incentivise state and local governments to demonstrably improve outcomes. We have focused on specific areas where such results might be achieved, with the hope that the demonstration effect will lead to all-round improvements across the public service delivering mechanism. Thus, we have proposed a forward looking grant that would reward states for their public health efforts towards reduced infant mortality rates–one of the most important MDGs.

3.57 Monitoring and evaluation to improve the link between outputs and outcomes requires adequate data and statistical systems that allow such monitoring and evaluation to be evidence based. We have, therefore, recommended a grant for improving statistical systems at the district and state level, that complements national level initiatives to improve the quality, richness and reliability of national statistical systems.

3.58 In addition, we have consulted with the Department of Justice and State Governments on appropriate fiscal incentives to assist the judicial system to improve the speed and effectiveness of delivery of this critical public good and have recommended a grant for the purpose. Likewise, we have made state-specific grants to expand and improve the training of police personnel.

3.59 Looking forward, we recognise that improvement in governance is as much, if not more, about emulating historic best practice as about innovating to deliver better. The President of India has declared the next ten years as the 'decade of innovation', but innovation happens not just in the laboratories, universities and cutting edge research institutions of our nation; it also happens, as we have seen in our visits to the states, in the districts, villages and towns of India, where people innovate to perform and deliver better in their day-to-day activities. We are of the view that these innovations are the essence of the continual effort to improve governance and, therefore, need to be recognised, rewarded and shared. To this end, we have recommended the creation of a district innovation fund to incentivise and recognise these processes, at the levels of government closest to the ordinary citizen as well as a grant for the establishment of a national Centre for Innovations in Public Systems (CIPS).

3.60 Thus, our approach to governance has been to incentivise innovations, improvements and outcomes in a selected number of areas in which such improvements can be easily designed and recognised. We believe that this would spur a virtuous cycle of improvements in governance in every sphere of public activity by demonstrating that such improvements are within the power of every civil servant and public agent, irrespective of their location and the challenges and constraints within which they work.

### State-specific Grants: Approach

3.61 The Commission has recommended the award of state-specific grants following two broad priniciples.

i) Our field visits and discussions led us to believe that even relatively small grants have shown discernible results, provided that these were directed towards felt needs. This was particularly true of sectors which do not benefit from centrally sponsored programmes or where there are significant funding gaps.

ii) There is also a rationale for state-specific grants where these address deprivation, generate significant externalities (especially environmental externalities), meet the needs of the marginal groups or areas and encourage policy innovations.

### Assignment of Resources to Local Bodies: Issues

3.62 We consulted extensively with representatives of both urban and rural local bodies as well as representatives of autonomous district councils during our visits to all the states. One issue raised uniformly by public representatives was lack of funds to provide adequate levels of even basic services such as drinking water, sewerage, solid waste management and street lighting to their citizens. This problem is intensified by the increasing pace of urbanisation as well as the rising cost of providing such services in rural areas.

3.63 The transfer of funds, functions and functionaries to local bodies consistent with the XI and XII Schedules of the Constitution has met with limited success so far. The traditional theology that funds and functionaries will follow functions does not appear to have worked. A number of states have notified transfer of functions, but this has not been followed by transfer of funds and functionaries. Only some states have significantly empowered local bodies by transferring expenditure obligations, taxation powers and staff resources to them. It has been contended that decentralisation is not fiscally neutral as it will generate increased demands in the scope, scale and quality of services provided by the local bodies. Thus, more funds devolved to local bodies would encourage State Governments to accelerate their decentralisation efforts. Transfer of functions and functionaries may then follow transfer of funds.

3.64 We have also noted that in recent times the local bodies have been entrusted with funds, often directly through Centrally Sponsored Schemes (CSS) such as the National Rural Employment Guarantee Scheme (NREGS) and Jawaharlal Nehru National Urban Renewal Mission (JNNURM), which have stretched their already limited planning implementation and accounting capacities. There is a felt need and demand for untied funds to augment local capacities, which was communicated to us almost universally across states during our visits.

3.65 While the issue of providing additional funding support to local bodies is significant, all the building blocks of the third tier structure deserve attention. These include: (i) entrusting local bodies with implementation and expenditure responsibilities consistent with their mandate; (ii) enhancing their capacity to meet these obligations through assigning necessary revenue raising powers as well as providing adequate transfers; (iii) making them accountable for their performance, including delivery of services as per previously notified standards; (iv) strengthening the functioning of the State Finance Commissions; and (v) providing focussed support to the scheduled and excluded areas. The Eleventh and Twelfth Finance Commissions made a number of recommendations in this regard. Some of these recommendations, though important, have not been implemented so far. More needs to be done to promote decentralisation. We also need to put in place a stronger incentive mechanism aimed at persuading State Governments to decentralise further. Our analysis develops on the work already done while attempting to identify and address major challenges in achieving these objectives.

3.66 Based upon our consultations, as well as the studies sponsored, the issues to be addressed by us were classified into four broad categories:

*i) Issues related to devolution:* These include: (a) The volume of support to local bodies and the parameters that should be used for deciding interstate allocations; (b) the basis on which grants are distributed between rural and urban areas; (c) whether local bodies can be provided a share of the divisible pool instead of a grant; (d) possibilities for using a devolution index; (e) how to prevent delays in transmission of funds to local bodies and (f) whether the use of conditionalities is advantageous.

*ii) Issues relating to preparation of accounts and audit:* The generation of credible data on the performance of local bodies is essential for any meaningful analysis of their financial and operational performance. Presently, the lack of audited comparable data across local bodies limits their effective utilisation by State Finance Commissions and prevents comparability across states. The issues which we examine include: (a) uniformity and consistency in the accounts of urban and rural local bodies; (b) a uniform audit procedure for all states in the country to ensure comparability and (c) accountability of local bodies through appropriate mechanisms.

*iii) Issues relating to the functioning of State Finance Commissions:* The State Finance Commissions, which buttress the functioning of local bodies, need to be strengthened, their functioning made more predictable and the process of implementing their recommendations made more transparent. To enable this, the issues to be addressed include: (a) the need to ensure that SFC reports across states are adequately analytical and similar in approach; (b) the need to ensure that State Governments take prompt action on the SFC recommendations; (c) the need to ensure that SFC reports are synchronous with the report of the National Finance Commission; (d) basis on which the grants would be divided between rural and urban local bodies and (e) whether the Finance Commission's recommendations for augmenting the consolidated funds of the states should be made after considering the SFC reports, rather than on the basis of these reports.

*iv) Other related issues:* (a) The role of development authorities and how their functioning can be made consistent with schedules XI and XII; (b) treatment of 'excluded' areas where parts IX and IX A of the Constitution do not apply; (c) measures needed to enhance the collection of property tax; (d) revamping of fire services and (e) treatment of nagar panchayats.

## Assignment of Resources to Local Bodies: Approach

3.67 In the light of past experience, we have adopted a platform-based incentive approach to determine the volume of local body grants to be provided to each state. Following previous Commissions, we will continue to provide for a grant to all the states for meeting the needs of the local bodies for the period 2010-15. In addition, we have sought to incentivise devolution and performance through the introduction of a performance-based component which will be available only to those states which meet the stipulations related to the issues identified above by 2011-12. The year 2010-11 will be available for states to meet these stipulations. In our view, this time is adequate. States which are unable to do so, but meet these stipulations in subsequent years, will be eligible for grants prospectively.

3.68 We have kept the performance grant at an appropriately high level so as to strongly motivate states to meet these conditionalities. The conditionalities imposed by us are not novel. They have been examined and recommended by a number of bodies including earlier Finance

Commissions, the Second Administrative Reforms Commission (SARC), the Comptroller and Auditor General (C&AG) and the respective ministries of the Government of India. They are aimed at inducing change to improve the functioning of local bodies, ensuring predictability and transparency in transfer of funds and enhancing the functioning of State Finance Commissions. A number of states are already in compliance with some of these conditionalities.