VII

Finance Commissions in India: An Assessment

The Finance Commission (FC) was created as a constitutional body to address issues of vertical and horizontal imbalances of federal finances in India. Apart from its constitutional tasks of deciding the proportion of tax revenue to be shared with the States and the principles governing the grants-in-aid of the revenues of the States, the scope of the FCs broadened over time as they were assigned several other issues on government finances, particularly those relating to augmentation of State Consolidation Funds to supplementing the resources of local bodies and debt-related issues. The approach of successive FCs varied as they addressed concerns raised by States from time to time regarding the composition of the divisible pool of central taxes and inter se distribution criteria. Recent constitutional changes have simplified the sharing arrangement of the divisible pool of Central taxes by clubbing all shareable Central taxes and excise duties. While determining the formula for horizontal distribution of inter se shares of States, various FCs attempted to correct the differentials in revenue capacity and cost disability factors inherent in the economies of States, while trying to foster fiscal efficiency at the State level. However, differences have been noticed in selection, definition and weight of variables, that have been used by FCs to prescribe the devolution formula for Central taxes. More recently, the Thirteenth FC has placed greater emphasis on fiscal capacity distance and fiscal discipline, which is expected to facilitate greater convergence among the States. In the context of grants, there has been some shift from a gap-filling approach to a normative assessment of resource requirements and expenditure. The pattern of transfers through the FC channel shows that the share in Central taxes has persistently been the predominant component of revenue sharing since the First FC. As far as the extent of equalisation is concerned, an analysis of transfers as recommended by four successive FCs (from the Tenth to the Thirteenth) shows that it was the highest in the case of the Eleventh FC as the gap between recommended and benchmark transfers was minimum.

1. Introduction

7.1 Centre-State fiscal relations and the relative spheres of activities of the two levels of the government constitute the most contentious issue of federal finances. Most federal governments are vested with powers to raise tax revenues, while States are responsible for undertaking a large part of the public expenditure. The rationale underlying this design of responsibilities lies in the fact that federal governments are supposed to enjoy scale economies in the collection of certain taxes, while expenditure responsibilities are assigned to States due to their proximity to local issues and needs. Similarly, taxes with an inter-State base and those in which uniformity in rates is desirable are vested in the Central government. Most federations across the world have been following this fiscal efficiency criterion for a long time (Kurian, 2008)[8].

7.2 Even in India, while the Central government has greater access to tax resources, the State governments have to face the greater responsibility of delivery of public goods. The constitutional division of taxation powers between the Centre and the States rests on economic and administrative considerations. The distribution of taxation powers is intended to minimise tax problems in a federal set-up, such as double taxation, tax rivalry among

[8] Kurian, N.J. (2008), "Equalising transfers through the Finance Commission", *Economic and Political Weekly*, 43(29), July 19–25.

States, duplication of tax administration and tax evasion. However, the allocation of taxation powers *vis-à-vis* responsibilities *per se* creates an imbalance referred to as vertical imbalance. In addition, the existence of vast regional disparities contributes to horizontal imbalances among States in terms of their resource capacity relative to their expenditure responsibilities. As the precise estimation of the quantum of resource transfers to address the vertical and horizontal imbalances is difficult, the Central Finance Commission (FC) plays an important role in this regard in the Indian federal set-up.

7.3 The basic task assigned to the Central FC is to recommend resource transfers aimed at correcting the vertical and horizontal fiscal imbalances in an equitable and efficient manner. Vertical imbalances refer to the mismatch between the revenue-raising capacity and expenditure needs of the Centre and the States. Horizontal fiscal imbalances exist on account of the inability of some States to provide comparable services due to inadequate capacity to raise funds. To address these imbalances, the FCs have been given a constitutional mandate to decide on (i) the proportion of tax revenue to be shared with the States and (ii) the principles which should govern the grants-in-aid to States. In addition to the core functions, the FCs are entrusted with the responsibility to make recommendations on various policy issues, as and when they arise. The FC also tenders advice to the President on any other matter referred to the Commission in the interests of sound public finance. The recommendations made by the FC are only advisory and, hence, not binding on the Government. Thus far, 13 FCs have been constituted with the last one constituted, in November 2007.

7.4 Against this backdrop, this chapter assesses the effectiveness of FCs in reducing fiscal imbalances through vertical and horizontal distribution criteria. This chapter is organised into five sections. Apart from this introductory section, Section 2 provides an overview of Central-State fiscal relations and the constitutional mandate of the FC in this regard. Section 3 discusses major developments in the mandates of various FCs. Section 4 deals with changes in the devolution criteria of resources from the Centre to the States since the First FC and examines the pattern of the Centre's transfers to States through the FC channel across various award periods. In Section 5, an empirical exercise is undertaken to estimate the vertical and horizontal components of resource transfers recommended since the Tenth FC. Section 6 provides the concluding observations.

2. Centre-State Financial Relations: Indian Context

7.5 In India, Centre-State financial relations relate to the distribution of power in resource mobilisation between the Centre and States as also the sharing of expenditure responsibilities. Most of the important and buoyant revenue sources are assigned to the Union Government, while major expenditure responsibilities in the social and economic sectors are assigned to State governments. In fact, the architects of the Indian Constitution drew on the experience of some extant federations where the assignment of taxes with a wide economic base to units had led to intractable problems of conflicting tax jurisdictions (Sury, 2010)[9]. The possibility of such conflicts was avoided by assigning such taxes right from the beginning to the Union Government. While the State governments in India collect about only one-third of the total tax revenue accruing to the government sector, their expenditure obligations are disproportionately high, accounting for three-fourths of the aggregate social expenditure and more than one-half of the aggregate expenditure on economic services. To enable the States to carry out their expenditure responsibilities, the FC is assigned the task of recommending the transfer of resources from the Centre to the States.

[9] Sury, M.M. (2010), *Finance Commissions and Fiscal Federalism in India*, Indian Tax Foundation, New Delhi.

7.6 The FC is constituted by the President under Article 280 of the Constitution every fifth year or earlier if necessary. The approach of each FC is guided by the mandate of the constitutional provisions and the terms of reference contained in the Presidential order constituting it. The duties of the FC are set out under Article 280 of the Constitution, the core duties that relate to sharing of Central taxes and the determination of grants for the States are laid down under Article 270 and Article 275, respectively. The Indian Constitution provides for Central transfers, but it neither indicates the share of States in the divisible taxes nor presents any principles for its distribution among the States. The precise manner of sharing taxes and the actual determination of grants is left to the FC.

3. Developments in Mandate

7.7 The Indian federal system has demonstrated remarkable resilience in coping with new demands made on it from time to time. The FC's mandates have been modified from time to time, taking into account the parametric environment that defines the economy and its immediate future. Accordingly, it is noted in the Sixth FC Report (p.5):

"The provisions of the Constitution concerning financial relations between the Centre and the States seem to have been designed with great care and circumspection so as to forestall precisely the kind of difficulties that even the older federations do not appear to have overcome in securing closer correspondence between resources and functions of the different layers of Government... [T]he financial provisions of our Constitution give enough room for reconciling such conflicts of interests as may arise from time to time between the Union and the constituent units."

7.8 The first FC was appointed in 1952 and, so far, 13 FCs have been appointed at intervals of almost every five years. Since the first FC, the nature of India's economy and the macroeconomic policy framework have changed dramatically. Accordingly, fiscal transfers have been used to fulfil a variety of objectives, with the design of the transfer scheme getting closely linked to the intended purpose. The terms of reference (TOR) of FCs have been expanded to include relevant issues of topical importance from time to time. While some of the issues were included under the TOR of FCs in response to constitutional changes, other issues were referred to FCs as and when they emerged. In the following part of this section, some of these issues are discussed.

Additional TOR with respect to Local Bodies

7.9 In the early 1990s, decentralisation reforms assumed significance with a view to ensure the empowerment of local people through local governments. A notable development in this regard was the 73rd and 74th amendments in the Constitution in 1993. These constitutional amendments aimed to provide an impetus to the decentralisation process through a system of self-government for rural and urban local bodies and devolve greater powers, functions and authority to them. Decentralisation in governance bodes well for efficiency augmentation as local representatives are presumed to have a better understanding of local preferences and needs for goods and services. These amendments underscored the organic link in the public finances of the multilayered federal polity in India. Thus, it became necessary to re-orient the mechanism of Central transfers to take care of the resource requirements of rural and urban local bodies.

7.10 Accordingly, for the first time the TOR of the Eleventh FC required it to make recommendations in accordance with these constitutional amendments. Before this, the Tenth FC had recommended *ad hoc* grants equivalent to 1.38 per cent of the divisible pool, *albeit* without any mandate under the TOR. The TOR for the Eleventh FC was extended to include recommendations on the measures needed to augment the consolidated fund of the States so as to supplement the resources of local bodies, *viz*., *panchayats* and municipalities. The tasks of State FCs were spelled out under Articles 243I and 243Y of the Constitution. In other words, these amendments establish an organic link between the two constitutionally created bodies – the Central FC and the State FC (SFC).

7.11 In line with this mandate, the Eleventh FC suggested measures to augment the Consolidated Fund of the States. The purpose of these measures was two-fold: (i) to help achieve the underlying objectives of the 73rd and 74th amendments of the Constitution by enabling local bodies to function truly as institutions of self-government, and (ii) to ease the burden that State exchequers may face in nurturing local bodies to help them attain their potential and discharge their appointed functions. The Eleventh FC recommended *ad hoc* annual grants of ₹2,000 crore (0.78 per cent of the divisible pool) for *panchayats* (₹1,600 crore) and municipalities (₹400 crore), which were earmarked for priority activities, *viz*., maintenance of accounts, development of databases and audit of local bodies. Subsequently, the Twelfth FC raised the grants to ₹25,000 crore (1.24 per cent of the divisible pool) to be divided between panchayats (₹20,000 crore) and municipalities (₹5,000 crore) during the period 2005-10. It also suggested that SFCs should be set up without delay. The Thirteenth FC raised the share of grants to local bodies to 2.28 per cent (₹87,519 crore) in the divisible pool of resources for the award period 2010-11 to 2014-15. These developments indicate that the FC channel has played an important role in strengthening fiscal decentralisation in India.

Alteration in the Pattern of shareable taxes

7.12 Another constitutional amendment was necessitated when the vertical devolution process was sought to be simplified by making all taxes and duties in the Union list shareable with the States. The States' demand for a larger pool of shareable taxes by including all Central taxes, particularly corporation tax, was deliberated by various FCs. The inclusion of certain other taxes and excise duties (*e.g.*, surcharge on income tax, surcharges duties on excise, earmarked cesses and miscellaneous receipts from penalties) in the shareable pool of taxes had been a contentious issue between the Centre and the States. Until the Tenth FC, the net proceeds of income tax and Union excise duties were the major shareable taxes for which a separate distribution criteria was prescribed by the FCs. This changed after the 80th Constitutional amendment in 2000 under which Article 270 was amended.

7.13 This amendment, which was based on an 'alternative scheme of devolution' recommended by the Tenth FC, fundamentally altered the pattern of sharing of Central taxes between the Centre and the States. Under the alternative devolution scheme, the proceeds of all Central taxes, except surcharges, were to constitute a common shareable pool from which a share was to be devolved to the States. The Scheme incorporated in the new Article 270 provided for a fixed percentage share of States in all Central taxes and duties (except central sales tax, consignment taxes, surcharges on Central taxes and earmarked cesses). The Eleventh FC was required to recommend the percentage of taxes or duties referred to in the new Article 270. This arrangement is expected to enable the States to share the aggregate buoyancy of Central taxes and facilitate the Centre's process of tax reforms without needing to consider the nature of the tax (shareable or non-shareable). The impact of fluctuations in Central tax revenues would, therefore, be felt by Centre and the States alike.

7.14 Apart from the above issues, other issues beyond the constitutional mandate such as the restructuring of public finances, sustainability of debt and calamity relief, have also been referred to the FCs.

Debt position of States

7.15 Determining the correct size of the fiscal deficit and the debt in relation to GDP is important for prudent fiscal management. Debt-related issues are dealt with by FCs as outlined in their respective TORs. The Second FC was the first one to handle the issue of State debt and to make recommendations on rates of interest and terms of repayment of Central loans made to States. From the Sixth FC onwards, a review of the States' debt position has been explicitly included as a term of reference. The Sixth FC was asked to make an assessment of the non-Plan capital gap of the States on a uniform and comparable basis for the five years ending with 1978-79. This required a general review of the States' debt position with particular reference to the Central loans advanced to them and likely to be outstanding as at the end of 1973-74 with a view to suggest changes in the existing terms of repayment. Since then, the assessment of the debt position of States has been a regular feature of TORs of most of the subsequent FCs. It is observed that the major recommendations related to grant of debt relief to States through rescheduling and write-off of Central government loans to mitigate the impact of high repayment obligations on State finances. However, TORs for the Ninth and Tenth FCs were more elaborate because they were asked to review the entire debt position of States rather than only Central government loans advanced to them. These FCs differed in their approach towards the issue of debt relief to States. This was driven by the belief that the debt relief measures by successive FCs created anticipations about such measures in future with a built-in adverse incentive. In recognition of the fact that debt relief often underwrites lack of fiscal discipline in the past, the Tenth FC recommended, for the first time, that general debt relief be linked to fiscal performance. The Eleventh FC continued the same principle with some modification in operational modalities.

7.16 The TOR in respect of the debt position of States in the Twelfth FC was more elaborate. Apart from suggesting debt sustainability measures, it was asked to recommend debt relief measures together with the objective of macroeconomic stability. In addition, the recommendations were to be linked to the performance of States in the fields of human development and investment climate. The Twelfth FC, therefore, followed a two-pronged approach to debt relief. First, a general scheme of debt relief applicable to all States by consolidating the past debt and rescheduling it, along with interest rate reduction, was devised. Second, a debt write-off scheme linked to fiscal performance, *i.e.*, a reduction in absolute level of revenue deficit, was introduced. A significant development was the stipulation by the Twelfth FC that fiscal responsibility legislation by each State would be a necessary pre-condition to avail of debt relief under the debt consolidation and relief facility (DCRF). The Thirteenth FC was mandated to examine the operation of the DCRF during 2005-10 as implemented by the Centre and suggest measures to ensure a stable and sustainable fiscal environment that was consistent with equitable growth. The Thirteenth FC held the view that the benefits of consolidation under the DCRF facility, limited to consolidation and interest rate reduction, should be extended to those States that had not yet availed of the same, subject to the enactment of the FRBM Act. The Commission also suggested that the benefit of interest relief on the NSSF and write-off should be extended to States only if they bring about the necessary amendments/ enactments of the FRBM.

Emphasis on Fiscal Reforms

7.17 Various FCs have been mandated to examine concerns that have emerged from time to time with regard to State finances. From the early 1990s, State finances came under stress as the State governments started paying market-related interest rates on loans from the banking system and the Centre. Recognising the need to improve the States' financial position, State-level fiscal reforms were explicitly emphasised in the TOR of the Eleventh FC. In fact, under an additional TOR the Eleventh FC was asked to review the position of finances of the Union and the State governments and suggest measures by which the governments, collectively and severally, may restructure public finances so as to restore budgetary balance and maintain macroeconomic stability. In particular, the Commission was mandated to draw a monitorable fiscal reforms programme aimed at reducing the revenue deficit of the States and recommend the manner in which the grants to States to cover the assessed deficit in their non-Plan revenue account may be linked to progress in implementing the programme.

7.18 Accordingly, the Eleventh FC recommended creating a scheme of States' Fiscal Reform Facility (FRF) for the period 2000-01 to 2004-05, backed by a Fiscal Reform Facility Incentive Fund to incentivise States to collectively eliminate revenue deficits by 2004-05. The FRF Incentive Fund was constituted by the Government of India and States were advised to prepare their Medium-Term Fiscal Reforms Programmes (MTFRP) aimed at bringing about necessary correction in the revenue deficits. The release from the Incentive Fund was linked to an improvement in single monitorable fiscal indicator, *i.e.*, revenue deficit (as a percentage of revenue receipts) by 5 percentage points annually (2 percentage points for special category States prospectively with effect from 2002-03). The MTFRP was accepted by all 28 States and MoUs were signed with 27 States. Realising the importance of fiscal discipline, some States enacted fiscal responsibility legislations, while many States also put in place medium-term reform programmes with specific monitorable targets.

7.19 While reviewing progress under the FRF, the Twelfth FC concluded that the FRF failed to play a significant role in improving State finances and hence recommended its discontinuation. However, recognising the need for improving the States' medium-term fiscal situation, the Twelfth FC decided to reflect upon the shortcomings in the earlier debt relief, and suggested a detailed fiscal reform path to enable each State to reach the targeted revenue balances by 2008-09. While taking note of the deterioration in the finances of the Centre and the States in 2008-09 and 2009-10, the Thirteenth FC suggested a fiscal roadmap for them backed by the objective of maintaining a stable and sustainable fiscal environment consistent with equitable growth. The Commission suggested that the States should amend/enact the FRBM Acts to enable them to move towards the fiscal reform path worked out for them. State-specific grants recommended for a State should be released only upon compliance with the stipulated norms. The Thirteenth FC has also designed grants with the specific purpose of incentivising improvements in accountability, transparency and the public goods delivery process.

Broadening the Issue of Relief Expenditure

7.20 The provisions relating to disaster management in the Constitution of India are ambiguous. Neither relief for natural calamities nor disaster management fall anywhere in the Union, State or Concurrent Lists. Under Entry 97 of the Union List, a subject that is not specifically mentioned in any of the lists would ordinarily have to be dealt with by the Union Government. However, by convention this responsibility lies with the States, while the Central government plays a largely supportive role with financial, technical and material support, whenever necessary. The expenditure on post-disaster response, relief and rehabilitation is generally incurred by the State governments and is met from the annual allocations made to the States on the basis of recommendations by the FCs. In fact, the entire system of financing relief for calamity expenditure in India has evolved around the recommendations of the successive FCs.

7.21 The issue of funding relief expenditure has been recognised by each FC since the Second FC. Since then, the FCs have made recommendations with regard to providing relief expenditure out of the revenues of the States and the amount of support to be extended by the Centre to the States. However, an institutional mechanism to deal with natural calamities has been put in place, as recommended by the FCs. For instance, the Ninth FC recommended setting up Calamity Relief Funds (CRFs) for each State. Going further, the Tenth FC recommended the establishment of a National Fund for Calamity Relief (NFCR) in addition to the CRF. The Eleventh FC recommended discontinuing the NFCR and suggested that a National Calamity Contingency Fund (NCCF) be set up with an initial corpus of ₹500 crore to be replenished by the levy of a special surcharge on Central taxes for a limited period. The TORs of the Twelfth and Thirteenth FCs included a review of financing of disaster management under the NCCF and the CRF. Apart from expanding the list of natural calamities, the Twelfth FC recommended strengthening both the NCCF and the CRF. However, the Thirteenth FC suggested merging the NCCF with the National Disaster Response Fund (NDRF) and the CRF with the State Disaster Response Fund of the respective States. It also suggested considering funding of man-made disasters from the NDRF.

Specific Grants

7.22 Specific or special grants are generally provided to States that are unable to spend adequately to deal with State-specific problems because of fiscal capacity constraints. Before the Sixth FC, the FCs did not have any specific mandate for making earmarked provisions through special purpose grants. Nevertheless, specific amounts were allocated through grants-in-aid to improve and augment services, *viz.*, the special grants by the First FC to expand primary education, special grants-in-aid by the Second FC to some States, and special grants by the Third FC to 10 States to improve road and communications. While recommending the grants, the Sixth FC was specifically mandated to examine the requirements of States that were backward in standards of general administration to upgrade the same and to bring them at par with advanced States over a period of 10 years. Since then, the TOR of each FC (with the exception of the Ninth FC) has mentioned the upgrading or special problem grants. To ensure better targeting of expenditure in certain important areas, the FCs have recommended specific grants mainly for the education and health sectors, maintenance of roads and buildings, drinking water, infrastructure, forests, and protection of historical monuments, archaeological sites and heritage buildings (that are not with the Archaeological Survey of India).

Sharing of Profits from Petroleum and Mineral oil Companies with States

7.23 An issue that many States have been raising with the Centre relates to the ownership of land and minerals and the royalty payable to States. Under the Oilfields (Regulation and Development) Act, 1948, the Centre has the authority to increase or reduce the royalty rates. Consequent upon the reduction in the royalty rates by the Central government for faster development of these sectors, many States raised the issue of compensation for the losses after the project starts generating profits. The Twelfth FC was asked to examine the issue of sharing the non-tax revenue of the Central government from the profits of the petroleum sector with the mineral oil-producing States. The Commission recommended that the non-tax income of 'profit petroleum' companies to the Union, arising out of contractual provisions in the case of New Exploration Licensing Policy (NELP) blocks, may be shared in the ratio of 50:50 with the States in which the mineral oils are produced.

4. Devolution of Resources from Centre to States

7.24 Although the role of the FCs has expanded significantly over the years, the basic mandate for FCs in respect of distribution of taxes and grants-in-aid to States has remained unchanged. Each FC is required to determine the aggregate and individual shares of the States in the shareable pool of Central taxes under Article 270. The Commission has to determine the aggregate share of States in shareable taxes, specify criteria for deciding the shares of the individual States, and the weights attached to different allocation criteria. The shareable pool of Central taxes has changed in its scope and composition. Each FC has exercised varying value judgements to determine the approach and size of the vertical revenue transfers (Chalam and Mishra, 1997)[10].

7.25 Prior to the 80th Constitutional Amendment, two major Central taxes were mainly shared with the States, *viz.*, income tax other than corporation tax and Union excise duties. The sharing of income tax was mandatory, but the sharing of Union excise duties with States was discretionary and could be shared if Parliament by law so provided. Following the 80th amendment of the Constitution, it became mandatory for the Centre to share all Central taxes (except taxes under Articles 268 and 269 and earmarked cesses, and surcharges under Article 271) with the States.

[10] Chalam, K. S. R. V. S and Rajiv Mishra (1997), "Streamlining norms: a renewed approach for Finance Commission", *Economic and Political Weekly*, June 21.

Evolution of the Sharing Process: Vertical distribution

7.26 The Constitution of India specifies the taxation powers of the Centre and States. To deal with the vertical imbalances between the Centre and the States, the FC recommends vertical transfers. These transfers act as an instrument to deal mainly with the extant asymmetric decentralisation of expenditure responsibility and revenue-raising authority. In the process of devolution of resources from the Centre to States, there are two major modes of transfers, *viz.*, States' share in Central taxes, and grants. The key factors for determining the States' share in Central taxes (vertical distribution) have varied across FCs. Grants to States can be unconditional and general purpose or conditional and purpose-specific.

7.27 The most vital aspect of intergovernmental fiscal transfers is the size of the distributive pool of taxes which is available for transfers. Various FCs progressively enlarged the size of the States' share in income tax collections. It increased from 55 per cent as recommended by the First FC to 85 per cent as recommended by the Ninth FC. The rationale for increasing the size of the States' share in net proceeds of income tax has differed across FCs. For instance, by raising the share of the States in net proceeds of income tax, the Third and Fourth FCs tried to compensate the States for the loss they incurred on account of exclusion of corporation tax in the divisible pool; the divisible pool shrank due to the reclassification in 1959 of income tax paid by companies as corporation tax. Similarly, for the first time, the Fifth FC included advance tax collections in the divisible pool of income tax and distributed the arrears while retaining the share of the States at 75 per cent. Subsequently, the Sixth FC realised that the arrears were no longer available to States and recommended an increase in the States' share in divisible pool of taxes from 75 per cent to 80 per cent for the award period 1974-79. Considering the States' grievance with regard to the levy of surcharge by the Centre as a normal tax measure, the share of States was again raised by the Seventh FC. The Eighth and Ninth FCs did not recommend any change in States' share in net proceeds of income tax. However, the approach of the Tenth FC towards the sharing of Central taxes differed from that of the earlier FCs; the Tenth FC held the view that the authorities engaged in levying and administering tax collections should get a significant and tangible interest in its yield but changes in the share of States should not materially impact the level of devolution. Hence, the Tenth FC recommended a downward revision in the share of States in net proceeds of income tax to 77.5 per cent for the award period 1995-2000 (Table VII.1).

7.28 Consequent upon the 80th Constitutional Amendment and the enlargement of the divisible pool of shareable taxes by including all Central taxes, the Eleventh FC recommended a share of 29.5 per cent for States. This share included 1.5 per cent of shareable Union taxes to be distributed among States and not levying or collecting sales tax on the commodities covered under the Additional Excise Duties (Goods of Special Importance) Act, 1957. The Twelfth FC recommended increasing the States' share from

Table VII.1: Recommended Share of States in Major Divisible Taxes

(Per cent)

Finance Commission	Income Tax (%)	Basic Excise Duties (%)	Number of Commodities Covered
1	2	3	4
First FC (1952-57)	55	40	3
Second FC (1957-62)	60	25	8
Third FC (1962-66)	66.6	20	35
Fourth FC (1966-69)	75	20	All
Fifth FC (1969-74)	75	20	All
Sixth FC (1974-79)	80	20	All
Seventh (1979-84)	85	40	All
Eighth FC (1984-89)	85	45 *	All
Ninth FC (1989-95)	85	45	All
Tenth FC (1995-2000)	77.5	47.5 *	All
	All Central Taxes#		
Eleventh FC (2000-05)	29.5		
Twelfth FC (2005-10)	30.5		
Thirteenth FC (2010-15)	32.0		

\# Inter se Share of States in net proceeds of all shareable union taxes and duties.
* 40% of the net proceeds to be distributed while the remaining 5% would be earmarked for the non-plan revenue deficit States.
** 40% of the net proceeds to be distributed while the remaining 7.5% would be earmarked for the non-plan revenue deficit States.
Source: Finance Commission Reports.

29.5 per cent to 30.5 per cent on the premise that additional transfers can be accommodated by rationalising the Centre's participation in areas that fall directly under the purview of the States. Taking into consideration the factors, *viz*., (i) the higher buoyancy of the Centre's taxes than that of the States during 2000-08, (ii) the States' increasing responsibility with regard to rural and urban infrastructure and (iii) the increase in the Centre's non-tax revenues particularly from royalties and the telecommunications sector, the Thirteenth FC recommended raising the States' share in Central taxes to 32 per cent for the award period 2010-15.

7.29 Apart from sharing net income tax, States were also dependent on their share in Union excise duties to meet their revenue needs. As Table VII.1 shows the First FC made a modest beginning by sharing Union excise duties with the States in respect of three commodities, *viz*., tobacco, matches and vegetable products. Successive FCs recommended larger devolutions to the States either by increasing the coverage of shareable items or by increasing the States' share. The number of items included in the list of shareable excise duties was increased from 3 to 8, *albeit* with a reduced share of 25 per cent, by the Second FC. The shareable basket of commodities in respect of Union excise duties was further expanded to 35 commodities by the Third FC, but the share was reduced to 20 per cent. Consequent upon the demand by the States, the coverage of items for the States' share in union excise duties has been made universal since the Fourth FC. The Seventh FC recommended increasing the share of the States in Union excise duties to 40 per cent, on the grounds that providing sufficient resources to States would reduce their dependence on the Centre. The Eighth FC further enhanced this share to 45 per cent but the increment of 5 per cent was used to meet the assessed post-devolution revenue deficit of States. The Ninth FC retained this scheme in its first Report submitted for 1989-90, but in its second Report for 1990-91 to 1994-95, the Ninth FC recommended distributing the entire amount of 45 per cent as a consolidated amount without any separate component to be used for reducing States' non-Plan revenue deficits[11]. The Tenth FC recommended a share of 47.5 per cent for States in the net proceeds of Union excise duties while setting apart 7.5 per cent of the Union excise duties for distribution on the basis of assessed deficits. With the 80th Constitutional Amendment, a single pool has been prescribed for all shareable Central taxes (except under Articles 268 and 269) since the Eleventh FC.

7.30 To sum up, an analysis of the recommendations of the FCs in respect of shareable taxes and excise duties suggests that various FCs have given due importance to States' concerns with regard to their share in the divisible pool and its composition. With the clubbing of most Central taxes since the Eleventh FC, the shareable pool of taxes has not only expanded but the States' share in it has also increased.

Shareable Taxes and Union Excise Duties: Horizontal Distribution Criteria

7.31 As regards the determination of the *inter se* shares of the States, the basic objective of the FC transfers has been to (i) correct the differentials in revenue capacity and cost disability factors inherent in the economies of the States and (ii) foster fiscal efficiency among the States. The criteria used in the past for these purposes can be grouped under (a) factors reflecting needs, such as population and income measured either as distance from the highest income or as an inverse; (b) cost disability indicators such as area and infrastructure distance; and (c) fiscal efficiency indicators such as tax effort and fiscal discipline.

7.32 As regards the weight of different variables in the distribution criteria of net proceeds of income tax, only two factors were taken into account till the Seventh FC. Population was a dominant factor

[11] Instead of earmarking a separate portion out of shareable Union excise duties, the Ninth FC introduced a variable non-Plan revenue deficit in its distribution formula of Union excise duties.

with the highest weight of 80 to 90 per cent, while contribution in tax collection was a minor factor. There was no change in the horizontal distribution criteria of net income tax proceeds except that there was some adjustment between the respective weights of population and contribution. In contrast, the Fifth FC felt that the appointment of a new FC should provide an opportunity for a fresh look at various issues in the light of changed circumstances and available information. The Fifth FC identified several inadequacies with regard to contribution criteria (based on tax collections) recommended by earlier FCs. It highlighted that (i) contribution was determined by the convenience of the assessees without reference to the origin of income, and (ii) large amounts of tax deduction at source on dividends, interest payments, *etc.* gave the undue benefit of larger collections to States with metropolitan and industrial centres. Therefore, apart from population (with a weight of 90 per cent), the Fifth FC added 'assessment' instead of 'collection' with 10 per cent weight in the distribution scheme of income tax proceeds. This distribution scheme remained unchanged till the Seventh FC (Appendix Table 22).

7.33 Keeping in view the memoranda submitted by various States, the Eighth FC noted that the criteria for allocating income tax should be more progressive. It recommended that 90 per cent of States' share in income tax remaining after distributing 10 per cent on the basis of contribution should be allocated based on population (with a weight of 22.5 per cent, *i.e.*, 25.0 per cent of 90 per cent), income-adjusted population (with a weight of 22.5 per cent, *i.e.*, 25.0 per cent of 90 per cent) and the distance of per capita income (with a weight of 45 per cent, *i.e.,* 50.0 per cent of 90 per cent)[12]. The distance of per capita from the highest per capita income was considered as a measure of the relative backwardness of States. Since population was used as a scale factor in determining the 'distance' and 'inverse of per capita', its weight in the overall scheme was much larger than 22.5 per cent. Subsequently, the Ninth FC made a major change by introducing a composite measure of backwardness with a weight of 11.25 per cent. The composite indicator of backwardness comprised two indices, *viz.*, (i) population of Scheduled Castes and Scheduled Tribes and (ii) number of agricultural labourers in different States as revealed by Census 1981. The Tenth FC adopted a different approach from the previous FCs and stopped using 'contribution' as one of the factors for the distrubution criteria. It argued that the country as a whole represents a common economic space and market, and economic interdependence among States was growing. Therefore, it was difficult to identify locally generated income in the non-agriculture sector and, hence, there was no need to retain 'contribution' as a criterion. The Tenth FC also discarded the inverse income formula due to the implicit convexity: middle-income States have to bear a higher burden of this adjustment. Instead, it assigned a larger weight of 60 per cent to distance of per capita income along with population (20 per cent) and some new factors, *viz*., tax effort (10 per cent), area adjusted (5 per cent) and index of infrastructure (5 per cent)[13]. Therefore, there was an explicit emphasis on incentivisation of States for their tax efforts.

7.34 Assessing the prevailing fiscal situation of the States, the Eleventh FC recommended restructuring States' finances through in-built incentives for fiscal discipline and linking them to the principles of devolution. The Eleventh FC introduced a new index of fiscal discipline; tax effort and the index of fiscal discipline were together given a weight of 12.5 per cent. The Twelfth FC evolved a new formula that balanced equity with fiscal efficiency. Equity considerations, however, dominated in the scheme of federal transfers

12 Income-adjusted population was worked out on the basis of the inverse of per capita income multiplied by the population of the State in 1971. Distance of per capita income of a State is worked out from that of the highest per capita income multiplied by the 1971 population of the State concerned.

13 Tax effort was suggested to be measured by the ratio of per capita own tax revenue of a State to the square of per capita income of the State. Thus, the respective shares were worked out after scaling by population.

implementing the equalisation principle. Accordingly, it accorded 50 per cent weight to income distance along with 25 per cent weight to population. While 'area' was assigned a weight of 10 per cent, better fiscal management in terms of tax efforts and fiscal discipline was given a higher weight of 15.0 per cent by the Twelfth FC compared with the 12.5 per cent weightage given by the Eleventh FC.

7.35 The Thirteenth FC recommended using the concept of 'fiscal capacity distance instead of 'income distance'. Instead of using a single average of GSDP to assess the fiscal distance between States, it recommended estimation of per capita fiscal capacity at reasonably comparable levels of taxation from their respective group averages of non-special category and special category States. The Thirteenth FC accorded the highest weight to fiscal capacity distance (47.5 per cent), followed by population (25 per cent), fiscal discipline (17.5 per cent) and area (10.0 per cent).

7.36 In respect of Union excise duties, population continued to be the largest determining factor in the criteria for *inter se* share of States up to the Sixth FC, although its weight decreased from 100 per cent to 75 per cent. This weight was further reduced to 25 per cent (a fall of 50 percentage points from the preceding Commission) by the Seventh FC. Up to the Seventh FC, the formulae used to determine the income tax shares were clearly distinct from those for the Union excise duties. Since the Eighth FC, there has been a convergence between the two sets of formulae (Appendix Tables 22 and 23). There was a move towards unifying the formulae for the *inter se* distribution of both income tax and Union excise duties. Thus, the Eighth, Ninth and Tenth FCs followed a unified formula for sharing of income tax and Union excise duties. As noted by the Twelfth FC in respect of sharing the formula of Union excise duties, among need-based factors, population and income distance gained acceptance; among the cost disability factors, area and infrastructure index distance tended to be the preferred indicators; and among the fiscal efficiency factors, tax effort and fiscal discipline, as measured by the ratio of own tax revenue to revenue expenditure, were regarded as appropriate.

7.37 The above discussion suggests that while determining the formula for horizontal distribution of *inter se* shares of States, the basic aim of the FCs has been to correct the differentials in revenue capacity and cost disability factors inherent in the economies of States and to foster fiscal efficiency among States. The choice, definition and weight of the variables used to define a devolution formula kept changing across the FCs. While the greater weight to 'fiscal capacity distance' in the tax devolution formula of the Thirteenth FC is expected to facilitate convergence among the States, the increase in weight for 'fiscal discipline' would encourage a reversion to the path of fiscal consolidation.

Principles Governing the Design of Grant-in-Aid: Shift from Gap-filling Approach to Normative Approach

7.38 Besides the shareable Central taxes, another important source of resource transfers to the States from the Centre is grants-in-aid contributions. Grant-in-aid are mainly targeted towards achieving a degree of equalisation. Generally, the amount of grants-in-aid provided to the States by different FCs has been in respect of their revenue gaps. Grants-in-aid under the FC are meant to fill a gap which represents the State's expenditure not covered by its own revenue and share in Central tax. Grants 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 particular circumstances; and (iii) provide resources for specific activities considered to be national priorities. In fact, grants-in-aid are considered as an important instrument to make the scheme of transfers more comprehensive and address issues spelt out in the TOR. Unlike the devolution formula for Central taxes, grants provide greater scope to make corrections for cost disabilities faced by many States.

7.39 The guiding principles for grant allocation among States as recommended by the First FC were broadly followed by most of the subsequent FCs. Under Article 275, the First FC recommended that grants should be determined based on (i) the budgetary needs of States, (ii) tax efforts, (iii) economy in expenditure, (iv) equalisation of standard of social services, (v) State-specific obligations and (vi) broad purposes of national importance. According to Srivastava and Rao (2009), the First FC explicitly stated the best theoretically accepted principles for guiding the determination of fiscal transfers. The Second FC observed that grants-in-aid should be a residuary form of assistance given in the form of general and unconditional grants; it was of the view that grants for broad purposes may be given, provided they were spent exclusively for that purpose. The Third FC also recommended specific-purpose grants for improvements in communications. Most of the subsequent FCs generally agreed to the principles laid out by the First FC, but they were primarily in favour of unconditional revenue grants. The Seventh FC made some departures from the previous FCs while recommending capital grants to meet capital expenditure as well. This was in recognition of the fact that revenue grants were not adequate for meeting the maintenance expenditure on administrative and residential buildings. Even though it was out of the purview of their TOR, the recommendation of ₹908.8 crore as capital grant was accepted by the Government.

7.40 Grants-in-aid are an important component of FC transfers. The determination of grants requires a comprehensive review of both the Central and State finances. The FCs have often been criticised for their gap-filling approach that leads to significant adverse incentives (Srivastava and Rao, 2009)[14]. Under the gap-filling approach, larger transfers depend mainly on a larger gap in the revenue account in the past, irrespective of whether the available revenue capacity was adequately exploited or whether there was undue growth in expenditures. Singh (2006) argues that the gap-filling approach of grants reduced State government incentives for fiscal discipline while doing little to reduce inter-State inequalities[15]. However, the FCs, particularly from the Ninth FC, to some extent have applied normative principles to assess State's own tax and non-tax revenues as well as revenue expenditures. Under the normative approach, adverse incentives can be effectively neutralised as States are assessed in terms of revenues that they ought to raise given their respective capacities. Similarly, expenditures are assessed on the basis of needs consistent with an average or minimum acceptable level of services and the relevant cost norms, and are not driven by the past history of expenditures.

7.41 While recommending grants, the most debatable issue across various FCs has been with respect to coverage of Plan and non-Plan accounts. The Constitution places no restrictions on whether revenue account or only non-Plan revenue account can be considered to assess the resource needs of States. However, the Third FC considered the needs of the States for the Third Five-Year Plan and recommended that the quantum of grants-in-aid should be fixed in such a way that it enabled the States, along with surplus out of devolution, to cover 75 per cent of the revenue component of their plans. However, this recommendation was rejected by the Government. Subsequently, the consideration of needs of revenue expenditure on Plan accounts was dropped explicitly from the purview of the FC

[14] Srivastava, D.K. and C. Bhujanga Rao. (2009), "Review of Trends in Fiscal Transfers in India", at http://fincomindia.nic.in/writereaddata/html_en_files/report02.pdf.

[15] Singh, Nirvikar (2006), "State Finances in India: A Case for Systemic Reform", In S. Narayan (ed.), *Documenting Reforms: Case Studies from India*. India: Macmillan.

through specific stipulations in the TOR. However, the TOR of the Ninth FC made it optional for the Commission to consider Plan revenue expenditure requirements. The Tenth FC again restricted the ambit of consideration to the non-Plan account. The TOR of the Eleventh FC explicitly included consideration of both the Plan and non-Plan requirements of States. Despite the Eleventh FC considering revenue requirements only in respect of the non-Plan account, the Twelfth and the Thirteenth FCs were required to consider the entire revenue account of the States.

7.42 To sum up, grants recommended by the FCs have generally been unconditional and largely based on the projected gaps between non-Plan revenue expenditure and post-tax devolution revenue receipts. This approach has often been criticised as it does not provide for fiscal discipline at the State level. However, of late there has been an increasing emphasis on a normative assessment of resource requirements and expenditures while recommending grants to States.

Pattern of Fiscal Transfers

7.43 In the present scheme of transfers, tax devolution plays a dual role of correcting vertical as well as horizontal imbalances. Grants-in-aid are mainly targeted towards achieving a degree of equalisation. In the transfer scheme of FCs, the share in Central taxes has persistently dominated. The share of grants-in-aid, intended mainly to fill the non-Plan revenue gap, has remained less than that of the States' share in Central taxes, reflecting the importance accorded by the FCs to the tax efforts of States in the resource transfer to States. Despite the grants being the more effective and predictable transfer instrument for State-specific and purpose-specific targeting, States have preferred devolution of Central taxes as they are unconditional.

7.44 A review of the awards by successive FCs reveals that the quantum of resources transferred to the States has grown significantly from ₹382 crore under the First FC to as high as ₹17,06,676 crore under the Thirteenth FC. However, the total resource transfers in the form of States' share in taxes and grants exhibited compositional shifts over various commission award periods. These shifts are due to the interplay of factors such as changes in the ratio of tax sharing between the Centre and the States (vertical distribution), revenue buoyancy in Central taxes (being shared with the States), fiscal performance of individual States including their non-Plan revenue deficit position and special problems with regard to transfer of grants-in aid (Kannan *et al.*, 2004)[16]. As Table VII.2 shows, the States' share in Central taxes in total transfers declined from 87.9 per cent under the First FC to 75.8 per cent under the Fourth FC. The recommended share in Central taxes was reduced because the Fourth FC explicitly included financial assistance to meet the residual deficit as grants instead of share in Central taxes. Since the Seventh FC, the share of Central taxes in total transfers ranged between 80 and 90 per cent. In view of the need to ensure a larger role for equalisation transfers, the Twelfth FC had proposed to increase the share of grants in the total transfers. However, the Thirteenth FC has recommended a lower share of grants in total transfers, as States are expected to revert to the fiscal consolidation path and reduce their non-Plan revenue deficit, which was witnessed from 2004-05 to 2007-08.

7.45 Table VII.2 shows that there were differences between actual share of devolution of taxes (SCT) and grants (FCGR) and the respective shares recommended by the FCs, though these were not very significant. Srivastava and Rao (2009) argue that the observed differences reflected non-adherence to the stipulated conditions or delays in submitting the relevant utilisation certificates for

[16] Kannan, R. *et al.* (2004), "Finance Commission awards and fiscal stability in States", *Economic and Political Weekly*, January 31.

Table VII.2: Pattern of Transfers from Centre to States by Finance Commissions

(Per cent)

Finance Commission	Recommended Transfers		Actual Transfers		Actual Transfers from all agencies	
	Taxes	FC Grants	Taxes	FC Grants	Share in Taxes	Grants*
First FC (1952-57)	87.9	12.1	91.6	8.4	53.6	46.4
Second FC (1957-62)	81.2	18.8	76.2	23.8	48.6	51.4
Third FC (1962-67)	81.4	18.6	77.0	23.0	49.5	50.5
Fourth FC (1966-69)	75.8	24.2	73.1	26.9	48.4	51.6
Fifth FC (1969-74)	86.6	13.4	85.2	14.8	54.4	45.6
Sixth FC(1974-79)	73.9	26.1	75.0	25.0	50.6	49.4
Seventh (1979-84)	92.3	7.7	92.3	7.7	58.6	41.4
Eighth FC (1984-89)	90.4	9.6	89.0	11.0	53.8	46.2
Ninth FC(1989-95)	82.9	17.1	88.9	11.1	53.2	46.8
Tenth FC(1995-2000)	91.0	9.0	90.2	9.8	60.1	39.9
Eleventh FC (2000-05)	86.5	13.5	84.2	15.8	55.4	44.6
Twelfth FC (2005-10)	81.1	18.9	82.5	17.5	54.6	45.4
Thirteenth FC (2010-15)	84.8	15.2	–	–	–	–

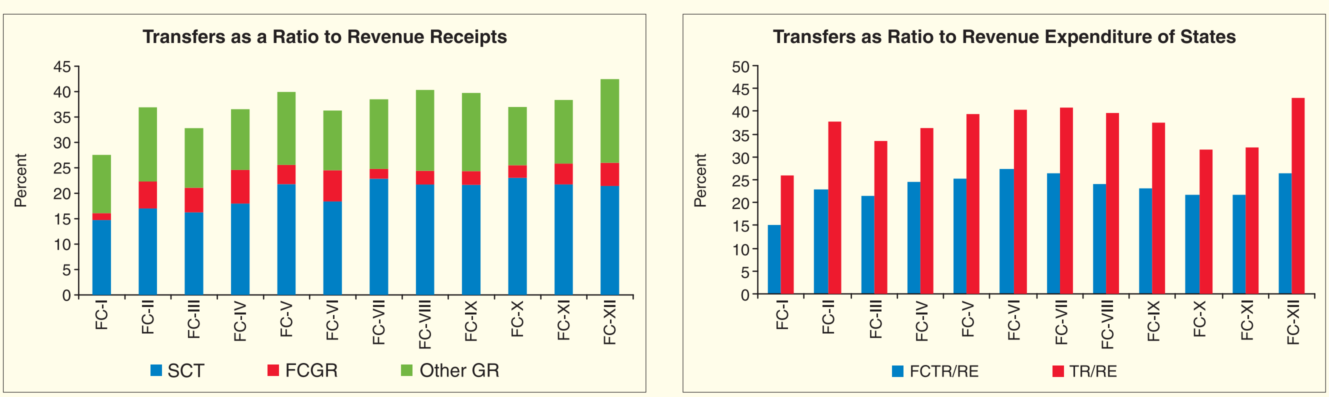
'–' : Not applicable

Note: *: Includes grants by FCs and agencies other than FC.

Source: (i) Reports of Finance Commission, (ii) State Finances: A Study of Budgets (various issues), (iii) Rangarajan and Rao, 2008.

procedural reasons. The contribution of FC transfers to revenue receipts of the State governments remained in the range of 16 per cent to 26 per cent across the award periods. However, since the Sixth FC, transfers through the FC channel have consistently accounted for around 25 per cent of the total revenue receipts of States. If the Central transfers through all other channels are included, they contributed 28-42 per cent of the total revenue receipts, during different award periods. Similarly, the transfer of resources through the FC channel enabled the States to meet around one-fourth of their revenue expenditure in recent years (Chart VII.1).

Chart VII.1: Transfers as Ratio to Revenue Receipts and Revenue Expenditure of States



5. Extent of Equalisation

7.46 The fiscal transfer system is expected to address the issues of vertical and horizontal imbalances. The equalisation component of transfers is quite important in federations like Canada where they have been mandated constitutionally since 1982 to ensure that sufficient resources are available to the provincial governments for providing comparable levels of public services at comparable levels of taxation. The Australian system of equalisation transfers is based on the criteria of cost differentials and equal efficiency in the provision of goods and services across provinces. The Australian equalisation differs from the Canadian equalisation due to the reference to efficiency and standard of services. In a federal set-up like India where regional variations in terms of per capita income, tax base and population are quite large, the equalisation component of central transfers assumes greater significance. In the Indian context, Srivastava (2006) argued that "for most of the early Finance Commissions, transfers followed a fragmented approach with different components of tax devolution being subjected to different considerations and the unconditional grants followed a gap-filling approach. Since different agencies dealing with transfers follow different approaches, without much coordination, a unified approach to transfers has not been developed. The net outcome of this segmentation has been that transfers have been far from equalising."[17]

7.47 Unlike other federations like Canada, the horizontal imbalance in India is resolved through a combination of tax devolution and revenue-gap grants. Based on the assessment of State finances and macroeconomic conditions for the award period, the FCs recommend State-wise total transfers comprising the States' share in Central taxes and grants-in-aid. However, actual transfers to States may vary from the recommended transfers, as some of the assumptions may not hold throughout the award period. Despite this conceptual distinction, it is difficult to separate the vertical and horizontal (equalisation) components of recommended fiscal transfers from the Centre to the States (Rangarajan and Srivastava, 2008)[18]. However, a few studies have attempted to quantify the vertical and equalisation components of recommended transfers. In the Indian context, Rangarajan and Srivastava (2008) attempted to work out the equalisation component of total transfers recommended by the Twelfth FC.

7.48 The framework adopted by Rangarajan and Srivastava (2008), though subject to certain qualifications, is being used in the study to quantify the degree of equalisation in the total transfers recommended by the recent four FCs (Tenth FC to Thirteenth FC). It is found that the degree of equalisation achieved was the highest in the case of the Eleventh FC as the gap between the benchmark and actual transfers was minimal. The State-wise distribution of transfers appears to be progressive as the State with the highest GSDP gap has been recommended for higher equalisation transfers, *albeit* less than the desired level, particularly in non-special category States. Furthermore, most of the special category States received transfers for cost differential and special needs (Box VII.1).

7.49 An analysis shows that the equalisation component in the recommended transfers has been less than the desired level in the case of all four FCs. Given the level of disparities in India, properly redistributing transfers to achieve full equalisation is a formidable challenge. Unlike other federations like Australia and Canada, the major proportion of the Indian population resides in recipient rather than donor States. In such a scenario, it becomes a challenging task to

[17] Srivastava, D.K. (2006), "Equalising health and education: approach of the Twelfth Finance Commission", *Madras School of Economics Working Paper* No. 6/2008.

[18] Rangarajan, C. and D. K. Srivastava (2008), ''Reforming India's fiscal transfer system: resolving vertical and horizontal imbalances", *Madras School of Economics Working Paper* 31/2008.

Box VII.1: Transfers from the Centre to States: Degree of Equalisation

Fiscal transfers are deemed to correct not only the asymmetries in decentralisation of expenditure to the States and the revenue-raising authority of the Centre (vertical imbalances) but also to equalise the differences in fiscal capacities across States (horizontal imbalances). However, the mechanisms to achieve these goals have varied across countries. While Canada and Germany follow an explicit equalisation mechanism of transfers to attain equity, India has an elaborate framework of tax revenue sharing, supplemented by revenue-gap grants. Even though the Finance Commissions in India have recommended fiscal transfers to address both horizontal and vertical imbalances, the quantification of these two components of transfers is a complex process. Rangarajan and Srivastava (2008) adopted a framework to separate the vertical, horizontal and residual components of per capita transfers to the States as recommended by the Twelfth FC. The present exercise updates the results based on the same framework to assess the degree of equalisation achieved across the States since the Tenth FC.

Under the framework of Rangarajan and Srivastava, the vertical component of transfers can be represented by the per capita transfer made on the basis of the resource gap of the richest state, assuming this to be the minimum benchmark allocation for any State. Incorporating this principle, the total vertical transfers should be proportional to the population of each State. The horizontal component of transfers (equalisation transfers) allocable to a State needs to be based on its per capita income gap relative to the richest State; this incorporates the horizontal equity principle that States with lower fiscal capacity, *i.e.*, per capita GSDP, would get a higher amount of transfers and *vice versa* in a progressive scheme of transfers. This framework can be represented as:

$t_i = (e-\beta y_n) + \beta (y_n - y_i) + resi$ *for a State where* $resi > 0$,

where ti denotes the recommended per capita transfers for i^{th} *State government;* $[e-\beta . y_n]$ *(assuming that* $e>\beta . y_n$*) represents the vertical component with e being assumed to be constant based on per capita expenditure norm,* β *denoting the average tax-effort, and* y_n *the per capita fiscal capacity of the highest income State;* $\beta (y_n - y_i)$ *represents the desired horizontal component; and resi denotes the residual transfers for special needs.*

The total transfers to States are derived by scaling up the per capita components of transfers with their respective size of population. An analysis of the relative shares of the three components in total transfers shows that the share of actual equalisation transfers works out to be the least and that of the vertical component the highest in the case of the Tenth FC. In contrast, the vertical component accounted for only 43.7 per cent of the total transfers recommended by the Eleventh FC, while the share of the equalisation component was the highest. As a result, the degree of equalisation, *i.e.*, the ratio of actual amount of equalisation transfers recommended by the FC to the amount needed for equalisation, turned out to be the highest in the case of the Eleventh FC. Although the Twelfth FC emphasised the equalisation approach by focusing on education and health, the degree of equalisation is estimated to be lower for the Twelfth FC award period than that for the Eleventh FC period[19]. The degree of equalisation is estimated to have come down further under the recommended transfers of the Thirteenth FC. An analysis of estimates for the residual components across the FCs since the Tenth FC shows that around 13 per cent of transfers were used for special needs (Eleventh FC) that have gone mainly to special category States. The share of special need transfers declined in the case of the Twelfth and Thirteenth FCs (Table A). A recent study by Srivastava (2010), however, found that the transfer scheme recommended by the Thirteenth FC would achieve equalisation to the extent of 90.5 per cent of the desired level. The variation in the estimated degree of equalisation to be achieved through the transfer scheme of the Thirteenth FC appears to be mainly due to differences in assumptions of the GSDP in terms of periodicity. While Srivastava (2010) assumed average per capita comparable GSDP at current prices for 2004-05 to 2006-07, centred in 2005-06 as used by the Thirteenth FC to be the macro proxy for the tax base, the present exercise uses the same during 2005-06 to 2009-10 (based on projected GSDP for 2009-10 as explained in Chapter V).

Table A: Recommended Transfers by Finance Commissions: Vertical and Horizontal Component

(₹ crore)

	10th FC	11th FC	12th FC	13th FC
Total Transfers	2,26,643	4,34,905	7,55,752	17,06,677
Annual Transfers	45,329	86,981	151,150	3,41,335
Amount used for Vertical Transfers	28,327	38,024	75,624	1,86,390
Amount for Equalisation Transfers	13,301	37,856	63,388	1,39,064
Amount used for cost differential and special needs	3,700	11,102	12,132	15,881
Amount Needed for full Equalisation	30,328	42,388	97,971	2,64,729
Share of Vertical Transfers (%)	62.5	43.7	50.0	54.6
Share of Equalisation Transfers (%)	29.3	43.5	41.9	40.7
Share of transfers for cost differential and special needs (%)	8.2	12.8	8.0	4.7
Degree of Equalisation achieved (%)	43.9	89.3	64.7	52.5

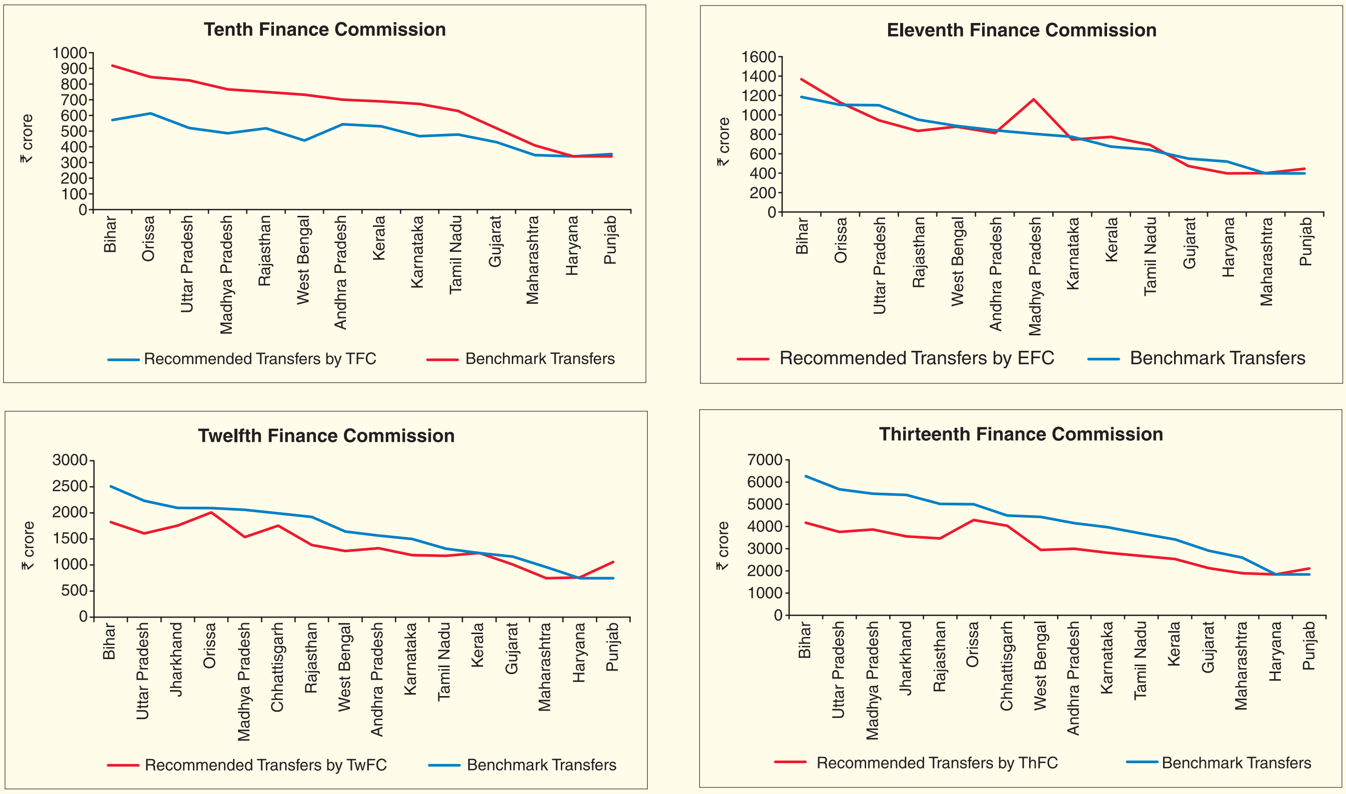
The State-wise distribution of recommended and benchmark transfers shows that the recommended equalisation transfers have been progressive and generally followed the same pattern as the desired equalisation transfers determined at the average tax-GSDP ratio. Chart A presents State-wise recommended and benchmark transfers in descending order in terms of per capita GSDP gap for non-special category States except Goa. It shows that States with a higher per capita output gap, in general, received higher per capita transfers and *vice versa*, thereby satisfying the principle of horizontal equity. A comparison of recommended and benchmark transfers across different FCs also confirms that the degree of equalisation was the highest in the case of the Eleventh FC as the gap between the recommended and benchmark equalisation transfers was minimum. As observed by Rangarajan and Srivastava (2008), the findings for the non-special category States suggest that the pattern of transfers in general follows an equalising approach and not a gap-filling approach. They also found that all special category States (except Assam) got substantial transfers under cost disability and special need considerations (Statements 49 to 52).

Contd...

[19] This estimate varies from that of Rangarajan and Srivastava (2008) mainly because per capita GSDP (y_i) and own tax revenue as a ratio to GSDP (β) in the present exercise are computed using the latest available data on GSDP for 2000-05 while they used GSDP for 1999-00 to 2001-02.

Concld.

Chart A: Comparison of Per Capita Benchmark and Recommended Transfers by Finance Commissions: Non-special Category States



References:

Government of India, Finance Commission Reports (10th FC to 13th FC).

Rangarajan, C. and D. K. Srivastava (2008), Reforming India's fiscal transfer system: resolving vertical and horizontal imbalances, *Madras School of Economics Working Paper* No. 31/ 2008.

Srivastava, D.K. (2010), Vertical sharing and horizontal distribution of resources: the equity and efficiency trade-off, *Economic and Political Weekly*, Vol. XLV, No. 48, November 27.

achieve full equalisation as the extent of redistribution implicit in the equalising scheme is far larger. With income disparity among the States being sizeable (the richest State had a per capita GSDP nine times higher than the poorest during 2005-10), equity has been an important component in determining relative fiscal needs since the Sixth FC. As observed by Rangarajan and Srivastava (2008), these findings need to be interpreted keeping in view various qualifications[20].

6. Conclusion

7.50 To sum up, the FCs have played a distinctive role in inter-governmental fiscal relations in India. The major points that emerge from the above discussion can be summarised as: (i) even though the core functions of the FCs have remained broadly unchanged with respect to distributing the net proceeds of taxes between the Union and the States and defining the guiding principles for grants-in-aid of revenues, the role of the FCs has considerably

[20] First, the equalisation benchmark is calculated with a revenue side approach using average tax effort while excluding expenditure side considerations. Second, fiscal capacity has been measured in terms of revenue base available in terms of GSDP. Third, the highest per capita GSDP among States, excluding Goa, is used as the benchmark. Fourth, shortfalls from the equalisation benchmarks are equally weighted. Ideally, higher weight needs to be assigned to lower per capita income States for having shortfalls in equalisation transfers.

expanded as new challenges in the economic and political environment emerged from time to time; (ii) the approach of the FCs while defining the distribution criteria and principles for distributing grants has changed with a focus on relevant issues and concerns of the States; (iii) despite the efforts made by various FCs to capture State/region-specfic socio-economic variations in their scheme of transfers, the impact of FC transfers on horizontal equity has been somewhat limited as vast gaps continue to exist between the actual and desired level of transfers for equalization; (iv) the recommended transfers have been progressive as the horizontal equity principle was generally followed and States with lower per capita fiscal capacities had a higher per capita share than others and *vice versa*.