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**EVOLVING CONTOURS OF CENTRE-STATE FISCAL
RELATIONS: INCONSISTENCIES, AD-HOCISM
AND CENTRALIZATION**

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Abstract

This paper highlights features of growing inconsistencies, ad hocism and centralization in the working of intergovernmental fiscal relations in India in recent years. To illustrate these issues, relevant examples are drawn from the 2018 amendment of Centre's FRBM Act, determination of the inter-se distribution of the divisible pool of taxes amongst the states, and the working of the GST Council. Methods are also suggested as to how reforms can be introduced in order to reverse these undesirable features. In the case of Centre's FRBMA, we suggest alternative but internally consistent combinations of debt and fiscal deficit relative to GDP. In the context of fiscal transfers, we recommend the incorporation of relevant information reflecting cost and need disabilities directly into the broad-based devolution criteria. In the case of GST, we recommend inclusion of important excluded items such as taxation of petroleum and alcoholic beverages while giving additional revenue autonomy to states by the introduction of a non-rebatable cess on polluting and demerit goods and services.

Keywords: *FRBMA, GST, fiscal transfers, Finance Commission, equalization, centralization*

JEL Codes: *E61, H10, H21, H77*

Preface

Madras School of Economics (MSE) established the Centre for Public Finance (CPF), which started functioning from April 1, 2021. This Centre is financed by the Government of Tamil Nadu. Its activities are guided by an Advisory Council (headed by me). The Centre focuses on both theoretical and empirical issues of public finance covering the following areas: deficit financing and public debt, monetary and fiscal interactions, tax policy and reforms, public expenditure management, public investment appraisal and cost benefit analysis, public enterprises reform, intergovernmental transfers, local finances and environmental issues.

Apart from general research activities, the Centre is committed (i) to review the Tamil Nadu Economy and State Finances every year, (ii) to conduct an Annual Conference on topics related to public finance and policy and (iii) to conduct Training Programs on public finance. It will also undertake specific studies on public finance funded by either Government of Tamil Nadu or other National and International agencies.

During the academic year 2021-22, the Centre organized "Virtual Meeting on Improving the Presentation of Tamil Nadu Budget Document" on April 29, 2021 and conducted the 5-day Training Programs on Public Finance for (270) 15 batches of Groups A and Group B officials of Government of Tamil Nadu through online mode (from August 31, 2021 to December 31, 2021). It organized a two-day National Conference on "Issues of Public Finance" during 20-21 January 2023. It has also initiated research studies which are published when completed as working papers of the CPF at MSE.

The study "Evolving Contours of Centre-State Fiscal Relations: Inconsistencies, ad-hocism and Centralization", by D.K. Srivastava is the Tenth working paper of the Centre for Public Finance. This study provides evidence to show growing inconsistencies, adhocism and centralization in the intergovernmental fiscal relation in India in recent period. It also provides suggestions on how reforms such as fixing debt-GDP ratio of 30 percent and fiscal deficit-GDP ratio of 3 percent for both centre and States, introducing cost and need disabilities in the area criterion of tax devolution and integrating environmental and demerit taxes in GST can reverse these undesirable features.

**C.Rangarajan
Chairman**

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D.K. Srivastava

INTRODUCTION

In the management of centre-state fiscal relations in India, noticeable but disturbing trends appears to have evolved in recent years. These trends, by and large, have worked in favour of the central government at the cost of the state governments. The state governments have suffered an erosion of their revenue autonomy along with capacity to undertake discretionary interventions in the light of challenges to their state-specific growth performance. The way the central government has responded to Finance Commission (FC) recommendations has also led to a loss in potential revenue for them due to a very large pre-emptive share of cesses and surcharges especially after the introduction of GST. Further, the FCs have also not refined their devolution formula in spite of a larger share of the divisible pool being distributed across states owing to the sudden increase in this share by FC14. With larger devolution being subjected to broad-based criteria implicit in the devolution formula and their near ad-hoc relative weights, the targeting of transfers has suffered. With grants, a finer targeting is possible. However, with devolution, only broad-based targeting using ad-hoc weights in the devolution formula is possible. The weight of the latter in total transfers has increased, implying an erosion in the quality of fiscal transfers. Besides these concerns, two more issues that this article examines pertain to a) inconsistent fiscal deficit and debt targets for central and state governments as per the 2018 amendment to Centre's FRBMA, and b) increasing centralisation and loss of revenue autonomy at the state level after the introduction of GST.

This article proceeds as follows. Next section discusses key issues with the 2018 amendment to centre's FRBMA and suggests possible reforms. Subsequent two sections 3 highlight several examples of ad-hocism prevalent in the current framework of fiscal transfers from the centre to states and provides corrective recommendations and examine the growing trend of centralization, drawing examples from the GST framework and the future of GST reforms in India. The final section provides concluding observations.

MANAGING DEBT AND DEFICIT: FROM SYMMETRY TO ASYMMETRY

The latest amendment in Centre's FRBM was undertaken in 2018 based on the recommendations of an FRBM Review Committee which was constituted on 17 May 2016. The Committee had suggested debt targets of 60 percent, 40 percent, and 20 percent of GDP respectively for the combined, central, and state governments. Covid-19 has disturbed these targets as well as the glide path indicated by the FRBM Review Committee. FC15 had examined this matter again and provided their own glide paths. However, they did not work out either a new set of debt and deficit targets or a new longer-term adjustment path. They however recommended that a High-powered intergovernmental group be constituted to review these matters. Such a review is needed, among other factors, with a view to removing some of the infirmities in the fiscal responsibility framework outlined by the FRBM 2018 amendment. *Srivastava (2021)* noted these infirmities as below:

1. Centre's original FRBMA, enacted in 2003, had emphasized the importance of maintaining balance or surplus on revenue account since it is linked to government sector dissavings.¹ This requirement was dropped in the 2018 amendment. However, there is a need to re-examine whether the target of a revenue account balance should be brought back in the FRBMA. India would be able to optimize its GDP growth by minimizing government dissavings.
2. There was an inconsistency in fixing debt and deficit targets for centre and states. *Srivastava (2021)* noted that a fiscal deficit target of 3 percent of GDP for both centre and states is not consistent with a debt-GDP target of 40 percent for centre and 20 percent for states. In fact, if the fiscal deficit targets are symmetrical, there should also be a symmetry in the debt-GDP

¹ Paragraph 4.13 of the Report of the Twelfth Finance Commission

targets independent of the underlying nominal GDP growth, as long as the Centre and states in aggregate are subject to a common growth rate. Simulations indicate that they should both be equal if the fiscal deficit targets are equal. Charts 1 and 2 show that with a nominal growth assumption of 12 percent, the debt-GDP ratios for the Centre and the states converge to 28 percent in both cases if a fiscal deficit to GDP ratio of 3 percent is maintained year after year. This is independent of the initial debt levels.

Chart 1: Centre's Debt-GDP ratio

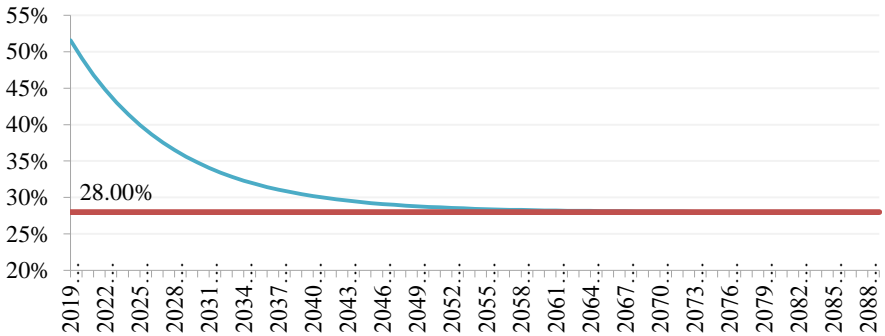
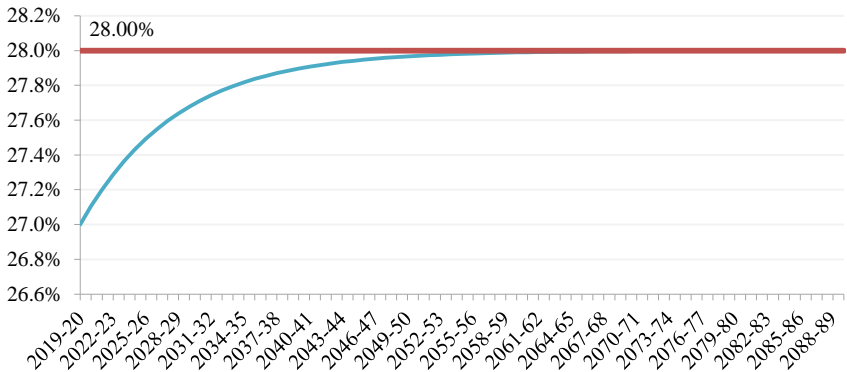


Chart 2: States Debt-GDP ratio



Source: RBI, MOSPI, and author's estimates

Note: Initial debt-GDP ratio is considered for 2019-20 at 51.6 percent for the centre and at 27 percent for the states.

3. A third major weakness of the FRBM 2018 amendment relates to its countercyclical clauses. According to the Act, five conditions in which a departure from the fiscal deficit target of 3 percent of GDP can be permitted are as follows: (a) national security, (b) act of war, (c) national calamity, (d) collapse of agriculture severely affecting farm output and incomes and (e) structural reforms in the economy with unanticipated fiscal implications. The Act provides that if, as a result of one or more of the above conditions, there is a "...decline in real output growth of a quarter by at least 3 percent points below its average of the previous four quarters...", then fiscal deficit limit may be increased but this increase "shall not exceed one half percent of the gross domestic product in a year".

The Covid-19 pandemic may be classified as a national calamity under clause (c) above. However, the real GDP growth had started declining in the pre-pandemic quarters. In fact, it declined progressively, quarter after quarter, from a peak of 8.9 percent in the fourth quarter of 2017-18 to 2.7 percent in the fourth quarter of 2019-20. Yet this rule of a departure of 0.5 percent points of GDP could not be invoked in view of the condition referring to the average of the previous four quarters. The macro stabilization conditions of FRBM 2018 proved to be too impractical to capture the evolving situation. When it was invoked in 2019-20, the cited reason was 'structural reforms' and the magnitude of actual departure became much larger than 0.5 percent points of GDP². Further, in a pandemic kind of situation also, the magnitude of permitted departure proved to be too inadequate.

Recasting Sustainable Debt and Deficit Levels

In this section, we look at sustainable combinations of debt and fiscal deficit with respect to GDP under alternative growth assumptions for the

² Centre's fiscal deficit was budgeted at 3.5 percent of GDP for 2019-20. The actual fiscal deficit relative to GDP was at 4.6 percent.

central and state governments and their combined account. Sustainability here means a level of fiscal deficit which if repeated, year after year, will result in keeping the debt-GDP ratio unchanged and at a sustainable level defined with respect to some objective criteria such as an acceptable ratio of interest payment to revenue receipts. This enables us to work out the relevant combinations of fiscal deficit and the target debt levels relative to GDP. For this purpose, we have used the following relationship (*Rangarajan and Srivastava, 2005 and Report of FC12*):

$$b^* = f^* \frac{(1 + g)}{g} \quad (1)$$

where b^* and f^* refer to the sustainable combinations of debt and fiscal deficit relative to GDP and g refers to the assumed nominal growth.

Table 1 provides such combinations for benchmark nominal growth rates ranging from 11 percent to 13 percent. The debt-fiscal deficit combinations given by FC12 and FRBM 2018 can be seen as special cases. Thus, at a nominal GDP growth of 12 percent and a fiscal deficit to GDP ratio of 3 percent, debt relative to GDP would stabilize at 28 percent both for the centre and states. This is consistent with the FC12 targets which were specified keeping in mind the saving-investment balance profile available at the time of their deliberations and related interest payment to revenue receipts ratios. At benchmark nominal growth of 11 percent, a fiscal deficit of 3 percent of GDP would stabilize debt for the centre and states at nearly 30 percent each. However, if an annual fiscal deficit to GDP ratio for the states is allowed only at 2 percent, their debt-GDP ratio would stabilize at 20 percent and if an annual fiscal deficit to GDP ratio of 4 percent is allowed for the central government, their debt-GDP ratio would stabilize at 40 percent. This is comparable to the FRBM 2018 debt targets except for the inconsistency in their recommended continuation of the fiscal deficit operational target of 3 percent of GDP for both tiers.

Table 1: Sustainable Combinations of Debt and Fiscal Deficit Relative to GDP for Alternative Growth Assumptions

f/g	11.0	11.5	12.0	12.5	13.0
2.00	20.18	19.39	18.67	18.00	17.38
2.25	22.70	21.82	21.00	20.25	19.56
2.50	25.23	24.24	23.33	22.50	21.73
2.75	27.75	26.66	25.67	24.75	23.90
3.00	30.27	29.09	28.00	27.00	26.08
3.25	32.80	31.51	30.33	29.25	28.25
3.50	35.32	33.93	32.67	31.50	30.42
3.75	37.84	36.36	35.00	33.75	32.60
4.00	40.36	38.78	37.33	36.00	34.77
4.25	42.89	41.21	39.67	38.25	36.94
4.50	45.41	43.63	42.00	40.50	39.12
4.75	47.93	46.05	44.33	42.75	41.29
5.00	50.45	48.48	46.67	45.00	43.46
5.25	52.98	50.90	49.00	47.25	45.63
5.50	55.50	53.33	51.33	49.50	47.81
5.75	58.02	55.75	53.67	51.75	49.98
6.00	60.55	58.17	56.00	54.00	52.15
6.25	63.07	60.60	58.33	56.25	54.33
6.50	65.59	63.02	60.67	58.50	56.50
6.75	68.11	65.45	63.00	60.75	58.67
7.00	70.64	67.87	65.33	63.00	60.85

Source: Author's estimates

Note: g refers to the nominal GDP growth rate (percent, y-o-y)

The question of maintaining symmetry or asymmetry in the fiscal deficit target is a relevant one. In the context of macro stabilization, there may be a case for giving a higher fiscal deficit benchmark for the central government. Thus, if we consider a fiscal deficit of 4 percent of GDP in combination with a nominal growth of 11 percent, centre's debt relative to GDP would stabilize at 40.36 percent. If states are allowed to continue with a fiscal deficit to GDP ratio of 3 percent, their debt to GDP

would stabilize at 30.27 percent and the combined debt-GDP ratio would stabilize at 70.64 percent. The corresponding combined fiscal deficit relative to GDP is 7 percent. These may be relevant values in the post-Covid period. The correction required with respect to the 2018 amendment is to deliberately match asymmetry in the debt-GDP ratios (40:30 respectively for Centre and states) with a corresponding asymmetry in the fiscal deficit-GDP ratios (4:3). These possibilities should be taken into account by the High-powered intergovernmental group which needs to be constituted to re-examine Centre's FRBM.

EXAMPLES OF AD-HOCISM

Non-Acceptance of FC Recommendations: Sector and State-Specific Grants

FC14 had uplifted states' share in the divisible pool of central taxes from 32 percent to 42 percent. In view of this sharp increase, they had not recommended any grant other than revenue deficit grants, local body grants and grants for natural calamities. FC15 however recommended certain additional grants, in line with the earlier Commissions which included sector and state specific grants and other special grants. The central government has shown reluctance in accepting these grants. It had observed in the Action Taken Report (ATR) that 'due consideration' would be given to these grants while 'while formulating and implementing existing and new Centrally Sponsored and Central Sector Schemes'. This effectively amounts to not accepting these grants. This was mainly on account of the fact that a much larger amount of transfers has been earmarked for the states through tax devolution rather than grants.

Relevant Sections from the ATR of FC 15

Grants to States for Specific Sectors

*18. The Commission has recommended providing grants to State Governments in eight different sectors, namely **health, school education, higher education, agriculture, maintenance of PMGSY roads, aspirational districts and blocks, judiciary and statistics.** The Commission has recommended providing grants to these sectors amounting to INR 1,29,987 cr during the five-year period of the award period.*

19. The details of the sectoral grants for health to be provided through State Governments are contained in paras 9.52 to 9.67 of Chapter 9 of Volume-I of the Final Report. The details of these sectoral grants are contained in paras 10.31 to 10.92 of Chapter 10 of Volume-I of the Final Report.

Government will give due consideration to sectors identified by the Commission while formulating and implementing existing and new Centrally Sponsored and Central Sector Schemes.

State Specific Grants

20. The Commission has recommended State Specific Grants amounting to INR 49,599 cr over the award period of the Commission. These recommendations are contained in paras 10.117 to 10.125 including Table 10.11 and Annexes 10.9 and 10.10 in Chapter 10 of Volume-I of the Final Report.

Keeping in view the untied resources with the State Governments and the fiscal commitments of the Central Government, due consideration will be given to the above recommendation.

Source: Explanatory memorandum for 2021-26, Finance Commission, Government of India.

Determination of Relative Weights in Devolution Criteria

It is notable that a much larger share of transfers has been earmarked for the states under tax devolution. This implies that the inter-se targeting of transfers would suffer since tax devolution is undertaken through broad-based criteria whereas grants could be more finely targeted. There is a need for the FCs to introduce modifications in the tax devolution criteria where better targeting can be achieved in the inter-se distribution of transfers with a view to satisfying the states requirements, bearing in mind that state and sector specific grants may not be available for finer targeting. In fact, instead of moving in this direction, the FC15 modified the weights associated with some of the criteria which resulted in greater ad-hocism and movement away from the objective of delivering equalization through fiscal transfers. Table 2 gives the relative weights associated with different criteria used by the recent FCs. These remain ad-hoc as any objective methodology for determining the relative weights has not been provided by any of the FCs. For recognizing the different roles of the factors considered under these criteria, we may divide them into four broad groups. One set is neutral, implying the same per capita transfers to all states. The population criterion is an example of this (See, for details, Rangarajan and Srivastava, 2011). Another major criterion is redistributing in the sense that a lower per capita income state receives a higher per capita transfer under these criteria. Examples satisfying this feature are income distance and fiscal capacity distance criteria. A third group of criteria reflects differences in unit costs of providing public and merit services across states. Examples include criteria based on area and forest cover. The fourth group relates to embedding incentives within devolution. Under this category, criteria pertaining to tax effort, fiscal discipline and demographic change may be listed. Recognizing that there is now a greater dependence on tax devolution as a instrument of fiscal transfers, ways need to be found to increase the information content under each of these groups so that devolution can be better targeted. By remaining unduly broad-based in terms of included information under each group and attaching to each criterion, an ad-hoc weight, the quality of fiscal transfers has actually

deteriorated. As shown in the next section, the use of area criterion is an example of this deterioration.

Table 2: Relative Weights for Different Tax Devolution Criteria: FC12 to FC15

#	Type of criteria	Criteria	Relative weights (percent)				
			FC 12	FC 13	FC 14	FC 15 (1)	FC 15 (2)
1	Neutral	Population	25	25	17.5	15.0	15.0
2	Redistributive	Income/fiscal capacity distance	50	47.5	50	45.0	45.0
3	Relative costs	Area	10	10	15	15.0	15.0
		Forest cover	-	-	7.5	10.0	10.0
4	Incentives	Tax effort	7.5	-	-	2.5	2.5
		Fiscal discipline	7.5	17.5	-	-	-
		Demographic change	-	-	10	12.5	12.5

Source (basic data): FC Reports [FC12 to FC15(2)]

Area as a criterion

The FC10 implemented the area criterion for the first time. It was introduced with exogenously defined floors and ceilings which were set at 2 percent and 10 percent respectively. States with area less than 2 percent were given the floor share. States with area higher than 10 percent were given the ceiling share. The area shares of other states were adjusted so as to keep the total area intact. FC11 continued this practice. FC12 to FC15 retained only the floor of 2 percent while dropping the ceiling of 10 percent.

We may note that for FC14, and FC15, there are twelve states whose share in area is less than 2 percent. As such, 24 percent of the total area gets earmarked for these states leaving 76 percent to be distributed amongst the other states. FC14 had increased the weight

attached to the area criterion from 10 percent to 15 percent. This was retained by FC15. This implies that for FC14 and FC15, the weight of 15 percent multiplied by the pre-determined share of 24 percent applied to 12 states amounting to 3.6 percent of the divisible pool gets earmarked because of the provision of the arbitrarily assigned weight of 2 percent. When the concept of floor was introduced by FC10, recognizing its arbitrariness, the Commission had kept the weight assigned to the area criterion limited to 5 percent only. The 2 percent share, at that time, was relevant for 11 states thereby earmarking 22 percent for the concept of floor area. As such, the weight of 5 percent applied to the pre-determined share of 22 percent amounted to 1.1 percent of the divisible pool. Thus, the arbitrary component of revenue sharing due to the provision of fixing the floor has increased from 1.1 percent of the divisible pool in the case of FC10 to 3.6 percent in the case of FC14 and FC15, an increase of more than 227 percent.

The floor of 2 percent was quite ad-hoc. Increasing the weight of the criterion in which this ad-hoc component is present implies increasing ad-hocism in the use of this criterion. A better option available to the FCs is to introduce directly, the consideration for which the floor area was fixed namely, increase in unit costs of providing select services to states with large shares of cost disabilities due to the nature of the terrain. We can directly use the share of hilly area in total area of a state as part of the area criterion by providing to it, a higher weight. In order to understand the implications of the area criterion, we may consider making a distinction between a 'pure' version of the area criterion in which actual area shares are used, vis-à-vis. an 'applied' version of the area criterion in which an ad-hoc component that uses 2 percent as the floor. Both of these can be compared with a 'modified' criterion in which the purpose for which the concept of floor was used can be better defined.

As an illustration given below, the area criterion has been modified by giving a higher weight to the share of hilly area in total area.

We may write total area of a state as $A_i = H_i + NH_i$, where H_i is the hilly area and NH_i is the non-hilly area of the i^{th} state. In determining the share of the i^{th} state, we can give a higher weight to H_i . Thus, the share of i^{th} state can be written as:

$$\psi_i^h = \frac{wH_i + NH_i}{\sum(wH_i + NH_i)}; \text{ where } w = 4 \quad (2)$$

Table 3: Pure, Applied and Modified Versions of the Area Criterion: Inter-Se Shares

State	Share in area (pure version)	Share in area as per FC 14 (applied version)	Gain (percent points)	Loss (percent points)	Share in hilly area (modified version)
1	2	3	4=3-2	5=3-2	6
Andhra Pradesh	4.89	4.16		-0.734	2.98
Arunachal Pradesh	2.56	2.17		-0.384	6.23
Assam	2.39	2.03		-0.36	2.53
Bihar	2.87	2.44		-0.43	1.75
Chhattisgarh	4.13	3.51		-0.62	2.51
Goa	0.11	2	1.89		0.07
Gujarat	5.99	5.09		-0.9	3.65
Haryana	1.35	2	0.65		0.82
Himachal Pradesh	1.7	2	0.3		4.14
Jammu and Kashmir	6.78	5.76		-1.02	16.53
Jharkhand	2.43	2.07		-0.36	1.48
Karnataka	5.85	4.97		-0.88	6.25
Kerala	1.19	2	0.81		2.37
Madhya Pradesh	9.41	8		-1.41	5.73
Maharashtra	9.39	7.98		-1.41	9.62
Manipur	0.68	2	1.32		1.66
Meghalaya	0.68	2	1.32		1.67
Mizoram	0.64	2	1.36		1.57
Nagaland	0.51	2	1.49		1.23
Odisha	4.75	4.04		-0.71	2.9
Punjab	1.54	2	0.46		0.94
Rajasthan	10.45	8.88		-1.57	6.36

Sikkim	0.22	2	1.78		0.53
Tamil Nadu	3.97	3.37		-0.6	3.69
Telangana	3.5	2.98		-0.53	2.14
Tripura	0.32	2	1.68		0.78
Uttar Pradesh	7.35	6.25		-1.1	4.48
Uttarakhand	1.63	2	0.37		3.56
West Bengal	2.71	2.3		-0.41	1.83
Share under area for 2 percent states	10.57	24	13.43		
Share under area for other states	89.43	76	-13.43		

Source (basic data): FC15(1) and (2) reports

The floor concept reflected higher unit costs for small and hilly states in providing public and merit services. These unit costs tend to be higher where the terrain is hilly, population is sparsely distributed across the state, and the size of the state is small even though certain fixed costs are to be incurred in the provision of public and merit services. If these factors are more directly reflected in the devolution criteria and relatively higher weights are attached to hilly vis-à-vis. plain areas, forest area vis-à-vis. non forest area, coastal area vis-à-vis. inland area, states with international borders vis-à-vis. domestic borders, the outcome of fiscal transfers would better reflect differences in unit costs.

It is possible to modify other major tax devolution criteria such as the population criterion and the income distance criterion to strengthen their equalization content and use these for better targeting of transfers. For example, in the case of the population criterion to which a relatively higher weight has been attached by the FCs, a distinction can be made between share of SC/ST/OBC population vis.-a-vis. the general population and a higher weight can be attached to the disadvantaged segments of population in order to reflect their higher cost and/or need disabilities. In the case of the income distance criterion also, a distinction can be made between per capita incomes below mean level and above it.

It is the distance of the states with below mean per capita income from the mean that makes a material difference for equalization transfers. There is no need for equalization transfers for states with incomes above the mean level. This consideration can also be provided by developing a modified version of the income distance criterion. This is explained in detail in Srivastava *et. al.* (2018)³.

Vertical Dimension: Effective Erosion of the Recommended Share of States in the Divisible Pool

The FC14 had recommended an increase in states' share in the sharable pool of central taxes from 32 percent to 42 percent. This increase was meant partly to make up for the discontinuation of plan grants. Partly however, the objective was to give greater emphasis to untied and unconditional transfers with a view to increasing the autonomy of the states. The FC15 reduced it to 41 percent to account for the UT status accorded to Jammu and Kashmir which is meant only for a limited period⁴. In practice however, the central government adopted measures by which this move has almost been fully neutralized. The central government succeeded in this effort by progressively increasing the share of cesses and surcharges associated with the central taxes which have remained non-sharable. This is reviewed in Table 4.

Secondly, the central government increased the share of state's contribution in the centrally sponsored schemes. From 2015-16, the sharing pattern for expenditure on CSS between the Centre and States was changed from an average of 67:33 to an average of 60:40 for all

³ See for example Srivastava, D. K, Bharadwaj, M, Trehan, R and Kapur, M (2019), Designing and implementing equalization in India, presented at EY-MSE Roundtable on 'Fiscal Federalism in India: Contemporary Perspectives' organized at Madras School of Economics, Chennai in February 2019.

⁴ With the enactment of the Jammu and Kashmir Reorganisation Act, 2019, the former state of Jammu and Kashmir has been reorganized as the new Union Territory of Jammu and Kashmir and the new Union Territory of Ladakh with effect from 31st October 2019. With this, there are 28 states and 3 UTs with legislature.

Core schemes⁵. Thirdly, the central government showed reluctance in accepting any FC recommended grants which were in addition to the revenue gap grants, the local body grants and the natural calamity related grants as discussed in section 3.1.

Table 4: Recommended and Effective Share of States in Sharable Central Revenues (percent): FC12 to FC15 (2)

Commission	Recommended share in divisible pool (percent)	Effective share in gross central taxes (percent)	Shortfall in effective share relative to recommended (percent points)	Share of cesses and surcharges [#] in centre's gross tax revenues (percent)
FC 12	30.5	25.9	-4.6	
FC 13	32.0	27.9	-4.1	9.6
FC 14	42.0	34.9	-7.1	12.8
FC 15 (1)	41.0	29.4	-11.6	20.2
FC 15 (2)	41.0	31.2*	-9.8*	18.0*

Source: Union Budget Documents, Reports of 12th-15th FCs

Note: *pertains to data for three years, FY22 (Actual), FY23 (RE) and FY24 (BE); [#]excludes GST compensation cess

Determination of Grants: Persistence of Revenue Deficit Grants

FC15 did not examine the substantive issue of the rationale for the revenue deficit grants. It only observed that it is continuing with the revenue deficit grants. It may be recalled that the extant literature⁶ on fiscal federalism in India has, in the past, heavily criticized, the mechanism of revenue deficit grants because of the implicit incentive in this principle for fiscal indiscipline. This adverse incentive arises because

⁵ Report on 'Development Expenditure in the States Post Fourteenth Finance Commission Award: An Assessment of the Centrally Sponsored Schemes', ICRIER, November 2018; [https://fincomindia.nic.in/writereaddata/html_en_files/fincom15/StudyReports/Development percent20Expenditure percent20in percent20the percent20States percent20post percent20FFC percent20award_An percent20assessment percent20of percent20the percent20Centrally percent20Sponsored percent20schemes.pdf](https://fincomindia.nic.in/writereaddata/html_en_files/fincom15/StudyReports/Development%20Expenditure%20in%20the%20States%20post%20FFC%20award_An%20assessment%20of%20the%20Centrally%20Sponsored%20schemes.pdf)

⁶ Bhatt and Scaramozzino (2013), Bagchi and Chakraborty (2004), Rangarajan and Srivastava (2008)

if a state creates a history of high expenditures based on excessive borrowings, it will create a history of interest payments which will be considered as valid expenditure for purposes of determining revenue deficits. As long as states know that revenue deficit is a principle for determination of transfers, it is in their interest to incur large per-capita expenditures financed by any means including additional and unsustainable borrowings and then ask the FC to underwrite the shortfall. This criticism was particularly valid in the presence of the mechanism of the plan financing where states attempted to maximize their plan size which would entitle them to higher central assistance in the form of loans and plan grants. Although the mechanism of five-year plans has now been discontinued, the adverse incentive of revenue deficit grants has not fully gone away because of the continuance of centrally sponsored schemes and differential performance of states in relation to their history of borrowing and accumulated debt.

To some extent, the adverse incentive of revenue deficit grants is mitigated by the application of normative principles in the assessment of state-wise expenditure needs and own revenues.

In consequence, it is not only the case that revenue deficit grants have been continued but also the case that these grants are determined without the application of any substantive normative principles in the assessment of revenues and expenditures and thereby making it the determining principle of fiscal transfers.

If we examine fiscal transfers to individual states, we can make a distinction between two determining principles of fiscal transfers in India's case by dividing the states into two groups. Group A consists of states where revenue deficit grants are zero. For this group, the amount of transfers is determined by the principles of tax devolution and other grants. Group B consists of states where total transfers are determined by other grants, share in central taxes, and revenue deficit grants. In this

case, the determining principle for total transfers is provided by revenue deficit grants.

In the case of earlier Commissions particularly some of the recent ones, revenue deficit grants were usually given for the erstwhile special category states which were small in size and had relatively larger cost disabilities. In the case of FC15, many of the larger states have also become recipients of the revenue deficit grants and as such a non-normative, non-principled basis has become the determining principle for fiscal transfers.

The ToR for FC15 had asked the Commission to examine whether revenue deficit grants be given at all. This reference however does not necessarily imply that grants given under article 275(1) of the Constitution of India should be discontinued. This article enjoins the FC first to determine the "*principles*" which should govern the grants-in-aid of the revenues of the state and then determine the "sums" that are to be paid. Revenue deficit grants often did ensue in the gap-filling approach, even when moderated by application of some partial norms. This approach has been heavily criticized in the literature on fiscal transfers in India for the adverse incentives it generates. In fact, there is a strong case to discontinue revenue deficit grants based on gap filling approach but continue to recommend grants under article 275(1) based on more acceptable principles. Just preceding the reference to "*revenue deficit grants*" under clause 5 of the ToR, FC 15 was asked to be "*guided by the principles of equity, efficiency, and transparency*". These considerations are best satisfied by equalization transfers. It would be ideal to take this as the guiding principle and use the two instruments of transfers namely tax devolution and grants, to complement each other to achieve this objective in an integrated and well targeted way. Equalization grants are not meant to affect state level policies and need not be sector-specific although FC11 and FC12 used the equalization principle partially to provide sector-specific grants.

In order to highlight the relative roles of revenue deficit grants vis-à-vis. tax devolution as the determining principle for general purpose transfers, we make a comparison between FC13, FC14 and FC15 recommendations. It is clear that the largest number of recipients of revenue deficit grants are in the case of FC15 (2) and the smallest number is for FC13. In the case of the medium and large states, only one state was a recipient of the revenue deficit grants under FC13, and only three states received this grant under FC14. But in the case of FC15(1), five medium and large states were recipients of revenue deficit grants. In FC15(2), this increased to eight states. This list includes some of the high-income states which are supposed to be dependent largely on their own resources. Not only the per-year revenue deficit grant magnitudes are non-zero but also quite large indicating that a good part of the overall transfers has been determined finally by the exercise that provides the estimates for revenue deficit grants. With reference to the small and hilly states, the list of recipients of the revenue deficit grants in the case of FC13, FC14, FC15(1) and FC15(2) is respectively 6, 7, 9 and 9. Clearly, in the case of small and hilly states also, the largest number of recipient states of revenue deficit grants are in the case of FC15(2).

Many of the special category states have been recipients of revenue deficit grants as shown by Table 5. These states are highly dependent on central transfers. Costs of providing services are high in these states because of the hilly terrain. They also have special fiscal needs. Their cases can continue to be covered by following the equalization principle. Grants as per Article 275 of the Constitution can be designed to take into account considerable details of and variations in state characteristics whereas horizontal sharing of central taxes depend on a limited number of criteria. Thus, while both may be instruments of unconditional transfers, grants can be finely targeted whereas sharing of central taxes can only be broadly targeted. A combination of these two instruments can serve to provide an optimal scheme of transfers.

Table 5: State-wise Recommended Revenue Gap Grants per Year (INR Crore)

State	FC 13	FC 14	FC 15 (1 st report)	FC 15 (2 nd report)
	2011-15	2016-20	2020-21	2021-22
Medium and large states				
Andhra Pradesh	503.2	4422.6	5897	6099
Bihar				
Jharkhand				
Gujarat				
Haryana				26
Karnataka				326
Kerala		1903.8	15323	7563
Madhya Pradesh				
Chhattisgarh				
Maharashtra				
Orissa				
Punjab			7659	5194
Rajasthan				2948
Tamil Nadu			4025	441
Uttar Pradesh				
West Bengal		2352.0	5013	8023
Telangana				
Small and Hilly States				
Arunachal Pradesh				
Assam		675.8	7579	2837
Himachal Pradesh	1577.8	8125.0	11431	7440
Manipur	1211.4	2045.4	2824	1959
Meghalaya	562.2	354.0	491	627
Mizoram	798.2	2436.6	1422	1309
Nagaland	1629.2	3695.0	3917	4250
Sikkim			448	253
Tripura	890.6	1020.6	3236	3978
Uttarakhand			5076	5629
Goa				

Source: reports of FC 13 to FC 15

GROWING CENTRALIZATION

GST and Its Voting Mechanism

In respect to the taxes merged in GST, the revenue autonomy, that is, the autonomy of the entities levying the taxes to change their rates, classification schemes, deductions, exemptions etc., was effectively vested in the GST Council. This applied both to the central and state governments. However, the provisions pertaining to the GST Council and the dynamics of its working has largely implied that it is extremely difficult for any individual state to change any tax rate or other GST-related provisions by itself. The weighting scheme and the voting pattern are such that the central government can almost always get its decisions implemented while no individual state can do so. As per Article 279(A) of the Constitution pertaining to the GST Council, the weight attached to the vote of the central government is 1/3 and that to the state governments/UTs in aggregate is 2/3. Since the number of states and UTs that are members of the GST Council add to 31, an individual state/UT accounts for 0.0215 that is 2.15 percent as compared to the centre's weight of 33.33 percent. These numbers are based on the assumption that all members of the GST Council are present and voting. Further, this Article provides that:

"Every decision of the Goods and Services Tax Council shall be taken at a meeting, by a majority of not less than three-fourths of the weighted votes of the members present and voting, in accordance with the following principles, namely:—

(a) the vote of the Central Government shall have a weightage of one-third of the total votes cast, and

(b) the votes of all the State Governments taken together shall have a weightage of two-thirds of the total votes cast, in that meeting."

Thus, even if all states join together, they will only have an aggregate vote of 66.66 percent which is less than 75 percent, which is the required majority for carrying a decision through. As such, states

individually or together, cannot carry forward any GST reform on their own. Thus, effectively, centre has a veto power. On the other hand, if the states were to form a group in order to hold a centre's move, they will require a minimum of 12 votes. If we examine these provisions from the viewpoint of the centre, they will require the support of 19.4 states/UTs with legislature that is at least 20 states/UTs with legislature (*This is so because $1/3 + 20 * 2/3 * 1/31 = 0.33 + 0.43 = 0.76$, thus crossing the 75 percent benchmark*) for a legislation to be passed. This may prove to be an uphill task so long as there are 12 states/UTs forming governments by opposition parties provided they form a group. These provisions, therefore, make any reform to GST extremely difficult. This is why the GST Council keeps going by the rule of unanimity. But unanimity leads to agreement on lowest common denominators. Such agreement is usually arrived at when rates are lowered rather than increased or rationalized. Further, incremental changes may go through relatively more smoothly whereas major reforms which India's GST actually requires are very difficult to be carried forward.

An important development in this context came from a recent Supreme Court judgement which clarified that decisions of the GST Council are not binding on the participating governments and at best have only a persuasive value. This has opened up the possibility of the GST tax rates evolving towards a heterogenous structure across states over time.

Loss of Revenue Autonomy

Major goods that could not be included in the present GST include petroleum products, alcoholic liquor, real estate, electricity, and agriculture. These items are of significant revenue importance both for the central and state governments. The continuation of taxation of these products outside GST provides a limited degree of residual revenue autonomy both to the central and state governments. Given the need to improve the revenue performance of GST, neither the central government nor the state governments are in favour of including these items excluded from GST.

Incomplete GST reforms appear to have entered a gridlock which none of the participating governments are willing to break out of, at least in the short to medium term. We have argued that there is only one way the GST reforms can be completed while ensuring revenue adequacy as well as revenue autonomy for the participating governments [*see Srivastava (2022)*]. This way is to integrate environmental and demerit taxes in the GST by including a non-rebatable cess in the GST scheme of taxation and giving a degree of autonomy for the participating governments to fix the rate of this cess. Such a cess or additional non-refundable levy may be levied by both centre and the states and the rate of such a cess can be different for the centre and individual states. For instance, in the case of petroleum products and alcoholic liquor, these rates may be fixed with a view to raising revenues consistent with their current revenues from these items.

CONCLUSIONS

The evolution of intergovernmental fiscal relations involving the central and state governments has been, in recent years, characterized by issues of growing inconsistencies, centralization, and ad-hocism. Examples covering instances of these issues include the reformulation of Centre's FRBMA as amended in 2018, approach and methodology for determining fiscal transfers especially by FC14 and FC15, and the provisions concerning decision making by the GST Council.

In the case of the 2018 amendment of Centre's FRBMA, we have noted a significant inconsistency in the specification of debt-GDP and fiscal deficit to GDP targets. For the central government, the debt target of 40 percent of GDP is inconsistent with the fiscal deficit operational target of 3 percent of GDP for any underlying nominal GDP growth. We have shown that with respect to a nominal growth assumption of 12 percent, the debt-GDP ratios for the Centre and the states converge to 28 percent in both cases if a fiscal deficit to GDP ratio of 3 percent is maintained year after year. These were the targets fixed by FC12. If the underlying growth is kept at 11 percent which was assumed by the FRBM

Review Committee, a 3 percent fiscal deficit maintained year after year would lead to a debt-GDP ratio stabilization at 30.3 percent. Given this, a debt-GDP target of 40 percent for the central government and 20 percent for the state governments are both inconsistent. Several examples of growing ad-hocism in fiscal transfers are noted in the context of the recommendations of two of the recent FCs. For example, the area criterion has been assigned a larger weight of 15 percent and 2 percent was earmarked as floor share for small and hilly states on an ad-hoc basis, thereby pre-empting 24 percent points of the share under the area criterion. We have demonstrated that the cost disability consideration can be more directly introduced in the area criterion. Similarly, the recent Commissions have fully gone back to the use of revenue deficit grants whereas it would be consistent with provisions of Article 275(1) to determine these grants for equalization of standards of selected services. In the case of vertical transfers, excessive ad-hoc use of cesses and surcharges have effectively reduced states' recommended share in the divisible pool of taxes from 42 percent/41 percent to about 31 percent. Finally, the decision-making rules and procedures of the GST Council have made this entire process highly centralized, making any substantive reforms of GST in the future quite difficult. These developments need to be reversed in order to put centre-state fiscal relations on a sounder foundation.

In order to reverse some of these undesirable features, our recommendations include the following:

1. Centre's FRBMA should be reamended to target consistent combinations of debt and fiscal deficit relative to GDP such as 30 percent and 3 percent for both central and state governments or to 40 percent and 4 percent for the Centre and 30 percent and 3 percent for the states.
2. Cost and need disabilities should be more directly introduced by capturing reliable and available data pertaining for example to, share of hilly area, forest area etc. in the total area of states, share of SC/ST/OBC population in total population of the states and so on.

3. Revenue deficit grants may be replaced by equalization grants pertaining to selected services such as education and health to be given under Article 275(1).
4. GST may be further reformed by integrating within it environmental and demerit taxes. This can be achieved by including a non-rebatable cess in the GST scheme of taxation and giving a degree of autonomy for the participating governments to fix the rate of this cess.

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