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Centre-State Negotiations for federal financing in India: Review of approaches of negotiations by state governments for greater horizontal devolutions

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Centre-State Negotiations for Federal Financing in India: Review of Approaches of Negotiations by State Governments for Greater Horizontal Devolutions

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Abstract

Formula based intergovernmental transfers through the Finance Commission of India are significant for States. This paper aims brings out the pattern of negotiations of typical States with the FC before the formula is decided. The negotiation for greater vertical devolution favoring States is very straightforward. Individual proposals on formula for horizontal devolution reflect the game theoretic negotiation with FC. The proposal on the parameters and weights proposed by individual State's is a reflection of the constraints faced by it. Linkages with state income, its performance in Human development index explains the choice of parameters. Despite opposing discretionary grants in favour of greater formula based devolutions, they are flexible in proposing sector/state specific grants in aid to further their own cause. States could do well to cooperate and scientifically design parameters that best reflect their individual concerns as well.

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Key Words: Fiscal federalism, Finance Commission, Negotiations, Political bargain, Sub national governments, India,

1. Introduction

Intergovernmental transfers are crucial for the sub-national governments in India. Low own resource base and huge inter-state variations in development emphasizes the need for greater resources in the hands of State governments. The Constitution of India assigns revenue raising powers and expenditure responsibilities to both the Union and State Governments[2]. Union Government transfers to States comprise of constitutionally mandated tax devolution and grants recommended by the Finance Commission (FC). Also, grants for Plan purposes are given through the Planning Commission[3] and grants for Centrally Sponsored Schemes (CSS) are designed by different Union Government ministries implemented with a matching/non matching contribution from States.

Article 280 of the Constitution of India provides the mandate for the appointment of the Finance Commission every five years or earlier. The major tasks of the union finance commissions are to recommend: (i) the distribution of proceeds from central taxes between the centre and states and among the states inter se; (ii) grants in aid to be given to the states, out of the Consolidated Fund of India for the states, in need of assistance under Article 275; (iii) measures needed to augment the consolidated fund of the states to supplement the resources of urban and rural local bodies on

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2 India is a constitutional democracy, now comprised of 28 states and seven "Union Territories" (UTs), the latter including the National Capital Territory (NCT) of Delhi. The states, Delhi and the UT of Pondicherry have elected legislatures, with Chief Ministers in the executive role. The other UTs are governed directly by appointees of the center.

3 The Planning Commission was set up by a Resolution of the Government of India in March 1950 to promote a rapid rise in the standard of living of the people by efficient exploitation of the resources of the country, increasing production and offering opportunities to all for employment in the service of the community. In 2015, Government of India constituted the NITI Aayog to replace the Planning Commission. An important evolutionary change from the past, NITI Aayog acts as the quintessential platform of the Government of India to bring States to act together in national interest, and thereby fosters Cooperative Federalism. As accessed http://planningcommission.gov.in/

the basis of recommendation made by the state finance commissions and (iv) any other matter referred to the commission in the interest of sound finance.

Vertical devolution of taxes between the Central and States is the result of the assessment of expenditure requirements of the Union and State, their respective views on the same, and the expected macro economic and fiscal scenario that is likely to impact the country. Horizontal devolution of taxes amongst the states is formula based. The objective of balancing equity and efficiency through horizontal fiscal equalization has influenced FC. Every FC considers the views and suggestions as presented to it by the States and by political parties, industry houses and local leaders and interest groups, academicians, etc. The deliberation on the mechanisms of FC is critical. The resulting devolutions directly equip the State in reducing its Non Plan Revenue Deficit and provide untied resources for implementation of State's development plan.

It's important to explore the possibilities in terms of negotiation with the FC that the low and high income states enter into before the actual formula is decided. States that are low contributors to the pool of shareable resources face inability to generate more funds on account of cost disability and low fiscal capability and they demand more share to address developmental needs. States that contribute heavily also demand more, as they are faced with high spending obligations and need to address huge inter regional disparities that require additional resources.

This paper explores the approaches of political bargain that states enter into with Finance Commission. Section II presents a review of relevant literature on the intergovernmental transfers and the impact of partisan politics, , vertical and horizontal devolution and a bargaining theory in a game theoretic framework. Section III sets the context of negotiation between States and FC. A discussion of the recommendations by the FC is elaborated in Section IV along with analysis of the proposals by States within the backdrop of states' income and ranking of HDI etc. States negotiate for a larger share individually and use parameters that best reflect their typical situation. Section V presents the conclusion and way forward.

2. Relevant literature

a. Intergovernmental Transfers -Tied and Untied grant

In the Indian federal set up, the pool of shareable tax resources through FC is Constitutional mandate and is largely formula based. Other transfers are given for Plan assistance (formula based) and grant-loan based (CSS with matching or non matching contribution). FC transfers are very significant as it is the constitutionally mandated channel of distributing the pool of shareable taxes to States with an aim to correct the vertical imbalances. During the period of 10-13 FC, the proportion of Union transfers through the FC has been in the range of 67-69% of total transfers. Overall, the ratio of Union transfers has grown from 4.09% to 4.95% of India's GDP.

Table 1: Transfers to States (2012-13, % of total Union transfers)

Period	FC Transfers	Other Transfers	Total	% GDP
10 FC (1995-2000)	68.61	31.39	100	4.09
11 FC(2000-05)	69.38	30.62	100	4.16
12 FC (2005-10)	68.91	31.09	100	4.86
13 FC (2010-15)	67.44	32.56	100	4.95

Source: Report of Fourteenth Finance Commission, India (2015-2020)

There is a high proportion of transfers in the nature of grants - grants received from Centre through FC and Planning Commission. In the period of 12 and 13 FC, it comprised nearly 15-20% of the total revenue receipts of State governments combined. Grants are usually tied in nature with matching/non matching contributions from States. Higher devolution of untied grants through FC is beneficial for States in comparison to the fund transfer mechanism through the Planning Commission followed prior to the restructuring of the CSS.

Rao observes that transfers are tilted in favour of discretionary based grants with a lesser component of formula based Plan assistance. (M Govinda Rao, 2004). Recently, States have expressed in favor of formula based transfers on grounds of efficiency and this has lead to reversal in number of CSS. This has been rectified with a huge reduction in the number of CSS and through the adoption of State budget mechanism for devolution of CSS funds[4]. Rao and Singh(2005) observe that over the years, however, because of political influences, transfers through other channels have increased in size, undermining the role of the Finance Commission.

Rao and Singh highlight the economic asymmetry[5] existing within Indian federalism. Huge inter-State and intra-State variation in Gross State Domestic Product (GSDP) and Net District Domestic Product(NDDP) respectively reflects the requirement of focused policy based intervention to reduce the disparity. There is significant reliance on FC devolutions in supplementing the State's finances towards development expenditure. In line with its development priorities, States are expected to utilize their own sources of revenue as well as the shareable resources transferred to it through the FC.

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[4] Refer to the Report of Restructuring of Centrally Sponsored Schemes (2014) and the Government Order on Rationalization of 66 Schemes into 28 Umbrella Schemes(2016) , issued by Niti Aayog, Govt. of India

Flexi funds up to 25% of the CSS allocation will allow States to attune to its specific development challenge/requirement

[5] "Asymmetric federalism" is understood to mean federalism based on unequal powers and relationships in political, administrative and fiscal arrangements spheres between the units constituting a federation.

14 FC notes that the objective of inter-governmental transfers is to offset the fiscal disabilities arising from low revenue raising capacity and higher unit cost of providing public services. The ultimate objective is to enable every State to provide comparable levels of public services that it is mandated to provide by the Constitution at comparable tax rates. Such enabling transfers are necessarily unconditional. At the same time, there is a case for inter-governmental transfers to ensure that people are provided with minimum standards of basic services which have significant inter-jurisdictional externalities irrespective of their state of residence. There are services which must be available at minimum specified standards to all and these include minimum standards of education, healthcare, water supply and sanitation. (Fourteenth Finance Commission, 2014)

The expansion in the size of divisible pool is a result of positive efforts of both high and low income states. Thereby FC devolutions are important to enhance the development expenditure of States further.

b. Vertical devolution

Usually, in a federal set up, national government collects more taxes and the resources are reassigned to the subnational governments to deliver services to citizens. In a federal set up, vertical devolution is meant to correct the asymmetry between the revenue raising capacity and the expenditure related resonsibilties of Union and State goverments. Baghci(2006) notes that transfers from the centre are a common feature in all federations. This is because economies of scale and other factors predi-cate assignment of mass based taxes to the national government, while because of their proximity to the people expenditure responsibilities are cast on the lower level governments thereby creating what is called a vertical gap. Anticipating this and in order that it did not make the states sub-servient to the centre our Constitution makers had ordained the appointment of a finance commission (FC) periodically (Bagchi A. , 2006)

Rangarajan and Srivastava(2008) mention that in federal systems, a vertical gap is often deliberately created for efficiency gains that result from the relative assignments and fiscal transfers that are used to close the gap or convert it into a balance. They have listed the main justification for such transfers as follows: first, transfers may be purely passive responses to the asymmetric decentralization of expenditure and revenue-raising authority (vertical transfers). Second, these may be used to equalise the fiscal capacity of the regions to avoid inefficient migration of persons and businesses among regions and to foster horizontal equity in the federation as a whole [Boadway et al 2002]. Third, these may also be used in conditional forms to neutralise fiscal externalities imposed by regional governments on other regions, as well as to achieve national standards in social programmes and to induce efficiency in the internal economic union of the federation [Dahlby 1996]. Finally, these may be used as instruments for insuring regions against shocks to their fiscal capacities [Lockwood 1999] (C Rangarajan, 2008).

In Indian federal set up, FC devolutions are expected to correct the fiscal imbalances between Union and States in a manner that both have resources to execute the responsbilties assigned to them by way of Seventh Schedule of the Constitution namely the Union, State and Concurrent list of functions. Vertical devolution assigns fiscal resources from the shareable pool, to Union and States in order to correct the assymetry in their revenue raising and expenditure liabilties. The Commission is required to balance the Union and States' revenue powers with expenditure responsibilities listed in the Seventh Schedule of the Constitution. Resources should be allocated according to the responsibilities specified in the Union, State and Concurrent Lists. (Fourteenth Finance Commission, 2015)

The FC recommends the share of divisible pool on basis of an asessment of gap between the resources of Union and State governments. The assessment is done following a two-step approach: (i) re-assessment of the base year data on revenues and expenditures for individual States and Union Government to ensure comparability and (ii) application of norms for receipts and expenditures for the award period[6]. Also, the union ministries/departments and states present their own set of projections on expenditure and revenue. Rangarajan(2005) observes that sometimes it is not recognized that the share of states in the combined revenue receipts undergoes a radical change after tax devolution. (Rangarajan, 2005)

c. Horizontal devolution

Norm-based equalization serves both equity and efficiency. Bagchi (2002) emphasizes the goal set by Gulati for federal transfers, viz, equalisation of primary civic services based on acceptable standards or norms. (Bagchi, 2002). Horizontal equalisation leads to equity and efficiency, as it is expected to provide fiscal headroom to poor States to provide similar levels of services and goods, as would be available in richer states. This would avoid migration to richer states that have fiscal surpluses and thereby reduce location inefficiencies in poorer states. Rangarajan and Srivasatava(2008) argued that the efficiency implications follow from two considerations: (a)

[6] The 14 FC notes that the basic approach to assessment remained similar, to a large extent, across Commissions, but there were differences in projecting individual items of receipts and expenditure.

locational inefficiencies that can result from inefficient migration induced by fiscal surpluses is neutralised by equalization transfers; and (b) the redistribution implied by equalization transfers from richer to poorer states also gives a return to the richer states by avoiding congestion resulting from excessive migration in the context of services provided by these states that are in the nature of “congestible” goods.

Musgrave (1961) classifies the objectives of federalism that may be to bring about various forms of equalization, be it in actual performance, in fiscal capacity, or in fiscal potential; or the objective may be to induce the states as a group to raise their service levels. Equalization of capacity to meet a centrally set level of performance renders any one state's position in the scheme (its own gains or losses) independent of its own tax rate. He mentions that the disincentive effect on state taxation disappears, but there remains the disadvantage that some states are called upon to contribute to the services of others which, while needy, refuse to make an adequate effort of their own. This remains a serious detriment to the establishment of an orderly system of fiscal federalism. (Musgrave, 1961)

The purpose of federalism in India is to provide similar of services to all citizens. Looking at the Australian and Canadian model of horizontal devolution, one finds that the difference in the resource base of the highest contributor to the lowest contributor is low in Australia and Canada in comparison to that in India. Also, the lowest contributor in India typically is the State with the highest population while this is not the case of Australia and Canada. Rangarajan(2008) argues that in India, the horizontal imbalance is resolved through a combination of tax devolution and revenue-gap grants. In Canada, this is done by grants. In Australia, this is done by sharing the revenue under the goods and services tax (GST) topped up by the healthcare grants. The Australian system has switched from grants to revenue sharing and back from time to time. Some economists consider grants as the right means of transfers. States themselves overwhelmingly prefer revenue-sharing. The transfer system in India has evolved in a manner that relies on both modes of transfers. (C Rangarajan, 2008)

The long-term criticism of the Indian approach has been the so-called gap-filling approach in the assessment of needs and resources by the finance commission because of the implicit adverse incentives. Bagchi(2001) re-emphaisizes the findings that higher the ratio of central grants in total expenditures of a state government, the lower is its tax effort (Jha, et.al. 1999), almost signifying a dependency syndrome among states receiving large amounts of grants from the centre. (Bachi, 2001). Rao(2004) mentions that States were incentivized to lower tax ratio and increase expenditure and still could access FC devolutions without any serious fiscal management. In fact, such was the deterioration of State Finances that the 11 FC was given an additional Terms of Reference lead to setting up on the Medium Term Fiscal Reform Program that gave incentives for target based reduction in fiscal and revenue deficits to States and Centre (M Govinda Rao, 2004). Reviewing the approach of 7-10FC towards horizontal devolutions, Rangarajan and Srivastava (2008) comment on the Gap-filling approach to determining transfers. However, the approaches of 11FC and 12 FC were considered to be more in balanced in reflecting the deficiency in fiscal capacities, cost disabilities and fiscal efficiency and also by including in elements of institutional reforms in fiscal management. Rangarajan expected that the approach and recommendations of 12 FC towards vertical and horizontal devolution could serve the objectives of equity and efficiency within a framework of fiscal consolidation (Ragarajan, 2005).

Singh and Srinivasan (2006) argue that the Finance Commission's methodology is non-transparent in its rationale and its outcomes. Theory would suggest using measures such as population density, overall size, topography, and economic structure to establish minimum norms for tax and expenditure levels, which could then be used to determine levels of transfers that would sustain minimum expenditure norms for a state that behaves according to the norm. States can then raise and spend money at the margin, without any distortionary effect of transfers. Instead, the Finance Commission uses various criteria in the formula itself, calculating tax shares based on this, without being able to assess if the transfers are adequate or not. To some extent, shortfalls are met through grants, but the use of ad hoc grants based on ex post gaps (after the preliminary devolution is calculated) has the potential to completely undermine incentives. The Finance Commission itself does not see this as a problem (Rangarajan, 2005), arguing that the gap-filling is based on normative measures. Nor does it show up in some econometric studies, though the results are not consistent across studies. To some extent, the problem may also be more severe with Plan grants, which are, in some ways, even more the result of bargaining, lobbying and "gap-filling. (Srinivasan, 2006)

13 FC reversed the approach of the earlier commission through choosing parameters that stressed on fiscal capabilities of States. Chakroborty(2010) criticizes this approach of the 13 FC on grounds of choosing parameters that penalize States instead of incentivising improved fiscal performances. He argues that design of the horizontal distribution formula is such that the fiscal capacity distance and the index of fiscal discipline are in conflict with each other and serve opposite purposes – while the former tries to increase the capacity of states to spend more, the latter tries to limit their expenditure in relation to own revenues. Both the indicators together in the same formula penalise states twice over for the same reason. (Chakroborty, 2010). 14 FC has

adopted the approach of 12 FC hereby bringing back the balance of equity and efficiency through devolutions.

d. State Specific grants

Grants are an important provision through FC in order to address the State or sector specific issues. 'Equalisation' of the standards of basic social services was postulated by the First FC as one of the principles to guide the grants-in-aid of the states in need of assistance contemplated under Article 275 of the Constitution but the First FC used the grants to provide funds for expanding only primary education. And this lead was not followed by subsequent FCs. Bagchi re-emphasizes Gulati's viewpoint who called pointed attention to equalisation of basic services as the central goal of centre-state transfers (Bagchi, 2002). The pattern of grants provided through successive FC is under constant review and needs a careful consideration. It is expected to correct the disparities in social services and is essentially discretionary in nature despite efforts to remain objective by successive FC. Rather, it has been observed that stringent conditionality related to Fiscal Responsibility and Budget Management (FRBM) Act lead to reduction in social expenditure by low income states that met the targets of reduction in fiscal/revenue deficit. (Bagchi A. 2006). States request for a variety of State/Specific grant to correct this situation is not found to be on the principles of sound fiscal management. Bagchi further observes that Specific purpose transfers should be limited only to correct glaring externalities and promotion of universally acknowledged national objectives.

The responsibility of state specific requirement must be met by States individually, through fiscal management and prioritisation(if at all by giving them additional fiscal space). Sector specific focus, if any could be met by national programs or through extra support to State's plan. Chakroborty(2010) criticized the approach towards sector/state grants adopted by the 13 FC. The design of the grant for elementary education through the 13 FC is such that it has the potential to reduce the expenditure of states instead of augmenting it. (Chakroborty, 2010). 14 FC reversed the trend of allocating to many types of sector/State specific grant and thereby has limited itself to three grants namely; disaster management, local bodies and revenue deficit grant.

e. States' memorandum of demands to FC: Game theoretic political bargaining

The ability of political parties to influence the discretionary transfers is high in comparison to formula based devolutions through Finance Commission. Singh and Vashishta (2004) argue that even though India was not formed out of an explicit bargaining process (except to some extent with respect to the inclusion of the princely states at the time of independence), the perspective of bargaining is commonly applied informally to resource sharing among the different constituent governments. The states, do not have sovereign status, and, constitutionally speaking, exist at the discretion of the central government. Nevertheless, they represent real and significant political groupings, based on language and culture. They are the sub national political units that matter above all, more so than caste or class (Vasishtha, 2004).

Singh and Vashista(2004) analyzed the extent to which the economic and political importance of the states influences the pattern of per capita transfers to the states. The results suggest that states with greater bargaining power, as proxied by the political variables, tend to receive larger per capita transfers. The positive estimated effects of the demographic size of the states suggest that population may well be an indicator of political influence, solely due to the size of the state and irrespective of its political influence. Similarly, Dasgupta et al obtained strong results in support of the hypothesis that political effects affect discretionary transfers. Rao and Singh showed that these effects extend to Finance Commission transfers as well as to more obviously discretionary transfers. Their empirical studies suggest that political factors, whether captured through direct political variables, or through measures of demographic and economic importance, matter for the actual pattern of transfers in India. (Singh, 2004). Rao (2005) , Rao and Singh (2009) argue that while the FC transfers have been more equalising, the discretionary transfers do not balance state fiscal abilities. Rao argues that discretionary transfers have been hugely influenced by political alignments resulting in negative effects of political influence on balancing through inter state transfer. (Rao A. P., 2015)

Hence, the ability to influence the recommendations of FC for vertical and horizontal devolution is limited in a sense that the political parties in power can press upon their requirements through the formal meetings and memorandums of demands but the FC can frame the final recommendations using its own assessments, as it is bound by the constitutionally mandated Terms of Reference through the Presidential Order. Brams (2005) mentioned that the bargaining power of players is a function of both their preferences and the constitutional structures under which they act (Brams, 2005). Hence, States can present their demands together to the FC by way of joint memorandum but the interests of States vary and and they individually compete for a higher share in the horizontal devolution.

The demands presented could be veiwed through the bargaining lens. Theoretically, building on J. Nash’s concept, Osborne and Rubinstein refer bargaining to a situation in which (i) individuals (\players") have the possibility of concluding a mutually beneficial agreement, (ii) there is a conflict of interests about which agreement to conclude, and (iii) no agreement may be imposed on any individual without his approval. A bargaining theory is an exploration of the relation between the outcome of bargaining and the characteristics of the situation. (Rubinstein, 1990). Hence, the situation of States opting to present a joint memorandum of demands to FC and a comparison of the demands with actual recommendations, can be viewed through the bargaining theory.

However, there has been rather limited documentation, outside of FC report itself, on the very nature of the consultations and the demands submitted to it, by the State and the stakeholders (public at large)[7]. Each FC must visit all the States, and it would meet the government and the members of opposition (both the State level and the representatives of local government), industry groups, academic institutions, traders, and other groups. Each FC in its report documents the view points that it receives on the Terms of Reference and presents it in the report appropriately. A review of report of FC provides the nature of recommendations that has been placed by the States before successive FC. The data collection process and outcomes are documented in the report itself, which is done in a very transparent manner[8].

The analysis of the variety of negotiation by the Indian States (that are economically, politically diverse and differ in their resource requirements), is an area of interest from the game theoretic

[7] The focus of the current paper remains the negotiations between the State government and the FC. However, the FC conducts exhaustive consultation with Central Ministries, departments, structured discussions with economists, social scientists and so on. These deliberations are outside the scope of the current paper.

[8] One can refer to the Report of the 14 FC for the list of meetings and discussions conducted by the Commission

perspective. States vary in terms of geographical size, population etc. The evolution of asymmetries in Indian federalism and its nature (geographic, economic etc.) has been documented. The political will determines the set of reasons that are proposed as response to the mandate of the FC. The political representative in the states influences the negotiations. Rao (2004) notes that equally important is the decreasing time horizon of political parties due to frequent changes in the governments (Rao, 2004). The strategy of negotiation by the States forms an interesting area of analysis- each State chooses to propose the arguments for greater vertical devolution with an awareness that it is in best interest to cooperate for a higher vertical devolution in favour of states. While proposing for higher individual share, it highlights very pointed issues pertaining to specifically to its unique context, pushing for greater shares relevant for that that phase only. It remains flexible in every FC term so that it is able to influence the FC in the short run to the fullest.

The horizontal devolution through FC leads to a redistribution from high tax yield- fiscally better managed States to low tax yield- fiscally poorly managed states. A state which is average in both respects remains unaffected, as are states which combine proper degrees of excess or deficiency on both counts. The needs of States are going to remain high for both high and low yield states due to the challenges of meeting the intra regional disparities of States (either pressures from huge urbanization or challenges of up skilling large rural population to help them stay gainfully employed and contribute to the State's growth of income). Empirical research shows that the transfer systems in Indian federal set up have led to perverse incentives for States. Rao (2004) emphasizes the standpoint of Bird and Smart (2002), to pay close attention to the structure of incentives in designing the transfers, as the impact of transfers depends on incentives ultimately, for its citizens. He mentions that, there is an acceptance of the prevalence of structural deterioration through the ‘tragedy of commons’ arising from the influence of special interest groups in states’ fiscal policy. Bagchi(2006) argues that the States refrain from reducing expenditure or taxing more and rely on borrowing as they are the elected government operating with a short term horizon. For at base, the fiscal problems of democracies have their origin in the short time horizon of periodically elected governments and their penchant for promising the moon to the electorate at the time of elections by expanding expenditures while showing extreme reluctance to tax. The assumption underlying this tendency is that money will somehow be found through borrowing, off-budget if need be, and in the case of the states, through transfers from the centre. The states often assume heavy expenditure liabilities (by handing to existing employees hefty pay rises and so on) on the presumption that ultimately the centre will come to their rescue by giving more grants or remitting their loans.[9](Bagchi A. 2006).

Based on an exhaustive review of the theory, Singh and Rao (2005) argue that inter-governmental transfers should aim at equity without creating adverse fiscal incentives for the state governments. The political influence on inter-governmental transfers has been so overwhelming that the transfers (both explicit and implicit) have not made any noticeable dent in bringing about equity between states. Rather there is evidence of persistent and possibly widening economic gaps between the states. (Singh, 2004)

Calvert, McCubbins and Weingast(1989) use the game theoretic approach to examine the sequence of decisions made by elected representatives and bureaucrats, to explore the strategies available to them, and to assess the policy outcomes that result. They view that implicit in the

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[9] Bagchi cites the example of West Bengal and Maharashtra. The scope for raising non-tax revenue also remains unexploited, on the plea of subsidising the poor although here is ample evidence that it is the better-off sections who benefit more.

structure of decision making created by the Constitution is a game that pits the ambitions of institutional actors against one another. In particular, the process of policy execution is a game among legislators, the chief executive, and bureaucratic agents; it includes the initial delegation of authority, the choice of policy alternatives, and opportunities for over-sight and control. The actions of political officials throughout this process jointly determine policy outcomes (Randall L Calvert, 1989). In the Indian conetxt, Khemani(2003) brings out evidence to suggest that while more discretionary transfers are indeed amenable to serve political objectives, the rules-based transfers may in fact be used by statutory bodies to counteract partisan effects on resources available to state governments. While plan transfers to politically affiliated states, whose distribution formula is determined by a national council with representation of the national political executive, are 10 percent higher than the sample average, statutory transfers to politically affiliated states, whose distribution formula is determined by a constitutional body whose members have no official political affiliation, are 13 percent lower than the sample average. (Khemani, 2003)

3. **Finance Commission: Transfers to States and ways to determine their requirements**

Table below shows the trends in central transfers to States through successive FC during the period 10FC to 13FC period (2000-2020). The growth in total transfers is very steep over the successive FC period. There has been more than doubling of total transfers in 13 FC period. This has been an outcome of high growth of state income, better fiscal management, larger contributions to the divisible pool and in turn receiving more through FC transfers.

Table 2: Transfers from Centre to States (INR million)

FC Period	10 FC	11 FC	12 FC	13 FC
Total Transfer	2,266,430	4,349,050	7,557,520	17,066,770
Annual transfers	453,290	869,810	1,511,500	3,413,350
Amount used for vertical transfers	283,270	380,240	756,240	1,863,900
Amount for equalisation transfers	133,010	378,560	633,880	1,390,640
Amount used for cost differential and special needs	37,000	111,020	121,320	158,810

Source: "Finance Commissions in India: An Assessment", RBI, 30 March 2011, Report of Fourteenth Finance Commission

Pangariya, Rao and Chakraborty(2014) present a case of higher per capita income development expenditure in both high and low income states in the period of high growth. Their key finding is that greater fiscal space is available not only in high income states but also through high GSDP and per capita income growth in low income states. High growth in GSDP in low income states has led to huge own source of revenue. This is further augmented through the inter governmental transfers that is fuelled by high growth in high per capita income states. Greater devolutions by

Centre to States that happen with consultations with States has provided greater fiscal space to low income states to channelise development expenditure. This sets a virtuous cycle of high growth leading to greater share of developmental expenditure causing further higher growth in income (Arvind Panagariya, 2014).

Operational features of FC [10]: After the constitution of FC [11], it starts functioning to assimilate data, conducts meetings of all stakeholders, collaborates with academic institutions falling within the realms of public finance as mandated by its Terms of Reference (ToR). The office of FC has two years of time for inviting inputs and seeking public opinion, meeting relevant stakeholders across States (including the State Chief Minister), Central Ministries, Accountant Generals, conduct conferences, regional workshops, and to draft its recommendations on the ToR. 14 FC[12] noted that the consultations with the State Governments and other stakeholders in the States have been an essential and enduring feature of work for all previous Finance Commissions.

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[10] [10] Refer to The Finance Commission (Miscellaneous Provisions) Act, 1951 and Rules for more details related to the formation, function, powers and duties of FC in India

http://fincomindia.nic.in/ShowContentOne.aspx?id=8&Section=1 as accessed on May 02,2017

For the period starting 2020-2025, the preparation was kickstarted by Government of India through allocation of budget in 2017-18. The recommendations of the 15th Finance Commission will be implemented for the period starting 1 April 2020 to 31 March 2025. A new FC is set up two years before the end of the current period for which it sets rules for devolution of taxes.

[11] Some of the procedural insights that form part of the Paper are based on the author's consultancy experience of assisting two State governments in formulation of memorandums for 13 and 14 FC.

[12] 14 FC covered all 29 States and held four meetings in each of them. The meeting with the Chief Minister, Ministers and officers of the State Government was one of the highlights of the State visits. Separate meetings were held with elected representatives of local self governments both rural and urban, representatives of trade and industry, and representatives of recognised national and state political parties in the States.

Memorandum to the FC by States: Each State prepares and submits a detailed Memorandum of Demands (MoD) to the FC prior to the FC's State visit/consultation. MoD is used by States to communicate its perspective on the ToR. State would present its Fiscal overview, Social Report Card, bringing out its growth and development story. The State presents its suggestions on the formula for vertical and horizontal devolution, the manner for distribution of grants in aid and the measures for augmenting the Consolidated Fund of State. Also, based on the important reforms that is in the pipeline or such matters of national importance, the ToR demands responses on these to consolidate the State views[13].

[13] In 13 and 14 FC, for example: the impact of the proposed Goods and Services Tax on the finances of Centre and States and the mechanism for compensation in case of any revenue loss.

4. Exploring the Linkages: Flavor of Negotiations by States

A. Observations on the recommendations of FC

Vertical Devolution:

Successive FC have increased the share of states vis a vis the union. The suggestions of States can be broadly grouped under four categories:

(a) Increase in the share of tax devolution- Government of Kerala emphasizes that the recommendations of the 10 FC was a watershed in fiscal transfers in India wherein it provided an alternative scheme of sharing of tax receipts. Since then the FC have followed this pattern and the share of transfers in the Centre's tax receipts awarded by the Commissions have risen from 26% (Tenth Finance Commission) to 32% (13 FC) (Department, 2013). **14 FC accepted the demands of all States to enhance formula based tax devolution and raised the share of States to 42% in the divisible pool, a very remarkable feat in the history of intergovernmental transfers in India.**

(b) Expansion of the divisible pool by including non-shareable cess and surcharges and non-tax revenues (Kerala and Maharashtra) 14 FC did not accept this as this is not mandated constitutionally[14].

(c) ensuring minimum guaranteed tax devolution-Not agreed by 14 FC

(d) reduced role of Centrally sponsored schemes (CSS)- This is out of purview of FC and has been separately addressed through restructuring of CSS. Also, 14 FC notes that enhanced vertical

[14] Article 270, taxes referred to in Article 268 and 269 - surcharges on taxes and duties and cesses levied for specific purposes - should not form part of the divisible pool. (Fourteenth Finance Commission, 2015)

devolution would serve the twin objectives of increasing the flow of unconditional transfers to the States and yet leave appropriate fiscal space for the Union to carry out specific-purpose transfers to the States.

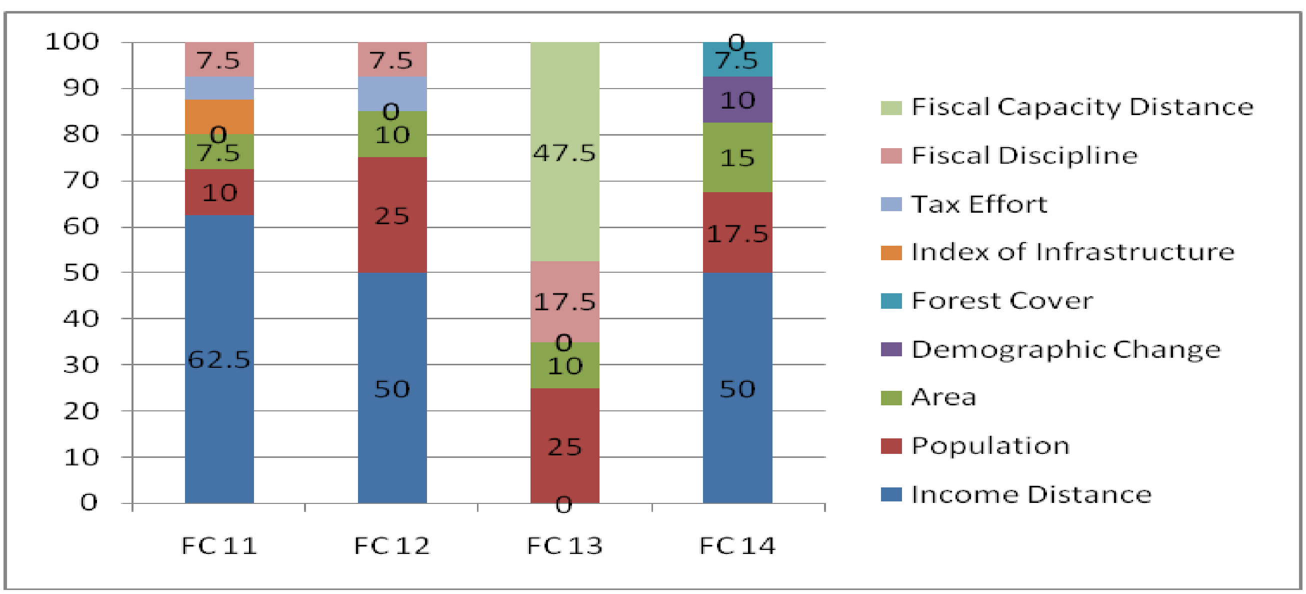
Choice of paramters for horizontal devolution: Bihar has mentioned that three groups emerge for the seven different criterions that have been used by the 11, 12 and 13FC:

Table 3: Types of Criteria used by FC for the formula for horizontal devolution

Group	Criteria	Objective
A	1. Population 2. Area	To judge the relative size of the state.
B	1. Income Distance 2. Physical Infrastructure 3. Fiscal Capacity Distance	To capture the relative economic disadvantage of the states and, hence, their needs for additional resources
C	1. Tax Effort 2. Fiscal Discipline	to incentivize the states for prudent fiscal management in terms of resource mobilisation and limiting deficit/debt

Source: Memorandum to the Fourteenth Finance Commission, Government of Bihar

Figure 1: Criteria used by successive FC towards horizontal devolution(%)



Source: Reports of various Finance Commission

Population and Area remain the two constant parameters for horizontal devolutions for all FC though in varying degrees. 14 FC has increased the weights for both these variables in comparison to those accorded by the previous 3 FC. In addition to Population, recognising the importance of changes in the demographic make up post 1971, 14 FC has gone a step further by assigning 10% weightage to demographic changes as well. Area is assigned weightage with an increasing trend as 14 FC assigns 15% in its formula. Following 12 FC, 14 FC also **puts the floor limit at 2 per cent for smaller States and assigned 15 per cent weight owing to the nonlinear relationship between the area and cost of services to be provided to its citizens.** 14 FC recognises the cost disabilities related to the forest cover. It has assigned 7.5% weightage.

Income Distance(distance of actual per capita income of a State from the State with the highest per capita income as a measure of fiscal capacity) has been assigned the highest weightage across successive FC- 11, 12 and 14 FC. 13 FC used the Fiscal capacity distance- distance of actual per capita income of a State from the State with the highest per capita income as a measure of fiscal capacity. 14 FC followed 12FC by assigning income distance. 14 FC took a three-year average (2010-11 to 2012-13) per capita comparable GSDP has been taken for all the twenty-nine States. Income distance has been computed by taking the distance from the State having highest per capita GSDP. Figure below presents the shift in choice of variables for horizontal devolution.

B. Proposals by States on Horizontal Sharing

States have a mix of opinion on what should be the purpose of horizontal sharing of funds through FC. Bihar, a high population, low Income State suggests that equalization of per capita development expenditure matters the most. Kerala recommends that Horizontal Fiscal Equalisation (HFE) is fundamentally based on the principle of equity between sub national jurisdictions and this principle has been accepted by all the FCs. HFE is the equalization of the fiscal capacity of the states. State governments should then receive funds from the pool such that if each made the same effort to raise revenues from its own sources and operated at the same level of efficiency each would have the same capacity to provide services at the same standard. The revenue bases of states taken for comparison should, however, reflect the range of activities, transactions and assets the states actually tax, as such bases capture the revenue raising advantages and disadvantages ("disabilities") that states face (Department, 2013).

Formula for horizontal sharing: Most states have restricted themselves to suggesting minimum 4 criteria namely population, area, fiscal discipline and tax effort, and a maximum of 7 criteria and weights have been assigned accordingly to arrive at the horizontal devolution formula. Total of 30 criteria were suggested together by 29 States, thereby bringing the State specific context as well. There lies huge variation in terms of geographical size, population, topography, demographic features. Indices related to Gross State Domestic Product, social sector indices and physical infrastructure brings out the variations and the prevalent inter State and intra state disparities.

Population: 13 States demanded the inclusion of Population based on 1971 Census while 10 States proposed using the recent Census 2011. The States pushing for the inclusion of 2011 Census reason out that huge demographic changes have happened since 1971. 7 States have proposed additional parameters like % of urban population, Composite SC/ST Population, States Dispersal of Population, Population Growth between 1971to 2001. Gujarat also proposed 5% weightage to decadal migration index.

Area: 18 States have proposed inclusion of Area in their formula. 9 States have proposed inclusion of Cultivable Area, three dimensional Area, Border Length, Area Distance, Forest Area.

Human Development Index and Poverty Ratio: Sikkim and Goa proposed inclusion of Human Development Index while Jharkhand proposed Poverty Ratio as a criterion. **Index of social and economic backwardness** was proposed by Jharkhand, Madhya Pradesh and West Bengal assigning 10% in their proposed formula.

Tax Effort: Andhra Pradesh, Goa and Karnataka (with one of the highest tax GSDP ratio) proposed tax effort

Income Distance: Income distance was proposed by 5 States (both high and low income) namely Bihar, Goa, Jharkhand, Odisha and Tripura.

Fiscal Capacity Distance: Fiscal Length Discipline was proposed by 21 States and 14 States proposed it with a combination of Fiscal Capacity Distance.

State's share in aggregate GSDP was proposed as a criterion by Gujarat and Punjab. Also Gujarat proposed 5% weight towards the reduction from fiscal capacity distance.

Fiscal Self Reliance was proposed by Karnataka (high income State) with a high weight (20%).

Table below summarises the key proposals on horizontal devolution-

Table 4: Proposals on criteria and weights for horizontal devolution formula by States

Criteria/ weights(%)	Assam	Bihar	Maharashtra	All States	14 FC
Population	20	20	35	13 States for 1971 Census 9 States for 2001Census	17.5
Demographic Change				7 other States suggested	10
Area	10		15	18 States 5 States also suggested other criteria related to area	15
Forest Cover	5			6 States-3 SC / NSC each	7.5
Income Distance		70		4 low incomes and 1 high income	50
Fiscal Capacity Distance	47.5		25	15 States	
Fiscal Performance					
Fiscal Discipline	17.5	10	25	20 States	
Tax Effort				4 States	

Total	100	100	100		100

Income capacity distance was used with a high weightage by 11 FC (62.5%) and 12 FC (50%). The 13 FC used the fiscal capacity distance[15] which was a revenue disability indicator and fiscal efficiency indicator such as tax effort and fiscal discipline. These two indicators were still suggested by more than half of the states to be included in 14 FC formula though with a varying weight from 20-50%. Most States proposed a reduction in the weight assigned during the 13 FC with the logic that better performing States were penalized in the income distance criteria[16] and States with revenue deficit were over burdened due to the fiscal discipline criteria. Bihar, Jharkhand, Odisha, and Tripura are the low income States but Goa is the smallest State with the highest per capita income (the Benchmark State). In 2013-14, a comparable year, Goa has the highest Per capita Net State Domestic Product (PC NSDP)[17] (INR 132,320) while Bihar has the lowest PC NSDP (INR 14,356). Jharkhand(INR 27,010) and Odisha(INR 25,163) are slightly better than Bihar. Tripura(INR 43,574) is ranked 13 amongst the 29 Indian States.

It is quite interesting to note that only 5 States have chosen income distance over fiscal capacity distance. 14 FC noted that the relationship between income and tax is non-linear, as the consumption basket differs between high, middle and low income States. States argue over the reasons of not being able to generate a high tax GSDP ratio, presence of cost disabilities, yet only five states proposed to include the income distance criteria for horizontal devolution.

[1515] distance between estimated per capita taxable capacity for each State and the highest per capita taxable capacity
[16] Income distance has been computed by taking the distance from the State having highest per capita GSDP.
[17] http://niti.gov.in/content/capita-nsdp-constant-2004-05-prices-2004-05-2014-15 accessed on 15 May 2017

Development indicators for consideration in horizontal devolution : Some States have argued that the concept of development is now more comprehensive and favoured the use of non-material dimensions like education, health and access to basic amenities captured by the Human Development Index (HDI), Few States have proposed poverty ratio, use of an index of social and economic backwardness like to consider the index of backwardness proposed by the Committee for Evolving A Composite Development Index of States (2013) headed by Raghuram Rajan.

State's Income, HDI ranking and their suggestion on horizontal devolution: States usually propose the formula(parameters and the respective weights) reflecting their unique situation;either to build on their strength or to cover for their individual constraints. States[18] propose in terms of their own size of population, geographical setting like coastline, extent of forest cover, proneness to natural disasters etc. pressures of urbanisation, etc. and lay emphasis on assigning higher weights reflecting these parameters. Table below links the suggestions with the State's level of per capita Net State Domestic Product in comparison to the national average(NA) and its HDI[19] ranking

Table 5: Sample States proposals, NSDP and HDI ranking

State	Suggestion on the formula @	NSDP 2013-14	HDI Ranking 2007-08
Odisha	Percentage of Scheduled & low population density Area in Total area.	Below NA	Below NA

[18] Of the twenty nine states, there are eleven special category (SC) states and eighteen non-special category (NSC) states. The SC states include Arunachal Pradesh, Assam, Himachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura and Uttarakhand while NSC states are Andhra Pradesh, Bihar, Chhattisgarh, Goa, Gujarat, Haryana, Jharkhand, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Odisha, Punjab, Rajasthan, Tamil Nadu, Telangana, Uttar Pradesh and West Bengal.(Report of Reserve Bank of India- State Finances A Study of Budgets of 2016-17

[1919] For more details on State's proposal refer to the 14 FC report -State wise criteria and weights proposed for horizontal devolution; For HDI ranking refer to 2015 report

Rajasthan	population should be weighted by the Composite index of i) SC/ST combined population (ii) proportion of youth below 25 years (iii) Crude birth rate (iv) Crude death rate(v) Child mortality rate and (vi) Maternal mortality rate Use of index of backwardness worked out by Raghuram Rajan Committee	Below NA	Below NA
Uttarakhand	Must serve the twin objectives of equity and efficiency	Above NA	Above NA
Meghalaya	states in strategic location should get more grants- Cost of living, Availability of rail, road, air link, Infrastructure distance, Revenue raising capacity, Administrative efficiency, Debt/GSDP ratio, Cost	Slightly below NA	Above NA
Nagaland	Factors: geographical location, infrastructure, historical factors like lack of capital, absence of scientific knowledge and industrial technology, absence of marketing and financial institutions and imbalance due to policy of locating major projects on the sole consideration of immediate gains. No suggestion on the specific weightage to be assigned to different factors.	Above NA	Above NA

Sources: @14FC Report NSDP in comparison to the 2013-14 all India average INR 39,904
HDI ranking based on 2011 Report

Observations on the State's context and proposals for devolution

Table below presents the facts related to sample states representing a low income(Bihar) , high income (Maharashtra), Kerala (highest ranking HDI) and Assam(North East).

Table 6: Fact file of Sample States

Indicators(2011)	Bihar	Maharashtra	Kerala	Assam	India
No. of Districts	38	35	14	27	640
Area ('000 ha) (% share)	94.2 (2.9%)	307.7 (9.3%)	38.9 (1.2%)	78.4 (2.4%)	3276.5
Population million (%of India Population)	104.1 (8.7%)	112.4 (9.4%)	33.4 (2.8%)	31.2 (2.6%)	1191
Population growth (Decennial %)	25.4	16	4.9	17.07	17.6
Urban (% of State population)	11.3	45.2	47.7	14.1	

Literacy rate (%)	61.8	82.3	94.0	72.2	74.10
Density (per sq.km)	1106	365	860	398	382
Sex Ratio (2011 Census)	918	929	1084	958	943
Gross State Domestic Product at Factor Cost (2014-15 at 2004-05 Prices)* (INR million)@2013-14	1,897,895	9,475,497	2,262,085@	924,316	57,417,910@
Per Capita NSDP at constant (2004-05 INR	16,801	72,200	58,961@	23,968	39,904@
Debt GSDP ratio 2013	26.4	21.3	31.6	21.4	22.1

Source: Report of 14 FC, 2015 and the data accessed through websites on 6 May 2017[20]

Based on the statistics provided in the table above, following contexts for these states emerge.

Table 7: Context of sample States

Bihar	Assam	Maharashtra	Kerala
Low Income, Per Capita very low as compared to National PC NSDP	Low Income, Per Capita very low as compared to National PC NSDP	High Income, Per Capita higher than National PC NSDP	Medium Income, , Per Capita higher than National PC NSDP
High proportion of rural population	High proportion of rural population	High level of urbanization	High level of urbanization
Lowest in terms of literacy, low Sex Ratio	High Literate population	High Literate population, Average Sex Ratio	Highest literacy, high Sex Ratio
Fiscal Deficit less than 3% norm, High Development expenditure GSDP Ratio (15.9%)in 2012-13	Development expenditure GSDP Ratio (21.3%) in 2012-13 similar to average amongst Special Category (21.9%)	High Debt GSDP Ratio Lower Development expenditure GSDP Ratio (8.1%) compared to Non Special Category (10.9%)	Higher FD than the 3% norm Low Development expenditure GSDP Ratio (9.3%)in 2012-13

Stylised facts emerging from the MoD submitted by sample states

a) Bihar's proposal for per capita development expenditure is a step towards equalizing the fiscal capacities of States. Low income States with high population high a huge committed expenditure. Fiscal management becomes a challenge with a target based

[20] * http://niti.gov.in/content/gsdp-constant-2004-05prices-2004-05-2014-15
http://www.census2011.co.in/sexratio.php
http://www.census2011.co.in/literacy.php
http://niti.gov.in/content/debt-total-outstanding-liabilities-percenatge-gsdp

reduction in fiscal/revenue deficit resulting in lesser fiscal space available for development expenditure. It is important in this sense when Bihar proposes equalization of per capita development expenditure, the rationale being equipping high population states with untied resources to reduce interstate and intra state disparities in growth and development

b) Following principle of equalization, Kerala proposed for the dropping of tax effort and fiscal discipline from the formula. The population and fiscal capacity distance should be related through weights generated by the devolution ratio starting with the principle of equalization. It proposed that population needs to be redefined incorporating the cost disabilities imposed by the share of aged population, level of urbanization, forest area and effective population density.

c) Maharashtra proposed that States should receive compensation for reduction in size of the Divisible Pool- It cited that certain sources of revenue that is contributed by States and yet it outside the divisible pool. The reasons cited were

   - Tax Concessions given by the Center
   - Growing size of Cesses & Surcharges
   - Delay in revision of Royalty on Minerals
   - Changes in Income Tax Act bringing in State bodies (carrying out the development function of State) in tax ambit
   - Additional source of Non Tax Revenue of Centre arising out of Spectrum Sales, License Fees

Expansion of the divisible pool by including non-shareable cess and surcharges and non-tax revenues was proposed by both Kerala and Maharashtra. The proposals of higher vertical devolution in favour of States emerge against the background that Union has other sources of revenue outside the divisible pool, hence States must access greater share of divisible pool.

d) Views on Goods and Services Tax(GST)

Both Kerala and Maharashtra cite the States experience of delays in receiving the Value Added Tax (VAT) related compensation.

- Kerala proposed a structured compensation mechanism in GST with clear guidelines and institutional mechanism, under the aegis of Empowered Committee and Government of India to disburse the GST compensation at least for a minimum period of 5 years.
- Replace the GST compensation grant recommended arbitrarily for States by 13 FC with a parameter based package -Kerala
- Independent compensation mechanism. GST should not increase compliance burden on businesses(Maharashtra)
- Constitutionally mandated, unambiguous compensation mechanism on a perpetual basis that factors in the CAGR in revenue growth (Assam)

e) Demands for grants in aid(GIA) from FC

The ToR usually mentions that FC would provide the principles" and "sums to be paid to the states which are in need of assistance". These have been given to States to meet their residuary budgetary needs after taking the devolution of taxes into account, to augment State expenditure, to ensure minimum expenditures on such services across the country. The previous FC recommended GIA for five purposes – revenue deficit, disaster relief, local bodies, sector-specific schemes and state-specific schemes***. The first three types of grants are formula based while sector and state specific grants are discretionary.***

States present a range of demands to meet fund requirements from police, housing, coastal zone protection, eldercare, irrigation, special requirements for Mumbai city etc. During 14 FC, The total demand for sector/state specific grants was INR 11,890,370 million. Maharashtra had demanded for INR 210,970 million. Kerala demanded 68,851 million, Bihar proposed INR 414,541 million and Assam proposed INR 390,383 million.

While States have presented a strong case for minimizing discretionary GIA and increase of formula based devolutions, yet they propose a range of state/specific grants with a view to not lose any chance of accessing the discretionary grants of FC. Bihar opined that of the total GIA by 13 FC, it also emerges that Local Bodies and Post-devolution Non-Plan Revenue Deficits, totaled 50% of GIA and with the Implementation of GST together account for 59.4 percent of the total grants. Yet it could hardly make any visible impact on the challenges. Still, Bihar maintained it should have a greater redistributive role and in favour of the disadvantaged States and claimed a 15% share in total GIA through 14 FC. (Government of Bihar, 2013)

GIA has been in the range of 7.7 % (7 FC) to 26.1% (6 FC) (13 FC- 18.03%) to total FC transfers. ***14 FC refrained from allocating any sector specific grant with the argument that these requirements of the State should be met out of their enhanced fiscal capacity and through appropriate transfers from Centre, not through the grants in aid mechanism of FC.*** 14 FC assigned formula based local bodies grant, disaster relief(past expenditure based) and post devolution revenue deficit grant.

Views on Debt Relief

Maharashtra reminded that the full compensation on write off on Central Loans on CSS & CPS are yet to be received by the State. States are locked in high interest regime. Hence, reduction in interest rate on National Small Savings Fund(NSSF) loans required. Also, it pointed that lower interest rates on NSSF loans enjoyed by Center and savings by improving operational efficiencies can be passed on to the States. Conditionalities if imposed, needs symmetric treatment for both the State & the Center. Kerala recommended that full waiver or at least 50% of waiver of central loans to States would improve the debt situation of States.

In contrast to several states demanding access to market borrowings, Bihar argues that lack of central mediation for borrowing and the option of raising market borrowings is not useful for low income states like Bihar. It is not confident to raise market borrowings. It proposed various debt relief measures like moratorium of 3 years towards interest payment to Centre, doing away with compulsion of expensive debt options and to explore the formation of Loan Council for market borrowings etc.

Similarly, the States have expressed suggestions on subsidies, regulators and pricing of public utilities. These are outside the purview of FC transfers and are meant to consolidate the opinion of States on these matters.

f) Solving the bargaining problem through Joint Memorandums to FC

States together presented a joint memorandum to the 13 FC with a view to correct the imbalance in the Centre-State financial relations[21], in addition to submission of individual MoD. The States are of the view that the more important powers of revenue sharing remained with the Centre, mainly powers pertaining to income tax, corporate tax, Union excise duties, customs, service tax, etc. The annual developmental expenditure of the States (INR 3.62 lakh crore) was more than one and a half times that of the Centre (INR 2.33 lakh crore). On the other hand, the Central

[21] Asim Dasgupta, West Bengal Finance Minister and Chairman of the Empowered Committee of State Finance Ministers, presented it to the 13 FC on behalf of the State Finance Ministers.

government raised 62 per cent of the total revenue collected in 2005-06 and all the States together raised the rest (RBI data). This was historic as for the first time a joint MoD was presented to FC. Major highlights included

- Enhance the share of the states in the net proceeds of central taxes from 30.5 per cent to at least 50 per cent
- The divisible pool of central taxes should include all cesses and surcharges
- The States should be given the option to access market borrowing, and should also be allowed the option to issue tax-free bonds.
- Provide States with concurrent powers of taxation of all services like the Centre had appropriated the entire power of levy of service taxation
- Central government should bear at least 50 per cent of their additional burden owing to the pay revision – 100 per cent of such burden for special category and north-eastern States

- Not to link the debt relief package of 12 FC with the enactment by the States of the FRBM Act.

States argued that achieving mechanically the targets of the FRBM Act might lead to a general curtailment of development expenditure and efforts to decentralise development grants through local governments.[22] Many of the demands were accepted in due course by 13 and 14 FC like greater vertical devolution to States, restructuring of CSS, access to market borrowings for states, consideration of flexible FRBM targets by 14 FC.

[22] Accessed on 1 June 2017

The bargaining theory suggests that States as a group could influence the choice of policy prescriptions tilting it in their favor collectively. However, it must be noted that, it must come with incentives for both category of -the high contributors as well as the relatively low contributors; and must bring in enough fiscal discipline in them so that the States can utilize the funds effectively and efficiently. Unlike the transfers through Planning Commission that is influenced by political parties in power, in case of the devolutions through FC, the political parties in power; ruling the State and/or the Centre, can influence through the memorandum /negotiations in a limited sense. The ruling parties in Centre really cannot swing the quantum of devolutions through the FC in the favor of State where it is ruling or supporting the party in power. Singh and Vashishta(2004) find evidence that states with indications of greater bargaining power seem to receive larger per capita transfers, and that there is greater temporal variation in Planning Commission transfers (Vasishtha, 2004). Rao and Singh(2004) suggest that all intergovernmental transfers should be routed through the FC and the Finance Commission transfers should be formula based and should be simple and clear and amenable to changes in economic conditions. In this context, it's important that States could come together to formulate suggestions that's more representative and within the constitutional framework.

14 FC has recommended a new institutional arrangement that could be equipped to design the transfer system other transfers than those covered by the FC. Reviving the Inter-State Council (ISC), created in 1990, would be useful. The ISC includes the Prime Minister, state Chief Ministers, and several central cabinet ministers as members. Singh and Srinivasan (2006) observe that while the ISC is merely advisory, it has formalized collective discussion and approval of important matters impinging on India's federal arrangements, including tax sharing and inter-state water disputes. In other cases, committees composed of state finance ministers have provided a means for reaching collective agreement by the states. It has become a forum where some political and economic issues of joint concern can be collectively discussed, and

possibly resolved. (Srinivasan, 2006). It will be useful to explore such an arrangement that could anchor the joint memorandums through a scientifically designed formulation of demands for collective and individual interest of States.

5. Way Forward

The empirical research on the political influences of intergovernmental transfers in India shows that partisan politics affects allocation to States through discretionary transfers but is very limited on the formula based transfers through FC. States favour less of discretionary grants that have been found to be more influenced by partisan politics. They prefer more of formula based transfers through FC though they also demand a range of state/sector specific grants. States present memorandum of demands to the FC. This is an important channel of communication, to influence the FC, and present a case for higher devolutions both vertical and horizontal. It is in their best interest to cooperate in a game theoretic sense; for higher vertical devolution, at the same time, claiming more individually through horizontal devolution.

The pattern of demands/viewpoints presented by States - High, Medium, Low; reflects flexibility on their part. States present their individual case with a view to tilt the negotiations for increment in individual shares through horizontal devolution. They propose their development agenda with specifics-laggard sector/ reasons for slow growth/development/constraints on development plans due to fiscal pressure. The reasons for increments in horizontal share may not be the same in successive FC. The overall rationales for low income States to propose parameters with a higher weightage is to ensure a higher share to compensate for lesser own resource base to overcome slow development, late start/legacy reasons. The low income States struggle to allocate higher budgets to development expenditure (school education and health care and public provisioning of urban civic amenities, rural and urban infrastructure etc.). High income States present a case for greater allocations on account of further requirements of maintenance of better social and physical infrastructure to continue the momentum of high growth/development. These States set the goals of meeting the growing pressure of urbanization and the onus of providing high standards of civic amenities/ public services, investments in world class infrastructure like mass rapid transit systems, low cost affordable housing, etc. The fiscal gap is well understood and is beyond doubt that chasing balanced budgets for States cannot be their agenda alone. Adhering to the FRBM targets leads to shrinking of fiscal space available for development expenditure on account of meeting a heavy committed expenditure in the first place. States struggle to allocate enough for development expenditure in the face of strict FRBM targets. Their own source of revenue is found to be sticky and is dependent on too many factors beyond their own control. FC transfers are thus important source for States to augment their fiscal capacity. Hence states push for higher allocations through FC citing a variety of sources of revenues that only the Union accesses out of recent developments.

FC estimates the requirements and projects the revenues in the light of the demands of States. The political representation of demands (through memorandum and meetings with heads of States) can influence the recommendations but FC decides on the parameters /devolution formula totally on grounds of its own assessment. It will be interesting to further explore the flavor of negotiations to develop game theoretic model to solve the bargaining problem of the States. The submission of joint MoD that is explored through an institutional arrangement like the Inter State Council, could influence the final recommendations of FC. States face the bargaining problem and in the event of cooperation, they could reach a settlement that is in their mutual interest. Yet, there will be greater requirements for states with lesser ability to contribute to the divisible pool. In order, to achieve the goal of horizontal fiscal equalization, the horizontal devolution formula needs to be reflect the cost disabilities well. Only then can public expenditure amongst low contributors/ low income states /high population states be augmented through a formula driven transfers in the best interest of all States without any disincentive to the high contributors in the spirit of cooperative federalism.

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