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**TAX DEVOLUTION AND GRANT DISTRIBUTION
TO STATES IN INDIA
Analysis and Roadmap for Alternatives**

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December 2009

*To our guide and source of inspiration,
the late Professor K K. Subrahmanian*

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ABSTRACT

The paper attempts to analyse the impact of devolution of taxes and distribution grants by the Centre to the States in India by taking fourteen major States for the time period 1980-81 to 2006-07. The study focuses on the impact of inter- State distribution of Central grants and taxes. Analysis reveals that formula based tax devolution has been more equalising than grants. Study finds that there is need to explore alternative mechanisms.

Keywords: Tax Devolution, Grant Distribution, Horizontal and Vertical Imbalance

JEL Classification: JE6

1. General Backdrop

Centre State relations are being widely discussed in the context of the Justice Punchi Commission on Centre-State relations and the Thirteenth Finance Commission. They are presently in their final phase of work. During 1980-81 to 2006-07, the time period selected for our analysis, a few perceptible changes took place in the mechanism devolution of taxes and distribution of grants from the Centre to the States. During this period, substantial measure of tax reform at the Central and State levels took place.

Regarding tax devolution, the Tenth Finance Commission (1995-2000) recommended that all taxes (except surcharge and cess) be made part of the divisible pool instead of only Personal Income Tax and Central Excise Duty which were the taxes that were devolved till then. During this period, the Centre began taxing the Services (since 1994), from which a major portion of Gross Domestic Product at the national level as well as the Gross State Domestic Product of the States was generated from. This became shareable through the awards of the Finance Commissions till the Twelfth. The Eighty Eighth Constitutional amendment, took the Services tax outside the divisible pool of taxes and the Thirteenth Finance Commission will not be able to award shares of service tax to the States.

During the 1980s and 1990s major reforms were undertaken by the Union Government in both indirect taxes and direct taxes. The

reforms were initiated with the introduction of Modified Value Added Tax (MODVAT) in Central Excise during the mid-1980s and later in the direct taxes front by slashing the rates. The latter began during the 1980s and gathered momentum during the 1990s. Indirect taxes which comprised more than 80 percent of Centre's tax revenue during the 1980s came down to around 50 percent by 2006-07. During the period, the Centre's tax-GDP ratio fell (during the 1990s), before rising again (in the latter half of the 2000s).

During the first half of the 2000s, sales tax was replaced with Value Added Tax (VAT) for intra-State sales (except for commodities like liquor and petroleum products). Presently, Goods and Services Tax (GST) is being scheduled to be introduced from 01.04.2010. All these have considerable implications for tax revenue of Centre and States as well as devolution.

In the General Purpose grants distributed by the Finance Commission, under Article 275 of the Constitution, a major change took place. The Ninth Finance Commission (1990-95) adopted Normative criteria to distribute General Purpose grants. Till then, they were granted as gap fillers in the Non-Plan Revenue account of the States¹. Despite the evolution of Normative criteria, General Purpose grants, in effect, continue to be gap fillers based on estimates of future revenue and expenditure of States. Besides this, the Centre also distributes non-formula based discretionary grants to the States. (one major component of the discretionary grants is the increasing number of Centrally Sponsored Schemes)

The period 1980-81 to 2006-07² includes two sub-periods, that is, the decade of 1980s which is prior to the changes in tax devolution and grant distribution and the decade and a half after the change. But our discussions rely largely on Eleventh and Twelfth Finance Commission for suggesting changes.

The Constitutional provisions for devolution of resources is intended for addressing,

- a) Vertical imbalances and
- b) Horizontal imbalances.

The first one is to take care of the imbalances between the Union and the States due to limited revenue powers and vast expenditure obligations of the latter. All elastic and buoyant tax bases like Personal Income Tax, Corporation Tax, Excise duty on manufacture (other than alcoholic beverages) and Customs Duty are with the Centre. The States mainly tax purchase and sale of commodities. This is a comparatively inelastic tax compared to the former. The alternative to devolution is transferring powers to tax to the States, which is not generally considered on efficiency and uniformity grounds³ (See Ter Minassian, 1997 for a discussion).

Horizontal imbalances exist due to differing levels of capacity for resource mobilisation by different States as their per capita income levels vary widely. Addressing Horizontal imbalances is to enable States with poorer per capita income (per capita GSDP) to provide a basic minimum level of services as the richer States do. This will have to be taken into consideration while deciding formula for *inter-se* distribution of devolved taxes.

Our study attempts to look into the problem of *inter se* distribution of taxes and grants among the States which have differing fiscal capacities and are at different levels of development. For analysis, we are taking fourteen major States in India. The selected States are from all geographic regions and at different levels of per capita Gross State Domestic Product (GSDP). Special Category States including the North Eastern States are not included as the criteria for distribution of grants to them and the problems they face are totally different and not directly comparable with that of other States⁴. The study analyses devolution of taxes and

distribution of grants, which impact the revenue side of the budgets. Central loans for Plans and loans out of Small Savings Schemes, are not made part of this study.

The discussion on the differential impact of devolution of taxes and distribution of grants, assumes importance in view of the persisting Horizontal imbalances among the States. The political scenario during the period of study is also briefly outlined in this paper.

2. *Objective of the Study*

The paper examines the impact of Central devolution of taxes and distribution of grants to various States and groups of States namely, High income, Middle income and Low income. The grouping is made by arranging them in descending order of per capita GSDP, with the top four States classified as High income, the subsequent five categorised as Middle income and the last five as Low income States. The focus is on the impact of devolution of taxes and distribution of grants in the context of persisting horizontal imbalances. Suggestions for change in the criteria for devolution of taxes and distribution of grants are also discussed.

3. *Distribution of Fiscal Powers and Mechanism of Devolution- A Summary*

During the British rule, there was strong political and fiscal centralisation. A series of piecemeal exercises in transfer of power to the provinces, culminated in the Government of India Act of 1935.⁵ This later became the bedrock of the Centre-State relations in the Constitution in which the position of the Centre *vis-à-vis* the States is very powerful. Indian Constitution is described as a federal one with very strong unitary features.

Though the powers of the States including that of revenue mobilisation and expenditure obligations are laid down in the Constitution, the Centre has several overriding powers. The most

important Unitary feature in fiscal distribution is that Parliament without the consent of more than half the legislatures can alter the size of the divisible pool of taxes from which Finance Commission can recommend States' and each State's shares⁶.

The Constitution of India has provided mechanisms to devolve taxes and distribute grants to the States. The Finance Commission recommends the percentage of the Central Taxes to be shared with the States and the distribution among the States is determined on the basis of criteria formulated by each Commission.

The General Purpose grants are distributed as mandated under Article 275 of the Constitution by the Finance Commissions, after determining the tax devolution shares by making normative projections of revenue and expenditure of the States (the practice of normative estimation started with the Ninth Finance Commission). There are also specific grants distributed by the Finance Commissions. The Plan grants and those for Centrally Sponsored Schemes are disbursed by the Planning Commission and Central Ministries respectively.⁷ The Plan grants are distributed on the basis of modified Gadgil formula⁸.

4. Per capita GSDP Rankings of States: A Brief Overview

Before proceeding to examine the main issues of the study, let us look at the per capita income rankings of fourteen States during the period 1980-81 to 2006-07. We consider per capita Gross Domestic Product of a State as the measure of comparable fiscal capacity across the States⁹.

Though there is no movement between the groups, namely, High, Middle and Low income States, there have been some movements within the groups as can be seen from the change in ranks in consecutive time periods (Table 1).

It can be seen that the Range, which is the simple measure of the difference between the average per capita income of the Highest income

Table 1: Change in Per capita GSDP Rankings of States

States	1980-85	States	1985-90	Change	States	1990-95	Change
Punjab	1	Punjab	1	0	Punjab	1	0
Haryana	2	Haryana	2	0	Maharashtra	2	-1
Maharashtra	3	Maharashtra	3	0	Haryana	3	1
Gujarat	4	Gujarat	4	0	Gujarat	4	0
West Bengal	5	West Bengal	5	0	Tamil Nadu	5	-4
Karnataka	6	Tamil Nadu	6	-1	Karnataka	6	1
Tamil Nadu	7	Karnataka	7	1	Kerala	7	
Kerala	8	Kerala	8	0	Andhra Pradesh	8	1
Andhra Pradesh	9	Andhra Pradesh	9	0	West Bengal	9	-4
Madhya Pradesh	10	Madhya Pradesh	10	0	Rajasthan	10	1
Rajasthan	11	Rajasthan	11	0	Madhya Pradesh	11	-1
Orissa	12	Orissa	12	0	Uttar Pradesh	12	1
Uttar Pradesh	13	Uttar Pradesh	13	0	Orissa	13	-1
Bihar	14	Bihar	14	0	Bihar	14	0

cont'd....

States	1995-00	Change	States	2000-06	Change
Maharashtra	1	-1	Haryana	1	2
Punjab	2	1	Punjab	2	0
Haryana	3	0	Maharashtra	3	-2
Gujarat	4	0	Gujarat	4	0
TamilNnadu	5	0	Kerala	5	1
Kerala	6	1	Tamil Nadu	6	-1
Karnataka	7	-1	Karnataka	7	0
Andhra Pradesh	8	0	Andhra Pradesh	8	0
West Bengal	9	0	West Bengal	9	0
Rajasthan	10	0	Rajasthan	10	0
Madhya Pradesh	11	0	Madhya Pradesh	11	0
Orissa	12	1	Orissa	12	0
Uttar Pradesh	13	-1	Uttar Pradesh	13	0
Bihar	14	0	Bihar	14	0

Source: Computed from Central Statistical Organisation Data

Table 2: Average Per Capita Income (in Rs.) during 5 year sub-periods

Averages	1980-85	Averages	1985-90	Averages	1990-95	Averages	1995-00	Averages	2000-06
Punjab	3839	Punjab	6644	Punjab	12613	Maharashtra	21650	Haryana	31077
Haryana	3267	Haryana	5547	Maharashtra	11483	Punjab	21537	Punjab	30483
Maharashtra	3209	Maharashtra	5464	Haryana	11112	Haryana	20221	Maharashtra	30277
Gujarat	2962	Gujarat	4778	Gujarat	9859	Gujarat	19735	Gujarat	27403
West Bengal	2395	West Bengal	3878	Tamil Nadu	8309	Tamil Nadu	17086	Kerala	25498
Karnataka	2164	Tamil Nadu	3878	Karnataka	7535	Kerala	16240	Tamil Nadu	25227
Tamil Nadu	2130	Karnataka	3650	Kerala	7383	Karnataka	14911	Karnataka	22624
Kerala	2106	Kerala	3460	Andhra Pradesh	7128	Andhra Pradesh	13729	Andhra Pradesh	21773
Andhra Pradesh	1983	Andhra Pradesh	3355	West Bengal	6636	West Bengal	12902	West Bengal	20745
Madhya Pradesh	1822	Madhya Pradesh	3035	Rajasthan	6304	Rajasthan	12320	Rajasthan	15945
Rajasthan	1785	Rajasthan	2926	Madhya Pradesh	6054	Madhya Pradesh	10969	Madhya Pradesh	14100
Orissa	1742	Orissa	2851	Uttar Pradesh	5174	Orissa	9102	Orissa	12696
Uttar Pradesh	1700	Uttar Pradesh	2785	Orissa	4944	Uttar Pradesh	8962	Uttar Pradesh	11650
Bihar	1360	Bihar	2274	Bihar	3412	Bihar	4526	Bihar	5996
Range	2478		4370		9201		17124		25081

Source: Computed from Central Statistical Organisation Data

State and that of the Lowest income State, has increased during each sub-period of the period between 1980-85 to 2000-06 (See Table 2).

When States are grouped into High, Middle and Low income groups¹⁰, the disparities between High and Low income States have increased throughout the period. The ratio of the average per capita incomes of four High Income States and the five Low Income States has increased from 1.86 during 1980-85 to 2.40 in 2000-06 (See Table 3). Likewise, the disparities between the Middle and Low Income States have also increased. But there is a slight decline in the gap between the High and Middle Income States.

It is clear that not only fiscal capacities of the States differ but the gap is widening. It is in this background of Horizontal Imbalances, that we are proceeding to analyse the Central transfer of taxes and grants to the States. As regards, the reasons for the differing per capita income

Table 3: Per Capita Income Levels of State Groups and their Ratios

Group Average	1980-85	1985-90	1990-95	1995-00	2000-06
High	3134	5262	10675	20046	28948
Middle	2096	3586	7171	14446	22592
Low	1682	2774	5178	9176	12077
Ratios					
H:L	1.86	1.90	2.06	2.18	2.40
H:M	1.50	1.47	1.49	1.39	1.28
M:L	1.25	1.29	1.38	1.57	1.87

Source: Computed from Central Statistical Organisation Data

Note: H –High M- Middle L- Low. The States included are the ones classified as such as per Table1 based on discussion in Section 2

levels and also growth rates, their analysis is beyond the scope of this study.

5. Central Tax Devolution to States- State-Wise Impact

Though there is consensus among the States that a higher share of Central taxes should be devolved to them¹¹, there is difference in approach on what basis the taxes devolved is to be shared. It will be clear if the memoranda of different States to the Finance Commissions are perused.

Prior to the Eleventh Finance Commission, multiple criteria like collection¹², backwardness, poverty ratio etc.¹³ were used for devolving a percentage of Personal Income Tax and Excise duties. The criteria used by the Eleventh Finance Commission for devolving a fixed share of all taxes were Population, Distance, Area, Index of Infrastructure, Tax Effort and Fiscal Discipline. The Twelfth Finance Commission has dropped the Index of Infrastructure from the criteria. The two major criteria are Population and Distance. The latter is the gap between the per capita GSDP of a State from the average of the highest three per capita GSDP States. The respective weights were 10 and 62.5 in the Eleventh Finance Commission and 25 and 50 percent in the Twelfth Finance Commission.¹⁴ Let us see how the tax devolution has impacted on different States during the time period 1980-81 to 2006-07.

While Uttar Pradesh and Bihar have ranked high in tax devolution, other Low income States like Orissa and Rajasthan have not ranked high. Middle income States such as West Bengal and Andhra Pradesh have ranked high in tax devolution. But certain other Middle income States with better tax effort have ranked low in tax devolution [For example, Kerala, Karnataka and Tamil Nadu (except during 1980-85)]¹⁵.

Table 4: Ranking of Tax Devolution to States

States	1980 -85	States	1986 -90	States	1990 -95	States	1996 -00	States	2000 -06
Uttar Pradesh	1	Uttar Pradesh	1	Uttar Pradesh	1	Uttar Pradesh	1	Uttar Pradesh	1
Tamil Nadu	2	Bihar	2	Bihar	2	Bihar	2	Bihar	2
Maharashtra	3	Madhya Pradesh	3	Andhra Pradesh	3	Andhra Pradesh	3	West Bengal	3
Madhya Pradesh	4	Andhra Pradesh	4	Madhya Pradesh	4	Madhya Pradesh	4	Andhra Pradesh	4
West Bengal	5	West Bengal	5	West Bengal	5	West Bengal	5	Madhya Pradesh	5
Bihar	6	Orissa	6	Tamil Nadu	6	Tamil Nadu	6	Rajasthan	6
Rajasthan	7	Maharashtra	7	Orissa	7	Orissa	7	Tamil Nadu	7
Kerala	8	Tamil Nadu	8	Maharashtra	8	Maharashtra	8	Karnataka	8
Andhra Pradesh	9	Karnataka	9	Rajasthan	9	Karnataka	9	Orissa	9
Orissa	10	Rajasthan	10	Karnataka	10	Rajasthan	10	Maharashtra	10
Karnataka	11	Kerala	11	Kerala	11	Gujarat	11	Kerala	11
Punjab	12	Gujarat	12	Gujarat	12	Kerala	12	Gujarat	12
Gujarat	13	Punjab	13	Punjab	13	Punjab	13	Punjab	13
Haryana	14	Haryana	14	Haryana	14	Haryana	14	Haryana	14

Source: Computed from RBI State Finances, A study of Budgets, various issues

Table 5: Period Wise Share of Low Middle and High Income States in Central Tax Devolution

Period	Middle	High	Low
1980-85	33.23	17.59	49.18
1985-90	33.38	14.18	52.44
1990-95	33.12	14.60	52.28
1995-2000	33.79	14.12	52.09
2000-06	32.92	11.50	55.57

Source: Computed from data available in RBI State finances A Study of Budgets, various issues

When States are grouped on the basis of per capita Gross State Domestic Product (Table 5), it is seen that during the period 1980-81 to 2006-07, the devolution of taxes have had an equalising impact. The share of Lower Income States has gone up and that of High Income States has fallen. This could be due to the change in criteria of devolution adopted by the Finance Commissions. At present, there is no weightage for the collection of Central Taxes from the State, which was previously there. Another feature to be noted is the stagnant share of the Middle income States and a minor fall in their share during 2000-06, the period of the Eleventh Finance Commission.¹⁶

6. Grant Distribution by the Centre to the States

Grants are another important component of Central revenue transfers and they are both formula based and discretionary. Grants to the States are disbursed by the Finance Commission, Planning Commission and the Central Ministries.

6.1 Grants by the Finance Commission

(i) Statutory Grants under Article 275

Based on formula, taxes are devolved amongst the States and the post devolution revenue and expenditure positions estimated on a

normative basis (since the Ninth Finance Commission), for the next quinquennial period,. This is considered for grant distribution. Since Planning Commission also disburses grants, the Finance Commissions (except the Ninth) have been distributing only non-plan grants by filling the normatively estimated gap in non-plan revenue account.¹⁷ The purpose of filling the gap in the non-Plan revenue account is to make available funds for Plan implementation, so that borrowed money is not spent for non-Plan recurring expenditure.¹⁸

After the 1960s, when the periods of the Finance Commissions and that of the Plans were not coinciding, these estimates and actuals were vastly different because the amount of plan expenditure getting transferred to the non-plan account was not known to the Finance Commissions. The difficulties in this regard have been discussed by in the report of the Eleventh Finance Commission.

(ii) In addition to Article 275 grants, Finance Commissions also grant specific grants for upgradation of standards in various spheres of administration and also grants for augmenting Consolidated Funds of the States for devolution of financial resources to the Panchayats and Municipalities.

6.2 *Other Grants*

Besides, Finance Commissions, the Planning Commission and the Central Ministries also distribute grants. This is done under Article 282 of the Constitution which provides for Miscellaneous Financial Provisions.¹⁹ The latter grants are distributed for State Plans, Central Plans and Centrally Sponsored Schemes. While the grants for State Plans are distributed under the Gadgil formula based on criteria like Population, special problems of the States, tax effort, fiscal discipline etc, there are ad hoc discretionary grants and grants like Centrally Sponsored Schemes based on scheme specific criteria. We will look at the aggregate and disaggregate picture of grants to the States for the recent period from 1990-91 to 2006-07, later.

Table 6: Ranking of the States in Receipt of all Central Grants

States	1980 -85	States	1986 -90	States	1990 -95	States	1996 -00	States	2000 -06
Uttar Pradesh	1	Uttar Pradesh	1	Uttar Pradesh	1	Uttar Pradesh	1	Uttar Pradesh	1
Bihar	2	Bihar	2	Bihar	2	Andhra Pradesh	2	Andhra Pradesh	2
Andhra Pradesh	3	Maharashtra	3	Andhra Pradesh	3	Madhya Pradesh	3	West Bengal	3
Orissa	4	Madhya Pradesh	4	Rajasthan	4	Rajasthan	4	Rajasthan	4
Madhya Pradesh	5	West Bengal	5	Madhya Pradesh	5	Bihar	5	Maharashtra	5
Maharashtra	6	Bihar	6	Maharashtra	6	Maharashtra	6	Gujarat	6
Rajasthan	7	Andhra Pradesh	7	West Bengal	7	West Bengal	7	Karnataka	7
Tamil Nadu	8	Orissa	8	Tamil Nadu	8	Orissa	8	Bihar	8
West Bengal	9	Tamil Nadu	9	Orissa	9	Tamil Nadu	9	Tamil Nadu	9
Gujarat	10	Gujarat	10	Karnataka	10	Karnataka	10	Madhya Pradesh	10
Karnataka	11	Karnataka	11	Gujarat	11	Gujarat	11	Orissa	11
Kerala	12	Kerala	12	Kerala	12	Kerala	12	Kerala	12
Punjab	13	Haryana	13	Punjab	13	Punjab	13	Punjab	13
Haryana	14	Punjab	14	Haryana	14	Haryana	14	Haryana	14

Source: Computed from RBI State Finances A study of Budgets, various issues

There is a perceptible fall in the share of the Low Income states in total grants, whereas that of the Middle Income States has considerably risen. There is a minor increase in the case of High Income States. The fall in share of Low income States is to the extent of 11.92 per cent, with that of Middle Income States going up by 9.56 percent (Table 7). In State-wise rankings Orissa, a Low income State is low in ranking of grant receipts. Middle Income States like Karnataka, Kerala and Tamil Nadu have also ranked low. A High Income State like Maharashtra has ranked high in grant receipts. Bihar has got lower ranking in grant receipts.

The above discussion indicates that the impact of distribution of grants has been less progressive than that of devolution of taxes.

Table 7: Period Wise Share in Central Grants of Low, Middle and High Income States

Period	Middle	High	Low
1980-85	29.48	17.44	53.07
1985-90	31.64	19.43	46.73
1990-95	30.44	15.46	54.11
1995-2000	34.43	17.88	47.68
2000-06	39.04	19.82	41.15

Source: Computed from *RBI State Finances: A Study of Budgets*, various issues

6.3 Grants - Disaggregate Picture

(i) Centrally Sponsored Schemes

The share of Centrally Sponsored Schemes is on an average 32 percent of total grants during the period 1990-91 to 2006-07.²⁰ It is a very important discretionary grant by the Centre to the States. Let us now proceed to see the share of resources which different States get from the total grants under Centrally Sponsored schemes.

Table 8: Share of States in Centrally Sponsored Schemes

States	1990-95	1995-2000	2000-2006
Andhra	8.90	10.84	11.16
Bihar	10.87	7.10	6.39
Gujarat	5.27	3.38	4.99
Haryana	2.59	3.26	2.97
Karnataka	6.30	6.69	9.46
Kerala	3.82	3.90	3.83
Maharashtra	9.76	11.29	9.21
Madhya Pradesh	9.77	9.29	8.95
Orissa	5.56	4.95	5.27
Punjab	2.12	2.75	2.07
Rajasthan	7.90	9.47	11.23
Tamil Nadu	7.02	7.09	7.11
Uttar Pradesh	16.03	13.69	12.02
West Bengal	3.87	6.31	8.18
Year	High	Middle	Low
1990-95	19.75	29.91	50.12
1995-2000	18.68	34.83	46.49
2000-06	18.97	39.73	44.13

The share of the Low income States has come down, while that of Middle income States has gone up. Among the latter, the share of Andhra Pradesh, Karnataka and West Bengal has gone up while that of Kerala and Tamil Nadu has stagnated. The shares of States having low per capita GSDP like Bihar, Uttar Pradesh and Madhya Pradesh has come down while that of Rajasthan has gone up. The share of Orissa has stagnated. States with high per capita GSDP like Maharashtra have got a higher share than the Low income States. The picture does not indicate an equalising effect²¹. There is a prevalent view that Centrally Sponsored Schemes need to be reconsidered by transfer of the Schemes with the funds to the States²². As the States are at differing levels of development, uniform criteria may not be suitable.

One argument in favour of Centrally Sponsored Schemes is that they address national priorities. In public finance literature, out of the three main functions of stabilisation, distribution and allocation, the first two are to be with the Federation and the last one with the provinces²³. Most of the Centrally Sponsored Schemes fall in the area of distribution. Oates (1999) has opined that in a Federation, the States have acted as fiscal laboratories for successful national level implementation of the schemes. This view seems appropriate in the Indian context.

It is to be noted that many of the Centrally Sponsored Schemes like Noon Meal Scheme and National Rural Employment Guarantee Act (NREGA) have State-level predecessors. Tamil Nadu and Kerala had implemented Noon Meal schemes successfully since the 1960s and Maharashtra had implemented Employment Guarantee Scheme (EGS) since the 1970s. States may be encouraged to formulate schemes with location specific criteria as part of the State plans and funds may be provided on a monitorable basis.

(ii) Statutory Grants

Statutory grants to the States are distributed by the Finance Commissions based on criteria fixed by them.

The substantial fall in the share of Low income States is due to the decline in the share of Bihar. The rise in share of Middle income States is due to the increase in share of West Bengal. The share of some individual States shows wide fluctuation.

(iii) Grants for State Plans

Plan grants to States are distributed on the basis modified Gadgil formula. The share of the Low income States is declining and that of the Middle income States increasing. The increase in the share of Middle income States has come due to the rise in the share of Andhra Pradesh

Table 9: Shares of States in Statutory Grants

States	1990-95	1995-2000	2000-06
Andhra Pradesh	14.72	19.54	6.16
Bihar	31.99	4.44	1.83
Gujarat	1.23	4.96	2.82
Haryana	0.34	0.75	1.11
Karnataka	0.63	1.43	2.84
Kerala	1.74	1.41	4.29
Maharashtra	1.46	2.46	3.00
Madhya Pradesh	4.70	5.37	4.77
Orissa	9.08	5.50	5.39
Punjab	6.70	7.17	1.93
Rajasthan	11.21	10.57	16.59
Tamil Nadu	1.34	2.56	2.21
Uttar Pradesh	9.76	19.37	12.08
West Bengal	6.62	14.49	33.64
	High	Middle	Low
	12.97	25.06	63.50
	18.24	39.43	42.33
	10.63	49.14	38.89

and Karnataka. Share of Kerala has been almost stagnant and that of Tamil Nadu and West Bengal has come down. Among the Low income States, the share of Bihar has increased while that of Uttar Pradesh and Rajasthan has come down. The movement over the period is not equalising.

The disaggregate picture of grants reveal that the share of the Low income States has been coming down and there is wide fluctuation in share of Statutory Grants. The share of grants among States has not been

Table 10: Shares of States in State Plan Grants

Year	1990-95	1995-2000	2000-06
Andhra Pradesh	6.61	9.12	11.58
Bihar	6.71	7.69	9.18
Gujarat	3.81	5.06	6.79
Haryana	1.10	2.28	2.32
Karnataka	3.15	5.20	6.30
Kerala	3.93	3.01	3.25
Maharashtra	9.34	6.13	7.49
Madhya Pradesh	5.65	9.01	8.09
Orissa	5.33	6.50	7.46
Punjab	1.57	2.15	1.90
Rajasthan	7.98	6.27	5.38
Tamil Nadu	5.86	7.52	6.84
Uttar Pradesh	28.51	19.78	15.48
West Bengal	10.44	10.26	7.95
Year	High	Middle	Low
1990-95	12.01	29.99	54.19
1995-2000	10.57	35.13	49.25
2000-06	11.71	35.92	45.58

an equalising one when their per capita GSDP ranking is considered. Comparing the State-wise movements in the share of discretionary and formula based grants and enquiring into its reasons is an area which can be identified for further study.

(iv) Grants as tool for fiscal correction

The Eleventh and Twelfth Finance Commissions attempted to use grant distribution as a negative incentive for ensuring achievements in deficit targets. While the Eleventh Finance Commission recommended

withholding of a portion of grants to be released to States on achieving targets, the Twelfth Finance Commission made debt relief conditional on achieving the targets. It is suggested that incentive grants may be devolved for fiscal performance, Instead of a deficit based indicator, revenue effort can be made the criterion as the former can be achieved by an indiscriminate expenditure cut. Suggested measures are:

- a) Improvement in tax buoyancy²⁴, of base period and a reference period
- b) Improvement in proportion of own revenue to revenue expenditure from base period to reference period.

7. *Central Tax Devolution and Grant Distribution - Salient Features and Suggestions*

7.1 *Tax Devolution*

Tax devolution constitutes the major part of Central devolution, (almost 60 percent) and the grants constitute the balance. As already stated, there are multiple criteria for tax devolution, though the complexity has come down since the Eleventh Finance Commission. The criteria used are:

1. Population
2. Distance
3. Area
4. Index of Infrastructure (dropped by the Twelfth Finance Commission)
5. Tax Effort
6. Fiscal Discipline

The first two have substantial weights (up to 75 percent). It is suggested that tax devolution being general purpose one, it should have the broad objective of attempting to tackle horizontal imbalances, If specific grants are distributed taking into consideration the level of education and other social services, the need for multiple criteria in tax devolution will be avoidable.

Tax devolution should not be the tool to consider emerging and specific needs of States which actually should be taken care of through grants. Grants can be made purpose based and need not act as gap fillers in post tax devolution situation as it is at present. Incentive criteria like better tax effort and fiscal discipline can be used for granting additional incentive grants.

Criteria of Population and Distance

As already seen, population and distance are the two criteria with 75 percent weightage in inter se distribution of taxes. There are other criteria like Area, Index of Infrastructure, Tax Effort and Fiscal Discipline. The criteria like Area and Index of Infrastructure have been included taking into consideration the fact that more the area and poorer the infrastructure, the cost of providing the services will be greater. Specific problems due to these can be left to be tackled through grants. Tax devolution should aim at equalising fiscal capacities.

For tax devolution, Distance weighted by Population seems to be an appropriate criterion as it provides more to States with lesser fiscal capacity. When various weights have been given to Distance and Population and alternative shares for various States computed, we find that Horizontal imbalances by way of differing fiscal capacities are better addressed by giving Distance a substantial share weighted by Population²⁵ (See Appendix for a Discussion).

7.2 Distribution of Grants- Suggestions

Though our discussion is focused on the Statutory Grants under Article 275 distributed by the Finance Commissions, other grants are also looked at briefly.

A) Statutory Grants by the Finance Commission

The Statutory grants are distributed on the basis of normative criteria and the estimates of gap in non-Plan revenue account and the

actuals have vastly differed. Moreover, the impact of statutory grants has not been equalising as seen earlier and there is wide fluctuation in the shares of different States.

Disbursing grants for filling gaps needs to be reconsidered. Any gap filling (for differing fiscal capacities) needs to be done through tax devolution and grants should be specific purpose based on criteria²⁶. The changes, to be brought about, will need discussion with the States and should take into consideration Constitutional implications.

The gap in State level indicators in education, health, infrastructure etc. needs to be measured using transparent criteria and grants for achieving a specified level distributed. The filling of post tax devolution deficits in non-Plan revenue account using estimates of future expenditure and revenue estimates amounts to doing again through grants by not so transparent methodology, what the tax devolution does on the basis of transparent criteria. It is felt that this can be changed and the corresponding share of the States in tax devolution can be increased from the 30.5 percent recommended by the Twelfth Finance Commission so that there is no loss to the States.

There can be a criticism that States will lose an important source of untied transfer of resources from the Centre. But it is to be taken note of that the General Purpose grants under Article 275, which are essentially gap fillers of non-Plan Revenue account, have not served the purpose they are meant for. They are actually an attempt to augment the fiscal capacity of a State to undertake activities in social, economic and infrastructural activities by taking care of the recurring current expenditure obligations. It would be better, if this is done through increased tax devolution based on simple criteria.²⁷

B) Other Grants

As regards other grants, it is suggested that the transfer of existing Centrally Sponsored Schemes with funds needs to be considered. In

future, instead of formulating schemes with straitjacket national criteria, State specific plans should be formulated and Plan grants distributed. Broad issues only need to be identified at the Central level.

8. *Political Background- A Brief Overview*

When there is substantial discretion in *inter-se* distribution of resources, the political situation in the federal set up becomes a crucial factor which needs discussion. A detailed analysis has not been attempted in this paper. However, we feel that it is necessary to outline the background, which could provide leads for formulation of hypothesis for a further study in this area.

The period under analysis witnessed considerable changes in the political scenario. The long period of single party rule at the Centre was replaced initially by minority governments depending on outside support and later by coalition governments with parties having predominant regional base. Some of them which had been protagonists of States' rights in the earlier decades are sharing power at the Centre²⁸.

In the initial three decades (till 1977), there was uninterrupted rule by the Congress Party. During that thirty year period, the character of the party itself underwent changes. In the initial two decades after independence, the Congress party had a Central leadership with a national appeal with States headed by powerful provincial leaders. Later, the powerful provincial leadership faded away and a single leader at the national level became the plenipotentiary²⁹. The low point of political centralisation was during 1967-69, when ruling parties in nine States were different from that in the Centre and the high point was 1975-77, the period of the internal emergency. The dissipating tendencies in political centralism gathered momentum in the latter half of the 1980s with many States coming under the rule of different parties other than the single party which was ruling at the Centre.

But the 1990s heralded a markedly different period with further setbacks for political centralisation. Coalition and Minority governments, in which State based political parties had a pivotal role, came to power at the Centre. The Supreme Court judgement in the case of S.R. Bommai signaled the stymieing of rather unbridled power to displace State Governments under Article 356 of the Constitution³⁰. This period can be termed as one during which centrifugal tendencies in centralised political system gathered momentum.³¹

Paradoxically, this period and the first half of the decade 2000-2010 witnessed centralisation of fiscal powers. The tax on Services (except a few such as Electricity duty and Entertainment tax) was made the exclusive domain of the Centre; first under Residuary power and later under the Union List. Fiscal targets were made mandatory initially through Memoranda of Understanding (MOUs) and later through Fiscal Responsibility Legislations. The transfer of grants and debt relief by the Finance Commissions were made conditional on these. Studies (Isaac and Ramakumar 2006) indicate that the Central devolution to the States fell during this period. The imposition of VAT based on rate harmonisation instead of one based on floor rates to reduce tax competition and attempts to introduce Goods and Services Tax (GST) .³² which will involve the restructuring of the taxing powers of the Centre and the States also took place during this period. Broadly, this can be called a period during which centripetal tendencies in fiscal policy gathered strength³³.

While the demand for a higher share in devolution will have considerable force in a scenario in which parties with State specific political base share power at the Centre, the problem of *inter se* distribution of taxes and grants will evade consensus. It is felt that in the interests of equity as well as for a healthy existence of a federal polity, ad hoc discretions need to be eliminated and devolution be based on objective and transparent criteria. Devolving a higher share will not in itself take care of this. Waxing influence of State based parties at the national level may also not result in this because, greater influence can

be used for getting State specific packages, which are ad hoc and discretionary³⁴. Though in the recent Lok Sabha elections, there appears to be a reverse trend, it is too early to assume that the centrifugal tendencies have ebbed leading to another era of political centralism.

This paper only intends to bring forth a few main aspects in this regard as Centre-State fiscal relations, with discretionary devolution of resources, is substantially determined by the political background. The province of this paper does not extend to an in-depth analysis of this. But there is enough scope for further study on political aspects of resource distribution, especially, discretionary ones.

9. Highlights in lieu of Conclusion

The study analyses and finds that the impact of tax devolution to the States had a more equalising impact than that of distribution of grants³⁵. There is considerable discretionary element in the latter while the former is criteria based.

The paper suggests avoiding multiple criteria for tax devolution and change in a criteria for disbursement of General Purpose grants from the present gap filling to ones taking into consideration emergent and specific needs of the States. Differing fiscal capacities can be taken care of through tax devolution. The share of States in tax devolution needs to be higher for ensuring that the States are not at a disadvantage due to restructuring of the grants.

The negative use of grants for achieving a target of deficit indicators have been questioned on the basis of Constitutional validity (See Bagchi 2008, Isaac and Chakraborty, 2008) as well as on its impact on the means to achieve these indicators. Instead, incentive grants in a positive manner for achieving better own revenue effort can be considered. They need not emphasise on deficits which can be achieved by cutting expenditure without augmenting revenue. These incentive grants will be for revenue led fiscal consolidation instead of a mere deficit reduction³⁶.

The present design of Centrally Sponsored Schemes needs to be restructured by transferring existing schemes with the funds to the States. In future, instead of having schemes with uniform criteria throughout, specific schemes with criteria suiting the local needs can be made part of State plans and funds provided by the Centre on monitorable basis.

To attempt restructuring of tax devolution and grant distribution among States in a country like India in the present circumstances is an arduous and a politically tantalising task. Nevertheless, it needs to be discussed and attempted.

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APPENDIX

Criteria for Tax Devolution

We examine various combinations of Population and Distance as criteria for devolution aimed at tackling Horizontal imbalances. Distance is the gap of the per capita income of a State from the average of the highest three States. (We have considered the figures of per capita income of States given in the report of the Twelfth Finance Commission, which is the average as on 2001-02).

Either Distance or Population alone is not sufficient and devolution aimed at augmenting fiscal capacity for providing minimum services to the citizens should include Distance and Population and the computations show that Distance should have more weightage in the interest of equity. The shares of the group of High, Middle, Low income States do not differ much when 1971 and 2001 population are used but the shares of States like Kerala and Tamil Nadu go down when 2001 population is used.

The shares of the High, Middle and Low income States based on alternative combinations are shown below. Though Population used as sole criteria offers a higher share to the groups, States with lesser fiscal capacity get a lesser rank in devolution than the States with higher fiscal capacity. To balance, a criterion with both Population and Distance seems to be a better one.

A) 100 percent Distance

Bihar	5.83
Uttar Pradesh	5.02
Orissa	4.94
Madhya Pradesh	4.54
Rajasthan	4.21
West Bengal	3.77
Andhra Pradesh	3.49
Karnataka	3.14
Tamil Nadu	2.78
Kerala	2.74
Haryana	2.08
Punjab	2.08
Maharashtra	2.08
Gujarat	2.76

B) 100 Percent Population

State	Share 1971 Population	State	Share 2001 Population
Uttar Pradesh	15.68	Uttar Pradesh	16.34
Maharashtra	9.43	Maharashtra	9.53
West Bengal	8.29	West Bengal	8.47
Andhra Pradesh	8.14	Bihar	8.16
Bihar	7.88	Andhra Pradesh	7.49
Tamil Nadu	7.78	Tamil Nadu	6.14
Madhya Pradesh	5.61	Madhya Pradesh	5.93
Gujarat	5	Rajasthan	5.55
Rajasthan	4.83	Karnataka	5.11
Orissa	4.1	Gujarat	4.98
Kerala	3.99	Orissa	3.62
Karnataka	3.8	Kerala	3.13
Punjab	2.54	Punjab	2.4
Haryana	1.87	Haryana	2.07

When Population is used as a single criterion, we find States with higher per capita incomes like Maharashtra, West Bengal and Andhra Pradesh getting more share than Bihar, the lowest Per capita income State. Southern States of Kerala and Tamil Nadu which have done better in Population control and health indicators get a better share when 1971 population is used.

C) 50 Percent Distance and 50 Percent Population

State	Based on 1971 Population	State	Based on 2001 Population
Uttar Pradesh	10.35	Uttar Pradesh	10.68
Bihar	6.86	Bihar	7
West Bengal	6.03	West Bengal	6.12
Andhra Pradesh	5.81	Maharashtra	5.8
Maharashtra	5.76	Andhra Pradesh	5.49
Tamil Nadu	5.28	Madhya Pradesh	5.23
Madhya Pradesh	5.08	Rajasthan	4.88
Orissa	4.52	Tamil Nadu	4.46
Rajasthan	4.52	Orissa	4.28
Gujarat	3.88	Karnataka	4.13
Karnataka	3.47	Gujarat	3.87
Kerala	3.36	Kerala	2.93
Punjab	2.31	Punjab	2.24
Haryana	1.98	Haryana	2.08

D) 75 percent Distance 25 percent Population

State	Based on 1971 Population	State	Based on 2001 Population
Uttar Pradesh	7.69	Uttar Pradesh	7.85
Bihar	6.35	Bihar	6.42
West Bengal	4.9	West Bengal	4.95
Madhya Pradesh	4.81	Madhya Pradesh	4.89
Orissa	4.73	Orissa	4.61
Andhra Pradesh	4.65	Rajasthan	4.55
Rajasthan	4.37	Andhra Pradesh	4.49
Tamil Nadu	4.03	Maharashtra	3.94
Maharashtra	3.92	Karnataka	3.63
Gujarat	3.32	Tamil Nadu	3.62
Karnataka	3.3	Gujarat	3.31
Kerala	3.05	Kerala	2.83
Punjab	2.2	Punjab	2.16
Haryana	2.03	Haryana	2.08

Distance is the gap between the per capita income of the State from the average of the three highest per capita income States. The share D_i of a State is its Distance divided by the sum of the Distances. The share of highest three States is the notional Distance between their per capita income and that of the fourth State. The computation is based on the methodology adopted by the Twelfth Finance Commission. Share based on Population is the share of the Population of the respective State in total Population.

Notes

- 1 Though the report of the Ninth Finance Commission discussed the methodology for making normative estimates, subsequent Commissions have not disclosed how they arrived at normative estimates. This has been criticised by States like Kerala.
- 2 The latest year for which comparable accounts figure of receipts and expenditure is available is 2006-07. For the later years, only budget estimates and revised estimates are available which are not directly comparable with accounts.
- 3 Corporation tax and Personal income tax are elastic taxes and they are levied by the Centre rather than the States as the bases are mobile and State level taxes on these can lead to shifting of tax bases and resulting inefficient impacts. The necessity for Union to levy these rather buoyant taxes results in Vertical imbalances in fiscal distribution of powers between the Union and the States.
- 4 The Plan assistance from the Centre to Special Category States is divided in the ratio of 90 :10 between grants and loans and 70:30 between loans and grants for other States. The Twelfth Finance Commission recommended doing away with Central loans and it has been accepted.
- 5 See Vithal and Sastry (2001) for a discussion
- 6 Article 368 deals with amending the provisions of the Constitution. For some of the amendments to come into effect, it requires ratification of more than half of the legislatures. For altering the divisible pool of taxes to be shared between the Centre and the States, this is not required.
- 7 Finance Commissions till the Fourth did not make the distinction between plan and non-plan grants. After that, all Finance Commissions, except the Ninth, were distributing only non-Plan grants. Plan grants and other grants by various Ministries are granted under Article 282 of the Constitution which is a provision for Miscellaneous Financial Powers.
- 8 For a discussion, see Vittal and Sastry (2002).
- 9 Many other indices like inequality, poverty ratio, human development indices etc. can be factored in for considering which States are similarly placed. But as per traditional principles of devolution States with higher per capita incomes can mobilise resources for providing a level of services which will in turn address the above mentioned issues. For want of another comparable measure, Gross Domestic Product (GSDP) is used. See the Report of the Twelfth Finance Commission for a discussion. For suggestions of an alternative base, see Kannan and Hari (2002).
- 10 The States in the High, Middle and Low Income Group as per the categorisation in the text have not changed during the entire time period.

- 11 The Finance Ministers of all the States have jointly represented to the Centre that 50 percent of the tax revenue of the Centre be devolved to the States.
- 12 There is a view that if collection is not used as a criterion, there will be discontent among States from whose territory more Central taxes are collected. Kurian (2008). But the aim of devolution is not rewarding collection. It is meant for attempting to equalise fiscal capacities so that all States are able to provide a minimum level of services.
- 13 For details of criteria for devolution from First Finance Commission onwards, see www.fincomindia.com
- 14 The Terms of Reference of the Twelfth and Thirteenth Finance Commission suggest that where ever Population is used as a criterion, it will be 1971 population. The Report of the Twelfth Finance Commission has not made any mention whether it has used 1971 population or not.
- 15 This aspect, that is, of perverse incentives, in which States with relatively poorer bases exploiting the same better to achieve a higher tax effort getting a lesser share than richer States with a poorer tax effort, is a separate area requiring detailed analysis, into which we are not venturing into.
- 16 It is to be taken note of that the recommendations of the Eleventh Finance Commission drew protests from the Middle income States like Andhra Pradesh.
- 17 The gap in the non- Plan Revenue account is also called Balance from Current Revenues (BCR). This is the gap between Revenue receipts net of plan grants and non plan revenue expenditure.
- 18 The gap filling role has been criticised as fiscal dentistry by some commentators. Resources for Plans comprise Additional Resource Mobilisation (ARM), loans and grants. If there is a deficit in non-Plan revenue account, most of the resources will go to meeting this. This will adversely affect Plan spending and future outlay.
- 19 See the report of the Ninth Finance Commission for a discussion on the Constitutional issues in making grants under Article 282 in a substantial manner.
- 20 The disaggregate picture is analysed from 1999-91 to 2006-07. The time period is long enough to get an idea of the impact of Centrally Sponsored Schemes and State Plan grants as there has been no substantial change in their distribution criteria.
- 21 There is a view that the richer States have intra State inequality and this should be taken care of while devolving resources like taxes and distributing grants for Centrally Sponsored Schemes. The example of Maharashtra with inequality between Mumbai and other districts is cited as an example. While this reason can be to an extent acceptable for grants, which use backwardness criteria of districts, it is not acceptable for tax devolution as the overall fiscal capacity has to be seen. A State with more overall fiscal capacity cannot get

more share because there is intra-State inequality. This has to be tackled through other schemes including ones in State plans.

- 22 This is the view of State governments like Kerala.
- 23 The view is based on the proposition that distribution should be a national priority and differential distributive policies at the provincial level will lead to inter-provincial migration which will have consequent impact on tax compliance.
- 24 Buoyancy is measured as the ratio of the rate of growth of Own tax revenue and the Gross Domestic Product of the State, which is the tax base. This captures both automatic response to income as well as discretionary changes. But there needs to be some weighting of the tax base by its inverse so that States with a poorer tax base and exploit it better will get a better weightage,
- 25 As regards other criteria like area, it can be eliminated if grants can take care of problems of large States with backward districts on an accepted norm. The incentive criteria like fiscal discipline and tax effort can be made basis for devolution of additional grants on States achieving certain targets.
- 26 The grants devolved for filling gaps in the non-Plan revenue deficit can act as a perverse incentive on own tax effort and also result in boosting expenditure. When we tested the association between the impact of devolution of taxes and grants and own tax effort of the States, using Fixed Effects Model in panel Data Regression, it was seen that the association is having negative sign and is statistically significant in the case of grants and statistically insignificant in the case of taxes. We also find that the association between own tax effort and total devolution is negative and statistically significant.
- 27 Grants are decided in absolute amounts and grants recommended under Article 275 are charged expenditure from Consolidated Fund of India. Tax devolution is decided as a percentage and is subject to the increase and decrease in tax revenue of the Centre. While recommending higher devolution of taxes in place of Article 275 grants, this has to be kept in mind.
- 28 This includes the Shiromani Akali Dal in Punjab which passed the Anantapur Sahib Resolution in 1973 calling for limiting the Centre's power to Defence, Foreign Affairs and Communications and the Dravida Munnetra Kazhagam (DMK) in Tamil Nadu which appointed the Rajamannar Committee on Centre State relations in the early 1970s.
- 29 See Partha Chateerjee (1997) for a detailed discussion
- 30 Under this Article, President's Rule could be imposed in a State by the Centre based on the recommendation of the Governor or otherwise.
- 31 We are not discussing the separatist movements with fissiparous tendencies. These movements like the ones in Punjab and Assam by and large subsided during the 1990s.

- 32 The suggestion to introduce Goods and Services Tax was proposed by the Kelkar Task Force on indirect taxes. The recommendation was to have 20 percent rate on Goods and Services, out of which 12 percent will be the share of the Centre and 8 percent will be the share of the State. Services are in the Union List, but the Centre can notify certain Services to be taxed by the States. The redistribution of powers between the Centre and the State on GST coming into being is not yet clear. The Thirteenth Finance Commission can make an attempt to lay down a roadmap for GST after discussion with the Centre and the States. Lack of clarity on the GST will make the recommendations for devolution of taxes rather irrelevant in the context of the post-GST situation.
- 33 In the Indian context, the Centripetal tendencies in the fiscal area are not perceptible in ratios like increase in Centre's share in total revenue collected or increase in Centre's share of expenditure as can be seen in the case of European countries (See Mueller 2002, Lee (1994) for a discussion). The Centripetal tendencies however can be easily discerned from the trends in tax reforms, conditionalities imposed in devolution and prevalence of discretionary grants.
- 34 At the time of writing the earlier version of this paper, the voting of the Fifth phase of the Lok Sabha Election 2009 had concluded and exit polls predicted a fractured mandate. This galvanised the moves for post poll alliances mainly aimed at parties with strong regional bases. There were demands for special State package as a quid pro quo for support and this was readily agreed upon by parties. It is a fact that it came from a low per capita income state but such demands coming from a rich State also could find acceptance depending on numbers required for a majority. The special packages make devolution of resources highly discretionary and result in asymmetric federalism. (Asymmetric federalism in India is the title of a paper written by M. Govinda Rao and Nirvikar Singh recently). The poll results were more decisive than expected and such demands did not come to the forefront. With multiple parties in power in the States and the Centre still having coalition government with parties having local aspirations foremost, it cannot be stated that centrifugal tendencies in the polity have been reversed, though they *prima facie*, appear to be stymied for the present.
- 35 When Panel Data Regression was run using Fixed Effects Model, it was seen that for both taxes and grants, the relationship between the share of a respective State (being the dependent variable) and the per capita GSDP (representing the fiscal capacity being the independent variable), was negative and statistically significant at 1 percent level. But the value of the coefficient in both the cases was very low. The R^2 was 0.95 for tax devolution and 0.78 for grant devolution. The State-wise and State-group-wise analysis reveal a clearer picture and hence this is used in the study.
- 36 The Finance Minister of Kerala Dr. T.M. Thomas Isaac in his maiden budget speech of 2006 emphasised on revenue led fiscal consolidation. This has been advocated in preference to a fiscal correction based on expenditure cut by the Kelkar Task Force on implementation of the FRBM Act

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