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Instilling Cooperation in Turbulent Times:
Some Issues before the 16th Finance Commission

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ABSTRACT

The geopolitical situation globally and in the immediate neighborhood, as well as the domestic fault lines that have been magnified by the recent Indian national elections, provide a context to the paper. As the 16th Finance Commission begins its deliberations, this paper underlines the crucial need, going forward, to instill co-operation between the three tiers of government in the Indian federation. We believe that a rules-based cooperative federalism, explicitly recognized and accepted by all players, will provide an appropriate institutional architecture for tackling many of the problems and challenges that India faces. Carrying out a few computational exercises, we propose that focusing on fiscal space available to state governments would be better than focusing on revenue deficits that has been the case so far, and suggest a few measures of fiscal space too. The instrument of incentives introduced by the various Finance Commissions to elicit co-operation from states and local bodies are critically discussed. We urge the 16th FC to strengthen this aspect. Empowering the third-tier of government, we believe, will give the much needed fillip to co-operative federalism. For this we recommend that the good work done by the earlier FCs be continued, using a quasi-formulaic approach in working out the magnitude of the fund flow. Finally, recognizing the importance of climate change in the future, we suggest a tweak in the treatment of Ecology while designing incentives for state and local governments.

JEL Classification: H5, H72, H77

Keywords: Fiscal federalism, Cooperative federalism, Indian federation, Indian Finance Commissions, Fiscal space, Incentive grants, 73rd and 74th Constitutional Amendments, Third tier of government, Urbanization

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1. Preamble:

The institution of the Finance Commission of India (FC), as envisaged by Article 280 of the Indian Constitution (Government of India, undated), has performed remarkably well over the last seven decades and has been one of the pillars of the Constitution. In terms of its essential duties and functions (as laid down in Article 280(3)), there is not much that is fundamentally different that can be attempted that would distinctively move away from the well-trodden path that has been laid down by the earlier FCs, right from the First FC which submitted its report in 1952 (Finance Commission, undated-a). Yet some efforts towards narrative resetting may be attempted by the Sixteenth FC (Finance Commission, undated-b) that would be particularly relevant to India at the current conjuncture. This is particularly true because the terms of reference for FC16 are minimal and, hence, leave space for creative play in its award (Ministry of Finance, 2023).

India is at the cusp of its economic and political journey, given the geopolitical situation globally, not to talk of turmoil in the immediate neighborhood, as well as the domestic fault lines that have been magnified by the recent Indian elections to the 18th Lok Sabha. The results of the Lok Sabha elections have revealed a fractured mandate that has thrown up challenges for a disciplined, single-minded, and stable agenda while, at the same time, relieving us of the worrisome burden of the ill effects of majoritarianism. As FC16 begins its deliberations, it cannot but take cognizance of these political developments which are likely to give substantial voice to the states of India and, potentially, open a major source of conflict. Any hope of smooth sailing for India over the next few years must further underline the identification of **cooperative federalism** as a major prerequisite and, hence, is a continually recurring theme of our paper.

Growth imperative needs to be recognized as a primary goal even though other big issues, such as unemployment, inflation, socio-economic vulnerability, and strife, not to mention climate change, need to be addressed and managed. However, without growth and the tax dividend it yields, dealing with these issues through a well-designed expenditure programme will turn out to be a chimera of sorts. Indeed, FCs cannot do it all and will need narrowly defined objectives to deal with.

We believe that cooperative federalism, explicitly recognized and accepted by all players, will provide a via media for tackling many of the problems and challenges that India faces. Fundamentally, we focus on cooperative federalism as an instrumentality for India to move forward. Keeping an eye on growth is essential as we try to suggest a few intervention points in the arenas of incentives and performance grants, fiscal capacity, and urban management. A few nudges here from the FC would go a long way in meaningfully ushering in cooperative federalism. Our view of cooperative federalism will go beyond the simple English language meaning of the word and we will emphasize its rules-based and institutional dimension. However, meaningful signals will go a long way to eliciting cooperation from the actors involved. The Centre could signal its good intentions by behaving statesman-like and giving up more to the states (Agarwal, Felman, Reji, Subramanian, 2024) and local bodies than might be warranted by the rules that are in place. A good signal will be to continue to increase the devolution percentage like a good elder

statesman. In doing so incrementalism should be adopted (even over the FC period) to avoid major fiscal shock to the Centre and let the States shore up absorptive capacity thereby avoid falling into the trap of the flypaper effect or the Dutch disease. Another good signal could be to scrap all surcharges and cesses which are, at the moment, not part of the divisible pool of revenues and kept by the central government (Ramakumar, 2024). In a reply to an unstarred question (no. 4268) on 27 March 2023, the Ministry of Finance reported that surcharges collected Rs. 173249.99 crore (2022-23 RE) and cesses collected Rs. 355320.01 crore (2022-23 RE) (Digital Sansad, 2023). The total of these collections of Rs. 528570 crore was as high as 22% of the total revenue receipts of Rs. 2348412.79 crore (2023-24 RE). If it is not feasible to scrap all cesses and surcharges because of the large collection of revenues under this head, the FC must nudge the Centre to add this (or a large proportion of this) to funds to be devolved to show camaraderie and as a first step towards signaling the move towards cooperative federalism. If this is difficult and requires a constitutional amendment, the cesses and surcharges could be converted into a sum (*a la* FC13 w.r.t. local body grants) and added to the grant corpus. In short, FC16 should find all possible ways through their recommendations to nudge the strengthening of cooperative federalism.

The current paper is organized as follows. Section 1 is the preamble where we set the context of the paper and flag the focus of this paper. Section 2 deals with the concept of cooperative federalism in general and particularly in the context of India. We also try to persuade the reader as to why, going forward. this is an important concept for India. Section 3 analyses the concept of fiscal space and suggests ways in which the FC could operationalize it and use it as an intervention point. Section 4 deals with the treatment of incentives and performance indicators by the earlier FCs in a nuanced manner, trying to argue how FCs can pursue this road whilst helping nudge the Indian state(s) towards cooperative federalism. In section 5, we touch on the third tier of government but focus only on the urban local bodies, wherein we argue that better and legitimate empowerment of Urban Local Bodies (ULB) will help secure a cooperative federal structure by tying the three tiers in an integral fashion. In section 6 we flag the elephant in the room viz., Climate & Ecology, and conclude.

2. Understanding Co-operative Federalism

A variety of terms have been employed to describe the nature of the relations between the Central/Union/Federal government and sub-national governments, such as state governments. Such terms are dual federalism, cooperative federalism, and coercive federalism (Kincaid, 1990; Zimmerman, 2001). In the Indian context, the most detailed discussion of cooperative federalism is available in the Report of the 14th Finance Commission. However, no description of cooperative federalism is given, and the word is used in the sense of the English language meaning of the term i.e. the Central and state governments are enjoined to cooperate with one another in order to achieve some desirable objectives. In the Indian case, we would wish to transition from ‘holding together’ to the ‘coming together’ type of cooperative federalism. Kincaid (2023) explains that “holding together” federations, while specifying the powers of the constituent governments, leave residual powers to the federal government; on the other hand, “coming together” federations

specify the exclusive and concurrent powers of the federation and leave residual powers to the constituent states.

2.1 Economic Case for Federalism

To get a sense of the issues involved, we should examine the basis of federalism from the point of view of economics. There are various reasons why the government of a country needs to intervene in a market economy. The primary reason for this is market failure which compromises the efficiency of a market economy. The market failure that we refer to stems from the presence of public goods which involve a varying extent of spillovers or externalities. Economic federalism is seen as the task of solving this problem of spillovers at the lowest cost and at the most appropriate level of government. Oates's (1972) decentralization theorem provides a formal statement of this principle. Inman and Rubinfeld (2014) note that economic efficiency demands the identification of the best level of government to manage government functions while balancing the costs and benefits of decentralized and centralized political structures.

The economic argument for federalism can begin at the most decentralized level, namely, the local government since that is where citizens experience the functioning of a government most acutely. Inman and Rubinfeld (2014) invoke the Tiebout model of a "marketplace" of competitive local governments providing a combination of public goods and public services. Individuals "vote with their feet" and select the jurisdiction that provides their most desired set of public goods and services at the most affordable "prices" (i.e. taxes). Of course, the Tiebout model comes with its set of assumptions, the most critical of which is the absence of inter-jurisdictional spillovers. Violation of this assumption opens the door for intervention from a higher-level government.

The problem of spillovers stems from the characteristic of public goods which may exhibit a range of spillovers from no spillovers across jurisdictions to extensive inter-jurisdictional spillovers. The absence of spillovers leads us to local public goods that Tiebout spoke about while inter-jurisdictional spillovers are common for pure public goods that Samuelson (1955) wrote about. The appropriate assignment of responsibilities to provide such goods is related to Oates's decentralization theorem or the European Union principle of subsidiarity. The assignment of responsibility to a governance level must ensure that the service is provided with the least economic spillover to a neighbouring jurisdiction (Inman and Rubinfeld, 1994, 2014). The application of this principle allows the following distribution of functions to different levels of government.

(a) National governments are best suited to perform the following functions: national defense, foreign affairs, telecommunications networks, ports and airports, public health, and macroeconomic stabilization among others. This assignment works best either due to reasons of economies of scale or due to spillovers across jurisdictions.
(b) Lower-level governments are best suited for functions such as education, fire and police protection, health care, sanitation, and taxation of immobile factors among others. This

assignment works best because the benefits of these functions can be internalized within the jurisdictions[5].

Maintaining this strict division of responsibilities leads to what has been called dual federalism (Bader, 2014). A strict adherence to dual federalism implies that the two levels of government exercise their sovereignty independently of each other in view of the economic rationale for their functioning. But as Kincaid (2017) notes dual federalism can accommodate cooperation between the levels of governments because they "cannot practically operate in separate watertight compartments". Cooperative federalism emerges as the compromise between dual federalism with equal sovereignty to the different levels of governments and coercive federalism where the central government dominates. Under cooperative federalism, all jurisdictions come together to provide public goods taking into account scale economies and internalizing spillovers (Inman and Rubinfeld, 2014). The interaction between the various governments represents a Coasian bargaining solution to providing public goods and limiting spillovers. It should be recognized that, as in the case of the Tiebout model discussed above, the Coasian solution may not emerge due to significant transaction costs. As already noted in footnote 1 with respect to lower-level governments, the term dual needs to be interpreted as a tripartite system that the Indian constitution validates. The current tendency of legacy overhang and treatment of local bodies as their 'own creatures' could be negated by the FC empowering the third-tier of government, via true decentralization and bringing it into the overall fold to strengthen the agenda of cooperative federalism.

As our discussion has shown most approaches to federalism take the narrative of decentralization forward but have a significant flaw, which makes their operationalization problematic. The economic case of federalism stumbles due to the assumptions of the Tiebout model (Inman and Rubinfeld, 2014). Cooperative federalism must tackle the problem of transaction costs, which are an inevitable part of the Coasian bargaining solution. Dual federalism, in which different levels of government operate independently of each other, runs into a problem due to the need for cooperation in the provision of public goods that involve spillovers. And, finally, coercive federalism strikes at the very root of decentralized decision-making thereby compromising economic efficiency. One final consideration needs to be introduced to round off this discussion. This is to recognize the political economy dimension of federalism.

The challenge in designing any federal structure is ensuring that the division of functions, while economically efficient, is also politically feasible. Sreenivasan and Walleck (2004) point out that the economic case for federalism as discussed above modelled central governments as benevolent

[5] The term "lower-level governments" should include multiple lower levels of government. There is nothing in Oates's theorem which restricts to only two levels of government. India, till 1992, had only two levels of government – national and states – but the 73rd and 74th Constitutional Amendments gave official recognition to Panchayat Raj Institutions and Urban Local Bodies.

social planners. A politico-economics approach to federalism moves away from the assumption of central governments as "omniscient social planners" and the assumption of subnational governments acting to maximize social welfare within their jurisdiction (Sreenivasan and Wallack, 2004). Overcoming the challenge of self-interested local government officials could set up incentives for the intrusion of the central government. This is especially likely where the inability or unwillingness of local governments to provide citizens with a socially desirable basket of public goods compromises the welfare of their citizens. Such situations may weaken the cooperative approach and may deteriorate into coercive federalism (Kincaid, 1990) where the higher-level government intervenes to provide a specified minimum standard of certain public services that should ideally be available to people, irrespective of where they reside.

2.2 The Indian Situation

The Indian context is clearly different from that in the USA where cooperative federalism, as a dilution of dual federalism, is understood "…to mean a system of divided sovereignty whereby the federal government exercises delegated powers independently of the states and state governments exercise reserved powers independently of the federal government" (Kincaid, 2017). Unlike in the USA, the Indian federation did not involve the coming together of independent states. If that were the case, Indian states would have enjoyed more autonomy which is perhaps why the Indian constitution does not refer to the country as a federation but as a union of states (Adeney, 2003). Many factors – the role of the Governor, the ability of the Parliament to change the boundaries and status of a state, and the power to devolve funds to the state – make the Indian federation very centralist with a strong centripetal bias.

The Report of the 14th Finance Commission (Finance Commission of India, undated-a), in its discussion of cooperative federalism, takes as its starting point the three lists of the Seventh schedule of the Indian Constitution (Government of India, Ministry of Law and Justice, undated, pp. 310-324). Items in the Central List are the exclusive domain of the Central government. The entries in the State List specify the functional domains of the states while many of the functions in the Concurrent List have traditionally been undertaken by the states and are in their area of responsibility. It may be noted that, despite the 73rd and 74th Constitutional Amendment Acts, we do not have a separate list for the third tier although we do have 11th and 12th schedules (Government of India, Ministry of Law and Justice, undated, pp. 349-350) which list out functions to be devolved. While it is not possible to classify all the functions in the lists based on their public goods characteristic, a rationale may be attempted (while accepting that some of the items in the lists need a re-look[6]):

[6] The lists need updating to include issues that have become relevant over the years. For instance, the list makes no reference to the environment or pollution. Water is referred to in the context of waterways and rivers but there is little regarding aquifers which may cross state boundaries.

Central List: covers public goods that are national, the so-called pure public goods, e.g. national defense, ports, airports, citizenship, national highways, currency & coinage, foreign exchange, etc.

State List: Covers (not pure) public goods which bestow benefits bounded by the boundaries of the state e.g. education, health, agriculture, public order, etc.

Concurrent List: Covers public goods whose benefits spill over state boundaries, e.g. Protection of wild animals and birds, prevention of the extension from one state to another of infectious or contagious diseases, interstate water distribution/disputes, etc.

Apart from the public goods characteristics, the division of functions is based on domain expertise, and information availability to the relevant level of government. The central government is best suited to provide goods where a one-size-fits-all approach works well but, where diversity of requirements is involved, the state governments are best suited to provide such goods (Oates's decentralization theorem). Of course, if Oates's decentralization theorem is to be understood in its true spirit, it is important to bear in mind that even state governments need to devolve or delegate responsibility and functions to local governments. Indeed, this would be in consonance with the idea that functions, finances, and functionaries (3Fs), adequately devolved at the local levels, would be in keeping with the true spirit of decentralization (Ministry of Panchayati Raj, 2022).

The cooperative federalism that we propose must be rules-based and the rules must take their rationale from the three lists of functions. Can there be exceptions to this? What if the states are rogue and do not provide the minimum quantum of public goods to their citizens? The Report of the 14th Commission has alluded to this possibility when it reports the views of the Union government on cooperative federalism: "The Ministry further highlighted the responsibility of the Union Government to make interventions, through programmes and schemes, for…ensuring specified minimum standards of services in sectors of national priority" (p.160). Kincaid (1990) refers to this as well when he quotes Jane Perry Clark "Cooperation offers means for determination of how far uniformity and a national minimum in the federal government may exist side by side with opportunities for experimentation by and within the states" (p. 141).[7]

What we must guard against is the usurpation of the functions in the state list under the pretext of "minimum standards of services". The deterioration of cooperative federalism into coercive federalism or, at least, intrusive federalism is a danger that India might have to guard against as the central government reaches over state governments to provide subsidized private goods to citizens of states. This is where conflicts may emerge, and it is important to have a dispute settlement mechanism. Future Finance Commissions need to observe the division of responsibilities envisaged in the three lists and eliminate any encroachment of the central government into the domain of the state governments. This sits well with the provisions of the Indian constitution as well as the economic theory of decentralization. The particular

[7] Of course, in cooperative federalism, such interventions must not be strict agency transfers but must have space for adaptability and flexibility in design and application at the decentralised level.

characteristics of the Indian federal system must be kept in mind here: tax bases available for taxation start to dwindle as one looks at lower levels of government (especially, the third tier). Consequently, the impaired financial capacity of these governments comes to the fore and the FCs may have to nudge state governments to transfer resources to the third tier.

3. Fiscal Space: Definitions and Measurement

The ability of state governments to perform their functions in the context of cooperative federalism requires that they have the fiscal space to do so and, more importantly, this fiscal space improves over time to allow states to fulfill their expanding role. Finance Commissions have an important role to play in ensuring that the fiscal space available to states expands over the tenure of each FC. Successive FCs have been doing this through expanding devolution from the divisible pool of tax collections. However, it is equally important that FCs nudge state governments through incentives to expand their fiscal space by improving their own revenue collection. We will be looking at these incentives in the next section but before that, we examine the fiscal space of state governments.

The earliest definition of the term fiscal space is available in Heller (2005): "Fiscal space can be defined as the availability of budgetary room that allows a government to provide resources for a desired purpose without any prejudice to the sustainability of a government's financial position". The issue of fiscal sustainability is important in this definition of fiscal space. It means that the government has the capacity to finance its desired expenditure programs, service any debt obligations (including those that may arise if the created fiscal space arises from government borrowing), and ensure its solvency.

The exact definition and understanding of fiscal space in the literature is elusive. One can identify two views:

Short-term Stability View

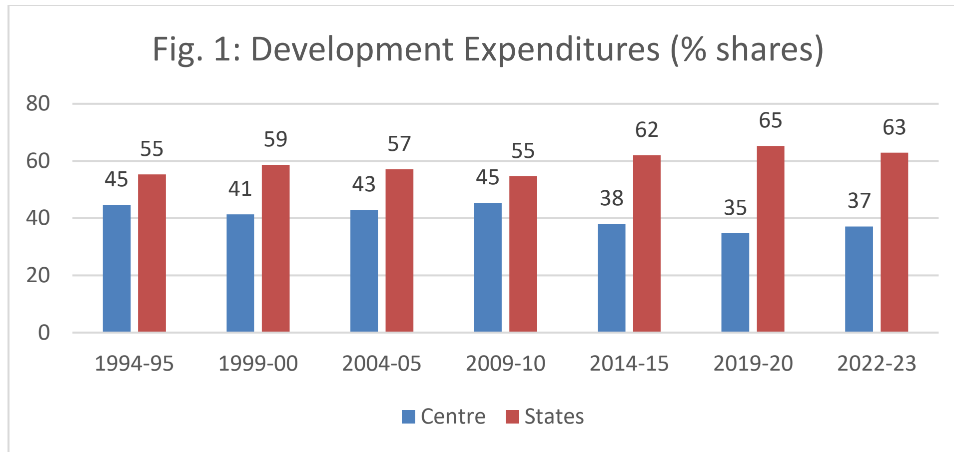
Ostry et al. (2010) defines fiscal space as the difference between the debt limit and current debt. Park (2012) employs a (standard neoclassical) model to generate a Laffer curve of public revenues. He defines fiscal space as the distance between current tax revenues and the peak of the Laffer curve (i.e. the maximum tax revenues possible). Schick (2009, 2010) defines fiscal space as the financial resources available to the government for fiscal policy, namely growth-enhancing investment in physical and human capital that governments can finance with borrowed funds without prejudicing the long-run sustainability of its fiscal position. Marcel (2013) states that fiscal space has been defined for developed countries as "the difference between the current level of public debt and the debt limit implied by the country's historical record of fiscal adjustment". Nerlich and Reuter (2015) define fiscal space as the difference between a so-called debt limit beyond which (without extraordinary measures) debt would be unsustainable, and the current debt level. Kose et al. (2017) define fiscal space as "the ability of a government to service its debt".

It should be remembered that borrowing by Indian state governments is always under scrutiny by the central government as per Article 293 of the Indian constitution. The power of the states to borrow is limited to within the territory of India. Further, state governments may not borrow more if there is any outstanding loan from the central government. A controversial issue has arisen in the context of the 2018 amendment to the FRBM Act of 2003. The amendment "incorporated the concept of "General Government Debt" which the Act defined as the sum total of debts of the Central Government and the state Governments, excluding inter-governmental liabilities" (Comptroller and Auditor General of India, 2021, chapter 3, p. 36). A limit of 60% of GDP for the general government debt was set, of which 40% was the limit for central government debt (Comptroller and Auditor General of India, 2021, Chapter 3, p. 36). While we do not go any deeper into this issue, it is important to point out its significance in the context of cooperative federalism that we have discussed above.

Long-term Developmental View

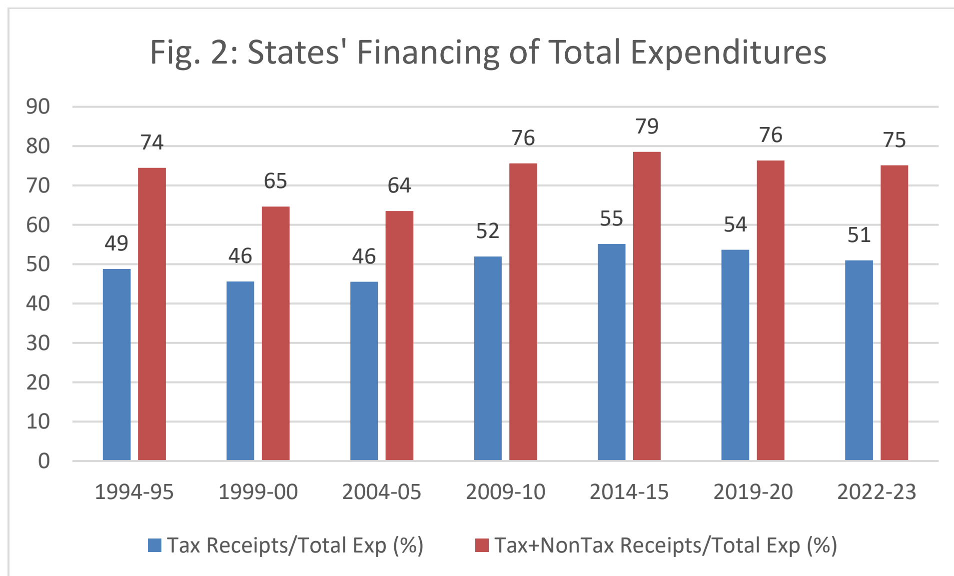
Roy et al. (2007) point out that Heller's (2005) definition and the Development Committee's (2006) definition are concerned with raising incremental resources for development. The emphasis is on short-term macroeconomic stability. They further point out that a focus on short-term macroeconomic stability is not an adequate basis for assessing the availability of fiscal space for low and middle-income countries that are engaged in significant development transformations, aimed at securing long-term human development and economic growth. Fiscal space is the financing that is available to the government as a result of concrete policy actions for enhancing resource mobilization and the reforms necessary to secure the enabling governance, institutional and economic environment for these policy actions to be effective for a specified set of development objectives (Roy et al., 2007).

If raising resources for development purposes is important for assessing fiscal space, we need to have a look at which level of government in India is burdened with greater responsibility for development. Oomen (2015), writing in the Indian context, but focusing on all three levels of government, correctly points out that the "Indian federation has a built-in bias in favour of the Union with great vertical imbalances in the resources and responsibilities at the state level and a local government with an amorphous functional domain and weak fiscal space". It is well-known that over the years, much of the responsibility for development expenditures has increasingly shifted to the states, as seen in Figure 1.



Source: Computed from Table 107 of the Handbook of Statistics of the Indian Economy, 2022-23

The states' share in developmental expenditures has increased by eight percentage points from 55% to 63% over the past quarter century. The critical question is whether a state's own revenue performance has improved over the years to cover its development expenditures. Figure 2 shows the trends.



Source: Computed from Tables 100 and 107 of the Handbook of Statistics of the Indian Economy, 2022-23

Excluding the years 1999-00 and 2004-05, the ratio of states' own tax receipts to total expenditure has hovered around the 50% mark, and the ratio of states' own total receipts (Tax plus non-tax) to total expenditure has remained around the 75% mark. No clear discernible trend is visible, but a rough measure of states' fiscal space (as measured based on their own revenue receipts) has not shown significant improvement over the last quarter century.

3.1 Measurement of Fiscal Space

We would like to note that Finance Commissions have not placed any emphasis on the idea of fiscal space in determining grants to state governments. The measure of choice for the FCs has been revenue deficits. Should states face revenue deficits post-devolution, FCs provide for a revenue deficit grant. Of course, this creates incentives for "bad" behavior or a moral hazard problem. Hence, the question arises whether revenue deficit grants are justified. Should revenue deficit grants be provided to states that use borrowings to meet their revenue expenditures (Bhaskar, 2018)? Further, the FRBM Act of 2003 had recommended that states should phase out revenue deficits by 2008-09 but the number of states receiving revenue deficit grants has been increasing (Ganguli and Sinha, 2024).

The problem with revenue deficits and revenue deficit grants is that there is no way for the FCs to know if states are providing a minimum level of public goods or services to their citizens. This is because, in the computation of revenue deficits, revenue expenditures include both the committed and discretionary (development-oriented) expenditures of state governments. It is quite possible for committed expenditures of state governments to squeeze out discretionary expenditures even while revenue deficits are brought down to zero. Hence, it is important to employ a measure that is insulated from the encroachment of committed expenditures. It is in this context that we discuss fiscal space and recommend that FCs also use this measure to evaluate state government expenditures. In passing, it may be noted that the Presidential order setting up FC15 had suggested that "The Commission may also examine whether revenue deficit grants be provided at all" (Finance Commission, 2020, Annex 1.1).

Even though the term 'fiscal space' has been bandied about a lot in the literature, there is no precise and unique definition. As Wyplosz (2020) cautioned, the concept of fiscal space, although potentially helpful, is unlikely ever to deliver a single number upon which policymakers can rely for framing policies. Despite this caution, we would like to state that it may be more meaningful to examine the finances of state governments from the point of view of fiscal space rather than revenue deficits as has been the approach in all Finance Commissions so far. In our discussion of fiscal space, we separate discretionary expenditures from total expenditures and this will allow us to examine how much leeway a state government has in meeting the expenditures which may be required for the development of the state.

Kose et al. (2017) discuss a variety of indicators of fiscal space which they categorize into four broad areas: government debt sustainability, balance sheet composition, external and private sector debt, and market perception of sovereign risk. Even though they accept that there is no single definition, a core aspect of fiscal space is "the ability of a government to service its debt". Since our objective is to obtain a quantitative measure of fiscal space that can be easily computed and

interpreted, we adapt the indicators listed under government debt sustainability by Kose et. al. (2017).[8]

We are concerned with measuring the fiscal space of states in the context of the Finance Commissions' devolutions to states in India. Hence, the resources that make up the fiscal resources available to the states include (a) revenues that the states themselves raise, the states' own tax revenues and states' own non-tax revenues, (b) the revenues that devolve to the states from the total taxes that go into the divisible pool of taxes. Given the mismatch between the expenditure responsibilities of the states and the tax bases available to them, it is to be expected that their own fiscal resources will be insufficient. There is also the issue of the differential ability of states to raise their own taxes, which brings about differential horizontal devolution of taxes.

Bearing all of the above in mind, we wish to ask whether the states' fiscal space has improved over the various Finance Commissions considering only their own tax resources. If this improvement is discernible, we could claim that the Finance Commissions have set up incentives for the states to improve their own revenue collection performance and that their dependence on the Central government for tax shares has declined over the years. It is, of course, accepted that no state is likely to be completely free from the dependence on the vertical devolution of taxes.

Our measures of fiscal space focus on state governments' discretionary expenditures which are understood as expenditures net of committed expenditures. Committed expenditures of state governments, employing the definition of the Reserve Bank of India (Reserve Bank of India, 2023 p. 10), are measured as expenditures on administration, interest payments, and pensions. ***Hence, focusing on the revenue account of the budget, we will define discretionary expenditures as revenue expenditures minus committed expenditures.***

3.2 Fiscal Space for Discretionary Spending

If the Fiscal Responsibility Legislations of the states are strictly adhered to, then revenue deficits will be eliminated, and any revenue account surplus could be used for developmental capital expenditures. Hence, we would like to examine if the non-capital resources of state governments can cover their discretionary (but development-oriented) expenditures.

The non-capital fiscal resources for the state governments will consist of two parts:

1. states' own tax and non-tax revenues
2. Devolutions from the central government

Our measure of Fiscal Space is initially operationalized in two ways:

[8] For the sake of completeness, we list out the measures of Kose et al. (2017) under debt sustainability: General government gross debt, % of GDP; Primary balance, % of GDP; Cyclically-adjusted balance, % of potential GDP; Fiscal balance, % of GDP; General government gross debt, % of average tax revenues; Fiscal balance, % of average tax revenues; General government gross debt, % of 10-year moving average GDP

$$Fiscal\ Space\ 1: FS1 = \frac{Non-capital\ fiscal\ resources\ excluding\ devolution}{Total\ Revenue\ Expenditure - Committed\ Expenditure\ including\ Pensions} \dots (1)$$

$$Fiscal\ Space\ 2: FS2 = \frac{Non-capital\ fiscal\ resources\ including\ devolution}{Total\ Revenue\ Expenditure - Committed\ Expenditure\ including\ Pensions} \dots (2)$$

Table 1 presents our computation of FS1 (based on equation 1). The columns of the table are organized FC-wise and the entry for each state's FS1 is averaged over the years of the FC. For example, the value of 85.12% for Andhra Pradesh for FC9 is the average of the ratios for FS1 over the years 1990-91 to 1994-95.

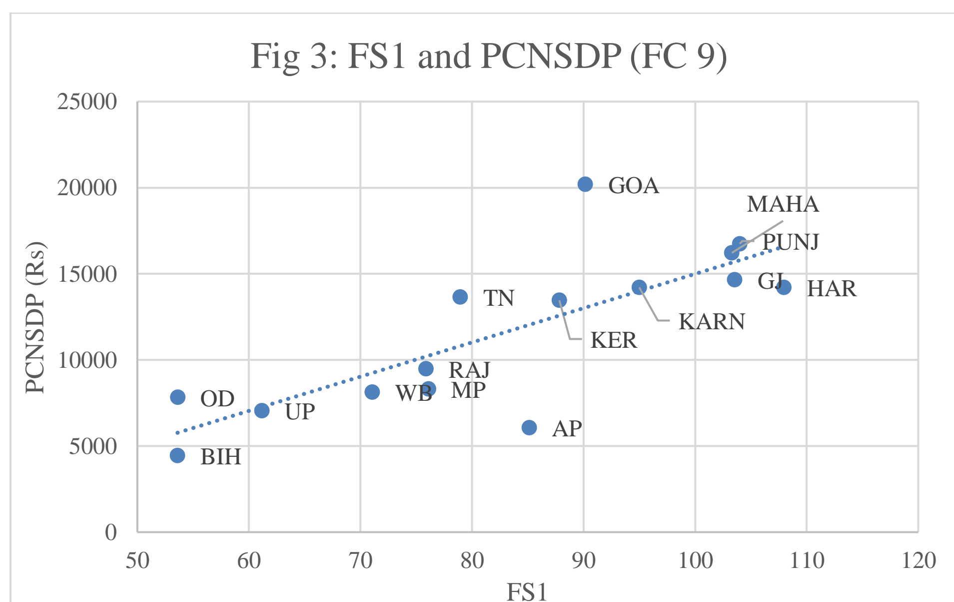
Table 1: Fiscal Space 1 (percent)

State	FC9	FC10	FC11	FC12	FC13	FC14	FC15
Andhra Pradesh (AP)	85.12	81.33	96.55	101.70	95.30	64.66	63.95
Bihar (BIH)	53.60	56.46	45.65	40.00	46.43	42.47	33.28
Chhatisgarh (CHATIS)	-	-	84.43	88.83	78.99	60.64	65.77
Goa (GOA)	90.16	102.74	109.50	121.03	117.32	98.63	93.35
Gujarat (GJ)	103.55	99.65	94.23	115.37	121.61	109.57	99.22
Haryana (HAR)	107.96	98.87	126.19	117.09	103.38	93.44	95.43
Jharkhand (JH)	-	-	70.25	65.69	75.12	64.28	68.35
Karnataka (KARN)	94.99	95.57	99.51	105.03	99.44	86.47	89.91
Kerala (KER)	87.83	91.33	96.38	102.92	93.22	95.22	80.82
Madhya Pradesh (MP)	76.11	74.19	77.04	84.73	79.92	58.74	57.54
Maharashtra (MAHA)	103.29	102.04	98.64	119.61	112.43	103.60	91.98
Odisha (OD)	53.62	50.77	67.05	79.41	78.98	68.31	92.22
Punjab (PUNJ)	104.00	119.84	113.91	115.20	117.62	107.22	74.61
Rajasthan (RAJ)	75.86	77.47	80.93	89.57	88.40	64.41	62.13
Tamil Nadu (TN)	78.95	92.69	108.04	115.48	108.42	92.15	80.42
Telangana (TEL)	-	-	-	-	94.64	106.87	95.74
Uttar Pradesh (UP)	61.16	62.26	66.12	75.52	76.32	78.67	71.23
Uttarakhand (UT)	-	-	53.22	65.41	69.14	74.99	68.70
West Bengal (WB)	71.06	64.39	68.03	66.81	65.91	61.12	55.14
Average	83.15	84.64	86.43	92.74	90.66	80.60	75.78

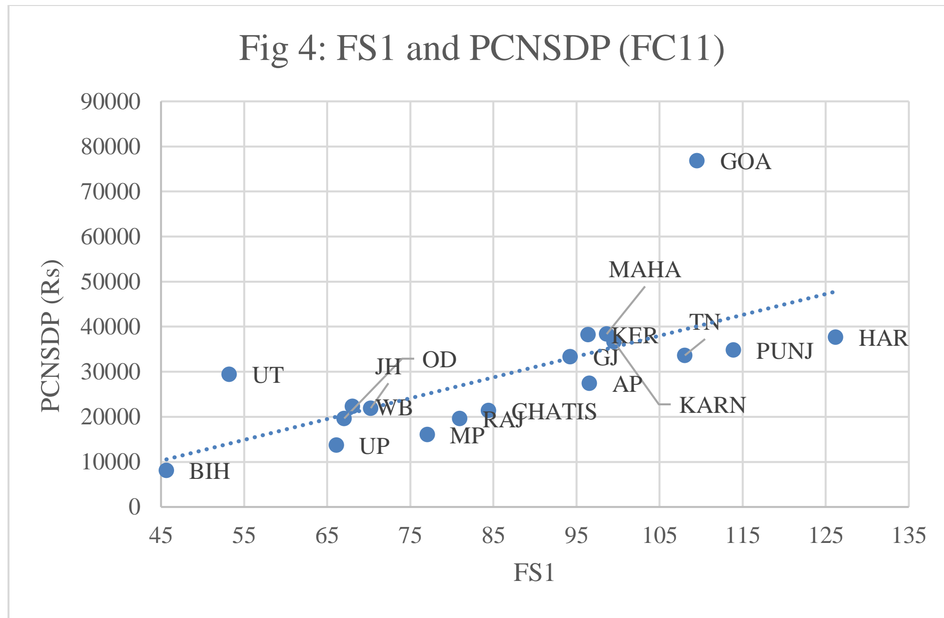
Notes: (1) Computed from Reserve Bank of India (various years) (2) The dates for the various FCs are: FC9: 1990-91 to 1994-95; FC10: 1995-96 to 1999-00; FC11: 2000-01 to 2004-05; FC12: 2005-06 to 2009-10; FC13: 2010-11 to 2014-15; FC14: 2015-16 to 2019-20; FC15: 2020-21 to 2025-06 (3) The period covered for FC15 is only 2020-21 to 2022-23

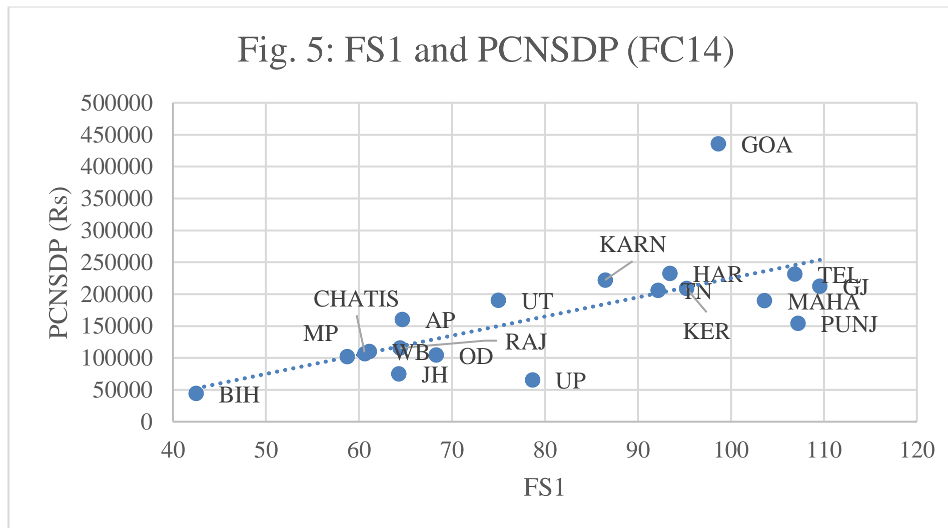
Table 1, which is based on equation (1), considers only the revenue receipts raised by the states (i.e. it excludes resources available to the state via devolutions from the central government). The important dividing line in Table 1 is the value of 100% which indicates that the own resources of the states are sufficient to cover their discretionary expenditures. Values less than 100% indicate insufficient fiscal space to meet discretionary expenditures while values above 100% indicate more than adequate fiscal space to meet discretionary expenditures. The number of entries that are less than 100% is substantially more than those which are greater. Among the better performing states, which clearly have more fiscal space than the others are Goa, Gujarat, Haryana, Maharashtra, and Punjab. States which have poor fiscal space include Bihar, Jharkhand, Madhya Pradesh, Uttar Pradesh, Uttarakhand and West Bengal. The last row of the table reports averages of the states for each FC period. As can be seen, the average for all states is less than 100% indicating insufficient fiscal space though, like all averages, the values hide substantial variation among the states.

A cursory look at Table 1 seems to suggest that the better off states (Goa, Gujarat, among others) seem to have a larger fiscal space as compared to the relatively poorer states. The question arises whether fiscal space improves with levels of income. We try to examine this by presenting a scatter plot of FS1 for each state against the Per Capita NSDP (PCNSDP) of the state. We have done this for each FC but report it for only a few since the scatter plots are quite similar



Note: The abbreviations for the states are listed in column 1 of Table 1





All the scatter plots show a positive relationship between fiscal space and per capita NSDP showing that the richer a state the more fiscal space it has to cover its discretionary expenditures. Consequently, it is inevitable that the FC compensates the poorer states for their inability to provide for their discretionary expenditures which are required to cater to the welfare of the citizens of these states. Table 2 reports for Fiscal Space 2.

Table 2: Fiscal Space 2 (percent)

State	FC9	FC10	FC11	FC12	FC13	FC14	FC15
Andhra Pradesh	133.1	127.8	140.5	150.2	138.0	122.5	124.8
Bihar	132.2	144.4	166.6	179.3	167.0	156.5	130.0
Chhatisgarh	-	-	140.4	156.5	137.1	129.5	132.3
Goa	140.0	121.2	123.2	144.1	143.4	139.7	145.6

Gujarat	128.8	124.5	119.7	153.1	154.5	154.5	144.2
Haryana	128.8	116.0	144.5	141.7	127.7	121.6	124.9
Jharkhand	-	-	148.7	143.7	160.0	153.5	153.4
Karnataka	130.3	129.2	134.8	146.4	136.5	132.4	129.7
Kerala	131.7	127.0	130.7	144.0	123.4	137.6	133.1
Madhya Pradesh	130.7	122.3	133.0	162.2	149.0	132.6	129.8
Maharashtra	130.1	123.1	115.3	152.1	142.6	139.6	132.5
Odisha	133.5	117.5	148.6	173.4	157.7	151.8	160.8
Punjab	128.9	142.0	130.4	145.0	152.2	161.6	142.7
Rajasthan	135.5	126.0	137.1	153.9	145.7	119.7	117.4
Tamil Nadu	113.3	124.4	141.0	157.0	143.3	131.9	120.5
Telangana	-	-	-	-	135.2	147.1	129.1
Uttar Pradesh	128.0	123.1	131.5	159.6	157.7	163.1	166.4
Uttarakhand	-	-	124.9	150.5	143.8	152.2	166.9
West Bengal	125.5	113.5	127.4	133.5	134.7	140.5	130.4
AVERAGE	**130.0**	**125.5**	**135.5**	**152.6**	**144.7**	**141.5**	**137.6**

Entries in Table 2 are based on equation (2) and it can be seen that, when devolutions from the Centre are added to the revenues raised by the state government, the discretionary revenue expenditures of the state government are fully covered by the revenue account resources available to the states. Every ratio in the table is more than 100%. The fact that all entries in Table 2 are more than 100% shows that the lack of fiscal space is more than compensated for by devolutions from the Centre. However, given the differing levels of development of the states, a clear differential approach is evident in the devolutions that different states receive.

We carry out a comparison of the devolutions received by the better-off and the not-so-better-off states. Considering Bihar and West Bengal as examples of the latter group, we compute their average FS1 (from Table 1) and average FS2 (from Table 2) over all the FCs. For Bihar, the average increases from 45% to 154%, an increase of 108 percentage points while for West Bengal the average increases from 64% to 129%, an increase of 65 percentage points. Considering Maharashtra and Tamil Nadu as examples of better-off states, Maharashtra's average increases from 105% to 134% (an increase of just 29 percentage points) while that of Tamil Nadu increases from 97% to 133% (an increase of 37 percentage points). It cannot be doubted that worse-off states need more support than the better-off states but how much more support is to be provided is a debatable and contentious issue. The preferential treatment of the worse-off states is inevitable due to the formulas being used for devolution which involve an equity component and a compensatory grant component. While it is clear that the lack of fiscal space of the worse-off states needs to be improved and brought on par with that of the better-off states, overcompensating them is likely to create misgivings among the latter. Further, this overcompensation is to be guarded against since it sets up incentives for the poorly performing states to be lax in their efforts to raise their own resources. There is, clearly, a moral hazard problem due to asymmetric information since only the states are fully informed about the efforts they have made to raise their own resources.

3.3 Fiscal Space and Development Expenditures

Having looked at fiscal space in the context of discretionary expenditures, we now operationalize it considering Development Expenditures instead of discretionary expenditures. Our rationale for this switch is that state governments are expected to provide a certain minimum level of services to their citizens so that a guaranteed level of services is available across all states in India. This will be captured by considering development expenditures.

Development expenditures on the revenue account include the following:

A. Social Services such as education, medical and public health, family welfare, housing, urban development, welfare of SC/ST and other backward classes, and nutrition among a few others.
B. Economic Services such as agriculture and allied activities, rural development, special areas programme, flood control, energy, industry, transport and communication, science and technology and environment.

To make the switch from discretionary to development expenditures, we modify Equations (1) and (2) as follows:

$$Fiscal\ Space\ 3: FS3 = \frac{Non-capital\ fiscal\ resources\ excluding\ devolution}{Development\ Expenditures\ on\ Revenue\ Account} \ldots (3)$$

$$Fiscal\ Space\ 4: FS4 = \frac{Non-capital\ fiscal\ resources\ including\ devolution}{Development\ Expenditures\ on\ Revenue\ Account} \ldots (4)$$

Table 3 reports results based on equation (3).

Table 3: Fiscal Space 3 (percent)

State	FC9	FC10	FC11	FC12	FC13	FC14	FC15
Andhra Pradesh	89.97	85.70	102.30	106.81	99.18	66.48	65.18
Bihar	57.25	60.46	48.74	42.08	48.86	44.06	34.37
Chhatisgarh			94.02	99.81	85.86	64.67	69.53
Goa	92.54	150.72	140.23	125.75	121.61	108.73	96.88
Gujarat	107.12	103.78	98.80	124.64	126.10	113.07	102.81
Haryana	144.54	140.65	142.97	124.25	107.92	96.93	99.03
Jharkhand			73.69	68.32	78.16	66.28	71.16
Karnataka	105.54	106.08	115.52	120.04	111.69	94.40	98.96
Kerala	97.40	100.90	105.50	131.14	130.80	126.84	108.54
Madhya Pradesh	83.13	82.05	87.78	101.76	94.02	66.04	64.07
Maharashtra	114.14	118.68	125.07	134.06	120.54	119.01	107.85
Odisha	57.47	56.38	91.80	84.58	77.88	86.06	69.54
Punjab	126.76	136.60	165.37	164.89	134.18	119.92	89.97
Rajasthan	84.00	86.46	86.35	94.38	92.84	66.81	64.34

Tamil Nadu	84.62	103.80	125.55	137.42	128.80	107.47	93.32
Telangana					98.18	110.24	97.60
Uttar Pradesh	73.91	75.22	81.30	94.31	96.01	93.90	80.83
Uttarakhand			59.24	73.99	83.87	84.97	78.13
West Bengal	77.96	70.28	74.28	72.39	69.90	63.67	56.94
AVERAGE	**93.09**	**98.52**	**101.03**	**105.59**	**100.34**	**89.45**	**81.53**

The results of Table 3 show that the states of Goa, Gujarat, Haryana, Karnataka, Kerala, Maharashtra, Punjab, and Tamil Nadu seem to have ample fiscal space to cover their development expenditures. On the other hand, the states of Bihar, Jharkhand, Orissa, Uttar Pradesh, Uttarakhand, and West Bengal are lagging. The latter states clearly require the support of devolutions to bring them to a minimum standard of providing for development expenditures. We show this in Table 4 which is based on equation (4)

Table 4: Fiscal Space 4 (percent)

State	FC9	FC10	FC11	FC12	FC13	FC14	FC15
Andhra Pradesh	140.68	134.61	148.82	157.71	143.54	125.95	127.24
Bihar	141.23	154.66	177.96	188.50	175.84	162.30	134.29
Chhatisgarh			156.24	175.86	148.97	138.05	139.92
Goa	143.65	177.85	157.48	149.68	148.67	153.74	151.17
Gujarat	133.19	129.62	125.56	165.40	160.26	159.44	149.28
Haryana	170.80	164.58	163.74	150.34	133.36	126.10	129.64
Jharkhand			155.93	149.51	166.47	158.30	159.69
Karnataka	144.81	143.40	156.22	167.18	153.26	144.54	142.76
Kerala	146.02	140.36	143.06	183.40	172.92	183.40	178.00
Madhya Pradesh	142.74	135.22	151.31	194.82	175.28	149.05	144.55
Maharashtra	143.80	143.23	146.21	170.48	152.86	160.42	155.24
Odisha	136.82	131.20	196.70	182.70	161.90	169.01	151.76
Punjab	155.67	161.75	189.19	207.48	173.31	181.09	172.22
Rajasthan	149.99	140.34	146.31	162.11	152.98	124.15	121.54
Tamil Nadu	121.44	139.29	163.84	186.80	170.21	153.91	139.81
Telangana					140.24	151.68	131.57
Uttar Pradesh	154.53	148.58	161.76	199.17	198.45	195.18	188.78
Uttarakhand			138.82	170.25	173.60	172.47	189.79
West Bengal	137.69	123.86	139.09	144.66	142.84	146.43	134.66
AVERAGE	**144.21**	**144.57**	**156.57**	**172.56**	**160.26**	**155.54**	**149.57**

We now see from Table 4 that there is an increase in the fiscal space for all states as compared to Table 3. In fact, there is over-compensation as we had seen in Table 2. It is understandable that

some states, such as Bihar, may need to be overcompensated given their limited capacity to raise taxes. However, the extent of this overcompensation needs to be such that it does not destroy the incentives to raise its own revenues (the danger of the flypaper effect and Dutch disease again!). Some of the laggard states of Table 3, now have ratios that substantially exceed those of the better-performing states. The problem of moral hazard that we had mentioned in the context of Table 2 is relevant here as well.

One caveat that needs to be borne in mind when interpreting the results of Tables 3 and 4 is that the ratios can cover "bad behavior" by states. If the ratios in the tables rise due to an increase in the numerator (that is, an increase in non-capital fiscal resources) while keeping the denominator (that is, development expenditures) constant (or increasing) then that is obviously for the betterment of the state's fiscal capacity while simultaneously ensuring that the provision of services to the citizens of the states is not compromised. However, the ratios in the above tables can also be increased by reducing the denominator which needs guarding against. Has that been happening? We examine this in Table 5 where we report the ratios of development expenditures on revenue account to total expenditures (revenue expenditures + capital outlay + loans).

Table 5: Development Expenditures/Total Expenditures (DE/TE) (%)

State	FC9	FC10	FC11	FC12	FC13	FC14	FC15
Andhra Pradesh	57.15	55.58	49.86	51.87	58.43	60.27	60.66
Bihar	55.86	52.68	43.23	47.31	50.93	55.00	59.88
Chhatisgarh			54.42	53.47	59.88	63.47	61.86
Goa	56.46	48.15	50.90	54.01	58.22	56.69	54.24
Gujarat	57.69	57.50	54.40	48.52	51.05	52.84	54.72
Haryana	50.79	46.47	48.46	56.35	58.69	52.89	55.04
Jharkhand			48.90	48.93	52.52	53.10	55.13
Karnataka	55.09	56.38	50.68	51.46	54.96	57.25	51.95
Kerala	54.08	52.43	49.27	43.25	43.85	42.11	41.44
Madhya Pradesh	58.79	58.09	50.04	44.55	49.31	56.55	55.03
Maharashtra	56.84	52.60	47.27	49.45	56.12	54.36	52.43
Odisha	54.59	48.99	43.68	54.18	56.90	55.61	51.98
Punjab	47.38	44.67	36.90	37.64	45.12	37.95	43.19
Rajasthan	52.57	48.93	47.89	50.69	57.04	56.95	61.79
Tamil Nadu	64.97	56.52	48.14	46.63	48.30	48.59	50.34
Telangana					60.13	50.60	55.33
Uttar Pradesh	48.27	46.02	42.75	41.41	44.02	45.40	45.86
Uttarakhand			55.80	47.28	49.18	46.26	46.72
West Bengal	56.61	50.12	41.95	47.06	52.40	55.40	57.11
AVERAGE	**55.14**	**51.68**	**48.03**	**48.56**	**53.00**	**52.70**	**53.41**

A mixed picture emerges from Table 5. Andhra Pradesh seems to show a gradual increase over the FCs but some states show a clear worsening of the ratio. See, for example, Kerala, Punjab, and Uttar Pradesh.

To get a sense of how the ratios have behaved, we estimated a dummy variables regression of DE/TE on a time trend and with dummies for each state except Andhra Pradesh. By excluding Andhra Pradesh, we make it the reference group and the intercept of the equation becomes the coefficient for Andhra Pradesh. The equation we estimate has the following specification:

$$\frac{DE}{TE} = \beta_0 + \beta_1 BIH + \beta_2 CHATIS + \beta_3 GOA + \beta_4 GJ + \beta_5 HAR + \beta_6 JH + \beta_7 KARN + \beta_8 KER + \beta_9 MP + \beta_{10} MAHA + \beta_{11} OD + \beta_{12} PUNJ + \beta_{13} RAJ + \beta_{14} TN + \beta_{15} TEL + \beta_{16} UP + \beta_{17} UT + \beta_{18} WB + \delta TREND + \varepsilon \ldots (5)$$

Each state name (abbreviations listed in Table 6) is a dummy variable, taking values 1 and 0 for the relevant state. The coefficient β_0 is the intercept and is associated with the state without a dummy variable (Andhra Pradesh). The reference regression is given by:

$$E(\frac{DE}{TE}) = \beta_0 + \delta TREND, when\ BIH = CHATIS = \cdots WB = 0 \qquad \ldots (6)$$

For a particular state, say Bihar, the equation will be given by:

$$E(\frac{DE}{TE}) = \beta_0 + \beta_1 BIH + \delta TREND, when\ BIH = 1\ and\ all\ other\ dummy\ variables = 0 \ldots (7)$$

Since BIH=1, the above equation simplifies to:

$$E(\frac{DE}{TE}) = (\beta_0 + \beta_1) + \delta TREND \qquad \ldots (8)$$

The intercept for the Bihar equation is given by (β_0+β_1). This intercept will be higher or lower than β_0 (coefficient of Andhra Pradesh, the reference group) depending on the sign of β_1. Table 6 reports the results of equation (5).

Table 6: Dummy Variables Regression

Variable	**Coeff.**	**Std. Error**
Intercept (Andhra Pradesh)	56.01***	1.89
Bihar (BIH)	-4.13*	2.40
Chhatisgarh (CHATIS)	2.30	2.63
Goa (GOA)	-2.16	2.40
Gujarat (GJ)	-2.44	2.40
Haryana (HAR)	-3.59	2.40

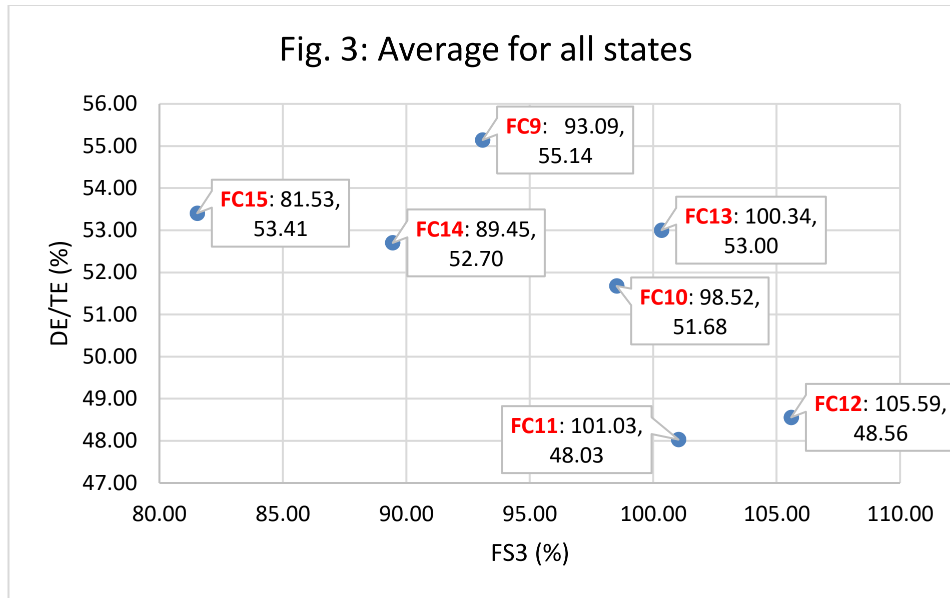
Jharkhand (JH)	-4.61*	2.63
Karnataka (KARN)	-2.29	2.40
Kerala (KER)	-9.63***	2.40
Madhya Pradesh (MP)	-3.07	2.40
Maharashtra (MAHA)	-3.54	2.40
Odisha (OD)	-3.98	2.40
Punjab (PUNJ)	-14.42***	2.40
Rajasthan (RAJ)	-2.57	2.40
Tamil Nadu (TN)	-4.33*	2.40
Telangana (TEL)	-1.03	3.12
Uttar Pradesh (UP)	-11.44***	2.40
Uttarakhand (UT)	-7.27**	2.63
West Bengal (WB)	-4.74*	2.40
TREND	0.06	0.21
Note: ***=Significant at 1%; **= Significant at 5%; *= Significant at 10*		

As an example, for Bihar, equation (8) above may be written as:

$$E\left(\frac{DE}{TE}\right) = (56.01 - 4.13) + 0.06TREND = 51.88 + 0.06TREND$$

The coefficient of TREND is not significant indicating that there has been no improvement or worsening of DE/TE over the various FCs. Most of the state dummies are non-significant except for Bihar, Jharkhand, Tamil Nadu, and West Bengal (all negative and significant at 10%); Uttarakhand (negative and significant at 5%); and Kerala, Punjab, and Uttar Pradesh (all negative and significant at 1%). Barring the states mentioned (especially the last three), we can conclude from these exercises that the DE/TE ratio has not worsened for the other states so that the increase or stability in fiscal space that is seen in Table 3 is due to improvement or stability in own revenue collection.

As a final exercise, we create a scatter plot of the average of FS3 for all states for each FC (the values in the last row of Table 3) against the average of DE/TE for all states for each FC (the values in the last row of Table 5). The purpose of this scatter plot is to examine whether FS3 (which shows the ability of state governments to meet development expenditures from their own revenues) rises due to a fall in development expenditures. Figure 3 reports this scatter plot.



Note: The first number in each box for each FC is the average FS3 and the second number is DE/TE(%)

Figure 3 shows a weak negative relation between FS3 and DE/TE. A high value of FS3 during FC11 and FC12 is associated with a relatively low DE/TE as compared to FC14 and FC15 when FS3 was lower and DE/TE was higher.

3.4 Summary of the Discussion on Fiscal Space

This section was concerned with examining whether FCs have been able to incentivize the Indian states to raise their own revenue resources and thereby expand their fiscal space. Why was this important? In the context of cooperative federalism:

(a) It is important that states can raise their own revenues so as to cover their discretionary expenditures as well as their development expenditures. This will allow them to carry out the responsibilities that are imposed on them via the items in the States List of the Indian Constitution. If they have such adequate fiscal space, the states will be able to provide a certain minimum level of public goods and services to their citizens on their own steam

(b) It is also inevitable that in a federation the performance of states is not uniform, and some states need the support of devolutions to meet their discretionary as well as development expenditures. Given that some states might have much lower fiscal capacity, they might have to be over-compensated to enable their citizens to enjoy adequate public goods and services.

Our broad conclusion is that barring Goa, Gujarat, Maharashtra and Punjab, most states have not been able to cover their discretionary expenditures when we exclude devolutions from the revenues

of the states (Table 1). After including the devolutions from the Centre, we have found that all states have enough revenue resources to meet their discretionary expenditures (Table 2). We find that the ratios of some of the poorly performing states exceed those of the better-performing states. This is not unexpected since some of the poorly performing states may not have the capacity to raise sufficient resources and some amount of overcompensation may be expected. The disconcerting picture is that there does not seem to be a trend towards improvement over the various FCs. As earlier noted, it is possible that devolutions from the Centre create a flypaper effect reducing the incentives of states to raise their own resources.

We have also sought to situate our discussion of fiscal space in the context of development expenditures of the state. This is of vital importance if all Indians are to receive a certain minimum level of public services irrespective of which state they reside in. Once again, we find that there is a clear partition between the better-performing and poorly-performing states (Table 3). We also found some extent of over-compensation to the poorly performing states. Our final exercise in this context was to examine if there has been an improvement in the ratio of DE/TE over the various FCs. The picture is mixed with some states showing a gradual improvement over the years while some have regressed in their provision of development expenditures. We would therefore urge FC16 to consider fiscal capacity rather than some normative level of revenue deficits in computing fund flows to States. Of course, a nuanced fiscal space-based measure will have to be thought of with some ingenuity that would bring some about equivalency across States.

4. An Instrument of Co-operative Federalism: Performance-based Incentive Grants

The discussion of the previous section has pointed out that some states may be lacking in their fiscal space when we exclude devolutions from the central government. If state government finances are to be set on an even keel (which will include reducing revenue deficits to zero), states must improve their own performance. While it is true that in the Indian federation, there will be vertical imbalances and devolutions will be required to sustain the finances of state governments, over-dependence on the central government must reduce over time. If cooperative federalism is to flourish, states must have the wherewithal to bear the burden of providing public goods that fall in their domain. We now turn our attention to the issue of how state governments can be encouraged to improve their own revenue performance.

Currently, most of the efforts by FCs via grants to nudge improvement of own revenues are directed at local level governments rather than focusing on the states directly. At the state level, performance-based transfers have been via small weights being assigned in the devolution formula. The weight assigned to performance criteria in the devolution formula in the form of tax effort or fiscal discipline has ranged between a low of 0% under FC14 and a maximum of 17.5% under

FC13 (Finance Commission of India, 2009). FC15 (Finance Commission of India, 2020) shifted its focus to performance-based grants but brought down the weight of the performance criteria in tax devolution to 2.5%. We believe that incorporating the performance criteria in both, the tax devolution formula and the grant component, is important to further the spirit of cooperative federalism, where states are equal partners and are expected to perform efficiently. We would urge FC16 to raise the weight of performance criteria in the tax devolution formula.

The other component of transfers from Central government viz. intergovernmental grants, are intended to ensure that state and local governments do not fall short of resources for public goods. Federal governments use grants of both the lump sum and matching varieties for this purpose. The matching variety grants are politically and fiscally advantageous for federal governments as it allows them to offload some of the cost on state and local governments and implementation is done by the state and local governments too. They, however, create a fiscal illusion, which benefits the federal government more than the state and local governments (Kincaid, 2017). Lump sum grants are observed to have a stimulatory effect that is greater than an equivalent increase in income, a phenomenon popularly known as flypaper effect. Empirical evidence suggests the presence of flypaper effect in India (Karnik and Lalvani, 2005, 2008; Lalvani, 2002). However, little do the state and local governments realize that these grants tend to create ratchets in public spending i.e. programmmes once instituted become hard to discontinue. In fact, some federal grants are given with the intention that states will pick up the funding of the programme in the future (Sobel and Crowley, 2014).

Federal governments can use the tool of intergovernmental grants to induce one-way cooperation from state and local governments. A carrot and stick approach could potentially work with grants as it is a channel via which sub-national governments seem to voluntarily permit federal governments to transgress into their jurisdiction since it allows increased spending without taxing their voters and state local governments welcome this (Kincaid, 2017). Such intrusion in a dual federalism context was seen as promoting cooperative federalism when the national government assumed responsibility for difficult lower-level government functions (Kincaid, 1990). India, of course, does not have the clear separation of responsibilities which characterizes dual federalism. In fact, India, with its strong centripetal characteristics, must guard against excessive intrusion by the central government into the domains of lower-level governments.

In order to elicit cooperation from sub-national governments via intergovernmental grants, such grants must account for a sizeable proportion of the state budget (Kincaid, 2017). Traditionally equity has always been, and continues to be the overriding objective of Finance Commission transfers but performance/efficiency-based criteria were introduced by the FC10 (1995-96 to 1999-00) (Finance Commission of India,1995) when a weight of 10% was assigned to fiscal self-reliance, measured by the share of own revenues in total revenue expenditure of a state. Since then, there has been some weight, albeit small, assigned to tax effort and/or fiscal discipline in the tax

devolution criteria. FC12 (2005-06 to 2009-10) (Finance Commission of India, 2004) went one step further and introduced a conditional debt write-off scheme for states, conditional on the states passing Fiscal Responsibility Legislations (FRLs). This scheme was a great success and resulted in a large number of states passing their FRLs after the acceptance of the FC report. It was the success of this scheme that paved the way for introducing conditionalities on states and local governments to make them cooperate and obtain desirable outcomes.

The approach of imposing conditionality on the intergovernmental grants component of FC transfers and using them as instruments to get cooperation from state and local governments was initiated by FC13. This marked a complete change in the design of intergovernmental grants. For the first time, grants were linked to the performance of state governments and intended to incentivize reform in sectors such as water, health, power sector, and governance. Such performance-based incentive grants constituted 19% of the total grants provided for by F13. To encourage further reforms in the water sector the conditionality of establishing a Water Regulatory Authority was imposed on state governments. This conditionality was expected to incentivize the formation of water user associations and decentralize maintenance of water bodies, thereby improving compliance and cost recovery. To improve health sector outcomes, the FC made provision for grants to states which improved their performance and reduced infant mortality rate. The grant was carefully designed so that states would be rewarded for both, improvement in the parameter and the level at which the improvement is made. This was done to ensure that states that were already at a high level and with limited scope for further improvement would not be at a disadvantage. To incentivize greater usage of renewable energy in the power sector, the FC made provision for grants to reward states that showed improved usage of renewable energy. To improve overall governance, the FC made provision of an incentive grant for people below the poverty line who would register for Unique Identification (UID) or the Aadhar Card.

The idea of empowering the third tier of government and getting it to cooperate by instituting conditionality to avail of performance-based incentive grants was a new perspective introduced by FC13. The report spoke of allowing local bodies to benefit from the buoyancy of central taxes by allocating to them a ‘share of the divisible pool’. FC13 introduced a performance grant component that would be available only to those states where local bodies met the nine stipulations listed by the FC. These included governance-related conditions such as making the electronic transfer of local body grants within five days of their receipt; putting in place an audit system for all local bodies; setting up a Property Tax Board to assist all municipalities and municipal corporations in the state to improve revenue collection; setting up an independent ombudsman to address complaints and grievances. The conditions laid down by the FC were all intended to force the hand of the state governments to cooperate and to empower local governments.

The trend of introducing performance-based or incentive grants hit an obstacle with the FC14 (2015-16 to 2019-20) (Finance Commission of India, 2015). This FC pushed back on this incentive-based approach. They made provision for performance-based components for local body

grants (details given in the sub-section 5.2.3 that follows) but there were no performance-based grants provided for states.

The Terms of Reference for the Fifteenth Finance Commission explicitly stated in Para 7 "The Commission may consider proposing measurable performance-based incentives for states, at the appropriate level of government." (Finance Commission of India, 2020[9]). Consequently, FC15 (2020-21 to 2025-26) (Finance Commission of India, 2020) made significant provision for performance-based grants and imposing conditionalities. For the first time, FC15 provided for sector-specific grants that rewarded states for their performance in the social sector specifically, school education, agriculture reforms; self-reliance, exports, and sustainability; aspirational districts and blocks; and power sector reforms. FC15 also attempted to get the local governments to cooperate in bringing about transparency in local body finances with online availability and improvement in air quality and quality of basic services.

While there is no comprehensive study of the impact of these performance-based incentive grants, which would be interesting to investigate separately, we would like to state that rising emphasis on such grants appears to be a step in the right direction. This assertion is based on a few examples of the outcomes of these conditionalities.

One clear example of the positive impact of the eligibility condition imposed by FC15 is the online availability of audited accounts of urban local body (ULB) accounts. It is only because of this conditionality that there is now a website where 3,500 ULBs have so far uploaded their audited accounts[10]. This conditionality of FC15 has for the first time brought ULB accounts into the public domain. Also, the requirement of publishing service level benchmarks by ULBs imposed by the FC14 has made a large number of ULBs put together this data. Its availability in the public domain was not mandated and yet we observe that six states are voluntarily participating in a project and have made available service level benchmarks at the city level[11]. We would like to point out that neither of these websites is user friendly for researchers. However, the fact that ULB-level data are placed in the public domain is a major success and this has been made possible only due to the conditionality imposed by FC15.

At this juncture, we would, however, like to sound a word of caution on the design of incentives based on one specific instance. One of the conditionalities imposed by FC13 was to set up a Property Tax Board in each state by passing the required legislation. FC15 in its state-wise report points out that 17 states have passed the legislation, but this also includes some states where the

[9] vol. II https://fincomindia.nic.in/asset/doc/commission-reports/XV-FC%20-VOL%20II%20Annexes.pdf). p.3 point no. 7.
[10] https://cityfinance.in/home
[11] www.pas.org.in

legislation has been passed but the Board is not functional. The possibility of such tokenism needs to be guarded against when designing performance-based incentive grants.

Another important lesson from this example is that a stock-taking exercise by every Finance Commission to assess the impact of the incentive grants by previous Finance Commissions would help in tweaking and re-designing conditions for such grants. FC15's observations in the case of the Property Tax Board have provided an important input for future Finance Commissions. An element of continuity is very crucial for making this instrument of performance-based incentive grants effective.

The broad picture that emerges, however, is that performance-based incentive grants have by and large succeeded in eliciting cooperation from state and local governments and, further, this has increased their share. We believe that incentive grants can play a very useful role in operationalizing cooperative federalism in the Indian context and the trend towards giving such grants increasing importance should be continued.

Our suggestions for FC16 in this context are listed below.

(a) To continue with the trend of increasing the share of performance-based incentive grants for states and local bodies
(b) To continue with the requirement of online availability of local body finances data as was mandated by FC15. This needs to continue till the system gets institutionalized.
(c) To follow the pattern of FC13 of empowering the third tier of government by considering them as equal partners and allocating to them a share of the divisible pool as is done for states to allow them to benefit from buoyancy in revenues.
(d) To undertake a stock-taking exercise of the impact of performance-based incentive grants given by previous FCs
(e) There should be continuity in the performance-based incentives that are introduced by FC reports. While modifications in the light of experience may be required, especially if the intended outcomes are not realized, continuity in the policy space makes for a more predictable environment for all levels of government.

These measures, if undertaken, we believe, would go a long way in furthering the cause of cooperative federalism.

5. Attempts by the FCs to Tackle the Third Tier

The Finance Commissions over the years – at least in recent times and as mentioned earlier – have all tried different tactics to make the states fall in line with regard to lending credence to 73rd and 74th CAAs but have uniformly failed. All of the FCs concerned with these issues have been quite liberal in interpreting the constitutional provision and have directly done their bit by providing ever-increasing resources to the third-tier government entities, although a strict reading of the constitution did not require them to do so. After all, the FCs are expected to suggest measures for

augmenting the consolidated fund of the state to supplement the resources of the local bodies based on the recommendations of the State Finance Commissions (SFC), without actually and otherwise allocating funds to the Urban Local Bodies (ULB) and the Panchayati Raj Institutions (PRI). Perhaps one could consider penalizing the states where such recommendations are unavailable, but that would mean penalizing the citizens for bad actions by the state. It would be wiser to incentivize those states that create synchronous SFCs and accept the financial recommendations. For the rest, given that the primary theme of this paper identifies a major issue confronting India as being one of ushering in vibrant and meaningful cooperative federalism, we would suggest that the current FC too continues with the efforts of its predecessors with renewed vigor. It would have to use ingenuity in devising nuanced incentives toward empowering the PRIs and ULBs and securing the third tier in the agenda of fostering cooperative federalism. Given the particular party political attritional politics that one is witnessing currently, securing a coalition amongst three entities may be easier than with just two entities taking diametrically opposed positions. A serious nudge here would thus be called for on the part of FC16. Of course, it would have to work out a circuitous strategic route here for, in realpolitik, the problem of traversing the strategic optimal path between two points is rarely a straight line. As an aside and perhaps a bit of non-sequitur, enforcing a bi-cameral structure in all the states will indirectly provide a greater status to the third tier. Of course, FC16 can do precious little about this.

To reiterate, tying up the third tier within the fold of the Indian federal system and empowering it will undoubtedly enable the process of converting the type of federal system from 'holding together' to 'coming together' giving a fillip to the much-needed cooperative federalism in India.

5.1. Empowering the Third Tier of Government:

Our constitution makers saw and shaped India as a union with centripetal bias, advisedly and with good reason (Kelkar and Pethe, 2019). The changing nature of Indian society, economy, and polity has meant that this vision of India requires a revisit. After the initial period of 'Congress Raj' under which the Indian National Congress was in power at the Centre and in most of the states,[12] Indian politics has seen an upsurge of regional political parties with their own agendas and state-level objectives. The domination of the India National Congress at the Centre waned after the national elections of 1985 giving way to coalition governments which continued without a break till 2014 when, once again, a single political party (the Bhartiya Janata Party) has dominated at the Centre for a decade. The national elections of 2024 have again diluted the domination of a single party. During the period of FC16, the centripetal bias will perhaps continue but it will have to be moderated to a great extent, making cooperative federalism imperative. The transformed political structure that FC16 will face – namely, a weakened central government, invigorated state

[12] The first non-Congress state government was formed in Kerala in 1957 (Routray, 2024)

governments, and local governments – perhaps offers the best architecture to usher in cooperative federalism.

In the early 1990s, the passage of 73rd and 74th Constitutional Amendments Acts (CAA) purposefully restructured the Indian federation to comprise three tiers. However, the programme of legally and constitutionally validating the third tier lost its steam right at inception in both the letter and spirit, of the 73rd and 74th CAA. The reasons why this happened are well known and documented (see e.g., Pethe and Lalvani 2008), suffice it to say that decentralization with the key elements of devolution and expenditure autonomy never really materialized, and the chief instrumentality of delivery of the above, viz., State Finance Commission (SFC), was almost universally trivialized.,(Pethe, Misra, and Rakhe, 2009). The SFCs which were to mimic the FC have never been granted that status and, even when set up, their awards (especially related to financial devolution) have hardly ever been accepted. Of course, there has been a fund flow to the third tier but that has been via- ad-hoc grants which smack of political pork barreling. Also, the fattening of budgets has been largely due to agency transfers rather than devolution with essential expenditure autonomy which is the soul of decentralization. At one step removed, this was the result of the states suffering from the legacy overhang and continued to see the PRIs and the ULBs as creatures of their own making rather than autonomous government entities with sanction from the Indian Constitution. Unsurprisingly then, PRIs were used for agency transfers rather than devolution with expenditure autonomy which is the true measure of decentralization. FCs, starting from at least FC12, have tried various ways to remedy the situation but in vain. Mercifully, the FCs have not given up, and nor should they as they must try to think of innovative ways of getting the third tier right, even more so now when, as hinted earlier, securing the partnership of empowered third tier will help in fostering the agenda of cooperative federalism. The issues mentioned above may be categorized as *wicked* problems that would require sustained efforts and angelic patience to solve rather than lazy solutions.

5.2 Urban Concerns

That India is urbanizing rapidly is well known. India's future is clearly urban. Agglomeration and the consequent productivity advantage of urbanization are well documented (See e.g., Shukla, 1995). After contributing overwhelmingly to the national income for several decades, the urban contribution in India appears to have stagnated at around 52% (National Institute of Rural Development & Panchayati Raj (2017-18)). This is a signal that urban spaces in India are in need of better planning and management. Cooperative federalism apart, tackling issues related to urban India in the immediate short run (say the next five years) will be crucial in setting the course for India in her quest to be a developed economy/nation. Of course, a truly developed nation cannot come about without a great deal of organizational and institutional building and strengthening, but that is an issue for another time. This apart, while lack of governance and capacity of all kinds are the usual suspects, one cannot ignore the core fact of lack of resources as a necessary condition to remedy the current malaise. In this context, FC16 should do something to nudge the urban agenda.

5.2.1 Urban Definition

An important first step in addressing urban concerns must deal with the identification and specification of urban India. Given the extant definition, it is clear that it leads to a severe underestimation of the extent of urban spaces in India. This is well documented through the studies of Tandel et. al. (2019) who used night light data to demarcate urban spaces. Lall (2009, 2013) among others was involved with two World Bank Projects over a decade ago. These studies showed that the level of urbanization in India was well over 60%, much greater than that determined by the official municipal boundaries. The above is underlined by two related issues: one, the fastest growing component of the urban spaces in India comprises census towns that continue to be governed/ administered by PRIs, and two, the reluctance by the states to declare many habitations as urban when they are clearly so (Kelkar and Pethe, 2024). The issue of incorrect demarcation of urban spaces is not merely pedantic in that the non-rectification of this matter leads to serious misallocation of resources between rural and urban sectors. Again, as an important aside, with the delimitation exercise looming large (Lahiri, 2022), a correction will lead to many elected representatives representing urban areas and in turn will help bring the urban agenda to the fore and in focus.

Taking the specific example of FC transfers, even if we were to take the total fund flow from FC to local bodies as given, if the 65:35 (rural: urban) division of the corpus were changed to (say) 50:50, more would flow to the urban sector. This would have two consequences: one, it would encourage more states to declare census towns as urban, and two, the additional funds would incrementally empower the ULBs, leading to the possibility of better governance and provisioning of basic local public goods and services. In turn, this will enable them to leverage their improved balance sheets to access larger infrastructure funding leading to growth.

Pethe and Lalvani (2022) have argued that a designated percentage of GST collection should be shared equally by the Centre and states and devolved to the third tier. This is necessitated by the fact that post-GST the revenue handles available with the ULBs have declined drastically. Something similar could be done by FC16 when it decides on the total funds that would flow to the local bodies as grants. Of course, this would be in addition to the usual expansion of flows that FCs recommend for the third tier. Such an act will benefit the agenda of cooperative federalism to be pushed in a couple of ways. One, it will lead to more resources being devolved to the more urban states (and perhaps as an aside incentivize states to declare spaces as urban more realistically). The utility gained thus would more than compensate for the loss suffered by the marginal shrinkage in rural fund flows. Two, empowerment of urban bodies would be partially attained leading them to be able to deliver better, which in turn would help them to contribute positively to the national agenda as equal co-partners in team India.

5.2.2 Formulaic Devolution Plus

The successive FCs have indeed been sending down funds in ever-increasing amounts. While this is welcome, it would be better to send down (largely devolve) the grants as a percentage of, say, the previous year's total fund flow in a quasi-formulaic manner (as was done by FC13). This will ensure buoyancy in the fund flow from the Centre to the states. Indeed, it can do one better and formulaically link up the flow of last year's GST collection. This will be pertinent especially since – as mentioned above – post-GST the third tier has been deprived of almost all its revenue handles except for property tax. The additional benefit of this measure will be that, in case of a business cycle hurdle (low) the fund flow will be reduced to some extent, but the credibility of the Central government (FC) will be intact. Thus, the empowerment of local governments will create a sense of involvement and lend them the status of almost equal co-partners which in turn would help in pushing forward the agenda of cooperative federalism.

As an aside, we may note that apart from FCs, the Centrally Sponsored Schemes (CSSs) have subtly laid down schemes that apply to the urban sector/ space keeping the road map for infusing such schemes whether through ULBs or Urban Development Departments or Developmental Authorities has been unclear. On it's part, even FC15 spoke of metro/ agglomerations as recipients of the grants. This has several implications: one, the institutional and organizational setup to deliver the grants is to be created thus leading to a lag in absorption; two, this detracts from the implicit capacity-building effort on the part of ULBs and leads to the practice of using the consultancy model ushering in the era of BIG-4 consultants; three, given the metropolitan nature of urbanization (Somik Lall, 2013) there is a tacit recognition of the fact that, going forward, administrative boundaries of municipal governments will not be an appropriate basis to tackle issues related to urbanization. The appropriate lens and geography going forward to tackle housing or solid waste management and, most importantly, climate-related concerns will need us to adopt a metropolitan lens. This position will birth several complex and complicated issues which while important will take us far afield and hence we desist from going into them here.

5.2.3 Local Body Grants

The constitutional provision (Article 280 3(bb)) strictly requires that the FC recommends measures to augment the consolidated fund of the States to supplement the resource flows to local bodies based on SFC recommendations. Even where there are no SFC recommendations or otherwise it does not need to allocate funds to LBs the FCs have done so and in increasing measure. We believe that this is good and should be continued at least till SFCs don't start functioning meaningfully leading to the empowerment of Local Bodies.

The FC10 for the first time recommended fiscal transfers from the Union government to local governments through state governments. The contours of decentralization were not very clear at the time hence the Commission adopted an ad hoc approach of a token nature and made a provision of Rs. 1000 crore for municipalities to be distributed amongst the states based on slum population. However, this was a crucial first step.

The Terms of Reference of the FC11, for the first time, started augmenting the Consolidated Fund of a state to enable them to supplement the resources of the local governments. The Commission recommended Rs.2000 crore for municipal institutions. The promotion of municipalities as institutions of self-government was the thrust of the grant. The Government of India accepted the recommendations with a caveat that required ULBs to raise suitable matching resources. This led to money not being utilized. FC12 pushed back on this point, "The central government should not impose any condition other than those prescribed by us, for release or utilization of these grants." In its recommendations, FC12 attempted to adopt the equalization principle for the general transfer but provided a grant of only Rs 5,000 crore to improve service delivery by the ULBs in respect of solid waste management. Thus, while a positive development, these FCs only recommended grants-in-aid of an ad hoc nature, and the allocations and releases continued to be negligible.

FC13 for the first time spoke of local Bodies as partners in the development process. There are 419 mentions of the term "local bodies" in FC13 report which spoke of allowing local bodies to benefit from the buoyancy of central taxes and allocating to them a share of the divisible pool. However, given the constitutional difficulty involved, a via-media approach was adopted to convert the share to an absolute amount (quasi-formulaic flow). FC13 also stated that the state governments should incentivize revenue collection by local bodies and put in a condition such as setting up a Property Tax Board. Taken in its proper spirit the setting up of such Boards should have enabled the utilization of the large untapped potential of property tax revenues.

FC14 retained the incentive-based approach for local Bodies alone and put in place two eligibility conditions for rural local bodies viz., having audited accounts and improvement in own revenues. For urban local Bodies, it also required that they publish Service Level Benchmarks relating to basic urban services.

FC15 imposed on the local Bodies an entry-level condition of *online availability* of audited accounts of the previous two years. The FC also set up a separate fund called 'Million Plus Challenge Fund' for Cities and Urban Agglomeration and linked it to achieving Ambient Air Quality and meeting Service Level Benchmarks in drinking water supply, solid waste management, and sanitation moving the focus away from ULBs to Urban spaces. The fact is that FC15 did increase the grants by an order of magnitude as compared to earlier FCs.

Table 7 Local Body Grants

	Local Body Grants as percent of Divisible Pool (%)	Local Body Grants as percent of total FC Transfers (%)	Performance-Based Local Body Grants as percent of total FC Transfers (%)
FC13	1.93	5.13	1.78
FC14	3.06	6.41	0.84

FC15	4.23	8.30	8.30

From the table above it is evident that the share of performance-based grants has risen substantially between FC13 to FC15 at the state and local body level. We believe that this is a welcome trend (in terms of a monotonic increase in fund flow to the third tier) and should be continued. Two caveats though: one, FC13 method of quasi-formulaic devolution should be restored (reversing the use of absolute numbers by FC14 and FC15);[13] two, some form of arm twisting of the states to at least partially accept the financial awards of the SFCs might have to be employed so that we can move towards empowerment of ULBS as well as establishing some form of status to SFCs which is comparable to the FCs. Some of the things here are slightly repetitive and have been dealt with in the earlier section. However, given the focus of this section on ULBs we beg indulgence and repeating them briefly for greater emphasis.

6. Conclusion

Before summing up and concluding what we have attempted in this paper, we need to flag a concern related to the environment, ecology, and climate change.[14] The importance of this was recognized for the first time fairly recently by FC13. This must be seen as a beginning that needed to be applauded although the treatment was fairly simple and the weight that it carried was quite small. This was the result of the paucity of data, unreliability of measurement as well as definitional issues. FC13 itself recognized some of the lacunae but went ahead and introduced the element in the formula in the knowledge that once started it is difficult to stop something in governmental mindset and hope that there would be refinement in proxies for capturing the crucial importance of environment, ecology, and climate.[15] It was also felt that ecosystems vary vastly in India and focus on a single component of the general ecosystem may be unfair to some regions and indeed lead to perverse incentives. For example, one may be incentivized to create a forest in a wasteland creating an overall ecological imbalance, according to the experts. Our recommendation therefore is to shift it from formulaic rendition to grants in aid-based fund flow, based on different components of ecosystem services to have a universal application. Ingenuity will be called for in the normalization of criteria that would form the basis of such grants.

Let us turn to flagging the intervention points recommended in this paper.

[13] This did not matter while the overall economy performed well but in case of cyclicality, either the buoyancy element will be lost or the Central government will find it difficult to credibly fulfil its promise.
[14] This is clearly the elephant in the room and we freely apologize for the fact that it is being treated by us rather cursorily. The theme is important to warrant a paper by itself but our defence is simply that it would detract from the focus of this paper.
[15] Sure there have been some refinements with broadening of the definition of 'forest cover' and introduction of delta/ incremental change element. Yet it is far from satisfactory. For example, using forests to cover plantations leading to monoculture is strongly objected to by champions of biodiversity.

- Given the geopolitical situation as well as domestic political situation, India is at a cusp and FC16m as one the few credible constitutional pillars remaining, will be called upon to play a significant role at the current conjuncture.

I. Nudging the Indian federation towards cooperative federal character should be the overriding concern as FC16 makes its recommendations. The federal government should behave like an elder statesman and be giving more than a fair share to the subnational governments This underlying, prime concern should be a cornerstone of everything that FC16 attempts to do.

II. We have argued for the dropping of grants based on prospective and normative revenue deficits and tried to persuasively argue that FC16 should replace it with Fiscal Space. A nuanced and benchmarked measure of Fiscal Space will provide a better alternative for the identification of the measure of grants. This approach will stop the laggard states from being hugely overcompensated thus avoiding the possible ill effects arising out of moral hazard, Dutch disease, and flypaper effect.

III. The performance-based incentives have largely had a beneficial effect and need to be strengthened. These are largely confined to the third tier and have been accepted without a major pushback. This could be remedied by trying to incrementally get a larger weight for performance-based or efficiency criteria in the formula applied for devolution.

IV. Turning to the third tier and focusing on ULBs, we applaud the fact that recent FCs have been monotonically increasing the grants and we recommend that this should continue. We however would like the FCs to take concrete cognizance of the evidence that the urban space is seriously under-estimated and rectify it so that ULBs will receive their fair share of funds. In doing so we also recommend that quasi-formulaic fund flow rather than absolute amounts be used so as to lend possible buoyancy and credibility.

V. There are pros and cons to the argument asking for continuity of the institution of FC at least in a skeletal but independent manner. The received wisdom thus far has effectively thwarted all such efforts. Bowing to the merit of such wisdom we would nevertheless flag a couple of points. FC16 should undertake/commission an evaluation of at least some major recommendations of the earlier FC(s) and how they have played out. Secondly, the FC should focus on some recommendations of the earlier FC that would have led to long-term reforms and if they are agreeable to the recommendations, the current FC should make suitable recommendations to see that there is effective fruition of such initiative for their full impact.

In sum, how does all of what we are saying lead to nudging forward the agenda of cooperative federalism in India? Firstly, each one of the areas of nudge viz., normalization of fiscal space in lieu of estimation of normative revenue deficits, performance-based incentives, and appropriate definition of 'urban' will treat most of the states in a fair and equitable manner. Secondly, tying in the third tier substantively will help create a narrative of three wings/arms of the state as almost equal and co-partners in India's progression. Thirdly, all three arms will help strengthen the primary focus of the Indian growth story as an imperative. It may be argued that there may continue

to be a bias in the application of the first criterion in favor of laggard states, while the second would be in favor of better-performing ones and the third would favor urbanized states. There is an element of truth in these concerns that the criteria we have suggested would be marginally differential in their impact on the states. As a counter, we propose that a carefully calibrated convex combination of the three criteria would lead to a satisfactory resolution of the concerns hinted at.

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