The Dynamics of Fiscal Federalism in India and the Global Financial crises

Aziz, Ghazala and Khan, Mohd Saeed

Department of Economics, Aligarh Muslim University, INDIA

2010

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Ghazala Aziz and Mohd Saeed Khan

The genesis of the economic crises was the emergence of what has been termed as shadow banking system in United States where each lending institution was treating each other's debt as asset in the capital base for lending resulting eventually in the circular credit interdependence (Bhaduri 2009). The absence of effective regulations in US economic governance could therefore be held responsible for current financial crises. In the era of financial globalization other economies could not have remained insulated. The crises spread to other economies closely integrated with it. Indian economy which was considered to be insulated because of well regulated financial sector also found itself inflicted by the global situation. Its difficulties arose on account of the shrinkage of demand for its export and slackening of capital inflows from these economies on which India's economic growth, during last one and a half decade, came to be critically dependent.

The crises, which by August-September 2008 assumed global coverage, demanded fiscal solution as the task was not only to inject extra liquidity into the economy but also to generate demand for it. Therefore most of the countries responded to the crises by offering stimulus packages. When it comes to such demand management in a federal country the dynamics of fiscal federalism inevitably comes under scrutiny. Federalism is the institutionalized arrangement that confers 'inextinguishable rights' on sub-national governments (Breton, 2000). Federalism is supposed to bring about political and fiscal decentralization to realize administrative and economic efficiency in the delivery of public goods. Optimal allocation of powers and responsibilities amongst governments at various levels in a federation is a significant and ever relevant issue. As political realities of a country are subject to a continuous change its financial system should be capable enough to adjust itself to the changing political scenario but without seriously compromising its capabilities to face economic challenges. So are the institutions that come up with the evolution of a federation. Federal relations undergo a change in response to changing political and economic scenario but the basic structure of federation normally remains unaltered. It is the system of finance especially the institutions of federal transfers that make a federation resilient to various challenges (both economic and political) and thus help federation keeps going.

This paper attempts to evaluate the working of fiscal federalism in India and its response and its capabilities to withstand crises and whether there could have been more efficient way of tackling the crises. A brief description of India's federal financial system and its working is necessary for the task in hand.

System of Federal Finance in India

India is a federal country with the constitutional assignments of legislative and fiscal jurisdictions to Central, States and local governments. The latter was granted Constitutional status only in 1993 through 73rd and 74th amendments to Indian Constitution and is yet to be properly integrated with the federation as it seriously lacks the financial and administrative autonomy. So not only these bodies continue to remain dependent on devolutions from State governments (in certain cases Centre provides the funds to them bypassing State government) they continued to remain deprived of the fiscal instruments. Therefore effective federalism in India consists of two layers of government at the Centre and at States' level. However the local governments do have serious financial implications for the States' finances as after coming into effect of the above mentioned Constitutional amendments it became obligatory on the States to devolve funds to these local bodies. It was further formalized by the creation of the 'Finance Commission' in every State to recommend the quantum of grants to be provided from State governments to the rural and urban local bodies.

Asymmetric Federalism

In terms of the constitutional assignments of legislative and fiscal powers India's is an asymmetric federalism with Centre enjoying greater amount of control over revenue resources while States are required to discharge larger responsibilities of providing public and merit goods besides providing various economic services. It is States that are responsible for the greater part of expenditure in the areas critical for accelerating growth and mitigating poverty such as irrigation works, roads, education, health and rural development. Against such responsibilities revenue sources assigned to them are meager and, barring one item i.e. tax on sales of goods, less elastic. To make up for the inadequacy of revenue the Constitution provided for the fiscal devolutions in the form of revenue sharing with Central government (Articles 270 and 272) and Grants-in-aid of the States' revenue (Article 275). The latter to be paid out of the 'Consolidated Fund' of India to the States that are in need even after the devolution Under Articles 270 and 272. Such devolutions constitute significant part of States' revenue receipts.

Monetary matters are under the jurisdiction of Central government, so it has certain amount of control over monetary policy. Fiscal measures whether of Centre or States are electorally sensitive and are often dictated by political expediency ignoring the economic reasoning. In this respect Centre is in an advantageous position it can push the monetary policy to neutralize the effects of fiscal profligacy if committed for reason of political expediency.

Finance Commission

Article 280 of the Indian Constitution provides for the Finance Commission (FC) to be appointed every five year to recommend the financial devolutions to States under various constitutional provisions mentioned above. The FC is required to assess the revenue and expenditure projections of both Central and States governments on some normative criteria and recommend (a) States' share from the sharable Central taxes and (b) the share of each State and union territory in such proceed besides any other item for which FC may be specifically asked in its terms of reference. Different FCs have invariably been asked, in their terms reference, to suggest measures for enhancing the fiscal capacity of States and reduce their debt burden. On account of Centre's financial commitments for planned economic development Centre's claim over larger revenue share from sharable taxes have been accepted by every FC.

Planning Commission's Transfers

States also do the economic planning to allocate resources to provide various economic services in a manner economically efficient and socially desirable. But their own revenue together with FC recommended devolutions are inadequate to find sufficient balance to finance their plans. In this regard they depend a great deal on financial resources provided to them by the Planning Commission (PC). The share of each State in the Plan assistance is worked out on the basis of 'Revised Gadgil Formula' that assigns different weights to different parameters in distributing the plan assistance to the States. Such transfers are in the form of loans and grants in the ratio of 70:30 for the general category States and 10:90 for special category States.

Constitution of India (Article 282) provides that "The Union or the States may make any grants for any public purpose, notwithstanding that the purpose is not the one with respect to which Parliament or the Legislature of Stat, as the case may be, may make laws." This 'Miscellaneous Financial Provision' of the Constitution is used to make devolution, for the purpose of socio-economic planning, through the PC. The funds are transferred to the States by the PC through two routs; one, in the form of support to States' plan called 'Central Plan Assistance' and two, via 'Centrally Sponsored Schemes' of the Central Ministries known as specific purpose grants.

There are twofold difficulties for the States that are inherent in the system of PC transfers; one, States do not have the complete freedom in the finalization of their plans as they need the concurrence of PC for the disbursement of financial resources and two, the mechanism of such transfers facilitates automatic flow of loans to the States which they receive as a matter of their entitlements. Therefore States' indebtedness, in a sense, is institutionalized one. Central Ministries' transfers to their State counterparts are purpose specific and often conditional to the States providing the matching or the specified allocations. Besides, the multiple channels of federal transfers leave a scope for jurisdictional conflict. So much so that often they seem to be working for cross purposes which is evident in the fact that while on the one hand most of the FCs have shown their concern for States' public debt and some like Eleventh and Twelfth FCs recommended effective relief measures also, and on the other, PC's transfers make them indebted as a matter of routine.

Table-1
Finance Commission Devolution and Other Current Transfers

Period	Share in Central Taxes	Statutory Grants	Finance Commission Transfers (2+3)	Non-Statutory Grants	Total (4+5)
Ninth FC (1990-95)	19,790 (2.6)	2,382 (0.3)	22,172 (2.9)	14,961 (1.9)	37,133 (4.9)
Tenth FC (1995-00)	37,608 (2.4)	2,935 (0.2)	40,542 (2.6)	21,332 (1.4)	61,874 (4.0)
Eleventh FC (2000-05)	61,047 (2.4)	9,792 (0.4)	70,839 (2.8)	36,651 (1.4)	1,07,490 (4.2)
Twelfth FC (2005-08)	1,15,315 (2.8)	20,620 (0.5)	1,35,935 (3.3)	78,389 (1.9)	2,14,323 (5.2)

Note: Figures in parentheses are as percentage to GDP.
Source: Budget documents of the State Governments.

Table-1 provides an insight into the magnitude of transfers through both statutory source (FC) and the non-statutory one (PC) which reveal the degree of States' dependence on financial devolutions from Centre as they currently constitute more than 5 percent of Gross Domestic Product and has never been less than 4 percent since 1990. Further, the share of non-statutory grant in such transfers is not the insignificant one.

Thus the system can be characterized as the one that gives greater leverage to the Centre but at the same time provide considerable amount of flexibility to address various issues that come up from time to time related to Centre – States financial relations. It also appears that the scheme of fiscal federalism as provided in the Indian Constitution, adopted in 1950, ensured the assignment of fiscal function to Central and States' governments almost in the same manner that was to be suggested latter by Musgrave (1958). The economic logic advanced by the latter favors the 'allocation function' to be with the States as they are closer to the people so they can judge people's preferences better. As far as 'stabilization' and 'distribution' functions are concerned it is the Central government which, in the absence of restriction on mobility of human and financial resources across States, can perform them efficiently as its jurisdiction extends to whole country.

India's Fiscal Federalism and Changing Political Realities

But despite all of its asymmetry India's federal system has been working well to keep the federation going. The system could be characterized as the one with strong Centre (in terms of revenue resources) with system of federal transfers providing it the flexibility needed for the cohesion of the federation consisting of federating units that are vastly heterogeneous almost in every respect. India's fiscal federalism has demonstrated remarkable degree of adaptability as it has suitably adjusted itself to the changing political scenarios from time to time. But surprisingly, no significant change in the federal fiscal arrangements has ever been observed as a result of economic challenges which the country faced in plenty. At the same time any significant change in the political landscape had always influenced, in varying degree, the magnitude of federal transfers and some time fiscal arrangements also.

A cursory glance at the table-2 would make one realize that successive FCs had recommended increased share (in comparison to the its predecessor) for the States from the divisible pool and some (Fourth and Seventh FCs) had raised it substantially before

80th amendment to the Indian Constitution in the year 2000 made all the Central taxes to be sharable and thus eliminating one of the major grievance of the States[1]. The share of the States from the Central taxes as recommended by the Eleventh FC to be 29.5 percent continued to be enhanced to 30.5 percent and 32 percent respectively by Twelfth and Thirteenth FCs. Especially significant is the latter's award for the reason discussed latter in paper.

Table-2

Recommended Shares in Divisible Taxes: First to Thirteenth Finance Commission

Finance Commission	Income Tax	Union Excise Duties (basic)	
	States' share (per cent)	States' share (per cent)	Number of articles covered
First	55	40	3*
Second	60	25	8**
Third	66.7	20	35
Fourth	75	20	All
Fifth	75	20	All
Sixth	80	20	All
Seventh	85	40	All
Eighth	85	45	All
Ninth	85	45	All
Tenth	77.5	47.5	All
Eleventh	29.5 per cent of all taxes		
Twelfth	30.5 per cent of all taxes		
Thirteenth	32.0 per cent of all taxes		

* Items like tobacco, matches, and vegetable products.
** Include all 3 items and sugar, tea, coffee, paper, vegetable non essential oils.
Source: Finance Commission Reports.

Beginning with the First FC when considerably small devolutions were recommended, every successive FC raised the States' share which could be viewed as rationalization only. The significant increases in their share were recommended by the Fourth and Seventh FCs which finalized their recommendations at a time when States

[1] The States' grievance was on account of the Centre's propensity to certain taxes that do not constitute the divisible pool but effectively reduce the collection of sharable taxes.

became politically significant. The last major event in this direction was the 80th amendment to the Constitution which was enacted when States' political assertiveness was at their peak. The amendment came at a time when Eleventh FC was about to finalize its recommendations so it had to rework the whole thing again. Twelfth and Thirteenth FCs raising the States share further without any visible political development points to the fact that it could be either realization of the need for the Centre to concede ground to the States or – especially the Thirteenth FC's award – it could be an attempt (without explicit mentioning) to release greater amount of resources to be spent by State to tide over the economic slowdown resulting from the exogenous factors.

Impact on the Economy of Global Financial Crises

When financial crisis began to surface in U.S and Europe in August, 2007 it was believed India would remain largely unaffected because of the 'strong fundamentals' of the economy and well-regulated banking system. But the deceleration in the growth rate of economy was very much in evidence in 2007-08 when it registered a growth of 9.2 percent as compared 9.7 percent in 2006-07. This small deceleration is significant as it occurred despite significant acceleration in agricultural output. Further, in view of the economic growth sustained by the economy over the last many years despite agriculture's less than satisfactory performance the small deceleration discussed above is significant.

In order to understand the contagion of the global meltdown for Indian economy the genesis of the economic boom in India that preceded the current downturn needs to be understood. Such boom was contributed a great deal by India's global integration in three ways; one, increased dependence on capital inflows especially of the short-term variety, two, greater reliance on exports particularly of services, and three, the role these played in domestic credit-induced consumption and investment demand. The question whether economic slowdown observed in 2007-08 was on account of the global crises contagion or the domestic factors[2] is not relevant (for this paper), what is significant here is that the

[2] Mihir Rakshit (2009) believes India began to slow down even before the emergence of the global crises.

economy's growth in the last many years was contributed a great deal by external sector which generated sufficient aggregate demand. With the crises in external market Indian economy was bound to suffer.

Foreign Capital Flows

The major part of the capital inflows consisted of foreign institutional investment (FII) which dried up as the crises deepened. The withdrawal of FII in substantial magnitude (table-3) caused, decline in Indian companies' access to foreign capital, reduced domestic liquidity and led to a downslide in the stock market. Rate of interest shot up compressing investment further and building inflationary pressure resulting ultimately in shrinkage of aggregate demand.

Table-3
Net Capital Flows

US$ billion

Items	April-March		2007-2008 (PR)	2008-2009 (P)			
	2007-2008 (PR)	2008-2009 (P)	Jan-Mar	Apr-Jun	Jul-Sep.	Oct-Dec.	Jan-Mar
FDI	15.4	17.5	8.5	9.0	4.9	0.4	3.2
Inward FDI	34.2	35.0	14.2	11.9	8.8	6.3	8.0
Outward FDI	18.8	17.5	5.7	2.9	3.9	5.9	4.8
FIIs	20.3	-15.0	-4.1	-5.2	-1.4	-5.8	-2.6
Net Capital Flow	108.0	9.1	26.0	11.1	7.6	-4.3	-5.3

P: Preliminary, PR: Partially Revised.
Source: External Economy July 27, 2009, RBI Publication III

Why Fiscal Policy?

For long since the economic crises of 1930s, discretionary fiscal policy with a combination of increased public expenditure or the tax concessions was actively used for the purpose of macroeconomic corrections if the economy exhibited recessionary trend. However by the early 1980s, it lost favor on account of some of its long term fallouts. Consequently it revived the neo-classical wisdom which believes in the self equilibrating capabilities of the market. For the purpose of dealing with the downswings of the business cycle Monetary Policy began to be favored as it induces the desired change through the function of the market. Further, since multilateral financial agencies too were obsessed with neo-liberal market policies they bitterly opposed expansionary fiscal policies involving public debt on account of its distortions it produces in the economy. However expansionary fiscal policy has been justified in case of sustained and long term decline in aggregate demand (Feldstein, 2002). For the fast deteriorating economy fiscal stimulus are expected to arrest such downturn quicker than the monetary measures.

With the outbreak of present crises fiscal policy swung back to contention again. The proper design of the fiscal policy, it is suggested, should have following properties; it should be ‘timely’ given the urgency for the action, ‘properly’ targeted for maximum impact and should be ‘temporary’ so as not to breach the sustainability conditions for long.

India’s fiscal Policy Stance

Among the public policy options Fiscal Policy occupies a prominent position in India. Though it has begun to gradually move away from the regime of social controls to the market economy but it did so in a cautious manner. In view of the large poor population it has to provide wide array of goods efficient provision of which cannot be ensured by the market (merit goods). Environmental issue also makes the government intervention inevitable as market does not exist for environmental goods. Therefore the tax and expenditure (that include subsidies) measures along with public debt continued to be the effective means for the socially desirable allocation of resources.

Since the onset of economic reforms in 1991 India's fiscal policy has been consistent with the objective of reducing fiscal deficit with occasional deviation from the path for social sector spending as well as for the reason of political expediency. The experience of the decade preceding reforms, when fairly higher growth rate failed to reduce economy's dependence on public expenditure for 'aggregate demand, made us obsessed with fiscal deficit as public debt reached to unsustainable level (Seshan 1987). Therefore managing fiscal deficit remained very high on any agenda of fiscal reforms.

As there was little coordination between the fiscal actions of the Centre and States, despite former having initiated the reforms, fiscal deficit had reached, towards the close of the century, to a level comparable with the pre reform period. The problem became so prominent that Centre had to introduce, in 2000, 'Fiscal Responsibility and Budget Management Bill' to its eventual enactment in 2003 albeit in a bit diluted form. In the meantime political conditions in the economy paved the way for the Eightieth Amendment to the Constitution making all the Central taxes sharable.

Political Economy of Fiscal Federalism

An interesting politico-economic scenario emerged in India in the current century. Centre, which hitherto enjoyed greater control over resources, became relatively weaker politically and its government became increasingly dependent for its existence on the support of the political parties whose core constituencies were their respective States. At the same time fiscal consolidation became absolute necessity. With Central taxes becoming sharable, States' fiscal imbalances were a great worry for the Centre as any of its reform measure would be critically dependent on States' fiscal health. In view of the abovementioned politico-economic scenario fiscal consolidation became a challenging task. But still the fiscal reform process went on resulting in States' transition from Sales tax to Value Added Tax (VAT) and the enactment of Fiscal Responsibility and Budget management (FRBM) Acts at the States' level.

Correction of States' fiscal imbalances was indeed a challenging task, extremely important for Central finances too, but seemingly difficult for Centre to enforce discipline. The task was accomplished by Twelfth FC which came out with debt relief package consisting of (a) Debt Swap scheme whereby all of the States' high interest debts would be consolidated and swapped with that of low interest and (b) Debt write-off scheme. The (a) was conditional to the States' enactment of FRBM legislation that made it mandatory for them to bring down their fiscal deficit to 3 percent and revenue deficit to zero by 2008-09. To avail the benefits under (b) States were required to follow fiscal correction path proportional to which would be their entitlements to debt relief. Such measures though enabled them to attain considerable amount of fiscal correction but reduced the space for the fiscal maneuverability. Simultaneously it recommended for a halt on Planning Commission's loan transfers to States thereby, it is argued, the FC has transgressed its jurisdiction. Thus it can be argued that India's federal structure does have the properties to withstand political and economic challenges.

India's Federal Institutions and Response to the Current Crises

As has been discussed earlier in the paper that by August 2008 crises assumed global dimensions affecting economies in all the corners of globe. By this time Indian economy started showing the signs of deceleration. This was in spite of the fact that massive public expenditure was incurred during 2008-09 on account of certain social security obligations like National Rural Employment Guarantee Act (2005) and the payment of part of arrears to the Central government employees following the acceptance the recommendations of Sixth Central Pay Commission. The finances of the Central and State Governments deteriorated considerably in 2008-09 as a result of global economic slowdown and fiscal stimulus measures consisted of indirect tax cuts and additional expenditure through three supplementary demands for grants undertaken by the Central

Government to support growth. The fiscal implications of the same were tremendous and the fiscal consolidation that was achieved by 2007-08 was lost the very next year. But the net result of such fiscal expansion was that economy's growth momentum, though decelerated a bit, was still impressive if viewed in comparison to the other economies of the world. But such growth could be achieved through fiscal expansion (as in the 1980s). Extra spending by the Central government continued into 2008-09 as well. One single item of non regular public expenditure again was the disbursement of the remaining 40 per cent of pay revision arrears of Government employees. But significant thing in this financial year as well as in the preceding one has been that it was not financed by the tax increase or subsidies rollback but through debt finance. It would not have been possible in the absence of crises for the government guided by fiscal conservatism. Thus the government could exploit domestic compulsions for fiscal expansion to its advantage.

Another response to the crises was the Centre allowing State governments, in 2008-09 and 2009-10, to spend beyond the FRBM stipulations temporarily restoring the fiscal space taken away from them. It was because of the fiscal correction measures undertaken by the States to fulfill the obligations under FRBM, and meet the requirements of the debt-write off that States could achieve considerable improvement in their finances up to 2007-08, reflected in the revenue surplus of States reaching 0.9 per cent of GDP and gross fiscal deficit (GFD) declining to 1.5 per cent of GDP in 2007-08. Such fiscal consolidation enabled the States for fiscal expansions as demanded by the current crises.

Considering the combined share of the States in the in the aggregate spending of the economy (table-4) and their fiscal obligations towards the local government the States should have been provided a little more fiscal space while the just contrary had happened. The net result of such developments is that the States seem to be unwilling to concede the same space to the local governments (aspect not discussed in this paper). It also results in various social security measures especially the employment programs fail to create social and economic infrastructure and continued to remain perpetually dependent on budgetary support

Table-4

Composition of Revenue Expenditures of State Governments (2000 to 2010)

(Per cent on GDP)

Item	2000-05	2005-10
Development Expenditure	7.3	7.2
Social Services	4.4	4.4
Economic Services	2.9	2.8
Non-Development Expenditure	5.8	4.9
Interest payments and Debt servicing	2.8	2.2
Pensions	1.2	1.2
Total Revenue Expenditure	13.3	12.4

Source: Reserve Bank of India, State Finances: A Study of Budgets of 2009-10

The observation of table-4 suggests that in relation to GDP States' revenue expenditure was roughly the same or a little less as it was in the five year period preceding it. Such revenue expenditure would not have been possible had the States not been allowed to breach the fiscal limits they were subjected to as per the requirements of FRBM Acts, a concession that stands withdrawn as the states have now been asked to go back to the fiscal correction path by 2011-12. The significant thing in this context is scenario that States themselves are not determining their fiscal priorities.

Conclusion

The analyses of the fiscal federalism in India suggests that the constitutional as well as institutional framework of it is well crafted as it provides tremendous amount of flexibilities to adjust itself to political and economic challenges. The Centre somehow is holding on to the almost the same position which was accorded to it when the system was created. The need was and continues to be, in view of the vast diversity that prevails in the country, of a strong Centre although the political realities have considerably changed and States are in a better position to tough bargaining with the Centre. The institutions of federal transfers, especially the 'Finance Commission' has the capabilities to keep the Centre as prominent as it was. India's federal fiscal system facilitated whatever was required to meet the challenges of the challenges of the current economic crises. Despite States having larger share in total expenditure they were utilized in limited manner. Major concessions fiscal concessions to maintain the aggregate demand came from Central government. The States could maintain their expenditure levels, though by fiscal profligacy, during the crises could be attributed to the fiscal correction they achieved in the last few years.

For such fiscal correction the credit should go to the FC but without bringing in any structural change to enhance the fiscal capacity of States the correction is likely to be fragile. Furthermore, the FRBM induced fiscal discipline has reduced the fiscal space to the States reducing their options to effectively intervene if the need be, as in the present case they could do only when Centre had allowed them to. Considering the assignments of responsibilities to the States they should have been devolved some more fiscal power as fiscal devolutions on which States are greatly dependent offer only revenue but keep them deprived of the fiscal instruments.

Present crises proved once again that the basic design of India's federal structure that accorded dominance to Centre is capable of somehow maintaining – through its institutions – such dominance even under adverse political and economic circumstances.

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