**Chapter 12: Towards Cooperative Federalism**

The commission, after considering the resources and needs of the States and the recommended tax devolution, provided grants for fully meeting their revenue deficits, as assessed. The tax devolution, supplemented by revenue deficit grants in some States, should normally provide the States with the fiscal space to take informed decisions on their requirements. Specifically, they have identified health, education, drinking water and sanitation as important sectors among such public services. The commission also have noted that the grants to these sectors should be carefully designed and implemented, and a new institutional arrangement be put in place with the involvement of the Union and the States, duly assisted by domain expertise.

The entries in the State List specify the functional domains of the States. Many of the functions in the Concurrent List have traditionally been undertaken by the States and are in their area of responsibility. However, even in the State and Concurrent lists, there are functions which are best carried out by both the Union and State Governments in the spirit of cooperative federalism. For example, specified minimum standards of certain public services should ideally be available to people, irrespective of where they reside. Thus, both the Union and State Governments have an overlapping responsibility to ensure such specified minimum standards. The commission recognizes that the primary responsibility for funding and providing most of these services rests with the State Governments. However, the Union Government must play a supportive role in supplementing such efforts. It also recognizes that it is difficult to clearly and definitively demarcate the overlapping responsibilities between the Union and the States. Further, the scope of such overlapping responsibilities and the relative roles of both could evolve over a period.

The commission believes that in proposing a new institutional arrangement towards strengthening cooperative federalism, one should take cognizance of the extant arrangements for transfers, views of the State Governments, views of the Union Government and discussions in the National Development Council (NDC), views of Commissions and Committees and views of previous Finance Commissions on this subject.

**Existing Arrangements for Transfers**

Up to 2013-14, funds for the Centrally sponsored schemes were routed through two channels - the Consolidated Funds of the States and directly to State implementing agencies. From 2014-15 onwards, direct transfers to State implementing agencies have been done away with, and all transfers to States for Centrally sponsored schemes are now being routed through the Consolidated Fund of the State. The non- Plan grants constitute a very small part of the 'other transfers'. Plan grants are utilized both for capital and revenue expenditures, though the share of the latter has been increasing in recent years.

Even within the Plan transfers, the share of untied normal Central assistance has shown a sharp decline, particularly after ending the intermediation of Plan loans to the State Governments by the Union Government, consequent to the recommendations of the FC-XII. This decline in the share of what is generally described as 'formula-based' grants has been mainly due to the expansion of grants for Centrally sponsored schemes. In fact, when grants given directly to implementing agencies are considered, the decline in the formula-based transfers to the States is even sharper.

**In recent years, the aggregate transfers from the Union to the States (including direct transfers), as a percentage of the gross revenue receipts of the Union, have ranged between 44.7 per cent and 53.7 per cent.**

**Views of the State Governments**

The States, in general, have been critical of the rise in the share of non-statutory transfers, non-formula-based transfers, at the expense of statutory transfers. The States mentioned that the Union Government has not only been introducing schemes which need to be implemented at the grass root levels but has also not been allowing them to be managed in a decentralized manner. They stressed that there has been an increase in non-formula-based fiscal transfers from the Union ministries, particularly through the mechanism of Centrally sponsored schemes. These schemes, they added, are often formulated without adequate consultation and without keeping in mind state-specific variations and priorities and have led to a significant burden on the resources of States. In their view, this has shrunk the fiscal space available to them and forced them to adopt expenditure patterns that do not reflect their own priorities. Further, the significant increase in the number of Centrally sponsored schemes and the funds allocated for them have led to a corresponding decrease in the untied resources available to States.

The States have, therefore, suggested that the funds transferred by the Union Government for expenditure on State subjects through various Centrally sponsored schemes should be subsumed under the funds transferred through vertical devolution. The States have emphasized that there is a need to enhance the existing level of formula-based fiscal transfers, with such transfers conforming to the principles recommended by the Finance Commission.

**Views of the Union Government**

In this regard, the Ministry of Finance highlighted the limited resource base available with the Union Government in the coming years. It felt that the finances of State Governments are comparatively in better shape and much of the fiscal impact of the development schemes, therefore, needs to be shifted to them. In its view, the States should bear a larger share of the financial burden of various welfare programmes. The Union Government felt that this would not only improve its own fiscal position but would also help in streamlining Union-State relations. The Ministry further highlighted the responsibility of the Union Government to make interventions, through programmes and schemes, for ensuring equalisation, promoting inter-state projects and ensuring specified minimum standards of services in sectors of national priority.

They explained the rationale for nation-wide approaches to sectoral policies and the need for providing guidance, incentives and disincentives to the States, mentioning, in this context, that Centrally sponsored schemes are meant to ensure that spending is directed towards nationally-agreed priority sectors critical for ensuring inclusive growth. They also indicated that there is an increasing awareness in the Union ministries about the need to provide greater flexibility to the States in implementing Centrally sponsored schemes.

**Views of Commissions and Committees**

The Commission on Centre-State Relations, headed by Justice R.S. Sarkaria (henceforth, 'Sarkaria Commission'), in its report submitted in 1988, had recommended that the number of Centrally sponsored schemes should be kept to the minimum. It, however, recognised the need for the Union Government to initiate pilot projects, even in regard to subjects in the States' sphere, if those subjects had inter-State, regional or overall country-wide significance with high national priority. It added that these should be formulated in prior consultation with the States and once a programme had passed the pilot stage and was found desirable for scaling up, it should appropriately form a part of the State Plan.

The National Commission on Review of the Working of the Constitution (2002), chaired by Justice M.N. Venkatachaliah, had observed that the rationale of the Concurrent list stems from the fact that certain subjects require simultaneous jurisdiction of the Union and the States.

The Commission on Centre-State Relations, headed by Justice M.M. Punchhi (henceforth, 'Punchhi Commission'), in its report submitted in March 2010, had observed that the share of normal Plan assistance in the total budgetary support to the State Plan had come down drastically relative to that of Centrally sponsored schemes, additional Central assistance and special Plan assistance. It observed that the number of Centrally sponsored schemes should be restricted to flagship programmes of national and regional importance.

A Committee constituted by the Planning Commission to consider the issue of 'Restructuring of Centrally Sponsored Schemes', under the chairmanship of Shri B.K. Chaturvedi (henceforth, 'Chaturvedi Committee') noted the concerns raised by States regarding the lack of flexibility in Centrally sponsored schemes, the adverse implications of the counterpart funding requirement on State finances and the questionable utility of operating a large number of Centrally sponsored schemes with thinly spread resources at the field level. In its report submitted in September 2011, the committee reiterated the need for a "national effort in education, childhood care, health, unemployment and old age, and for minimising inequalities in income amongst States", guided by the Directive Principles of State Policy.

**Views of Previous Finance Commissions**

Successive Finance Commissions had considered this issue, keeping in view the significant quantum of Central transfers being made through the route of Centrally sponsored schemes. The FC-XI had recommended that these schemes need to be transferred to the States, along with funds. It also recommended that all other schemes be implemented by panchayats and municipalities, on the basis of plans prepared by the District/ Metropolitan Planning Committees. The FC-XII had recommended that there should only be a grant element for all Centrally sponsored schemes without any grants linked to loans. It had further recommended that States be given their total entitlement of grants and allowed to select their own mix of Centrally sponsored schemes, within the limit of the total grant. The FC-XIII had recommended reduction in the number of Centrally sponsored schemes and restoration of the predominance of formula-based Plan transfers.

**Issues and Approach**

**To take a comprehensive view of the fiscal relations between the Union and the States, the commission reviewed the existing arrangements for transfers and the views of the Union, States, various Commissions, Committees etc. This review leads us to several conclusions:**

* While it is reasonable to conclude that there is a convergence of views about the need for some specific purpose transfers from the Union to the States, differences persist in regard to the desirable magnitude and current manner in which such transfers are taking place outside the tax devolution and Finance Commission grants.
* The Union Government has suggested avoidance of overlap between the Finance Commission grants and its own transfers, presumably regarding sector-specific and state-specific schemes.
* There are differences of views about the scope or purposes for which such transfers outside the Finance Commission should take place. Concerns have been expressed that the scope and conditionality of such transfers have expanded considerably in recent years. Our data confirms that such a significant expansion did take place.
* While the fact that there are overlapping functions warranting transfers is generally accepted, there is a perception that the Union Government is stretching the interpretation of the Concurrent List in its favour and, in fact, treading into areas in the State list of the Constitution.
* Most States have repeatedly expressed concerns that the Union Government exercises excessive discretion in distributing the resources among them through the transfer mechanism, especially regarding Centrally sponsored schemes. The States have generally described these transfers as being 'non-formula-based' and 'discretionary'. Data reveal that the share of formulabased distribution (such as transfers based on the Gadgil-Mukherjee formula) in the aggregate transfers has been decreasing. It is noted that the Union Government does adopt certain criteria for allocation of funds in respect of Centrally sponsored schemes and some other forms of grants. However, the actual transfers to States are often noticeably different from the allocations based on these criteria for a variety of reasons, including non-compliance with conditionalities and the procedures laid down for releases.
* Concern has been expressed that many of the Centrally sponsored schemes are based on a 'one size fits all' approach and that often the design of schemes is inappropriate for several States. There is a consensus that the design should be improved and flexibility to the States should be increased.
* Various Commissions and Committees have supported rebalancing the transfers of funds from the Union to the States in favour of formula-based untied transfers.
* The previous Finance Commissions have also expressed their views in regard to the significant quantum of Central transfers being made particularly through Centrally sponsored schemes. Their suggestions include transferring of all these schemes to the States along with funds and restoring the pre-dominance of formula-based Plan transfers.
* Despite some differences of opinion, there is virtual unanimity on one issue - that there is universal dissatisfaction with the existing system of transfers from the Union to the States outside the awards of the Finance Commission. In the process, suggestions have been made implicitly and explicitly to expand the role of the Finance Commission.

**The commission, therefore, concludes that a compelling case has been made for reforming the existing system of fiscal transfers from the Union to the States in a comprehensive manner. They recommend that the existing system be reviewed, and necessary institutional changes be considered.**

There are three possible ways in which specific-purpose grants for nationally important schemes or overlapping functions can be determined.

*First*, the Finance Commission may recommend specific-purpose grants for programmes and schemes in a comprehensive and significant manner to encompass all fiscal transfers. *Second*, the Finance Commission may identify sectors with overlapping responsibilities between the Union and the States, indicate the volume of assistance for these schemes and leave it to the Ministry of Finance and the relevant Union ministry to design and implement them. *Third*, the Finance Commission may determine the fiscal space available for specific-purpose grants, both those for which the States have made a strong plea for assistance with the Commission as well as those coming under the rubric of Central schemes. The design, implementation and monitoring of the schemes under this fiscal space can be left to a new institutional arrangement that addresses the current concerns of the States and objectives of the Union. **The commission believes that the option of entrusting the Finance Commission with responsibilities relating to all transfers from the Union to the States is not advisable. At the same time, they believe that a Finance Commission should take a comprehensive view of all fiscal transfers from the Union to the States. However, it should limit its own recommendations only to tax devolution, grants-in-aid and any other matter referred to it in the interest of sound finance. In their view, the Union Government should continue to have fiscal space to provide grants to States for functions that are broadly in the nature of 'overlapping functions' and for area-specific interventions. The commission, however, believe that the existing arrangements for transfers between the Union and the States need to be reviewed with a view to minimising discretion, improving the design of transfers, avoiding duplication and promoting cooperative federalism, insofar as such transfers are required to be made outside of the recommendations of the Finance Commission.**

**In the light of this, commission recommends for consideration the evolution of a new institutional arrangement, consistent with the overarching objective of strengthening cooperative federalism, for: (i) identifying the sectors in the States that should be eligible for grants from the Union, (ii) indicating criteria for inter-state distribution, (iii) helping design schemes with appropriate flexibility being given to the States regarding implementation and (iv) identifying and providing area-specific grants.**

**North-eastern Region**

The North-eastern and hill States have several unique features that have a bearing on federal fiscal relations. These States are characterised by: (a) low level of economic activity and the consequential low revenue capacity; (b) the disability arising from large forest cover and hilly terrain; (c) remoteness; (d) infrastructure deficit; (e) international borders and the law and order problems due to persistent insurgency; (f) high level of expenditures on public administration and police, relative to the overall gross state domestic product (GSDP) of the States and the large proportion of government employment in total employment. Most of these States are largely dependent on the resource flows from the Union Government, both for balancing their revenue account and for capital investment. There is, in addition, currently a special dispensation for flow of Plan grants to them.

While we have addressed the issues related to North-eastern States to the extent feasible, we assess that these States would continue to need a special focus, particularly in terms of social and economic infrastructure with inter-state significance. The proposed new institutional arrangement should have a special focus on these States, particularly in terms making investments in infrastructure. **The commission, therefore, urge that the suggested new institutional arrangement also consider taking up issues related to identifying and recommending resources for inter-state infrastructure schemes in the North-eastern States.**

**Natural Resources**

A related issue is that of States with large areas covered by forests and their demand for adequate compensation for the global public good they generate, the income and taxes they lose on account of preserving the forests and the additional tasks of providing public services on account of forest cover. Promoting the objectives of sustainable development in policy making requires a conceptualisation of the benefits of economic activities, social and welfare needs being met, and natural capital being conserved. The policy choices need to be proactive, anticipating the likely causes and consequences of economic policies on the environment with built-in corrective actions to remove or minimise the negative fallouts. In practical terms, this would mean establishing mechanisms that integrate economic and environmental concerns in decision making across different tiers of government and in a host of government agencies that are involved in development tasks. It would also serve to give a measure of participation and involvement to both the Union and the States within the overarching fiscal and economic policy concerns. **The commission, accordingly,** **urge that the new institutional arrangement should also become the forum for integrating** **economic and environmental concerns in decision making.**

**Towards a New Institutional Arrangement**

Accepted theories of institutional design, as well as international practice, indicate the need for the States to play a role in the decision-making process relating to fiscal allocations from the Union to the States. This is a crucial element of co-operative federalism, which requires continuing consultations on issues that affect the interests of Union and State Governments. **Further, although each level of government takes decisions independently, an exchange of views and information before each takes action that impact the other is necessary. It is in this context that institutionalised channels of consultation between the Union and State Governments are of relevance. They have, accordingly, addressed these broader issues in proposing a new institutional arrangement.**

**Institution for Cooperative Federalism: Redesigned Inter-State Council**

**The commission commissioned a study to understand the manner in which the Inter-State Council could be strengthened or organised to cover, within its ambit, the function of allocation of financial resources to the States so as to supplement the statutory transfers recommended by the Finance Commission.** The Inter-State Council, headed by the Prime Minister, with representation from the Union Government as well as all the State Chief Ministers has the potential to become the forum for outlining, discussing and strategising the goals, objectives and direction for the national economy. It can set out the important national priorities through negotiation, bargaining and consensus building where all stakeholders will have ownership and participation. It has the potential to be a forum for sharing of experiences and exchange of important initiatives taken up by States. It can also serve the purpose of enabling disadvantaged States to achieve a measure of equality in competing with other States by providing and monitoring incentives. It would need to be supported in its duties by the Council Secretariat, which would not only process the issues for the consideration of the Council but also maintain constant liaison with the Union and the States.

**Aggregate Transfers**

**The indicative ceiling on transfers, suggested by the previous Finance Commissions, has, however, not restrained the Union Government from making larger transfers to the States.** As per the finance commission recommendation, the tax devolution to the states is 42 per cent of the divisible pool. The aggregate grants recommended, expressed as a percentage of the divisible pool, are in the range of 6.4 per cent to 5.2 per cent, with an average of 5.7 per cent, over the award period. The total Finance Commission transfers, including the tax devolution projected, amount to an average of 37.2 per cent of the projected gross revenue receipts of the Union during our award period. **Therefore, it is expected that the Union Government to utilise its available fiscal space to continue to address the needs and expectations of the States and ensure the prevailing level of transfers to States of about 49 per cent of the gross revenue receipts during the award period.**