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**Fourteenth Finance Commission:  
Continuity, Change and Way Forward**

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# *Fourteenth Finance Commission: Continuity, Change And Way Forward*

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**Y.V. Reddy**

Respected Dr. Rangarajan, Dr. Shanmugam, Mr. Jawahar Vadivelu, and distinguished friends,

I am greatly honoured by the invitation to deliver the Raja Chelliah Memorial Lecture. I narrowly missed the opportunity to work with Professor Raja Chelliah in early 1960s. When he joined the Osmania University, I had to leave the University to join the Indian Administrative Service. However, we came into contact later when I was with the Government of India. I have interacted with him since 1990, particularly in the context of economic reforms. When I was in the Reserve Bank of India, we continued to meet often in academic seminars and policy fora. He was always cheerful and personally pleasant to one and all. All of us recognise and appreciate his immense contribution to knowledge and policy in India. Yet, it is appropriate to very briefly recall that Dr. Raja Chelliah is known as father of Tax Reform in India. In particular, he was a Member of both, the Planning Commission, as well as the Finance Commission, like Dr. Rangarajan himself. Above all, he was a builder of institutions, and has nurtured, trained and encouraged several economists. He founded the National Institute of Public Finance and Policy (NIPFP). I congratulate the Madras School of Economics for instituting this Memorial Lecture in honour of its chief architect and compliment the Southern India Chamber of Commerce and Industry for its initiative in instituting this lecture.

I have selected the subject for the 2<sup>nd</sup> Memorial Lecture keeping in view the fact that the Union-State fiscal issues were an important part of Professor Raja Chelliah's interest in public finance, in addition to his contribution to tax policy. The subject is also of contemporary interest since the Report of the Fourteenth Finance Commission has been submitted recently and accepted and incorporated in the budget. As Chairman of the Commission (FFC) I had the benefit of some insider information, which I can draw upon for the purpose of this lecture, without violating the laws of secrecy or propriety. Above all, Dr. Rangarajan, my guru, suggested the subject.

### **Guiding Factors and Work Processes**

The FFC, like its predecessors, was guided by the Terms of Reference (ToRs); the approach of the previous Finance Commissions; the experience gained in this regard[ the prevailing macro-economic situation, in particular, fiscal environment of the country; and the evolving circumstances relevant to the ToRs. In addition, the FFC reviewed in great detail the relevant deliberations in the meetings of the National Development Council, the views of the Administrative Reforms Commission (1966), National Commission on Review of the working of the Constitution (Venkatachalaiah Commission 2002), Commission on

Centre-State Relations (Sarkaria Commission 1988), Commission on Centre-State Relations (Punchhi Commission 2010), etc. to analyse the Union-State fiscal relations in a fundamental manner. In the process, reference to debates in Constituent Assemblies also became necessary and useful.

The FFC followed the work processes and procedures consistent with previous practices. These included internal procedures, consultations with States, Ministries in Union Government, experts, political parties, local bodies and others. As in the past, a number of studies were commissioned.

In addition, in order to obtain an overview of state finances from local experts, the FFC commissioned studies for every State generally through universities and institutions located in those States. This was in addition to the previous practice of engaging the National Institute of Public Finance and Policy (NIPFP), as well as other institutions, to study select subjects. One of the studies commissioned gave an account of practices in select major emerging economies; while the experience of major advanced economies was already available with FFC.

### **Mandate**

The core mandate of the FFC, as laid down in Article 280 of the Constitution and incorporated in the ToR relates to: a) Proceeds of taxes to be divided between Union and the States, usually referred to as the Vertical Balance; b) the allocation of distribution of taxes among the States, usually referred to as the Horizontal Balance; c) The principles which should govern the grant-in-aid to States by the Finance Commission, which are over and above the devolution of taxes as per formula; and d) measures to augment the consolidated fund of a State to supplement the transfer of resources to Panchayats and Municipalities, based on the recommendations of the respective State Finance Commissions, usually referred to as Finance Commission Grants to Local Bodies. In addition, the ToR also incorporated what are generally referred to as other Terms of Reference by virtue of the powers of the President to refer "any other matter in the interest of sound finance".

The core mandate of the Commission remains broadly no different from the previous Commissions. However, a reading of the ToR as a whole shows two striking aspects that have a bearing on this core task. First, in some, though not all previous Finance Commissions, there is no specific mention of the treatment of gross budgetary support to plan as a committed liability of the Union Government. The ToR also does not

bind the FFC to look at only non-plan revenue expenditure of the States. The absence of reference created an opening to the FFC, if it so desired, to dispense with the distinction between Plan and non-Plan. Unlike many of its predecessors, the FFC was emboldened to pursue this idea since it was formally recommended by Dr. C. Rangarajan in his capacity as Chairman of the High Level Committee on Efficient Management of Government Expenditures, but not acted upon by the Union Government. The FFC seized the initiative and worked on operationalising the recommendation. Actually, the recommendation of the FFC in this regard is to make such a distinction redundant and irrelevant, but the Union and any State could choose to retain the distinction if they find any use for it.

Second, in the past, the ToR required the Commissions to take the base of population figures of 1971 in all cases where population was a factor. Our ToR indicated that, in addition, we may also take into account the demographic changes that have taken place since 1971. The FFC took advantage of this opening to take into account of both 1971 population and 2011 population, while reluctantly giving higher weight to the 1971 population.

### **The Context**

Every Finance Commission has to start with an initial position of the fiscal conditions in a given macro context. In a way, therefore, the macro context, as well as the fiscal position addressed by each Finance Commission, is unique in its own way. FFC recognised that the then prevailing macro-economic and fiscal position was not encouraging while the global uncertainties were striking. However, during the course of the work of the FFC, especially towards the later part of its work, the sentiments improved for Indian economy. Following past practice, the assessment of finances of Union and States, as well as the projections, took account of the prevailing environment relevant to the FFC's work.

In addition, the FFC made special efforts to take cognizance of fundamental changes that have taken place over the years which were critical to work of Planning Commission (as it existed then) and the Finance Commission. The fact that the balances between the public and private sectors, the government and the public enterprises, the domestic and global economy, and the fiscal and non-fiscal elements of the government, have dramatically changed over the years, was considered in depth by the FFC, since this cannot but have a significant impact on the Union-State fiscal relations during the award period (2015-16 to 2019-20). The FFC, thus, took cognizance of the changing balances

and the new realities of the macro-economic management and made an effort to place the prevailing fiscal situation and the evolving relationship between the Union and the States in the broader context also. In a way, a balance had to be struck by FFC between the need for fundamental changes in the balances and addressing the immediate challenges posed by the prevailing macro and fiscal situations.

In addition to an appreciation of the broader context along with immediate challenges, the FFC laid emphasis on listening and learning from all stakeholders, in particular all the three tiers of the Government and political parties. This approach resulted in special emphasis by the FFC on some of the issues that are relevant to work of all Finance Commissions. *First*, a demonstrably symmetric view of the Union finances, State finances and their fiscal relations has been attempted. *Second*, an integrated view of revenue expenditure with no distinction between Plan and non-Plan, and a comprehensive view of revenue and capital expenditures, including public debt were attempted. *Third*, the special responsibilities of the Union in macro-economic management and its relationship with global economy had to be explicitly recognised. *Fourth*, a comprehensive view of the transfer from the Union to the States, both within and outside the recommendations of the Finance Commission, was necessary to address the fundamental issues relating to constitutional assignment, plans and Centrally Sponsored Schemes. Implicitly, the issue of conditionalities in the transfers and the role of tied and untied grants had to be reckoned. *Fifth*, the predominant role of the States, in particular, the State Finance Commissions, in empowering the local bodies, had to be recognised. *Finally*, the FFC examined the issue of separate treatment of the special category States. While each special category state argued that it is special within the special category, some others in general category States demanded their inclusion in the special category. It was felt that, as per the Constitution, all States have to be treated equally by the FFC, and any categorization of States has to be based on application of mind and reasoning by the FFC. On a detailed examination, it was found that such a two-fold categorisation of States over-simplifies the reality. It was concluded that a combination of a well-designed formula to restore Horizontal Balance by taking into account revenue and cost disabilities of the states in the projection of revenues and expenditures, as necessary, will address problems of all States, in a fair manner. Given that the forest cover is an important factor in revenue and cost disabilities, this approach provided an opportunity for the Commission to mainstreaming sustainability in ecology and environment in the devolution formula itself.

## **Review of Fiscal Positions**

All fiscal indicators, both quantitatively and qualitatively, warranted a significant reversal in the trend of dilution in the quality of fiscal management that had set in during the review period of the Finance Commission. However, FFC had to recognise that such a reversal may have to be anticipated and projected in the award period in a realistic manner. In assessing what appears to be realistic, FFC had to make a judgement on whether it should err on the side of more rapid improvement than that submitted by the Ministry of Finance, Government of India. The judgement depended upon what was desirable, what appeared feasible, and above all, the possible implications, both for the Union and the States, in case the projections turn out to be overly optimistic or pessimistic. In this regard, the track record of a Union Government in fiscal management could not be totally ignored.

On balance, a view was taken that the Union Government's projections in regard to both macro and fiscal position should be—the anchor along which the FFC would proceed. At the same time, the FFC articulated that there is significant scope for improving the fiscal position of the Union through increased disinvestment of shares in public enterprises, a rational dividend policy, sale proceeds from spectrum, a discriminatory capital infusion into the financial enterprises and the introduction of GST. Keeping this cushion in view, the possible initial fiscal burden due to GST has not been reckoned. In brief, the FFC was aware that there is ample scope if there were will and skill for accelerating the fiscal consolidation projected and rapidly improving the quality of fiscal management.

The fiscal position of all States taken together has shown significant improvement during the review period, both in terms of quantity and quality. In fact, many States had not fully utilized the fiscal space available to them to incur capital expenditure within the fiscal targets prescribed by the 13<sup>th</sup> Finance Commission. The States in general, with a few notable exceptions, are spared of undue stress on fiscal management due to outstanding debt in the years ahead. Perhaps, the record of fiscal management by States as a whole reinforced the soundness of recommendations of 12<sup>th</sup> and 13<sup>th</sup> Finance Commissions relating to fiscal responsibility. The FFC recognized that the process of fiscal consolidation in the Union should ideally be accompanied by prudent fiscal expansion at the level of States.

### **Inter-governmental transfers and consolidated Public Finance: A Review**

The FFC paid considerable attention to an analysis of the consolidated public finance, and in particular, inter-governmental transfers. The review has shown that, within the overall fiscal trend in the country, there has been a greater expansion in the fiscal activity of the Union than of States. In particular, the transfers from the Union to the States have increased substantially. Moreover, overall transfers, viz., FC transfers and other transfers put together, far exceeded the indicative ceiling prescribed by the previous Finance Commissions. Within the transfers, discretionary components had increased in the review period, undermining the role of the Finance Commissions.

These developments in other governmental transfers required the FFC to take a comprehensive view on several aspects of Union and State Finances, viz., a) Union Finances as a whole, of which the divisible pool of taxes is one component; b) the total transfers from the Union Government, of which transfers on account of Finance Commission is one component; c) the revenue expenditure of the Union and the States, as a whole; and d) the consolidated public debt of the Union the States and their respective shares.

The literature on fiscal federalism delineating the functions of different levels of government assigns predominant responsibility for macroeconomic stabilization to the central governments. In Indian context, in taking a comprehensive but symmetric view of Union and State finances, the criticality of the fiscal management of Union, relative to the States, had to be recognised in terms of (a) creating space to undertake counter-cyclical policies, (b) managing the impact of shocks, such as global uncertainties and uncertain monsoon conditions, and (c) the sensitivity of financial markets to the fiscal policies of the Union Government. In brief, it was concluded that the burden of fiscal consolidation rests heavily on the Union Government, in view of the initial conditions and its importance. In such a situation, the FFC concluded that it was not possible to increase the level of aggregate transfers from the Union to the States. The focus, therefore, was to concentrate on the composition and the quality of the aggregate transfers from the Union to the States.

### **Union Finances: Assessment**

Since FFC decided to dispense with the distinction between Plan and Non-Plan, and since the Government of India had dispensed with its role of borrowing from the markets in order to lend to the States – the FFC had to take responsibility of balancing Union and States' revenue powers with expenditure responsibilities listed in the Seventh Schedule of

the Constitution. Hence, in its assessment, the priority was to provide appropriate fiscal space to the Union Government for expenditures, as defined in the Union list. At the same time, the assessment recognized and articulated the scope for revenue mobilization, though its full scope could not be quantified and incorporated in the assessment. In addition, the FFC has explicitly provided a fiscal head-room for the Union Government to carry out the transfers to the States by way of expenditures with externality considerations and equalization in select sectors.

In the treatment of committed expenditure, the FFC took into account the resources required for the Union to meet its commitment for providing the public services detailed in the Union list. In addition, it has taken into account the expenditure commitment of the Union Government listed in the Concurrent or State lists, to the extent that it was warranted.

In brief, the FFC has followed the practice of assessment of Union finances that was done by earlier Finance Commissions, but, in addition, the FFC considered the magnitudes, legitimacy and appropriateness of Union transfers to States outside the mechanism of the Finance Commissions, keeping in view the Constitutional provisions. A major challenge in this regard was the enacted legal commitment and expenditures on ongoing schemes that fell under the Concurrent List and were being funded by both, the Union and the States. Several internal exercises on these matters were undertaken to obtain insights relevant to the assessment of respective needs of Union and States. Other united transfers from Union to States are not relatable to individual sectors or activities in the Seventh Schedule, and hence did not pose a problem.

### **State Finances**

To a large extent, the basic approach to assessment of State Finances remained similar across Commissions, though there were some differences in projecting individual items of receipts and expenditures. However, as mentioned, FFC differed from the earlier Commissions in taking account of both Plan and non-Plan expenditures in the revenue account.

In regard to assessment of the own tax revenues of States, FFC considered aggregate own tax revenue as a single category, following the methodology adopted by the preceding three Finance Commissions. In making the projections, a two-step methodology was followed. The first step involved reassessment of the base year 2014-2015. The second step involved application of normative growth rates for the

projections. For States with an above average tax-GSDP ratio, the assumed own tax buoyancy was 1.05 implying a moderate increase, and for others, a higher buoyancy of 1.5 till it reaches the target tax-GSDP ratio. This resulted in an improvement in the assumed aggregate tax-GSDP ratio from 8.26 of GSDP to 9.0% in the terminal year. The assessment of own non-tax revenues was made in terms of major items of non-tax revenue separately for each State, consistent with past practice.

The FFC followed past practices in the assessment of revenue expenditures of States, but made some notable departures. It included revenue expenditure under plan also in the assessment. In the process, only the States' contribution towards share of Centrally Sponsored Schemes was included.

In computing the liabilities of the interest payment, the FFC took a view that it is a legacy of the past and an inevitable commitment and hence it should be treated as committed expenditure.

It was assumed that each State will take full advantage of the fiscal deficit target of 3% of GSDP each year. No request for debt restructuring was entertained, since the full burden of interest payment for the debt had already been provided in the assessment of needs. There was a view that such a full provision for interest payments would amount to rewarding States that were fiscally not responsible. The counterview was that the obligation arose out of less than responsible enforcement of fiscal rules, and so the solution does not lie in the under-provision for totally committed liabilities or restructuring debt to avoid full provision. Further, restructuring would be a non-transparent manner of transfers to select States.

The FFC also did not consider any proposal for debt-restructuring on the ground that it will be a good practice for governments to honour their debt obligations. It was noted that open market borrowings by States through banks cannot be restructured at the instance of FFC. Hence, the relief may not be substantial in view of significantly reduced share of the State's debts to Government of India in the total debt outstanding.

The FFC also accepted the pension expenditure for the base year provided by the States and assessed this expenditure in a manner that reflects true pension liabilities for the assessment period. The FFC also adopted norms for certain expenditure like police and general administration in a way that reflects the need of State to make adequate spending on these services.

The FFC also attempted to address the goal of equalization of expenditures across the States in terms of per capita expenditures. It made additional expenditure provision in assessment of needs of States which required such a provision to ensure that, in the final year of the FFC projections, every State reached at least 80% of all State average per capita revenue expenditure (excluding interest payment and pension and CSS transfers). It is interesting to note that the own Revenue Receipt-GDP ratio will be 8.58% during the award period, as against 7.36% projected by the States. The assessment of expenditure needs would be 11.12% of GDP against 13.57% projected by the States. The pre-devolution deficit as estimated by FFC is 2.70%, which has been fully covered by tax devolution and revenue deficit grants. It needs to be highlighted here that for many States, post devolution surplus is huge and the actual equalisation would be more than what has been estimated in the FFC report.

### **Vertical Balance**

The approach to vertical devolution was governed by three factors, viz. a) the spirit of Constitutional provisions; b) the concerns about the fiscal space expressed by the States and the Union; and c) the need for clarity on the respective functional and expenditure responsibilities of the Union and States. As already mentioned, FFC took the view that there was no scope to reduce the fiscal space available for discharging its responsibilities in the Union List of the Constitution. In this background, the FFC took a consolidated view of the aggregate transfers from the Union and the States, while recognizing that the tax devolution should be the primary route of transfer of resources to States since it is formula-based and, thus, conducive to sound fiscal federalism. It was also recognized that, to the extent the formula-based transfers do not meet the needs of the specific States, they need to be supplemented by Grants-in-Aid on an assured basis and in a fair manner.

Keeping this in view, the FFC recommended increasing the share of tax devolution to 42% of the divisible pool would serve the twin objectives of increasing the flow of unconditional transfers to the States and yet leave appropriate fiscal space for the Union to carry out its own functions and make specific-purpose transfers to the States. FFC has factored in four important considerations in arriving at the level of devolution: (i) States are not entitled to the growing share of cess and surcharges in the revenues of the Union Government, and the Constitution was not amended despite earlier recommendations of the past Finance Commissions in this regard; (ii) the importance of increasing the share of tax devolution in total transfers; (iii) an aggregate view of the revenue expenditure needs of States without the Plan and non-Plan distinction; and (iv)

the space available for the Union Government. In brief, tax devolution of 42% recommended by FFC with 32% recommended by the previous FC needs to be seen in light of the changes mentioned. However, there has been a composition shift in transfers from grants from the Union to the States in favour of tax devolution, thus enhancing the share of unconditional transfers to the latter. The balance in fiscal space thus remains broadly the same in quantitative terms, but tilts in favour of States in qualitative terms through compositional shift in favour of devolution and hence fiscal autonomy.

### **Horizontal Balance**

In regard to horizontal balance, FFC was guided by the broad criteria of the earlier Finance Commissions, viz., a) Population and income to reflect the needs; b) area and infrastructure distance to indicate cost disabilities; and c) fiscal indicators relating to tax and fiscal discipline to assess resources. There are three notable features of the criteria used by FFC. In recent years, the ToR of Finance Commission required use of population of 1971, whenever population was utilized as a factor for determination of devolution of taxes and grants-in-aid. The ToR of FFC, however, added that demographic changes that have taken place subsequent to 1971 could also be considered. FFC was of the view that use of dated population data was unfair, but having been bound by the ToR, a weight of 17.5% has been given. However, consistent with the unique ToR for FFC, the demographic changes were incorporated by giving a 10% weight to 2011 population. No doubt, the age structure of the population and net immigration are more direct indicators, but analysis showed that Population of 2011 best reflected the changes, while being transparent and simple. It may be useful to explain why the FFC expressed a view that using dated population was not fair. The requirement of the Constitution is that public services should be provided to the entire population and, therefore, the needs should be assessed for the latest population than that of forty years ago. The objective of insistence on 1971 population was entirely in a different context, namely, electoral constituencies, and expressed through a Parliamentary Resolution. An incidental objective at that point of time was to provide incentives to States to adopt family planning and not to penalize the States which have adopted family planning in the allocation of funds. There is also a question as to the effectiveness of tax devolution policy as an instrument of population control.

It is difficult to establish that the weights in the recommendations of the FC operate as an incentive or disincentive in regard to family planning activities. Further, it is also doubtful whether the growth of population reflects the policy of the State

governments by itself in a significant manner. It is also debatable whether it is appropriate to build any rewards, incentives or disincentives as part of assessing the fiscal needs of a State. To avoid distortions in assessment of needs, it may be appropriate to consider such rewards and incentives on a standalone basis. The FFC exploited the window of opportunity in its ToR to include the latest population data (2011), while retaining dominant weight to population of 1971.

The second departure from the previous practice is assigning a weight of 7.5% to the forest cover to assess cost disabilities. The FFC was convinced that maintaining a good forest cover provides good ecological benefits to the country as a whole, and even for the global community. However, the concerned States will have to incur additional costs for provision of services to the relevant population. Because of the restrictions imposed on the exploitation of valuable resources due to ecological resources, the concerned States are deprived of resources for development. Hence, the FFC concluded that cost disabilities of maintaining large forest cover and ecological balance are best reflected in assigning a weight to forest cover. Use of forest cover as a factor addressed the issue of climate change that was mandated in the ToR of FFC. This step obviated the need for specific grants for incentivizing forest cover adopted by the 13<sup>th</sup> FC.

The increase in the share of Area of a State as an indicator of need with 15 per cent weight was higher than the 10 per cent weight assigned by previous Finance Commission. This helped the States in a way to take into consideration the disabilities arising due to large area. In order to ensure that States with small areas do not suffer due to this, a minimum cap of 2 % per cent area was assigned to States with area below 2 per cent.

Third, the FFC continued with the weights for revenue disability, but expressed it in terms of income distance, which was the practice prior to the 13<sup>th</sup> FC. The income distance method is an easy to understand, transparent and straightforward method of assessing fiscal capacity. More sophisticated methods did not yield improvements in assessment of fiscal capacity commensurate with a long standing practice.

After considerable deliberations, the Commission did not take into account the fiscal performance criterion in the tax devolution and three important reasons. *First*, there are questions on the measurement of performance criterion. The improvement or deterioration in the share of expenditures financed from own revenues may simply be due to the variation in the transfers from other sources. *Second*, even if the measure is

taken, it only reflects the past trend and does not reward or punish the future behaviour. *Third*, there is no comparable approach to evaluate the performance of the Union government. *Fourth*, it needs to be recognized that as States are operating in a rule based fiscal regime due to Fiscal Responsibility Act, it is not necessary to introduce separate fiscal discipline indicator in the devolution formula.

It is tempting to make a comparison of the shares of States between the successive Finance Commissions. In doing so, it will be useful to recognise that there are same elements of the inter-se distribution recommended by the FFC which makes such comparisons difficult. For instance, in the assessment of needs by FFC, revenue expenditures on account of Plan are also included. The practice of recommending State or sector-specific grants-in-aid was eschewed by the FFC. In any case, the share of States would have changed even if the criteria and weights adopted, say by the 13<sup>th</sup> FC, were retained by the FFC.

### **Local Governments**

Transfer and allocation of resources to local bodies by Finance Commissions is beset with several complications. The recommendations are meant only to indicate measures to supplement the resources available to the States to support the local bodies. They are to be made on the basis of the recommendations made by the Finance Commissions of the State. In reality, the Finance Commissions in many States do not exist, or, their recommendations are not up-to-date. The amounts that each State sets apart for transfer to local governments from the consolidated funds themselves are unclear. There are certain areas which are explicitly excluded from the jurisdiction of the Finance Commission. The FFC had to address these issues with basically similar limitations as those of the previous Commissions. In addressing these issues, the FFC recognized that the local bodies are the primary responsibility of States concerned, both in the spirit of the Constitution and the wording of the ToRs. Similarly, State Finance Commissions are required to play a key role in allocation of resources with a State. It noted that FFC should not undermine or enhance the statutorily determined role and functions of local bodies. It was essential to avoid advocacy of centralized mechanisms to facilitate democratic decentralization through conditionality by FFC. In this background, the FFC concluded that it was necessary to significantly enhance the resources to be transferred to local bodies on an assured basis and mainly without imposition of conditions by Union or States. The practice of using an index or indices of devolution or decentralization for the purpose of transfer of resources to States on this account was given up.

The FFC devoted significant time and attention to quantitative and qualitative improvements to the design of support to local bodies, without undermining the authority of States. The working of the SFCs were examined in depth and detailed consultations held with the Chairmen of the earlier Finance Commissions, to the extent possible. The consultations were held with elected representatives of local bodies during visits to States. As per the final recommendations, the local bodies are required to spend almost all the grants only on the services within the functions assigned to them under the relevant legislations. It has been clarified that no further conditions should be imposed by either the Union or the States in this regard. Their performance grant has been restricted to compilation of accounts and their audit, and generation of own resources. The distribution of grants between the Panchayats and between the Municipalities has been left to the State governments provided it is based on the recommendations of the State Finance Commissions. In case the SFC formula was not available, a default option was provided whereby the distribution was on the basis of 2011 population with a weight of 90% for population and 10% for area. In regard to the measures to augment the revenues from own resources, the focus has been on the roles of the States in removing the bottlenecks under local bodies in this regard and empowering them. Among the measures suggested is mobilization of funds for the local bodies through Municipal Bonds, either directly or through an intermediary institution to be set-up by the State Governments.

There are certain "scheduled" areas which are covered under the proviso to Article 275(1) and excluded from the consideration of Finance Commission in the ToR. In strict compliance with the legal provisions, and in a departure from the recent past, no allocation has been recommended to these areas. However, the FFC urged the Union Government to consider a large, sustained and more efficient intervention for the up gradation of administration as well as development of these areas.

### **Disaster Management**

The scope of the ToRs in regard to Disaster Management implied that its recommendations be restricted to existing arrangements on the financing of constituted funds. Funds have been constituted at national and state level, and to some extent at the district level. The FFC adopted the practice of the previous Commissions and used past expenditure on disaster relief for determining the corpus for Disaster Management for each State. Similarly, the decision of constituting district level funds has been left to the wisdom of State governments, and no separate grants have been recommended. There are only three departures from the past. First, procedural changes for

reimbursement of expenditures incurred by the defence forces on disaster relief; State's contribution to the SDRF to be uniform at 10% for all States, replacing the differentiation between special category and other States; and (c) flexibility to States to make available up to 10% of the SDRF funds to each State for "local disasters" beyond the list of disasters notified at the national level.

### **Grants-in-Aid**

Previous Finance Commissions have enunciated four main considerations governing grants-in-aid to the States: (a) to meet their residuary budgetary needs after taking the devolution of taxes into account; (b) to facilitate the up gradation of standards of administrative and social services, and (c) to ensure minimum expenditures on such services across the country. Grants-in-aid have been recommended in the past to meet the special needs, burdens and obligations of the States and also to address the specific sectors of national importance. (d) a separate grant was given to the states for maintaining ecology and environment for promoting sustainable development. They have generally been recommended for augmenting expenditures, rather than for substituting what a State Government was already spending.

The FFC departed, to some extent, from previous practice, and adopted four principles: *First*, the devolution of taxes from the divisible pool should, as in the past, be based upon an appropriate formula which should, to a large extent, offset revenue and cost disabilities. *Second*, the assessment of expenditures should build in additional expenditures in the case of those States with per capita expenditure significantly below the all-State average. The assessment of revenues should build in the scope for additional revenue mobilization based on current tax-GSDP ratio relative to the all-State average. This will enable fiscally-disadvantaged States to upgrade their services without earmarking or specifying sectors. *Third*, if the assessed expenditure need of a State, after taking into account the enabling resources for augmentation, exceeds the sum of revenue capacity and devolved taxes, then the State concerned will be eligible to receive a general purpose grant-in-aid to fill the gap. *Fourth*, Grants-in-aid for state-specific projects or schemes will not be considered, as these are best identified, prioritised and financed by the respective States. *Fifth*, promotion of sustainable development is mainstreamed by taking the area under forest cover as a factor in tax devolution itself.

The FFC conceded that there is a case for transfers from the Union Government to the States to augment expenditure in specific sectors with a high degree of externalities in order to ensure desired minimum level of expenditures in every State.

However, past experience shows that achieving this through the mechanism of Finance Commission grants may not be appropriate. Further, Finance Commission grants on this account often operate in parallel with other transfers. FFC concluded that all such transfers, in whichever sectors are considered necessary, should be addressed through a different institutional arrangement proposed by FFC.

### **Other Transfers**

In recent years, the aggregate transfers from the Union to the States, including "direct transfers" to implementing agencies in the States as a percentage of the gross revenue receipts of the Union, have ranged between 45-54%. The Finance Commission transfers comprised only 59% of the aggregate transfers of the Union to the States, with the other transfers accounting for 41%. The FFC decided to consider other transfers in detail. In the past, there was a controversy as to whether transfers from the Union to the States outside the recommendations of the Finance Commission were in consonance with the constitutional provisions. There was a view that such transfers should be exceptional and not excessive. Irrespective of the legal or constitutional position or appropriateness, it is a fact that the other transfers are of a magnitude and complexity that it has a serious bearing on the fiscal relations of the Union and the States, which could not be ignored by the FFC.

The other transfers flow mainly as Plan grants, and marginally as Non-plan grants. Plan grants can be divided into two broad categories, viz., (a) central assistance (normal, additional, special and special plan); and (b) central schemes and centrally sponsored schemes which are conditional upon the implementation of specified schemes and programs. A detailed analysis of the existing arrangements, in particular, the Centrally Sponsored Schemes, was attempted in terms of the State lists, Union list and the concurrent list of the Constitution, as also through a differentiation between public goods and private goods. The views of the State governments and the Union Government, in terms of their operations, were considered carefully. A reference was also made to the discussions in National Development Council and various Commissions and Committees to review the Centre-state relations. The previous Finance Commissions had also made several observations. A comprehensive review of other transfers led FFC to the following conclusions:

There is some need for transfer of funds from the Union to the States which go beyond tax devolution and grants from the Finance Commission. Such transfers should be for supplementing the transfers recommended by the Finance Commission, and not

supplanting or undermining them. At the same time, duplication should be avoided. There are differences in views about the scope or purpose of other transfers, and the conditionalities associated with such transfers. There is agreement, however, about the need for flexibility for the States in regard to design and mechanism for implementation of such schemes. Significant discomfort has been expressed about the Union Government unilaterally deciding the scope, the nature and design of the Centrally Sponsored Schemes. The Union Government was keen to accord flexibility to States. Finally, the previous Finance Commissions had also expressed their discomfort in regard to the significant quantum of Central transfers being made, particularly through centrally sponsored schemes. Their suggestions included transferring of all these schemes to the States along with funds and restoring the pre-dominance of formula-based Plan transfers.

The approach of the FFC can be summarised as follows: *First*, the option of entrusting the Finance Commission with responsibilities relating to all transfers from the Union to the States is not advisable when the Finance Commission is a temporary body. At the same time, the FC 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 as per principles indicated earlier and any other matter referred to it in the interest of sound finance. *Second*, 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 especially of inter-State significance. *Third*, 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 the recommendations of the FC. *Fourth*, in the light of this, the FC recommended for consideration the evolution of a new institutional arrangement 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. In this light, FFC suggested that present role of the inter-state council be expanded to operationalise the institutional arrangements for rationalizing other transfers in the interest of sound and healthy union fiscal relations.

### **Goods and Services Tax (GST)**

The ToR in regard to Goods and Services Tax is contextual and, thus, required the Commission to consider the impact of the proposed tax on the finances of Centre and

States, and the mechanism for compensation. In the absence of clarity on the design of GST and the final rate structure, the FFC was unable to estimate revenue implications and quantify the amount of compensation. It, however, recognised that the Union Government may have to initially bear an additional fiscal burden on this account, and expressed that such fiscal burden should be treated as an investment which is certain to yield substantial gains in future. It was also observed that the GST compensation can be accommodated in the overall fiscal space available with the Union Government. This statement was made keeping in view the fact that the Union Government has several cushions (to which a reference has been made in the Report) beyond the formal projections made by the Finance Commission.

The FFC did not indicate any fiscal incentives to the States to adopt such a tax, nor did it indicate an appropriate design. However, to facilitate speedy resolution of the outstanding issues, suggestions were made for consideration of the Union and States on (a) period of GST compensation; (b) legal status of the compensation fund; and (c) universal application of the GST regime.

### **Fiscal Environment**

The ToR of FFC relating to the fiscal environment and fiscal consolidation roadmap is, in many ways, more comprehensive than the previous Commissions. FFC has been tasked with evolving an approach based on its review of Union and State finances to create a fiscal environment that is sustainable, and also promotes equitable growth. The FFC had the benefit of pioneering work in this regard done by the 12<sup>th</sup> and 13<sup>th</sup> FCs. It also had the benefit of experience in implementing these fundamental changes. Inevitably, the review by FFC encompassed legal and institutional aspects. A major problem faced by the FFC in assessing fiscal environment in a comprehensive manner was the debt position of States, and to some extent, the Union Government also. The concept of extended debt could not be applied for want of requisite information. The FFC has recommended computing of extended public debt of both Union and States and presenting it as a supplement to the budget documents.

The FFC noted that both the Union and State Governments often take up capital projects far in excess of capacity to implement them. This has complicated fiscal management and also assessment of the committed liabilities in regard to capital works for the future. In fact, a statutory ceiling on the sanction of new capital works to an appropriate multiple of the annual budget provision has been proposed.

As regards fiscal rules, consistent with the approaches in the past, a ceiling on fiscal deficit at 3% of GDP in respect of the Union was considered appropriate, though realistically it may be implemented from the year 2016-17. There was a view in the FFC that fiscal rules in regard to the Union should provide for counter-cyclical fiscal policies. While there was an agreement that in theory this was desirable, there was a counterview about its relevance to India at this juncture, especially in the light of experience so far. The counterview also felt that the international experience both in law and in practice is somewhat equivocal on this subject.

In regard to fiscal deficit targets for the States also, following the past practices, a limit of 3% was suggested. Further, for the States, some flexibility has been suggested in regard to fiscal targets and annual borrowing limits linked to: a) a shortfall in utilization of borrowing limits in the preceding year; b) the interest payments being less than or equal to 10% of the revenue receipts in the preceding year, provided there were no revenue deficits in the year in which borrowing limits are to be fixed, and c) the debt-GSDP ratio being less than or equal to 25 per cent of the preceding year. The flexibilities have been provided taking into account several factors including the huge cash balances held by the States with the Reserve Bank of India. Ambiguities in regard to the procedure for assessing of borrowing limits to each State by the Union were also removed.

In view of the uncertainties in regard to the future of National Small Savings Fund (NSSF) and the frictions in Union-State relations in this regard, including an element of involuntary borrowings, the FFC recommended discontinuance of operations of NSSF. Accordingly, in future, while the State Governments will have to repay the dues under NSSF to the Union, the Union will not be lending receipts under NSSF to States.

As specifically required by the ToR, the operation of the Fiscal Responsibility Budget Management (FRBM) Act was reviewed. In addition to the amendments required consequent to various recommendations, the FFC suggested that the concept of effective revenue deficit should be dispensed with in view of inconsistencies with the globally accepted best practices.

It noted the experience in regard to independent fiscal councils globally, and has suggested amendments to FRBM Act in the Union for this purpose.

The FFC suggested replacing the existing FRBM Act with a debt ceiling and fiscal responsibility legislation, specifically invoking Article 292 in its Preamble. This recommendation for formally invoking the Constitution is to accord greater sanctity and legitimacy to fiscal management legislation. In this regard, a reference was made to the debates in the Constituent Assemblies wherein Dr. Ambedkar stated: "I therefore think that from all points of view this article 268 as it stands is sufficient to cover all contingencies and I have no doubt about it that, as my friend Mr. Ananthasayanam Ayyangar said, we hope that Parliament will take this matter seriously and keep on enacting laws so as to limit the borrowing authority to the Union. I go further and say that I not only hope but I expect that Parliament will discharge its duties under this article.' (*Dr. Ambedkar in the Constituent Assembly – 10-8-1949*). It may be noted that Article 268 in his remarks corresponds to Article 292 of the Constitution.

The FFC computed the implicit capital outlay of the Union and each State, as per the road map indicated in FFC's projections. The results show that capital outlay by States put together is likely to exceed that of the Union, during the award period.

In our meetings, many of the States expressed the view that while they had adhered to the fiscal targets given to them, the Union government was found wanting in meeting its fiscal targets. There were questions relating to the realism of budget forecasts, monitoring fiscal targets and making policy announcements and initiating programmes without costing them at the Union level. These have implications on the fiscal management in the States. We have, based on the international experience recommended the institution of an independent fiscal institution reporting to the Parliament on the above issues to provide adequate checks for improved budgeting practices and monitoring the fiscal rules.

### **Pricing of Public Utilities:**

For the first time, the FC was asked to consider statutory provisions relating to pricing of public utilities. The ToRs of previous Commissions emphasised commercial viability of public utilities mainly at the State level. The FFC's ToR does not distinguish between the Union and State Governments. FFC took the view that pricing of public utilities raises several policy issues, and that insulating pricing from policy fluctuations need not exclude targeted subsidies. It recognised that it would be appropriate for pricing of public utilities to be considered essentially as a matter to be determined by independent regulators.

The thrust of the FFC recommendations, therefore, was a) to establish independent regulators where they do not exist; b) to empower the regulators with sufficient independence; c) to ensure effective implementation of the legislative provisions and the recommendations of the regulators; and d) to ensure that the consumption of public utilities is measured even if they are subsidized, to enable appropriate regulation. In view of the importance of water and energy for fiscal management in our country, FFC recommended universal metering essential for regulation and subsidization. These recommendations have essentially been made in the context of fiscal implications, both in terms of the profitability of government owned public utilities and the policies of subsidizing them.

### **Public Sector Enterprises**

The ToR of the FFC in regard to Public Sector Enterprises differs from the ToR of earlier Finance Commissions in several ways. Unlike in the past, it covers both the Union and State Governments in a comprehensive manner, and makes a reference to relinquishing of non-priority enterprises. Implicit in the ToR is the idea that the Government could raise resources through making the enterprises competitive and also through listing and disinvesting in them. Accordingly, the FFC took a comprehensive approach to the prioritization of Central Public Enterprises, based on new realities, fiscal implications and interest of employees.

The main recommendation is that the new realities should be considered in evaluating the future of each public enterprises in the entire portfolio, rather than view the policies incrementally and purely from the point of view of disinvestment. Secondly, it is suggested that fiscal implications in terms of opportunity cost should be factored in, while evaluating the desirable level of government ownership for each public enterprise. The disinvestment would then be derived from this approach. Other recommendations relate to the approach to the payment of dividends, transfer to reserves, creation of subsidiaries, and immense scope for borrowings by the public enterprises instead of depending on government support of retained earnings and establishment of new public enterprises. In particular, FFC noted that the policies of the government in regard to public enterprises as a whole have tended to ignore the fiscal implications, and made recommendations accordingly.

One recommendation of particular interest to Union-State relations is a suggestion to the Union Government to consider dispensing a small share of proceeds of disinvestment to the States in recognition of the fact States have also contributed

significantly to the establishment and growth of central public enterprises in several ways, including in some cases, provision of free land and other facilities.

### **Public Expenditure Management**

In regard to Public Enterprise Management Systems also, FFC has been given a wider mandate than the previous Commissions. However, on a detailed examination, it was noticed that the issue has been examined by several Commissions and Committees in the past. In addition, an Expenditure Management Commission was appointed by the Union Government recently. Accordingly, the thrust of recommendations was that the Government should examine all the recommendations made by various Committees so far, and decide on the future course of action and implement the actions as soon as possible. In addition, the FFC recommended the linking of pay with productivity, with a simultaneous focus on technology, skills and incentives, and designating Pay Commissions as 'Pay and Productivity Commissions', with a clear mandate to recommend measures to improve 'productivity of an employee', in conjunction with pay revisions.

### **WAY FORWARD**

The FFC benefitted immensely from the work done by the previous Commissions. It benefitted spectacularly from the way the Terms of Reference was constructed for which credit should go to the President of India, Mr. Mukherjee, the then Prime Minister, Dr. Manmohan Singh and the then Finance Minister, Mr. P. Chidambaram. The ToR gave an opening for examining several fundamental issues, such as population, Plan and non-Plan distinction, fiscal management legislations, privatisation of public-enterprises, etc. The ToR required the consideration of several issues affecting both Union and States symmetrically. The listing of considerations in assessment of resources and needs was thoughtful, though superfluous matters persist. Regarding the way forward, it is hoped that the ToRs of future Finance Commissions will continue to facilitate, but will be confined to, consideration of fundamental and contextual issues directly relevant to sound finance and will also accommodate some of the suggestions made in the report of FFC.

The FFC has formulated its recommendations without reference to the distinction between Plan and non-Plan. As a follow-up, it is essential to delink the Plan from the classification in budget documents and accounts so that the intended benefits accrue. Such a delinking will facilitate assessment, scrutiny and approval of all expenditures in a sector or activity, or department in a comprehensive manner, and not only incrementally. It will facilitate greater attention to maintenance expenditures, and hopefully reduce

incentives to boost capital works and show large sized plans. The provision of some public goods, such as police and judicial services, may attract the attention they deserve. Above all, the planning process will also be liberated from its close association with the budget, reflecting the new realities, namely, that the process of development requires significantly more than investments by government in development activities, and actions by the regulators, private sector and financial markets are at least equally important. A planned approach in the current context involves actions in multiple areas, as well as by several institutions and layers of government. The Union Government may have to consult the Comptroller and Auditor General on this matter, though the proposed change will not be inconsistent with globally accepted budgeting and accounting practices. In brief, the plan mindset should be replaced with a development mindset, of which government budgets are one element.

The inter-governmental fiscal relations in future will also, hopefully, reflect the principles underlying the recommendations of FFC. *First*, our Constitution, and for that matter, available literature on the subject, does not confer overriding responsibilities to national governments on the economic and fiscal management of state governments. Every tier of government should be regarded as equally accountable and responsible for functions assigned to it. At the same time, existence of overlapping responsibilities should be recognised and mechanisms put in place for their discharge. Clarity in regard to respective jurisdictions including overlapping responsibilities will add to healthy Union-State relations. In this regard, every entry in the Concurrent List of the Constitution should be disaggregated into distinct components in the interest of clarity, and assigned to Union, State and overlapping or truly concurrent. No doubt, the residuary powers will remain with Union, but residuary powers do not imply overriding powers. *Second*, the global trend is towards greater centralization of taxes and decentralisation of government expenditures, and such trends should be analysed in their relevance to our systems. Similarly, globalisation of economic activity and need for provision of global goods cast special responsibility on the Union. These do have an impact on Union-State fiscal relations. *Third*, it should be recognised that the Directive Principles of State Policy of the Constitution or national priorities are of equal concern to Union and State Governments. Similarly, a subject of national importance does not automatically confer total expenditure responsibility on the Union Government without reference to the Constitution. The new economic realities, including globalization, may warrant greater importance of the Union Government in many ways, but they do not necessarily justify intrusion into the legitimate fiscal space of the States accorded by the letter and spirit of

the Constitution. This requires a change in the “mindset”, and operationally a review of composition of “other transfers”, in particular, centrally sponsored schemes.

The State Governments being closer to the people, have an increasingly important role to play in view of greater fiscal freedom that has been accorded to them by FFC in the fiscal transfers from the Union to the States. In particular, each State has the opportunity to take a comprehensive view of its developmental strategies and allocate financial resources appropriately without being unduly constrained by approvals of annual plans by an agency like the Planning Commission in the Union Government and multiplicity of central schemes with conditions attached. Further, if the recommendations of the FFC in regard to other transfers are fully implemented, the States may also have a say in regard to sectors to which the centrally sponsored schemes will be justifiable, their distribution across the States and their design. The States could take full advantage of interacting with the experience of various strategies and programmes in other States, in view of greater autonomy in deciding some of their strategies and schemes. On the way forward, it may be appropriate to consider significant inter-state exchange of information and even expertise in regard to public fiscal management and public expenditures, in particular. The implicit capital outlay of all States during the award period is projected to be about double that of the Union which implies that States have a critical role to play in maintaining growth momentum at a time when Union would be focusing on fiscal consolidation.

In regard to Local Bodies, it is hoped that the State Governments will, depending on the local circumstances, strengthen the local bodies, in particular, those in urban areas. The State Governments could consider three important initiatives, *viz.*, to remove the bottle necks and hurdles in the exercise of the powers of local bodies within the existing legislation; empower the State Finance Commissions; assist capacity building at local levels for implementing works and maintaining accounts; and review the existing legislations to empower the local governments in terms of resources and functions. These efforts would enhance the contribution by the FFC in terms of a steep step-up in untied grants recommended for local bodies.

The quality and credibility of fiscal management in both Union and States requires to be critically examined. In this regard, the relationships between government, public enterprises, and regulators are still treated with a “joint family approach”, where contributions, burdens and financial linkages are seldom clearly accounted for. Hence, the fiscal accounts conceal more than what they reveal, both at Union and State levels.

As explained in the report of the FFC, computation of extended public debt, and the fiscal implications of the functioning of public enterprises become difficult under the current dispensation. Improvements in this regard will facilitate the work of future Finance Commissions.

Finally, what did the FFC learn from the process that could be of benefit for the future Finance Commissions? Value is added by adhering to the letter and spirit of the Constitution. It helps to listen and learn from the stakeholders so that current problems are appreciated. It is most productive to attempt to address, in a focused manner, the troubling contemporary issues relevant to the ToRs. Further, legitimacy for the Finance Commission in advocating policy-agendas and assigning priorities, should be kept in view. In addition, the expertise available with, or at the disposal of the Finance Commissions and the time span available to them for making their recommendations limits their capacity to address many issues, except in terms of general principles. In brief, the inherent complexities in rebalancing the resources and needs of Union and several States are so complex in India that the task of the Finance Commissions warrants humility.

The reports of Finance Commissions invite universal dissatisfaction, but FFC, like its predecessors, tried to ensure that all stake-holders are equally dissatisfied with the recommendations to establish its credibility. I am hoping that FFC has achieved the objective of being fair in this limited sense of ensuring widespread and equal dissatisfaction.

I express my gratitude to the organizers again, and conclude by paying tributes to Professor Raja Chelliah – a scholar, a gentleman, a policy-maker and an institution builder.

Thank you.

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