Chapter 8

Sharing of Union Tax Revenues

8.1 One of the core tasks of a Finance Commission as stipulated in Article 280 (3) (a) of the Constitution is to make recommendations regarding the distribution between the Union and the states of the net proceeds of taxes which are to be, or may be, divided between them under Chapter I of Part XII of the Constitution and the allocation between the states of such proceeds. This is the most important task of any Finance Commission, as the share of states in the net proceeds of Union taxes is the predominant channel of resource transfer from the Centre to states. In the total resource transfers recommended by the Finance Commissions, from the First to the Twelfth, tax devolution accounted for an average of over 84 per cent. The share of tax devolution in the total transfers recommended varied from 73.9 per cent by FC-VI to 92.3 per cent by FC-VII. In the total transfers recommended by FC-XII, tax devolution accounted for 81.1 per cent as compared to the 86.5 per cent share recommended by FC-XI.

Vertical Devolution

8.2 Our first task is to arrive at the share of states in the net tax revenues of the Centre. For this purpose it is necessary to assess the vertical gap between the Union and the states. The vertical gap is the difference between the normatively assessed expenditure share and revenue capacities of the Union and the states. Our normative assessment of the revenues and expenditures of the Union and the states is presented in chapters 6 and 7, respectively. In addition, while formulating our recommendations, we have considered the views of the Centre and the states, developments having a bearing on the finances of the Centre and the states, as well as the overall macroeconomic and fiscal situation in the country.

Views of the Union and the States

8.3 The Ministry of Finance, in its memorandum, has drawn our attention to the steady increase in the resources transferred to states, both by way of the share in central taxes and in the form of grants, particularly since 2005-06. The ministry has also indicated that there has been an increase in the net transfers to states since 2005-06 following the discontinuation of the practice of on-lending to states. The other issues raised in the memorandum relate to increasing direct transfers to state level agencies and the rising expenditure of the Centre on food and fertiliser subsidies. The ministry has contended that expenditure on food and fertiliser subsidies, in a way, amounts to negative taxation and that such expenditure is incurred on behalf of the states. We have been requested to keep these points in view while recommending transfers to states. The ministry has reiterated in its submission made to FC-XII that tax devolution should be gradually reduced to a maximum of 28 per cent of the net proceeds of central taxes. The ministry has further contended that the tax devolution recommended by FC-XI may not be changed as there has been no change in the responsibilities of the Centre or states, as envisaged in the Constitution.

8.4 The states have, for the first time, submitted a joint memorandum to the Commission. In this joint memorandum, the Commission has been urged to enhance the share of the states in the net proceeds of central taxes from 30.5 per cent to at least 50 per cent considering the fact that the states' share in the combined developmental expenditure is much higher than that of the Centre. The states have further urged that the divisible pool of central taxes should include all cesses and surcharges. The states have contended that the requirement for an increase in their share of central taxes is much stronger now as the implementation of state-level Value Added Tax (VAT), with its built-in documentation of value addition, has simultaneously contributed to growth in income and corporate tax revenues. The memorandum also states that pay revision of Central and State Government employees will further enhance income tax collections by the Centre.

8.5 The states, in their individual memoranda have, without exception, sought an increase in their share of central taxes. The majority have sought an increase from the present 30.5 per cent share in net tax revenues of the Centre to 50 per cent. Increase in the share of states in a phased manner, to 50 per cent, has been suggested by a few states. A minimum guaranteed tax devolution to insulate the states from a possible shortfall in the Centre's revenues as compared to the forecast made by the Finance Commission has been suggested by some states. Earmarking of 30 per cent of the divisible pool to special category states has been suggested by a few states belonging to this category.

8.6 On the issues of cesses and surcharges, views expressed by states ranged from capping the cesses and surcharges as a percentage of gross tax revenue of the Centre to their inclusion in the divisible pool of central taxes. While some states have sought an increase in the indicative ceiling on overall revenue account transfers to states from 38 per cent of gross revenue receipts of the Centre recommended by FC-XII, some others have sought removal of the indicative ceiling on the grounds that such a ceiling restricts the scope of central transfers to states. A share in the non-tax revenues of the Centre, such as sale proceeds of spectrum and off-shore royalties has been sought by some states.

8.7 The states have advanced a number of reasons for seeking an increase in their share of central taxes. These include reduction in the size of the divisible pool due to increase in the scope of cesses and surcharges; growing vertical imbalances in the form of increasing number of Centrally Sponsored Schemes (CSS), declining shares of state plan outlays and increasing expenditure needs of states in areas such as infrastructure development, social and human development, environmental protection and establishment in the wake of the pay revision.

Recommendations on Vertical Distribution

8.8 After due consideration of the views of the Centre and states, we are of the opinion that vertical devolution should be informed by the revenue-raising capacity of the Centre and states as well as emerging pressures on their expenditure commitments. We have observed that buoyancy of central taxes, at 1.49, has been higher than that of the states (1.18) during the period 2000-08 and that there are reasons to believe that the Centre's revenue buoyancy will continue to remain higher than that of states. Further, the Centre has the advantage of resorting to levy of cesses and surcharges to meet some of its expenditure commitments. As indicated in Chapter 4, the share of cesses and surcharges in gross tax revenue of the Centre increased sharply from 3.51 per cent in 2001-02 to 13.63 per cent in 2009-10 (BE). This has led to considerable reduction in the divisible pool as a percentage of gross revenue receipts of the Centre.

8.9 There has been a significant increase in non-tax revenues of the Centre, particularly from royalties and the telecommunication sector. Receipts from telecommunication services increased from Rs. 8018 crore in 2001-02 to Rs. 26,729 crore in 2007-08. Royalties from off-shore hydrocarbon resources are expected to increase substantially in the near future. The Union Government presently shares profit petroleum only from on-shore fields under the New Exploration Licensing Policy (NELP). The resource position of the Centre is expected to improve on account of buoyant non-tax revenues. Thus, there is a case for increasing the share of states in the net tax revenue of the Centre.

8.10 The increasing number of CSS, though largely funded by the Centre, has, nevertheless, significant expenditure implications for states in terms of cost sharing, provision of supporting infrastructure and committed liability. The sharp increase in outlays on CSS, thus, requires greater contribution from states as well. There has also been an increase in the share of states in the funding of CSS. Under the Sarva Shiksha Abhiyan (SSA), the matching contribution of states has gone up from 15 to 40 per cent. It is proposed to further increase the contribution of states in this regard to 50 per cent. In addition, the responsibility of maintaining the services and assets created under CSS ultimately rests with the states. There are substantial direct transfers to implementing agencies in states under the CSS. The assets created by local bodies through direct transfers have to be ultimately maintained by states as own revenue generation by these local bodies is very poor.

8.11 There are a few other developments as well, which are likely to increase the expenditure commitments of states. The Government of India has proposed building up of a legal structure of rights and entitlements in a number of areas to ensure provision of uniform quality of services all over the country. Food, social security and land compensation are some of the areas where the legislative process has commenced. The Right of Children to Free and Compulsory Education (RTE) Act, 2009 has proposed free and compulsory education for all children in the age group of 6 to 14 years. The Act contains a number of provisions relating to teacher-student ratio, infrastructure facilities in schools and qualifications of teachers. These provisions are likely to have significant financial implications for states. The President, in her address to Parliament on 4 June 2009, announced that a new law—the National Food Security Act would be legislated to set out a statutory framework for providing food security. Under the proposed legislation it is envisaged that every below poverty line (BPL) family will be entitled by law to a certain quantity of food grains every month. While the Centre is likely to provide subsidised food grains, states will probably need to take on the responsibility of putting in place storage infrastructure as well as maintaining a comprehensive distribution system.

8.12 As emphasised in the Eleventh Five-Year Plan document, protection of environment has to be a central part of any sustainable inclusive growth strategy. Environment is a residual central subject and the responsibility for its maintenance rests on all levels of government, more particularly on state governments. There are a number of central and state enactments in the area of environmental protection. The compliance cost of most central legislation falls on the states. During our visits, states have contended that the benefits derived from mining were insignificant as compared to the additional costs in terms of pollution of water resources, degradation of land, loss of agricultural output, damage to roads and air pollution. States have also drawn our attention to additional costs towards rehabilitation of displaced persons. Until the cost of environmental damages is internalised by all polluting industries, state governments will continue to bear these additional costs. This Commission is required, as per its Terms of Reference (ToR), to consider the need to manage ecology, environment and climate change consistent with sustainable development. Implementation of such a mandate would require that the states be provided additional assistance to enable them to address these issues upfront.

8.13 The states have a major responsibility in terms of provision of both rural and urban infrastructure. The proportion of urban population of the country is projected to increase from 28 per cent of the total population to about 38 per cent in 2026. Further, the projected growth of urban population will account for two-thirds of the total population increase. The current state of supply of core services in the urban areas, viz. water supply, sewerage, solid waste management and street lighting, is inadequate by any standards. The higher growth of urban population will add further pressure on provision of these services.

8.14 The size and scope of infrastructure projects sponsored by the State Governments is smaller than those sponsored by the Central Government. Thus, State Governments have relatively less scope than the Central Government for resorting to Public Private Partnerships (PPP) to meet the funding gaps in these projects. This imbalance in scope is likely to result in states having to depend more on own funding.

8.15 Our assessment indicates that the impact of implementation of the recommendations of the Sixth Central Pay Commission (CPC) is likely to be asymmetrical as between the Centre and the states. Incremental expenditure on civilian and defence employees at the Centre on account of the implementation of the recommendations of Sixth CPC is estimated at Rs. 37,130 crore per annum. For the states, the incremental expenditure is estimated at Rs. 49,532 crore per annum. Income tax collection on the additional salary expenditure of the Centre is estimated at Rs. 3294 crore, net of tax exemptions. Additional salary expenditure by states is likely to improve income tax collections by Rs. 4393 crore. Thus, the aggregate additional income tax revenue amounts to Rs. 7687 crore per annum. Of this additional revenue, Rs. 2306 is likely to accrue to states as their share in central taxes while the remaining amount of Rs. 5381 crore accrues to the Centre. The ratio of net additional expenditure on account of pay revision between the Centre and states is 1:1.49. Thus, net additional liability on account of pay revision is higher for states.

8.16 FC-XII recommended the share of states in net central taxes at 30.5 per cent. For the purpose of tax devolution, the proceeds of additional excise duties in lieu of sales tax on textiles, tobacco and sugar were treated as part of the divisible pool of central taxes. FC-XII further recommended that the states' share in the net proceeds of shareable central taxes shall stand reduced to 29.5 per cent in the event of the termination of the tax rental agreement and states being allowed to levy sales tax (or VAT) on these commodities without any prescribed limit.

8.17 There has been a long term stability in the relative shares of the Centre and the states in the combined revenue receipts and in the combined revenue expenditure as discussed in Chapter 4. We are of the view that such fiscal stability be maintained during our award period. The share of states after transfers will be constant only if their share in central taxes is increased by a margin by which the buoyancy of central taxes exceeds the buoyancy of combined tax revenue.[1] As indicated in para 8.8, the buoyancy of central taxes has been higher than that of state taxes. This points to the need for increasing the share of states in central tax revenues. After considering all the reasons adduced in paras 8.8 to 8.15, we recommend that the share of states in the net proceeds of shareable central taxes be raised from 30.5 per cent to 32 per cent. The recommended increase in the share of states in net central taxes is unlikely to impose a burden on the Centre and can be accommodated by pruning and better targeting of subsidies as well as through the restructuring of some of the CSS.

8.18 The position with respect to the levy by the Centre of additional excise duties in lieu of sales tax has changed since submission of the report of FC-XII. All the goods under the Additional Duties of Excise (Goods of Special Importance) Act, 1957 have been exempted from the payment of duty under the Act from 1 March 2006. Following this exemption, the Centre had made suitable adjustments in the basic excise duty rates on cigarettes, beedis and sugar. The three goods covered under the tax rental agreement, namely, textiles, tobacco and sugar continue to remain in the list of declared goods under the Central Sales Tax Act, 1956 thus binding the states to prescribed rates in case states decide to levy VAT on these commodities. The Ministry of Finance has indicated that releases of states' share in net central tax revenue are in conformity with the states' share of 30.5 per cent as recommended by FC-XII. Keeping in view these developments, we are not earmarking any portion of the recommended 32 per cent states'

[1] Rangarajan, C. and Srivastava, D.K. 'Reforming India's Fiscal Transfer System: Resolving Vertical and Horizontal Imbalances', *Economic and Political Weekly*, 7 June 2008

share in shareable net central tax revenue as attributable to additional duties of excise in lieu of sales tax and are not recommending any reduction in the share of the states in the event of levy of VAT on textiles, tobacco and sugar by them.

8.19 For the purpose of determining the states' share in central taxes, we have treated proceeds of service tax as part of the divisible pool. In terms of the 88th Amendment to the Constitution, the power to levy service tax is vested with the Centre and distribution of the tax proceeds between the Union and states shall be in accordance with the principles to be determined by the Parliament. So far, the amendment has not been notified. It is unlikely that it will be notified, in view of the proposed introduction of the Goods and Services Tax (GST). FC-XII recommended that in the event of such notification, it should be ensured that the revenue accruing to a state under the notification should not be less than the share that would accrue to it, had the entire service tax proceeds been part of the shareable pool. We fully endorse the recommendation of FC-XII in this regard.

8.20 We are unable to accede to the states' demand for inclusion of cesses and surcharges imposed by the Centre in the divisible pool of central taxes, as under Article 270 of the Constitution, taxes referred to in Articles 268 and 269, surcharges on taxes and duties and cesses levied for specific purposes shall not form part of the divisible pool. However, we recommend that the Centre review the current surcharges and cesses with a view to reducing their share in the gross tax revenues. We hope that with the introduction of GST, most of the cesses and surcharges will be subsumed under the basic rate of central GST.

8.21 The Commission has taken into account the overall central transfers to states on revenue account in relation to gross revenue receipts of the Centre, while recommending the states' share in net central taxes. For the first time, FC-XI recommended an indicative ceiling on all revenue account transfers, at 37.5 per cent of the Centre's gross revenue receipts. This was raised by FC-XII to 38 per cent. In Chapter 4, we broadly discussed the trends in the overall transfers on revenue account. We recommend raising of this indicative ceiling to 39.5 per cent of the Centre's gross revenue receipts. In fact, transfers on revenue account are already above 39 per cent of the revenue receipts of the Centre in the years 2008-09 (RE) and 2009-10 (BE).

Horizontal Sharing

8.22 Recent Finance Commissions have used equity and efficiency as the two guiding principles while recommending *inter se* shares of states in tax devolution. The principle of equity addresses the problem of differences in revenue raising capacity and cost disabilities across states. When capacity is assessed on the basis of observed revenue collected there is the risk of moral hazard in making the states lax in terms of improving their revenue effort and managing their finances prudently. The principle of efficiency is intended to address this issue and to motivate the states to exploit their resource base and manage their fiscal operations in a cost effective manner. A combination of these two principles has found wide acceptability and addressed the concerns of reforming states. Our recommendations on horizontal sharing have been informed by these principles.

8.23 Having decided on the basic principles, the next issue is that of selecting the criteria representing these principles. Before we come to the selection of criteria, there is the issue of whether these criteria should be forward looking or based on past trends. There is no doubt that forward looking indicators are better, as devolutions are linked to future performance rather than past performance. As there is no certainty that the criteria will remain the same in future, there may not be enough incentive for states to improve their performance. However, a Finance Commission can only recommend the criteria but cannot determine the shares of states based on future performance, as it is not a permanent body. There is no mechanism currently in place to arrive at the shares of states on the basis of year-to-year performance. Besides, the performance indicators become available only after a gap of a few years. Therefore, we do not consider it feasible to adopt forward looking indicators for tax devolution involving yearly updating of *inter se* shares of states. However, we have considered such an option in the context of our recommendations for grants.

Views of State Governments

8.24 A majority of states, in their memoranda, favoured population as a criterion for determination of *inter se* shares of states in tax devolution. While some states are in favour of using the population figures of 2001, a few others have urged the Commission to use 1971 population figures, as mandated in the ToR. The weights sought to be assigned to this criterion varied from 10 per cent to 70 per cent. A few states have suggested that suitable weightage be assigned to the SC/ST population in a state. Population below the poverty line has also been suggested as a criterion. A majority of states favoured retention of income distance as a criterion. However, the weight suggested for this criterion varied widely, from a low 10 per cent to a high 70 per cent.

8.25 A number of states favoured continuation of area as a criterion in the distribution formula, with some states suggesting an increase in the weightage and others suggesting a reduction. Continuation of tax effort and fiscal discipline as criteria for tax devolution has been suggested by the majority of states. Other criteria suggested by states include forest cover, length of international border, index of infrastructure, levels of backwardness, human development index, share of primary sector in Gross State Domestic Product (GSDP) of a state, contribution to central taxes and expenditure on social sectors and infrastructure. Criteria and weights for tax devolution suggested by states are summarised in Annex 8.1.

Criteria for Horizontal Sharing

8.26 FC-XII assigned a weight of 25 per cent to population, 50 per cent to per capita income distance, 10 per cent to area and 7.5 per cent each to tax effort and fiscal discipline in the formula for arriving at the share of each state in tax devolution. We have taken into account each one of these criteria and have also examined the suitability of other criteria in our effort to arrive at an appropriate formula for tax devolution. The components of the distribution formula recommended by us are discussed below.

Population

8.27 Population is an indicator of the expenditure needs of a state. It is a simple, objective and transparent indicator that ensures predictability. The criterion ensures equal per capita transfers to all states, not taking into account cost disabilities across states because of differences in the geographic spread of population. FC-XII assigned a weight of 25 per cent to population. We consider population as an important indicator of the needs of a state and assign it a weight of 25 per cent, as was done by FC-XII. For this purpose, we are bound by our ToR to take into account population figures for states based on the 1971 Census (Annex 8.2).

Area

8.28 Area as a criterion in the devolution formula was first introduced by FC-X on the grounds that a state with larger area has to incur additional administrative costs to deliver a comparable standard of service to its citizens. As pointed out by that Commission, the differences in the costs of providing services may increase with the size of a state, but only at a decreasing rate and that, beyond a point incremental costs may become negligible. The Commission further pointed out that states with small areas have to incur certain minimum costs in establishing the framework of government machinery and the costs of providing services in many of these smaller states may be higher because of the terrain. Taking into account these considerations, FC-X used an adjustment procedure whereby no state received a share higher than 10 per cent at the upper end or less than 2 per cent at the lower end. The Commission assigned a small weight of 5 per cent to area subject to the above adjustment. FC-XI assigned a weight of 7.5 per cent to area, subject to the minimum of 2 per cent and maximum of 10 per cent as recommended by

FC-X. Area was assigned a weight of 10 per cent by FC-XII. The Commission assigned a minimum of 2 per cent share to those states whose share in total area is less than 2 per cent but did not fix an upper ceiling of 10 per cent.

8.29 We have assigned a weight of 10 per cent to the area criterion as adjusted on the lines of FC-XII. States with less than 2 per cent share in total area, but assigned a minimum share of 2 per cent, are Goa, Haryana, Himachal Pradesh, Kerala, Manipur, Meghalaya, Mizoram, Nagaland, Punjab, Sikkim, Tripura and Uttarakhand. There is no upper limit on the shares of other states (Annex 8.3).

Fiscal Capacity Distance

8.30 Population and area have both been adopted by this Commission as criteria in the horizontal devolution formula, with the same weights as those used by FC-XII (paras 8.27 and 8.29). These are equity-neutral measures of fiscal need. In a country like India, where there is a 10:1 ratio between the per capita incomes of the highest and lowest income states (based on average comparable per capita GSDP for the years 2004-05 to 2006-07), there is an overwhelming case for an equity component in determination of relative fiscal need and indeed, this has been recognised by every Finance Commission from FC-VI. The intent of the equity component in the devolution formula is to ensure that all states have the fiscal potential to provide comparable levels of public services to their residents, at reasonably comparable levels of taxation. The equity component is justified, not merely to ensure equal treatment of citizens by governments, but also for economic efficiency reasons, so as to minimise fiscally-induced migration. However, it does not, by itself, ensure achievement of common standards in quality or outcomes in public services. For that to happen, it is necessary that the comparable level of tax effort assumed to hold across states actually prevails in each state and that efficiency in delivery is reasonably uniform. One of the terms of reference of this Commission requires us to look at improvement in public service delivery and we do so through the design of the conditionalities attached to some of our grants. The equity component in the devolution formula is an enabling provision that does not, by itself, guarantee uniformity in public service delivery across states.

8.31 The income distance criterion used by FC-XII, measured by per capita GSDP, is a proxy for the distance between states in tax capacity. When so proxied, the procedure implicitly applies a single average tax-to-GSDP ratio to determine fiscal capacity distance between states. This Commission recommends, instead, the use of separate averages for measuring tax capacity, one for general category states and another for special category states. The justification for doing this is that between the two categories, a single average applied (implicitly) to GSDP does not accurately capture the fiscal distance between the two groups. This is because overall GSDP does not accurately capture the taxable base for two reasons. The first is that the sectoral composition of GSDP varies across states and the sectors are not uniform in their taxability. Agriculture, for example, is not effectively taxable in states, except where there are plantations. The second reason is that GSDP estimates presently available are at factor cost and therefore, exclude income such as that accruing in the form of remittances. The cross-state average ratio of tax-to-GSDP is higher for general category states than for the special category, where this difference encapsulates the combination of factors underlying the relative fiscal capacity of the two groups. Thus, group-specific averages are applied to the two categories so as to obtain a closer approximation to the distance in fiscal capacity between states, which is ultimately what is sought to be captured. Ideally, tax frontiers specific to each state should be estimated, but an exercise of this kind was constrained due to lack of the necessary data.

8.32 The procedure used is, therefore, as follows. We have first worked out the three-year average per capita GSDP for the individual states based on comparable estimates for the years 2004-05 to 2006-07 (Annex 8.4). In the next step, the average tax to comparable GSDP ratio has been obtained as a weighted mean separately for general category and special category states (Annex 8.5). These group-specific averages are then applied to the constituent states in each group so as to obtain the per capita tax revenue in each state, potentially available at the average tax effort for the group in which it falls. This is an estimated average. Observed per capita tax revenue will be higher than the estimate generated here in states with observed tax-to-GSDP ratios higher than the group average and lower in states with lower ratios. The intent is to estimate per capita fiscal capacity at reasonably comparable levels of taxation by application of the observed group average.

8.33 Fiscal distance is obtained for each state by the distance of its estimated per capita revenue, by the procedure described in the previous para, from the estimated per capita revenue of Haryana, the second highest in the per capita income ranking after Goa. The distance so computed for all states, barring Haryana and Goa, defines the per capita revenue entitlement of each state based on fiscal distance. For Haryana and Goa, a revenue entitlement of Rs. 100 per capita has been assigned. For Maharashtra, with average per capita GSDP slightly lower than that of Haryana, the fiscal distance computed based on the procedure described in the earlier paragraph worked out to be negative. We have assigned it a notional revenue entitlement of Rs. 100 per capita, at par with Haryana and Goa. These per capita entitlements are then multiplied by the respective 1971 population figures of each state to arrive at the share of each state in tax devolution. We have assigned a weight of 47.5 per cent to the fiscal capacity distance criterion.

8.34 The use of average tax-to-GSDP ratios specific to each category neutralises to an extent the fiscal disadvantage of special category states in terms of tax capacity.

8.35 Finally, another principle governing devolution has to be cost disability, so that the amounts devolved conform to equity-based fiscal need, modified by differing costs of service delivery. Cost disability affects both general and special category states. Within the general category, there are many states with spatially dispersed human habitations, which raise the cost of equivalent service provision. The weight assigned to area is conventionally designed to take this into account. One of the suggestions made to the Commission was to use a three-dimensional measure of area, with topographical variation factored in, to better capture the relative cost disabilities of states and to place them all on a uniform platform. However, the necessary data for such an exercise were not available from the Surveyor General of India. In states with hilly terrain, the ratio of uninhabited area to total area will be higher. To the extent that the entire area has been used in our devolution formula, the provision per square kilometre of inhabited area will be higher. This implicitly covers the cost disability of such states, to a limited degree.

Fiscal Discipline

8.36 Fiscal discipline as a criterion for tax devolution was used by FC-XI and FC-XII to provide an incentive to states managing their finances prudently. Both these Commissions assigned a weight of 7.5 per cent to this criterion. The index of fiscal discipline was arrived at by relating improvement in the ratio of own revenue receipts of a state to its total revenue expenditure to average ratio across all the states. FC-XII had worked out the index with the reference period of 2000-01 to 2002-03 and the base period of 1993-94 to 1995-96. We have retained this criterion and have worked out the index of fiscal discipline with 2005-06 to 2007-08 as reference years and 2001-02 to 2003-04 as the base years (Annex 8.6). The own revenue receipts of a state include own tax revenues and thus, the criterion of fiscal discipline also captures the tax effort of states. We have, therefore, dropped the use of tax effort as a separate criterion. FC-XII assigned a weight of 7.5 per cent each to fiscal discipline and tax effort. Thus, the combined weight assigned by FC-XII to these two criteria was 15 per cent. There is a strong case to incentivise states following fiscal prudence, particularly in the context of the need to return to the path of fiscal correction. We have, therefore, assigned a weight of 17.5 per cent to fiscal discipline. Under this criterion, if all states have improved their respective ratios of own revenue to total revenue expenditure, then the states with relatively higher improvement than the average receive higher transfers.

Similarly, if the ratio has deteriorated in all states, then states with lower deterioration than the average receive higher transfers.

8.37 The criteria for determining the *inter se* shares of states in tax devolution, along with the weights assigned to them, are summarised in Table 8.1. The formula for deriving the *inter se* shares of states in tax devolution under each of the criterion are given in the end note to this chapter.

Table 8.1: Criteria and Weights for Tax Devolution

(*per cent*)

Criteria	Weight
1. Population (1971)	25.0
2. Area	10.0
3. Fiscal Capacity Distance	47.5
4. Fiscal Discipline	17.5

8.38 Our recommendations on tax devolution are based on the considerations of need, fiscal deficiency and adequate incentivisation for better performance. The *inter se* shares of states in the net proceeds of central taxes (excluding service tax) as recommended by us in each of the five years 2010-15 are specified in Table 8.2.

8.39 At present, service tax is not levied in the state of Jammu & Kashmir. Therefore, net proceeds of service tax are not assignable to this state. The shares of the remaining 27 states in the proceeds of service tax will be as indicated in Table 8.3.

8.40 In case service tax is levied in the state of Jammu & Kashmir, the share of each state, including Jammu & Kashmir, will be in accordance with the percentages indicated in Table 8.2 from the year in which the service tax is levied in Jammu & Kashmir. If in any year during our award period of 2010-15, any tax of the Union is not leviable in a state, the share of that state in the tax should be treated as zero and the entire proceeds of that Union tax should be distributed among the remaining states by proportionately adjusting their shares.

Table 8.2: *Inter se* Shares of States

(*per cent*)

States	Share
Andhra Pradesh	6.937
Arunachal Pradesh	0.328
Assam	3.628
Bihar	10.917
Chhattisgarh	2.470
Goa	0.266
Gujarat	3.041
Haryana	1.048
Himachal Pradesh	0.781
Jammu & Kashmir	1.551
Jharkhand	2.802
Karnataka	4.328
Kerala	2.341
Madhya Pradesh	7.120
Maharashtra	5.199
Manipur	0.451
Meghalaya	0.408
Mizoram	0.269
Nagaland	0.314
Orissa	4.779
Punjab	1.389
Rajasthan	5.853
Sikkim	0.239
Tamil Nadu	4.969
Tripura	0.511
Uttar Pradesh	19.677
Uttarakhand	1.120
West Bengal	7.264
All States	**100.000**

8.41 The Commission also noted that, relative to FC-XII, there is an increase in the ratio of devolution to GSDP (as projected by us) for each state (Table 8.4). Thus, every state, taken individually, gains in terms of devolution relative to its GSDP.

Table 8.3: Share of States other than Jammu & Kashmir in the Service Tax

(*per cent*)

States	Share
Andhra Pradesh	7.047
Arunachal Pradesh	0.332
Assam	3.685
Bihar	11.089
Chhattisgarh	2.509
Goa	0.270
Gujarat	3.089
Haryana	1.064
Himachal Pradesh	0.793
Jammu & Kashmir	NIL
Jharkhand	2.846
Karnataka	4.397
Kerala	2.378
Madhya Pradesh	7.232
Maharashtra	5.281
Manipur	0.458
Meghalaya	0.415
Mizoram	0.273
Nagaland	0.318
Orissa	4.855
Punjab	1.411
Rajasthan	5.945
Sikkim	0.243
Tamil Nadu	5.047
Tripura	0.519
Uttar Pradesh	19.987
Uttarakhand	1.138
West Bengal	7.379
All States	**100.000**

Table 8.4: Average Devolution as Percentage of GSDP

States	FC XIII	FC XII	Difference (FC XIII-FC XII)
Andhra Pradesh	3.34	2.80	0.54
Arunachal Pradesh	14.24	8.91	5.33
Assam	7.79	5.16	2.63
Bihar	19.44	13.57	5.87
Chhattisgarh	5.47	4.55	0.92
Goa	2.14	1.74	0.40
Gujarat	1.48	1.44	0.04
Haryana	1.10	0.93	0.17
Himachal Pradesh	3.59	1.83	1.74
Jammu & Kashmir	6.66	4.23	2.43
Jharkhand	5.44	5.15	0.29
Karnataka	2.69	2.21	0.48
Kerala	2.13	1.94	0.19
Madhya Pradesh	8.61	5.61	3.01
Maharashtra	1.36	1.04	0.32
Manipur	12.92	7.24	5.68
Meghalaya	7.64	5.20	2.44
Mizoram	13.77	8.31	5.46
Nagaland	9.20	4.95	4.25
Orissa	6.73	5.69	1.04
Punjab	1.92	1.22	0.70
Rajasthan	5.52	3.88	1.64
Sikkim	18.05	12.08	5.97
Tamil Nadu	2.58	2.07	0.51
Tripura	9.31	4.74	4.57
Uttar Pradesh	10.09	6.79	3.30
Uttarakhand	5.35	3.40	1.95
West Bengal	3.67	2.82	0.85

Notes: 1. Average devolution is determined over the five year period of each of the Finance Commissions, as projected.
2. Comparable GSDP used for 2005-06 and 2006-07.
3. Comparable GSDP projected over the period 2007-08 to 2014-15 has been used.

End Note

The *inter se* share of i^{th} state in the tax sharing formula, s_i, is determined as the weighted sum of state shares by the four parameters. Thus,

$$s_i = \sum_{m=1}^{4} s_i^m w_m$$

$$\textit{where} \sum_{m=1}^{4} w_m = 1; \quad \sum_{i=1}^{28} s_i = 1$$

w_m= weight of the m^{th} parameter; m=1, ..., 4
i = index for states; i = 1, ..., 28

The formula for each of the four parameters used by the Commission is as follows:

1. Population

For the i^{th} state the share under this criterion ($s_i^{m=1}$) is derived as

$$s_i^{m=1} = pop_i^{1971} \Big/ \sum_{i=1}^{28} pop_i^{1971}$$

where pop_i^{1971} = 1971 population of the i^{th} state

2. Area

For the i^{th} state the share under this criterion ($s_i^{m=2}$) is derived through a two stage procedure. In the first stage

$$s_i^{m=2} = area_i \Big/ \sum_{i=1}^{28} area_i$$

where $area_i$ = area of i^{th} state

In the second stage, the share of each state is subject to a floor of 2 per cent, i.e., states having area less than 2 per cent of the total area are assigned a share of 2 per cent, and the shares of the other states are reduced proportionately so as to restore the sum across all states to unity.

3. Fiscal Capacity Distance

For the i^{th} state the share under this criterion ($s_i^{m=3}$) is derived as

$$s_i^{m=3} = pop_i^{1971} d_{i,j} \Big/ \sum_{i=1}^{28} (pop_i^{1971} d_{i,j})$$

where $d_{i,j}$ = $(kY^* - k_j Y_{i,j})$ for all states except Goa, Haryana & Maharastra
= 100 for Goa, Haryana & Maharastra

k = three year (2004-07) average tax to comparable GSDP ratio of all states

k_j = three year (2004-07) average tax to comparable GSDP ratio of general/special category states; j=1,2

Y^* = three year (2004-07) average comparable per capita GSDP of Haryana

$Y_{i,j}$ = three year (2004-07) average comparable per capita GSDP of i^{th} state in j^{th} category

pop_i^{1971}= 1971 population of the i^{th} state

4. Fiscal Discipline

The share of the i^{th} state under this criterion ($s_i^{m=4}$) has been derived as

$$s_i^{m=4} = pop_i^{1971} f_i \Big/ \sum_{i=1}^{28} (pop_i^{1971} f_i)$$

$$\textit{where, } f_i = \left[\frac{A}{B}\right]^{2005\text{-}08} \Big/ \left[\frac{A}{B}\right]^{2001\text{-}04}$$

$$A = \left(\frac{\textit{own revenue}}{\textit{revenue expenditure}}\right)_i$$

$$B = \frac{\sum_{i=1}^{28} (\textit{own revenue})_i}{\sum_{i=1}^{28} (\textit{revenue expenditure})_i}$$

pop_i^{1971}= 1971 population of the i^{th} state