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Government of Karnataka
FISCAL POLICY INSTITUTE

Kengeri Post, Bangalore-Mysore Road, Bengaluru-560060

Phone: +91 80 26971000, Fax: +91 80 26971010,

e-Mail: director@fpibangalore.gov.in

Internship Report

On

‘Fifteenth Finance Commission’s Recommendations and its Implications on Karnataka’s Fiscal Position’

Ayush Mehrotra

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Certificate

This internship report titled *"Fifteenth Finance Commission's Recommendations and its Implications on Karnataka's Fiscal Position"* is a report on the study taken up at the Fiscal Policy Institute (FPI) in 2020-21.

The internship report is prepared by Ayush Mehrotra studying at National Law School of India University, Bengaluru under the mentorship of Dr. M R Anantha Ramu, Consultant (A&R), Fiscal Policy Institute.

All opinion and conclusions expressed in the internship report are of the Intern and usual disclaimer applies.

Sujit Kumar Chowdhury

Director, FPI

Fiscal Policy Institute * Bengaluru-560 0 F.P.I.

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Declaration

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Ayush Mehrotra

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Abstract

The report analyses the key recommendations of the Report of the Fifteenth Finance Commission (FFC) for the period 2020-21 and their impact on the state finances of Karnataka. An exploratory study is undertaken with respect to the various performance-based indicators that the FFC seeks to reward the better performing states with and delves into the various measures that Karnataka can take in these six major domains as highlighted by the FFC to be eligible for the financial incentives in the award period of 2021-25.

1. Introduction

The Chairman of the Fifteenth Finance Commission (FFC), N K Singh, had once remarked, ‘The Government of India Act, 1935 established the basic structure of fiscal federalism in India, one that survives even today’ (Singh, 2019). The framers of the Constitution were looking to address the vertical imbalance between the taxation powers and expenditure, and responsibilities of the Central government and the states, and the horizontal imbalance, between states that were at different stages of development. Article 280 of the Indian Constitution mandates the President of India to constitute a technocratic Finance Commission in order to distribute the revenue collected as taxes through vertical and horizontal devolutions between the Centre and the states and among all states[1]. The Constitutional Adviser to the Constituent Assembly of India, Dr B N Rau, had described the Finance Commission as ‘a quasi-arbitral body whose function is to do justice between the Centre and the states.’

The Fifteenth Finance Commission was constituted in November, 2017 and submitted its interim report in December, 2019 for the period 2020-21. Previously, it was supposed to submit the final report for the five years in December, 2019 itself. However, an unusual extension was granted to the FFC and it will now submit two reports with the first one already available for public access while the final one is yet to be tabled in Parliament. The extension was probably an outcome of various uncertainties beyond the FFC’s control like the macroeconomic concerns of declining savings and investment rates, declining revenue resources, and severe stress in the banking sector (Isaac, Mohan, & Chakraborty, 2020). Another source of concern could have been the subdued revenues from the Goods and Services Tax (GST) due to several teething issues which made a realistic assessment quite difficult.

Intriguingly, an amendment was made to the Terms of Reference (ToR) of the FFC almost two years after its constitution through which an additional two clauses were inserted for the FFC to consider. The first one was ‘whether a separate mechanism for funding of defence and internal security ought to be set up and if so, how such a mechanism should be operationalised’ while the second one was to ‘make a reference to the Fifteenth Finance Commission to include Union Territory of Jammu and Kashmir in its Terms of Reference and make award for the successor Union Territory of Jammu and Kashmir.’ The FFC did in fact act on the second amendment and reduced the states’ share of the divisible pool by 1 per cent in order to

[1] Article 280(1): The President shall, within two years from the commencement of this Constitution and thereafter at the expiration of every fifth year or at such earlier time as the President considers necessary, by order constitute a Finance Commission which shall consist of a Chairman and four other members to be appointed by the President.

accommodate for the extra expenditure to be incurred by the Centre due to the formation of the Union Territory of Jammu and Kashmir. However, the interim report of the FFC did not make any recommendation with regard to the amendment on defence and internal security and therefore its final decision in this respect is yet to be seen. However, the states have vehemently opposed the idea of creation of a separate fund as this will further reduce their share in the divisible pool as well as it is considered to go against the Government Accounting Rules 1990 where such a fund in the public account is meant for certain schemes of the ministries and not for entire departments of the government (Bhaskar, 2019).

1.1 Key Functions of the FFC

Some of the key functions as per the Terms of Reference (ToR) of the FFC are as follows:

(i) Tax Devolution: This includes both vertical and horizontal devolution to ensure that all states have resources so as to ensure at least a minimum standard of living and to minimise the inequality.

(ii) Grants-in-aid: As per the ToR, the FFC is permitted to recommend certain grants to states as revenue deficit grants, special grants, sectoral grants, and performance-based grants.

(iii) Empowering Local Bodies: In order to ensure the availability of adequate resources for the rural and urban local bodies, the FFC can recommend additional financial incentives to better performing local bodies measured against certain parameters as laid down by the FFC.

(iv) Disaster Risk Management: The FFC has recommended the creation of disaster response funds along with the disaster mitigation funds in order to build resilience against unforeseen circumstances in future.

1.2 Key Recommendations by the FFC

(i) Vertical devolution between the Centre and the states would be Rs 8,55,176 crore i.e. 41 per cent of the total divisible pool instead of the 42 per cent as recommended by the Fourteenth Finance Commission, to take into account the formation of a separate Union Territory of Jammu and Kashmir.

(ii) A new criteria for horizontal distribution between states has been devised with 45 per cent weightage for income distance, 15 per cent for the population in 2011, 15 per cent for the area, 10 per cent for forest and ecology, 12.5 per cent for demographic performance, and 2.5 per cent for tax effort (See Table 1).

Table 1: Criteria for devolution (2020-21)

Criteria	14th FC 2015-20	15th FC 2020-21
Income Distance	50.0	45.0
Population (1971)	17.5	-
Population (2011)	10.0	15.0
Area	15.0	15.0
Forest Cover	7.5	-
Forest and Ecology	-	10.0
Demographic Performance	-	12.5
Tax Effort	-	2.5
Total	**100**	**100**

Source: Report of the Fifteenth Finance Commission for the year 2020-21

(iii) There were other grants-in-aid like revenue deficit grants worth Rs 74,340 crore, special grants worth Rs 6,764 crore, Rs 7,375 crore for nutrition, and Rs 90,000 crore to local bodies that were also recommended.

2. Objective

This report is primarily based on the Report of the Fifteenth Finance Commission (2019) for the year 2020-21. It draws from the various recommendations that the Fifteenth Finance Commission (FFC) made towards fiscal transfers between the Centre and the states. The focus was on analysing the recommendations with respect to the performance-based incentives under various key domains with a focus on what the state of Karnataka can do to meet the requisite targets and receive those additional grants. There are no studies found in this regard. Hence, the key objective of this report is to analyse the recommendations of the FFC and the impact it would have on the state of Karnataka. The FFC had listed out six domains under which it would give out performance-based incentives to the best performing states for the period 2020-21 and those that are able to meet certain specified targets.The research question here would be 'what is the status of Karnataka under the six specified domains and what can it do to capitalise on the opportunity under each area.'

3. Performance-based Grants: Analysis and Roadmap

A study on measuring performance-based incentives for states in India by the National Council of Applied Economic Research (2019) provides an analytical framework into 'what to measure' and 'how to measure'. The emphasis should be on reliable databases with simple indicators to achieve the most efficient results. Based on ToR 7 of the Fifteenth Finance Commission, nine areas had been identified to reward states under performance-based incentives[2]. The FFC decided to choose six of them which are as follows:

(i) Implementation of Agricultural Reforms

(ii) Development of Aspirational Districts and Aspirational Blocks

(iii) Power Sector Reforms

(iv) Enhancing Trade including Exports

(v) Incentives for Education

(vi) Promotion of Domestic and International Tourism

The FFC expects States to develop robust indicators and an effective mechanism for implementation, evaluation, and monitoring of these indicators under these six domains. The States are also required to define baseline indices to measure and record incremental changes in these indicators. The following section would look into these domains with Karnataka as a focus and suggest the areas where the State can improve and thereby benefit from its improved performance.

[2] ToR 7: The Commission may consider proposing measurable performance-based incentives for states, at the appropriate level of government, in following areas:
(i) Efforts made by the states in expansion and deepening of tax net under GST;
(ii) Efforts and progress made in moving towards replacement rate of population growth;
(iii) Achievements in the implementation of flagship schemes of Government of India, disaster resilient infrastructure, sustainable development goals, and quality of expenditure;
(iv) Progress made in increasing capital expenditure, eliminating losses of power sector, and improving the quality of such expenditure in generating future income streams;
(v) Progress made in increasing tax/non-tax revenues, promoting savings by adoption of Direct Benefit Transfers and Public Finance Management System, promoting the digital economy and removing layers between the government and the beneficiaries;
(vi) Progress made in promoting ease of doing business by effecting related policy and regulatory changes and promoting labour intensive growth;
(vii) Provision of grants in aid to local bodies for basic services, including quality human resources, and implementation of a performance grant system in improving the delivery of services;
(viii) Control or lack of it in incurring expenditure on populist measures; and
(ix) Progress made in sanitation, solid waste management and bringing in behavioural change to end open defecation.

3.1 Implementation of Agriculture Reforms

As a prerequisite for getting grants under this head, the FFC wants the States to ensure that the distress in the agricultural sector is mitigated and the road to doubling farmer's income becomes clearer. The stagnant growth in farm income for farmers and workers has been a cause for concern and to address this issue, the FFC wants the States to take steps that liberalise the agricultural markets, promote seamless trading and competition, and get private sector investment in the agricultural sector. To this effect, the States are required to enact and implement all features of the following model laws:

a) Model Agricultural Produce and Livestock Marketing (Promotion & Facilitation) Act issued by the Ministry of Agriculture, Cooperation and Farmers Welfare in 2017
b) Model Agricultural Produce and Livestock Contract Farming and Services (Promotion & Facilitation) Act, issued by Ministry of Agriculture and Farmers Welfare in 2018
c) Model Agricultural Land Leasing Act, 2016 prepared by the NITI Aayog

Let us look at the status of these laws with respect to Karnataka and what the state can do to secure financial incentives in this sector.

a) Model Agricultural Produce and Livestock Marketing (Promotion & Facilitation) Act issued by the Ministry of Agriculture, Cooperation and Farmers Welfare in 2017[3]

In May, 2020 the Karnataka government promulgated the Karnataka Agricultural Produce Marketing (Regulation and Development) (Amendment) Ordinance, 2020[4] to amend the Karnataka Agricultural Produce Marketing (Regulation and Development) Act, 1966[5]. The Ordinance allows for sale and purchase of agricultural produce outside the market yards and sub-yards, thereby giving an impetus to direct marketing, private market yards, and electronic trading. However, there are a few issues which are not addressed by the Ordinance and this could limit its effectiveness in achieving its goals.

(i) Licensing system for market functionaries: The Ordinance does not do away with the system of licences that need to be secured by commission agents, traders, etc. in the regulated markets. This does not help in solving the problem of cartelisation and monopolisation among the traders and thus defeats the goal of increasing competition in the marketplace. Steps should be taken to replace the restrictive system of licensing with a system of single registration as has been recommended by many experts.

[3] http://agricoop.gov.in/sites/default/files/APLM_ACT_2017_0

[4] https://prsindia.org/files/bills_acts/bills_states/karnataka/2020/Karnataka%20APMC%20Regulation%20and%20Development%20Amendment_Ordinance%2020201

[5] https://prsindia.org/files/bills_acts/acts_states/karnataka/1966/1966KR27

(ii) Condition of infrastructure in APMC markets: While the Ordinance prescribes certain standards for private market yards and sub-market yards, it does not specify any such standards in the case of the state-run APMC markets which are in a dismal condition. It is important to note that the benefits that farmers can derive from the APMC markets depend on the infrastructural facilities like adequate storage capacity, proper weighing scales, etc. and therefore the state should ensure the upgradation of these marketplaces to enhance their efficiency.

(iii) Number of APMCs: Karnataka has a total area of 1,91,791 sq. km. with a total of 513 APMC markets. This brings the average area covered by each APMC to about 374 sq. km. The National Commission on Farmers (2006) recommended that each APMC should not cover an area more than 80 sq. km. and therefore there is a strict requirement for Karnataka to ensure that more such marketplaces are constructed with adequate infrastructure to enhance the capacity of the system of regulated markets and for them to compete with the private markets as well.

b. Model Agricultural Produce and Livestock Contract Farming and Services (Promotion & Facilitation) Act, issued by Ministry of Agriculture and Farmers Welfare in 2018[6]

Under this, the key issues that need to be addressed are as follows:

(i) Role of APMCs: The Committee of State Ministers on Agricultural Reforms (2013) had recommended that the process of contract farming should not be bound by the APMCs and that they should not play any role and therefore should not charge any fees or levies on such transactions. The Model Act calls for the setting up of a Contract Farming (Promotion and Facilitation) Authority at the state-level which would publicise the practice of contract farming and act as a dispute resolution authority.

(ii) Registration of contract farming agreements: It is again proposed that the APMCs should not play any role in registration and recording of agreements and that a separate Registering and Agreement Recording Committee should be formed at the district or block level to settle all such recordings.

(iii) Limits on stock holdings: The current practice of imposing stock holding limits under the Essential Commodities Act, 1955 should be done away with and that no such limits should be placed on agricultural produce procured under contract farming.

c. Model Agricultural Land Leasing Act, 2016 prepared by the NITI Aayog[7]

[6] http://agricoop.nic.in/sites/default/files/Model%20Contract%20Farming%20Act%202018

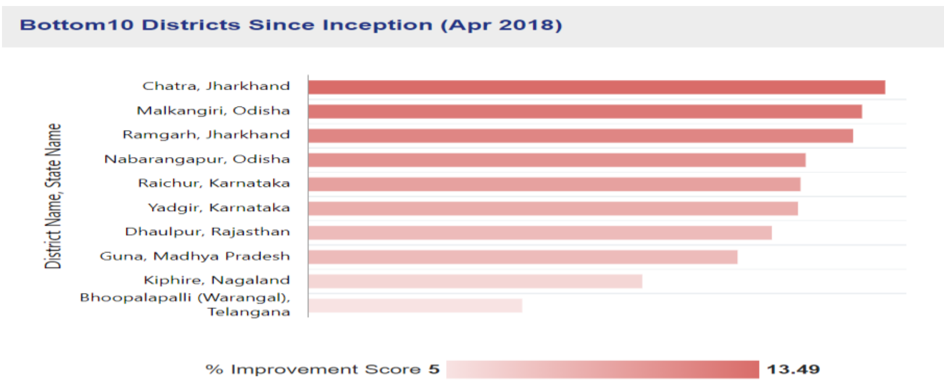
[7] https://niti.gov.in/writereaddata/files/document_publication/Final_Report_Expert_Group_on_Land_Leasing

The Karnataka government amended Section 5 of the Karnataka Land Reforms Act, 1961 to boost agricultural productivity and investment. The farmers would be able to lease out their agricultural lands to individuals or corporates at terms of agreement that they deem fit without any interference of the government. Karnataka's average farmland holding is 1.2 hectares and the small holdings would require investments in order to modernise and make farming viable. This reform would ensure that investments flow and that the fallow land is also utilised for agriculture or other allied activities. However, the state needs to ensure that farmers' rights are not encroached upon by the more powerful and well-connected corporate entities and that the reform does not pose a threat to the food security of the state as well as that of the country.

3.2 Development of Aspirational Districts and Aspirational Blocks

The UNDP Human Development Index had ranked India 131 out of 188 countries in 2016 and taking a lesson from this, the initiative for 'Transformation of Aspirational Districts' was undertaken. The aim was to minimise the heterogeneity in living standards among different states and districts in India by focussing on the 100 most backward districts where there was enormous scope for improvement. The programme focussed on converging the Central and state schemes, ensuring collaboration between various Central, state, and district level officials, and promoting a sense of competition among the districts to perform well in each subsequent rounds of evaluation (Niti Aayog, 2018). In Karnataka, the districts of Yadgir and Raichur were identified under this initiative and their performance in this regard would be instrumental on whether they are able to secure additional funds from the FFC (See Figure 1).

Figure 1: District Performance (Overall) Since Inception (April 2018)



Source: Aspirational Districts Programme: Champions of Change Dashboard (August 2020)

a) **Yadgir:** This district started with a baseline composite ranking of 40 and was neither in the 'Better 20' category nor in the 'Bottom 20' category; therefore, it lay in the middle. However, as of August 2020, Yadgir is among the Bottom 10 performing districts since the inception of this programme with an improvement score of just 11.45 per cent. There is a need to especially focus on the indicators of Health and Nutrition, and Agriculture and Water Resources as these make up 50 per cent of the overall composite score. In this regard, a targeted approach towards improving the health infrastructure and institutional support to the agricultural sector in the form of electronic markets, crop insurance, etc. would help in improving the district's performance.

b) Raichur: This district started with a baseline composite ranking of 12, thereby making it among the 'Better 20' performing districts. However, despite a good start, as of August 2020, Raichur is also among the Bottom 10 performing districts since the inception of this programme with an improvement score of just 11.51 per cent. While the district has performed relatively well in the sectors of Agriculture and Water Resources, Education, and Financial Inclusion and Skill Development, it lags behind in providing Basic Infrastructure and adequate Health and Nutrition. In this regard, a targeted approach should be adopted to improve antenatal, postnatal, and neonatal care in addition to upgrading the overall health infrastructure of the district. Additionally, provision of basic infrastructure like drinking water, sanitation, electricity, common service centres, etc. should be a priority.

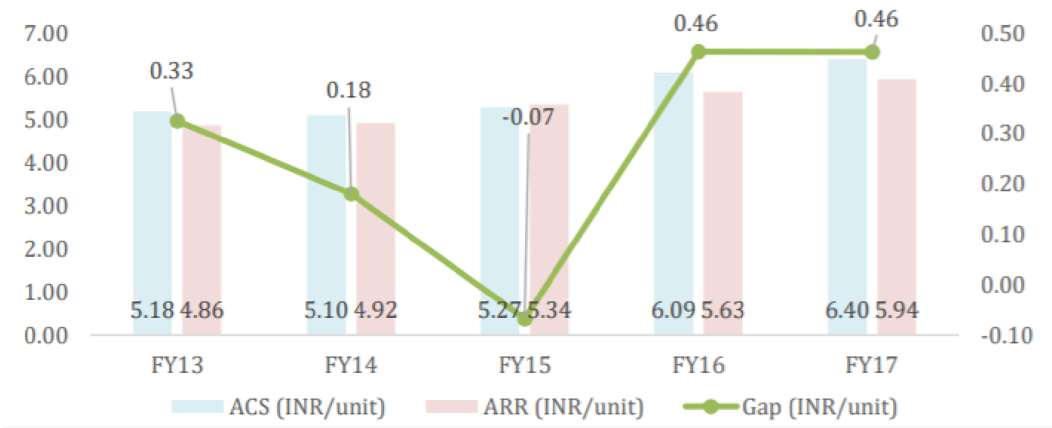
3.3 Power Sector Reforms

The FFC has decided to reward states that undertake systemic reforms in the power sector to ensure its improved efficiency and sustainability. It has decided to give financial incentives to top performing states for indicators like Aggregate Technical and Commercial (AT&C) losses, Average Cost of Supply (ACS) and Average Revenue Realisation (ARR), open access for industry to choose their power supplier, and direct cash transfer to eligible consumers for subsidy. Major reforms took place in the power sector in Karnataka with the enactment of the Karnataka Electricity Reform Act (KERA), 1999 and later with the launch of Ujwal DISCOM Assurance Yojana (UDAY) in 2015, there was a further improvement in operational efficiency (Gayithri, Chandrakanth, & Ramanjini, 2018).

Under the UDAY scheme, the distribution companies in Karnataka were expected to reduce the AT&C losses to 14.2 per cent and reduce the ACS-ARR gap to zero by 2019. With respect to the former, Karnataka has performed well and has been able to meet the target. However, the ACS-ARR gap has instead widened over the past two years (Garg & Sundararagavan, 2018) (See Figure 2). Although the installed capacity has grown over time, the low Plant Load Factor

(PLF) due to inefficiencies is a cause for concern and needs to be addressed (Rajkumari & Gayithri, 2018).

Figure 2: ACS-ARR gap in Karnataka, FY 13 to FY 17



Source: (Garg & Sundararagavan, 2018)

Some of the steps that need to be taken further could be as follows:

a) ACS-ARR gap can be bridged through better power procurement strategies to account for future hikes.

b) Need to strengthen the evaluation of the manner of reporting AT&C losses for a more accurate representation.

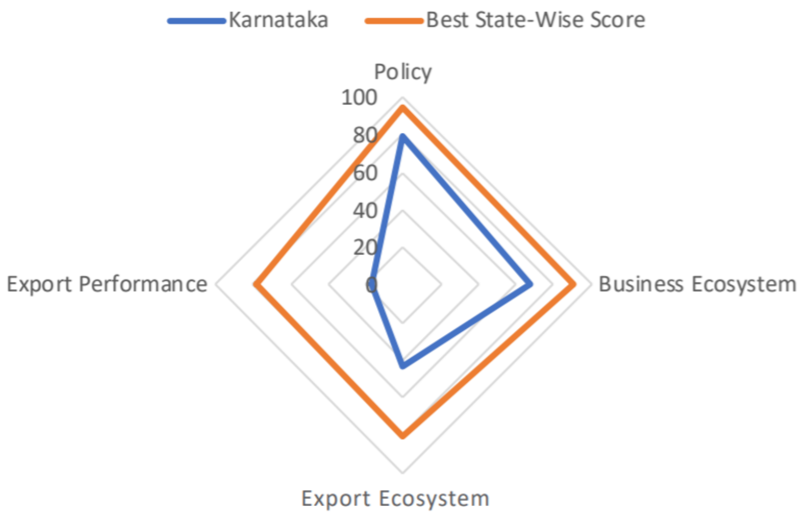
c) The impact of Niranthara Jyoti Yojana needs to be strictly monitored to gain better insights from the consumption data.

d) More targeted and accurate monitoring and regulation system is needed to measure supply for agricultural needs in order to limit the reliance of electricity distribution companies on subsidies from the government.

3.4 Enhancing Trade including Exports

The FFC proposed to support those states which can demonstrate well-designed initiatives for employment generation through inter-state as well as intra-state exports. Following is the assessment of Karnataka's performance in this regard using some of the parameters given by Niti Aayog's Export Preparedness Index 2020 where the state stands ninth among all states and union territories (See Figure 3).

Figure 3: Distance to Frontier



Source: Export Preparedness Index 2020

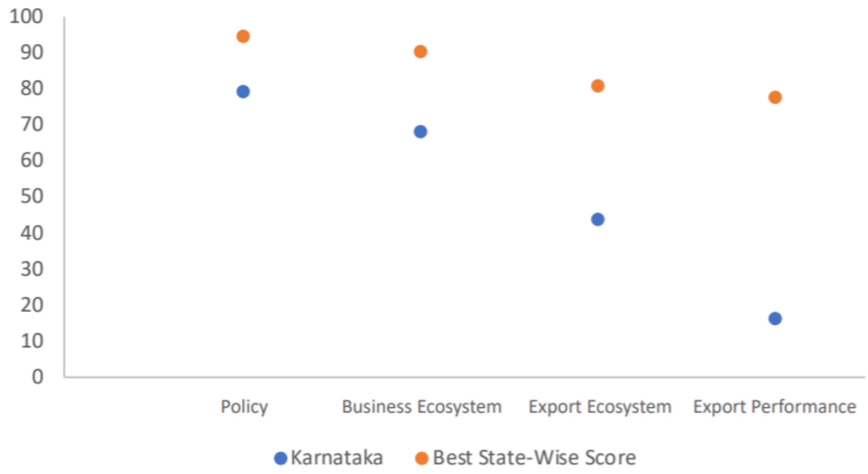
a) **Policy:** Karnataka has performed fairly well in this regard with a well-designed Export Promotion Policy and providing the requisite institutional framework to support it and ensure its effective adoption.

b) **Business Ecosystem:** While Karnataka has performed well in this aspect as well, however, more work could be done towards provision of infrastructure and transport connectivity. There is a need to increase the number of industrial corridors and IT/Food Parks which bring in investment, in addition to ensuring the availability of power. To improve connectivity, impetus should be placed on improving air cargo facilities and the number of inland container depots (ICDs).

c) **Export Ecosystem:** Karnataka has been performing within the expected range in this regard. However, areas of trade support, and research and development (R&D) infrastructure need improvement. There seems to be a lack of hand holding by the government in terms of capacity building, workshops, and number of trade fairs conducted when it comes to providing adequate support to the exporters. On the R&D front, there is a severe deficiency of inspection agencies, professional colleges and research institutes.

d) **Export Performance:** This area has been severely lacking, with Karnataka underperforming compared to other similar states. There is a lack of growth and orientation, and inadequate export diversification. The state needs to improve its average exports growth and export-to-GDP ratio in addition to increasing the number of exporters by providing enough incentives. Diversification of export is equally important and Karnataka performs poorly on the Market Penetration Index in this regard (See Figure 4).

Figure 4: Comparative Analysis



Source: Export Preparedness Index 2020

3.5 Incentives for Education

In the field of school education, the FFC will reward states that perform well in some of the identified indicators that are also used to compile the Performance Grading Index 2018-19 (PGI) by the Ministry of Education. As per the five domains under which various indicators are measured by the PGI, Karnataka has improved its performance over the last two years in Learning Outcome and Quality, Access, and Governance Processes. Even though it remains slightly behind some of the top performing states in these domains, the overall performance of the state is better than the average among all states (Jacob & Chakraborty, 2020).

Two areas where Karnataka lags behind are Infrastructure and Facilities, and Equity. Some of the important indicators within the former domain which need attention are the percentage of elementary level students getting uniforms within three months and free textbooks within one month, secondary schools having computer labs, and schools having libraries. In the case of the latter domain, important indicators to focus on would be the percentages of entitled students receiving aid from schools, and schools having functional and separate toilets for boys and girls.

3.6 Promotion of Domestic and International Tourism

The outbreak of the COVID-19 pandemic has severely affected the tourism industry all across the world. It is imperative for the state to promote both international and domestic tourism in order to revive the sector and regenerate livelihoods that are based on it. The FFC had intended to reward the states with attractive financial incentives with the highest percentage of increase in aggregate nights spent by tourists in that state. In 2018-19, the number of domestic tourists footfall was more than 18.7 crore and that of foreign tourists was close to 5.5 lakh.

In order to sustain these numbers and grow year-on-year, it is important for Karnataka to drastically improve its social media presence through an active tourism website, international and domestic events, and strategic collaborations with overseas tourism markets. In the short term, the state could also explore the possibility of giving away free vouchers up to a certain limit to be spent by tourists on travel, hotel, etc. in order to incentivise tourists to visit, a strategy that is being deployed by various European nations as well to promote their tourism industry. Some other long term goals could be to focus on some of the important tourist destinations within the state, ensure adequate availability of board and lodging facilities, and provide skill training in tourism and hospitality to the people already involved in this sector and to prospective entrants as well.

4. Conclusion

This report provides a number of immediate measures as well as a few long-term measures which the state of Karnataka can undertake to convince the Fifteenth Finance Commission about its strong performance in the six areas which will be evaluated for the performance-based grants. Over the last few years, Karnataka has been among the better performing states when it comes to being fiscally prudent; however, this stress on reducing public expenditure has come at the cost of compressing the capital expenditure and marginally reducing its spending on social welfare, education, and health (Jacob & Chakraborty, 2020). This trajectory would have to be reversed in order to achieve long-term economic and social benefits.

Agricultural reforms could be further strengthened if issues like the licensing system, infrastructure and number of APMCs, registration of agreements, and limits on stock holdings are addressed. A block-level focus in the districts of Yadgir and Raichur particularly in basic infrastructure and health and nutrition would enable strong overall performance. Reforms in the power sector would yield more benefits if steps are taken to improve power procurement strategies in order to bridge the ACS-ARR gap and the regulation, monitoring and evaluation systems to capture AT&C losses are made more robust. In order to give its economic growth an impetus, Karnataka needs to diversify its exports in addition to improving the trade support and R&D infrastructure. Karnataka's social infrastructure for education is better than many other states and more focus on the aspects of equity and infrastructure and facilities would further improve its performance in this domain. To kick-start the tourism industry again, the state needs to resort to some innovative measures like leveraging the power of social media for promotion, issuing free vouchers to incentivise tourists, and ensuring adequate availability of hotels in all major tourist attractions.

An important change was made by the Fourteenth Finance Commission which altered the structure of tied and untied grants given to the states and put renewed impetus on the states to focus more on their priorities and fiscal direction as per the local conditions and status of development (Kotasthane & Ramachandra, 2015). Against the backdrop of the pandemic where the state finances are already under stress, Karnataka can significantly gain from the performance-based grants if it further improves its performance in these sectors, since it is historically considered to be a better performing state comparatively on all these fronts. It would require meticulous planning to identify the key areas which would return maximum benefits and a time-bound action plan for targeted delivery and effective implementation.

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