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Internship Report

On

**‘The Changing Nature of Fiscal Federalism in India: A Critical
Analysis on the Constitutional and Legal Provisions’**

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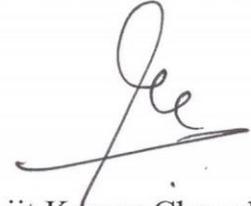
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Certificate

This internship report titled “*The Changing Nature of Fiscal Federalism in India: A Critical Analysis on the Constitutional and Legal Provisions*” is a report on the study taken up at the Fiscal Policy Institute (FPI) in 2020-21.

The internship report is prepared by Chitra Rajpal studying at National Law School of India University, Bengaluru under the mentorship of Prof. M R Narayana, Consultant (A&R), Fiscal Policy Institute.

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



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Declaration

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1. Introduction

The Government of India Act of 1919 and 1935 provides for the provisions of fiscal federalism in India. In layman's terms, fiscal federalism is the sharing of the total revenue accumulated in the form of taxes between the Centre and the states. Naturally, this also entails the division of responsibilities between the Centre and the state with regard to the expenditure side. Oftentimes, the Centre also provides the States with grants to deal with development issues or crises of a public purpose.

The taxes assigned to the Centre or state are not a reflection of who will bear the responsibility of tax collection. Some taxes, for example, are collected and charged by the Centre, but given to the states. Similarly, some taxes can be charged by the Centre and also assigned to it, but the state becomes responsible for collecting it.

Several reforms and revisions in the past decade have changed the structure of fiscal federalism significantly. Some of the most important ones are:

- i) The abolition of the Planning Commission and the creation of NITI Aayog
- ii) The changes brought forth in tax devolutions by the 14th Finance Commission
- iii) The introduction of the Goods and Services Tax (GST), and
- iv) The creation of the GST Council for the purpose of Centre-state deliberations.

Horizontal imbalances in the context of fiscal federalism translates into the imbalances that emerge on account of different states receiving different revenue allocations—a result of differential growth rates. There also persists an unequal level of development amongst these states, both within society and in infrastructural development. The end of the Planning Commission paved the way for a higher degree of horizontal imbalances (Mukhopadhyay and Das, 2003). The creation of Niti Aayog effectively meant that only the Finance Commission became the driver of fiscal federal practices in the country. The policy deliberations and outreach on the issue at hand significantly declined, resulting in regional imbalances.

Coming to the 14th Finance Commission, on the face of it, the higher allocation of tax devolution to the states, i.e. from 32% to 42%, seems generous and skewed in favour of the states. However, an in-depth analysis would tell us otherwise. After taking into consideration the Gadgil formula which came out to be 55% of the divisible pool, and the Finance Commission's reluctance on awarding decisive sectoral grants, the actual allocation of tax devolution amounts to 39% and 42% for the states and Centre respectively (Chakraborty, 2018).

These developments make it pertinent to address and study the transition that fiscal federalism in India has undergone to understand its implications in the present as well as in the future. The study becomes important not just due to the gradual encroachment of the Centre in the states' share of revenue, but also due to the matter becoming a festering wound as a result of the COVID-19 pandemic.

While several important papers have been written on the matter from an economic perspective, none have attempted to dive deep into the legal and constitutional aspects of the issue. The term federalism itself has been enshrined in the Constitution in many regards, and it would be an important as well as interesting study to assess the legality of the turns fiscal federalism has taken in the past few years. For this purpose, the key areas to be studied have been handpicked to provide both depth and breadth into the area of study. The first chapter will attempt to unravel how the coming of the GST has affected the fiscal federalism structure of the country. Within the chapter, two sections on the history of GST and its linkages with fiscal federalism have been talked about. The subsequent chapters dive into the constitutional provisions, the altered revenue sharing regarding Central sector schemes, and the Fiscal Responsibility and Budget Management Act, and their impacts on repainting the picture of fiscal federalism in India.

The report is a product of qualitative secondary research. The study is positivist and descriptive in nature, and its findings can be largely attributed to the information and data published by the government bodies. An attempt has been made to discern fresh inferences and patterns from the available secondary research from a legal and constitutional viewpoint.

2. The History of Goods and Services Tax

The GST Bill, while approved in the year 2016, actually has its antecedents much further back in history. Two decades back, i.e. in the year 2000, the idea of GST was put into the limelight by the then Prime Minister Atal Bihari Vajpayee. A committee to determine its provisions in order to form a unique GST model catering to the demands of the country was also established. Four years later, the Fiscal Responsibility and Budget Management Committee also enshrined the advantages of the GST model, and recommended that it should replace the then existing system of taxation ("Brief History Of GST | Goods And Services Tax Council" 2016).

Spikes in the discussion of a GST regime were observed subsequently over the years, more noticeably in the years 2006, 2009, and 2011. The Union Finance Minister P. Chidambaram in his budget speech for the fiscal year 2006-2007, proposed the rolling out of the GST taxation framework from April 1, 2010. Chidambaram argued for a unified taxation system on behalf of the UPA-II government, highlighting its merits of creating a single unified market. Subsequently, in the year 2009, the Empowered Committee of State Finance Ministers released the First Discussion Paper (FDP) on GST. The FDP laid down the foundation of discussion on GST between the Centre and the states for the next couple of years to come, and thus was a benchmark report in its own right. The year 2009 is also important in the development of the GST's trajectory as in that year the NDA vehemently opposed its framework when re-proposed by Pranab Mukherjee, the then finance minister, on behalf of the UPA. Most controversially, the constitutional amendment proposed in the year of 2011 in lieu of bringing the GST Bill was rejected by the primary opposition, i.e. the NDA (The Economic Times, 2018). The NDA called the proposal backward and against the tenets of fiscal federalism. This made for an ironic stance since the genesis of the GST—as discussed above—lies in the Atal Bihari Vajpayee's government introducing the new tax regime back in the year 2000.

The 101st Amendment of the Indian Constitution which brought forth the GST regime also established within its ambit a GST Council. The Council's provisions are laid out in the

279A Article of the GST Act. The GST was acclaimed as a revolutionary measure to cut the clutter of several taxations levied both at the Centre and the state levels. It was said that the GST regime would only create a unified system of taxation by subsuming the nine types of taxes charged by the state and the eight types of taxes levied by the Centre under one umbrella. Naturally, the subsuming of all nine variety of taxes by the states would cause losses to the states, especially when one takes into account the time and cost accrued by the states to put up adequate measures for the application of the GST in the first place.

To resolve this issue and ensure that the states do not have to face a loss of revenue, a compensation cess to be paid by the Centre for the first five years was put in place. The provision for this was given under a separate Act altogether. The GST (Compensation to States) Act (2017) states the following:

“The compensation payable to a State shall be provisionally calculated and released at the end of every two months period, and shall be finally calculated for every financial year after the receipt of final revenue figures, as audited by the Comptroller and Auditor-General of India”.

2.1 Linkage between GST and Fiscal Federalism Issues

As discussed above, the state's share of revenue estimated to be decreased due to the coming of the GST in the first five years is to be compensated by the government. However, as V. Bhaskar (2019) along with other critics has mentioned, the Cess Fund made for the special purpose of compensation to the states has been utilised for the benefit of the Centre. The Government of India is accused of using the fund for financing its own share of activities as has been very recently also highlighted by the CAG report on GST (2020).

In fact, during the COVID-19 pandemic when an increased burden on the State's exchequer is caused in order to provide for health facilities as well as essential items, the compensation from the Centre is an important source of revenue. Unfortunately, the Centre has fallen short of obliging to its legal and constitutional commitment even during the times of an emergency such as this. It is estimated that

a sum of 30,000 crores as part of the GST compensation has not been released to the States (Ohri, 2020).

One would assume that since the entire ambit of GST falls within the constitutional framework, there would be legal safeguards in place to avoid such an erroneous and misguided shortfall from the Centre's side. As mentioned before, the creation of a GST Council come into the limelight here. Since the GST regime impacts both the states and the Centre, the creation of the GST council was envisaged to resolve any issues arising between them.

Hence, in case decisions relating to the GST regime do not arise out of consensus, there exists a voting mechanism to break the deadlock. This is however, where one notices the tilted balance of power in favour of the Centre. The section on GST Council states that in the situation where voting is to be resorted to, a decision can be passed with a three-fourth majority. When one notices and takes into account that the Centre in effect accounts for a one-third share in the voting, the picture becomes clear to translate into the conclusion that the Centre effectively has a veto over the decisions passed through the voting mechanism. Simply put, the bargaining power given to the states is much less in this arrangement as opposed to that of the Centre.

Keeping aside the issue of GST compensation, the very division of how revenue collected through taxation will be distributed is flawed when one compares it against the share of revenue that went to the states in the pre-GST era. For instance, the share of indirect tax accrued to the states in the pre-GST era through the Value Added Tax (VAT) and the Sales Tax made up for about 66% of the state's revenue share. For the Centre, however, indirect taxes only constituted one-half of the Centre's share. This can lead us to the simple conclusion that the states are losing out on more revenue as compared to the Centre upon the application of the GST nationwide (Reddy, 2019).

This brings us to the question on what exactly is the division of taxation between the Centre and the state under the GST, and is the division adequate? The GST base

has been divided equally between the two, i.e. Centre gets 50% and the states get 50%. When taken into account what the critics and experts have had to say about this division, one is forced to ponder whether this division of revenue through taxation is adequate.

For example, the GST task force that was constituted under the 13th Finance Commission, recommended that the state's tax base should be higher. It suggested that a 12 per cent GST rate with a bifurcation of 7 per cent for the states and the rest for the Centre should be allocated. In fact, the former chief economic advisor (Economic Times, 2010), Arvind Subramanian argues for the state's taxation base to be higher too. The reason for this is that a higher rate of state's tax base was subsumed under GST, making it only fair to provide states with a higher supply of revenue (Reddy, 2019).

3. Constitutional Provisions

Article 268 to Article 293 of the Indian Constitution talks about the established fiscal relationship between the Centre and the states. There are two constitutional provisions that specifically can be remarked for the purpose of our understanding of fiscal federalism. Article 293, Section 3 talks about putting the states under vigilance, and thus keeping a check on it. Thus while through this provision of the Constitution, the borrowings of the state have been put under the radar, providing for regular checks on it, such a provision does not exist for the Centre. The Centre can thus borrow and not be held accountable constitutionally and legally.

Another Article that can be read for the purpose of fiscal federalism is Article 282. The Article talks about how either the Union or the state have the power to make grants for any motive that is related to public functioning and its benefit. However, for this particular purpose, no special legislative division should have been demarcated, either in the Centre or the state's laws (Singh, 2019).

Article 282, while made for the specific purpose of exercising grants for a residuary purpose, has been unfairly utilised by the Centre. As Lekha Chakroborty points out in her

article, the Centre has exploited this residuary provision by coupling it with the expansion of the concurrent list. Despite the 7th Schedule of the Constitution laying down the list of subjects falling under the Union, State, and Concurrent lists, the Centre has been making inroads into matters outside of its jurisdictions (Chakraborty, 2019). This transgression is not only limited to the Concurrent list—upon which both the Centre and the state can make decisions with mutual agreement—it has also been encroaching upon the state subjects. This task has been achieved through the means of changing the contributory share by the state and the Centre as 50:50 for the Centrally Sponsored Schemes.

The share earlier was based on a 60:40 division, with the Centre's contribution the larger piece of the pie. The implication of this change will be discussed later in the next section. However, it is important to note that such changes have been justified as being made due to issues of national importance. The government has stated that these aforementioned changes with regard to the 7th schedule will serve the priorities of the nation in a better manner. However, no justification for which priorities are addressed through these alterations and how they will benefit have been offered. In fact, as argued before as well, a lesser share of revenue for the states hampers its capacity to deal with a crisis situation, as has been demonstrated quite clearly during the COVID-19 pandemic.

The Centre, thus, has misused this constitutional provision to misdirect funding for its own purposes, which naturally do not fall under the ambit of either the legal or the constitutional framework. The CAG report on GST released in the month of September underlines how the Centre retained a whopping Rs 47, 272 crore in the Consolidated Fund of India in the initial two years, using it for its own purposes.

4. Centre's Transgression through Central Sector Schemes

In addition to this, the cesses and surcharges were increased and the Centre run Social Sector Schemes' financial design was tweaked. The increment in cesses and surcharges result in the states losing revenue. This is because unlike taxes, the cesses and surcharges are not shareable and cannot be split between the states and the Centre. With regard to the Centre's Social Sector Schemes, the states' contribution was increased from 50 per cent to

60 per cent (Kapur, 2019)—a hefty revenue allocation which could have been utilised for states' own schemes and programmes.

The states which are already economically disadvantaged will in fact have to put in additional funds to make up for the state's share of the contribution to the central sector schemes. This is despite the poor state of the provision of being provided with a higher devolution in lieu of offsetting the horizontal imbalances. The Union government's decision on stripping off the non-Finance Commission transfers is the cause of the problem here (Reddy, 2019).

5. Fiscal Responsibility and Budget Management (FRBM)

In any healthy democracy, it is an important requirement to maintain fiscal discipline for the economy to function adequately while ensuring that the public is also serviced adequately. For the same purposes, the Fiscal Responsibility and Budget Management Act was created in the year of 2003. The main purpose behind the enactment was to balance the fiscal deficit adequately, along with re-emphasising the importance of managing the public funds in a better manner, concretising fiscal discipline within governments, and solidifying fiscal prudence in the country.

The Bill was introduced in the year 2000 by Yashwant Sinha, the Finance Minister under the Vajpayee government, and was approved in Parliament three years later. It was a year later in the month of July that the Act became effective. The Act was proposed and approved in order to ensure that there was transparency in budget and fiscal management. As laid out in the legislative debates that ensued in Parliament, the objective of the Act was to resurface an equitable distribution of the country's debt that has occurred over the preceding years.

In pursuit of this objective, the provisions under the Act made it compulsory for the ruling of the government to include the following statements in addition to the year's Union Budget when discussed in Parliament: a) The Medium Term Fiscal Policy Statement; b) The Macroeconomic Framework Statement; and c) The Fiscal Policy Strategy Statement.

In respect of the brief above, a layman's understanding of the FRBM Act can be that it is meant to restrict the expenditure of the government. Such an understanding, however, is not completely correct, since the FRBM Act actually acts like a mechanism of switching on instead of one that contracts the expenses of the government. Simply put, by constraining the fiscal deficit and limiting the revenue deficit at zero, the government aims to switch their expenses from revenue to capital.

The above-mentioned caps on fiscal deficit are a resultant of the Fiscal Responsibility and Budget Management Review Report (or the N K Singh Committee), and not an inbuilt provision within the Act. The N K Singh Committee was set up in the year of 2016. The aim of the committee was to dive deep into reviewing the FRBM Act in its entirety. After a closer look into the provisions, the N K Singh Committee made several recommendations, one of which said that the government should aim to target the fiscal deficit as being 3 per cent of the GDP. To follow this recommendation in its letter and spirit, the target given was for the current year, i.e. 2020. Subsequently, the committee recommended that this fiscal deficit should be brought down further in the next three years to 2.5 per cent, i.e. in 2030. (ibid.)

For the fiscal year of 2019-2020, the government estimated the fiscal deficit to be 3.8 per cent. However, it ultimately skyrocketed to 4.6 per cent of the GDP (Noronha, 2020). The rise largely is attributed to the steep decline in tax revenue collection, as well as the lockdown of the COVID-19 pandemic. It is interesting to note that the last time the fiscal deficit breached 4.5 per cent was in the fiscal year of 2012-13 when it rose as high as 4.8 per cent—which was still less than the revised estimate of 5.2 per cent. The situation in 2012-13 was a resultant of slowdown in the mining and construction sector, and the revision of growth data for the prior fiscal year (Mishra, 2014).

5.1 Fiscal Responsibility and Budget Management Review Committee

The N K Singh Committee, also popularly known as the FRBM Review Committee, also made several other recommendations which are touted to have an equal impact on the states. The committee, constituted after the 14th Finance Commission, argued for the complete repealing of the FRBM Act and replacing it with the Debt and Fiscal

Responsibility Act. Coupled with this, the committee recommended forming an independent fiscal council. Another significant recommendation which highlights the asymmetrical level of impact on the Centre and the state talks about the setting of debt to GDP targets for the Centre and the state differently. The Centre's target is set for 40 per cent, while for state it's 20 per cent. These targets are to be achieved by the year 2025 (PRS India).

Table 2: Deficit & Debt Profile of Union Government

Deficit and Debt Profile of Union Government (In Percentage)								
	2014– 2015	2015– 2016	2016– 2017	2017– 2018 (RE)	2017– 2018	2018– 2019 (BE)	2018– 2019 (RE)	2019– 2020 (BE)
Revenue deficit	2.9	2.5	2.1	2.6	2.6	2.2	2.2	2.2
Effective revenue deficit	1.9	1.6	1	1.5	1.5	1.2	1.1	1.3
Fiscal deficit	4.1	3.9	3.5	3.5	3.5	3.3	3.4	3.4
Primary deficit	0.9	0.7	0.4	0.4	0.4	0.3	0.2	0.2
Debt to GDP ratio	50.07	50.14	48.75	0.00	49.10	0.00	48.65	47.41

Source: Various Union Budgets

When one takes into account the fiscal year of 2018-19 according to the budget estimate, the debt to GDP ratio for the states stood at 24.91 per cent to GDP. Whereas, for the Union government, the debt to GDP ratio for the fiscal year of 2019-20 was anticipated to be 47.71 per cent. When read in context of the FRBM Review Committee recommendation, the states will have to incur a larger correction and make higher adjustments to reach its GDP to debt target of 1.78 per cent. On the other hand, the Centre will but obviously have to put in lesser efforts to reach its more achievable debt to GDP target of 2.5 per cent. This excessive burden also comes under the light of the states actually being more prudent than the Centre in its fiscal targets.

In addition, the fiscal council proposed by the N K Singh Committee will not only be appointed by the Central government, but also report to it, i.e. to the Union ministry of finance. The council aims to predict macro variables of GDP growth, commodity pricing, and tax buoyancy. Furthermore, it will also perform a monitoring role and give advice on the use of escape clause, along with charting out a return path.

In contrast, the fiscal council as proposed by the 14th Finance Commission was to be statutory in nature. By the virtue of the council being a statutory body, it would have been more independent, since it would have been a non-constitutional body which would have been set up by the entire Parliament. Furthermore, it would have derived its power from the enactment of the parliamentary laws. The 14th Finance Commission's proposal for the fiscal council also stated explicitly the assessments made by the council to be tabled in both the houses of the Parliament, since it had derived its power from the Parliament in the first place.

Thus, the Financial Reforms and Budget Monitoring Review Committee has strengthened the Union government further and added to the miseries of the state. Furthermore, it suggested that in order to bring down and balance off the debt to GDP ratio, both the Centre and the state should work together. However, the parameters listed won for them weren't uniform. For the Union, it recommended bringing down the debt to GDP ratio by closing their deficits at the 2.5% marker. However, for the states, the deficit should not be more than 1.78% of the GDP. The targets given are to be reached by the year 2025. In this scenario as well, the states are at a significant disadvantage.

6. Major Conclusions and Recommendations

A systemic analysis of the developments of the past decade or so is a clear indicator towards the fact that the Centre has been slowly and gradually encroaching upon the state's share of revenue. This chipping away of the fiscally federal nature of the country has come under the radar by scholars of their fields, as well as by bureaucrats and the media. However, this criticism hasn't espoused the Union government to become answerable or justify its ways, or undertake reforms.

A summation of the report leads to the below mentioned conclusions:

i) The implications of the GST regime go beyond the state's revenue share being siphoned off by the Centre. The legal and constitutional mechanisms devised to safeguard the state or the Centre, like the GST Council, are not just inadequate, but have the power of setting a precedent for the Centre to overpower the state in the future for issue both economic and non-economic.

ii) The alteration in the Central Sector Schemes' funding is in fact, following the precedent set by the Centre through the GST where it has successfully attempted to practice its heavy handedness in economic matters without the states' consultation. The impact of this alteration can very well result in states not being able to adequately devote its revenue to other welfare activities. An example of one such situation where the states haven't been able to sufficiently address the welfare requirements of the public due to their inability to leverage funds which legally belong to them is the current pandemic.

iii) Mechanisms like the deficit targets set by the FRBM Review Committee and loopholes within the constitutional ambit—like Article 282—have the capacity to prolong this fiscal imbalance currently existing. Serious consideration and revamping will have to be undertaken to correct this balance. Certain recommendations have been highlighted below.

Thus, certain constitutional and legal reforms would have to be advocated for in order to pave way for a true fiscally federal state. A fiscal roadmap for both the Centre and the states should be laid out annually. Each state should have its roadmap catered to its specific needs; also including incentives for previous year's fiscal performance. The roadmap should be created through a statutory body comprising of, and monitored by both the Centre and the state to avoid biases. This body, as well as the Finance Commissions, should necessarily include lawyers and constitutional experts to ensure that the guidelines and provisions are constitutionally sound. Lastly, federalism at each level should be respected, and the third tier of our country, i.e. the Panchayats and the Urban Local Bodies should be awarded their own sanctioned funds which are legally backed through an Act. This would resolve the tussle of funds these bodies have to indulge in with the state governments, along with strengthening their functioning at the ground level.

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