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AN OVERVIEW ON THE FISCAL TRANSFERS TO THE STATES OF INDIA

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1. Introduction:

India is a developing federation and wastage of financial resources is a luxury which it cannot afford. Therefore, it is of utmost importance that all States put in the maximum efforts to raise and conserve scarce financial resources. If the financial transfer scheme is based solely on equalization of general need of the States and neglects the resource mobilization efforts of the States, some of the backward states might enjoy the benefits of federal transfers without making any effort of their own. Such States would live like parasites on the other States which are exploiting their financial capacities to go in for self help. They must get incentive for doing so by Finance Commission. At the same time States with a perpetual begging bowl must be discouraged. No Finance Commission should subsidized inefficiency. The present paper analyses the fiscal transfers from centre to States by calculation of growth rates up to 12th finance commission. Shortcomings of the Transfer System has also presented at some extent.

2. Criteria & relative weights for fixation tax devolution in practice

The criteria and relative weights used by different finance commissions for fixation of the income tax shares of individual states are varied. Table 1 reveals the pattern criteria and relative weights used by different finance commissions for fixation of the income tax shares and union excise duties of individual states in successive finance commissions.

3. Pattern of Transfers from Centre to States by Finance Commissions

Table 2 shows that there were differences between actual share of devolution of taxes (SCT) and grants (FCGR) and the respective shares recommended by the FCs, though these were not very significant. Srivastava and Rao (2009) argued that the observed differences reflected non-adherence to the stipulated conditions or delays in submitting the relevant utilization of certificates for procedural reasons. The contribution of FC transfers to revenue receipts of the State governments remained in the range of 16 per cent to 26 per cent across the award periods.

Table 1 Devolution of Income Tax to States as per the Finance Commissions

Criteria	**Weightage** /basis of distribution (percent)												
	1^{st} FC	2^{nd} FC***	3^{rd} FC	4^{th} FC	5^{th} FC	6^{th} FC	7^{th} FC	8^{th} FC****	9^{th} FC	10^{th} FC	11^{th} FC	12^{th} FC	13^{th} FC
Population	80.0	90.0	80.0	80.0	90.0	90.0	80.0	25.0	22.50	20.0	10.0	25.0	25.0
Area										5.0	7.5	10.0	10.0
Income Distance*									45.0	60.0	62.5	50.0	50.0
Inverse Per capita Income**								50.0	11.25				
Fiscal Discipline											7.50	7.50	
Tax Effort/ collection)	20.0	10.0	20	20	10.0	10.0	20.0	10.0	10.0	10.0	5.0	7.50	7.50
Backwardness									11.25				
Infrastructure										5.0	7.50		5.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
%age to total income tax	55.0	60.0	66.1/3	75.0	75.0	80.0	85.0	85.0	85.0	77.5	29.50	30.50	32.0
											%age to all Central Taxes		

* On the basis of distance of per capital income from the highest per capita income state multi-plied by population * *On basis of inverse of per capita income multiplied by population; ***100 population Goal **** In order that Punjab, which is the highest per capita income state, also gets a share under this formula, income distance of Punjab and Haryana are treated as equal. Note: FC= Finance Commission. # Inter se Share of States in net proceeds of all shareable union taxes and duties Source: Reports of success Finance Commission in India, Government of India, Ministry of Finance, New Delhi.

However, since the Sixth FC, transfers through the FC channel have consistently accounted for around 25 per cent of the total revenue receipts of States. If the Central transfers through all other channels are included, they contributed 28-42 per cent of the total revenue receipts, during different award periods. Similarly, the transfer of resources through the FC channel enabled the States to meet around one-fourth of their revenue expenditure in recent years

Table 2: Pattern of Transfers from Centre to States by Finance Commissions (percent)

Finance Commission	Recommended Transfers		Actual Transfers		Actual Transfers from all agencies	
	Taxes	FC Grants	Taxes	FC Grants	Share in Taxes	Grants*
First FC	87.9	12.1	91.6	8.4	53.6	46.4
Second FC	81.2	18.8	76.2	23.8	48.6	51.4
Third FC	81.4	18.6	77.0	23.0	49.5	50.5
Fourth FC	75.8	24.2	73.1	26.9	48.4	51.6
Fifth FC	86.6	13.4	85.2	14.8	54.4	45.6
Sixth FC	73.9	26.1	75.0	25.0	50.6	49.4
Seventh FC	92.3	7.7	92.3	7.7	58.6	41.4
Eighth FC	90.4	9.6	89.0	11.0	53.8	46.2
Ninth FC	82.9	17.1	88.9	11.1	53.2	46.8
Tenth FC	91.0	9.0	90.2	9.8	60.1	39.9
Eleventh FC	86.5	13.5	84.2	15.8	55.4	44.6
Twelfth FC	81.1	18.9	82.5	17.5	54.6	45.4
Thirteenth FC	84.8	15.2	–	–	–	–

Note:*: Includes grants by FCs and agencies other than FC.
Source: (i) Reports of Finance Commission, (ii) State Finances: A Study of Budgets (various issues)

4. Gross and Net Transfers from Centre

Table 3 depicts an average basis the ratio of Gross devolution to Gross Domestic Product. It has increased from 2.5 per cent during First Finance Commission to 5.3 per cent during first four years of Twelfth Finance Commission. The Gross devolution to states as percentage of Gross Domestic Product witnessed a decline in the 1990s and early 2000s coinciding with the period of Tenth Finance Commission and Eleventh

Finance Commission .On an average basis, the share of Net Devolution during the first four years of Twelfth Finance Commission was higher at 5.2 per cent of Gross Domestic Product than the Eleventh Finance Commission (3.8 per cent) and Tenth Finance Commission (4.9 per cent) periods. The table further shows that the ratio of Net Devolution to Gross Domestic Product is less as compared to ratio of Gross Devolution to Gross Domestic Product during the period covered by different finance commissions.

Table 3. Growth Rates of Net Transfers to States

Period	Sub-Components of Transfer of Resources	Growth Rate (per cent per annum)
1951-52 to 2009-10	Share of States in Central Taxes	15.38
1951-52 to 2009-10	Share of States in Central Taxes	15.38
1951-52 to 2009-10	Grants from the Centre to States and UT's	10.38
1951-52 to 2009-10	Gross Transfer to States	13.76
1951-52 to 2009-10	Repayment of Loans by States and UT's	12.2
1951-52 to 2009-10	Net Transfer to States	13.5

Source: Annual Report of Reserve Bank of India, Various Issues, Reserve Bank of India, and Various Issues of National Income Statistics and Centre for Monitoring Indian Economy.

5. States Share in Central Taxes

The Share of Central Taxes as per cent of Cross Devolution and Transfers declined continuously from 26.6 per cent during the period of First Finance Commission to 21.6 per cent in the Third Finance Commission's period. It again rose to 23.4 per cent in the Fourth Finance Commission period and showed an increasing tendency up to Seventh Finance Commission's period. It has increased from 23.4 per cent in fourth Finance Commission's period to 38.3 per cent in Seventh Finance Commission's period. During the period of Fight Finance Commission it declined to 33.9 per cent and again increased to 37.9 per cent during the period of Ninth Finance Commission, to 45.4 per cent during the period of Tenth Finance Commission and to 46.8 per cent during the period of Eleventh Finance Commission. For the first four years of Twelfth Finance commission the share of central taxes as per cent of gross devolution and transfers is 45.3 per cent. Share in Central Taxes as per cent of Gross Domestic Product increased steadily from 0.6 per cent during the period of First Finance Commission to 2.6 per cent during the period of Eight and Ninth Finance Commission. Then it declined marginally to 2.4 per cent during Tenth and Eleventh Finance Commission's period and again increased to 3.03 per cent during the first four years of Twelfth Finance Commission.

6. Grants-in-aid to the states

The share of grants-in-aid in gross devolution to states increased from 15.5 per cent during the period of first finance commission to 26.2 per cent during the period of second finance commission. During the period of third finance commission it declined to 22.7 per cent but again rose to 25.9 per cent and 26.6 per cent during the period of fourth and fifth finance commission respectively. It declined marginally to 26 per cent during sixth finance commission's period and then showed an increasing tendency up to ninth finance commission's period. It has increased from 26 per cent during the period of seventh finance commission to 31.7 per cent during the period of eight finance commissions and further it increased to 32.3 per cent during ninth finance commission's period.

During the period of tenth finance commission it declined to 31.2 per cent but again increased to 34.2 per cent during the period of eleventh finance commission and to 40.8 per cent during the first four years of twelfth finance commission. Grants-in-aid as percentage of Gross Domestic Product increased steadily from 0.39 per cent during the period of first finance commission to 2.2 per cent during the period of ninth finance commission. During the period of ninth and tenth finance commission, it declined to 1.7 per cent and again increased to 2.1 per cent during the first four years of twelfth finance commission.

7. Transfer of resources from Centre to States by category

Among the non-special category states, the dependence of states like Bihar, Orissa, Chhattisgarh, Hilar Pradesh and Madhya Pradesh on resource transfer from the centre is higher than that of other non-special category states. Among the special category states, the dependence of states like Assam, Jammu and Kashmir in higher than that of other special category states. The general view -point is that with economic development of any economy, the absolute taxable capacity would increase, thereby, enlarging the base of the States own resources. Bihar was the only state (in 1990-91), which had absolute negative fiscal capacity. Kerala is a middle level state, whereas Bihar, Rajasthan and Uttar Pradesh are backward states. They can be excused for not having improved their performance in relative taxable capacity. These states have not been able to overcome their inherent fiscal disadvantages. Such a situation after five decades (1952-2002) of transfer of resources from the Centre to States cannot be lauded. It needs immediate attention and restructuring.

State-Wise analysis reveals that fiscal correction has not been uniform across States, notwithstanding a strong commitment by almost all State Governments to carry forward the process of fiscal correction and consolidation. Only a few States account for the major part of the overall correction. With Twelfth Finance Commission recommending a uniform target oriented fiscal restructuring path to be attained by all the states by end of 2009-10, the fiscally weak States may initiate measures to catch up with the fiscally sound States within the timeframe (Reserve Bank of India, 2007-08; pp.81-82)[78]

8. Shortcomings of the Transfer System: It is fact that the Finance Commission has earned appreciation as a useful fiscal institution for a federation, the transfer system that has been operating on the ground is marked by features that are perceived to conducive to fiscal discipline among states. However, it has some weaknesses. The weaknesses of the transfer system as it has been operating in India seem to stem from the following:

Infirmities of Statutory Transfers

The statutory transfers of tax devolution and grants -in-aid to states in need of assistance are mediated by the Finance Commissions. Although the devolution of tax revenue of the centre is based on well-defined criteria, the Finance Commission's dispensations have come in for persistent criticism as a source of fiscal indiscipline in the system because of the "gap-filling" approach underlying them. In principle, transfers need not lead to fiscal indiscipline if they are properly structured and do not purport to underwrite the actual budget gaps of the states. On the contrary, the transfer system can serve as a potent instrument for inducing fiscal discipline if the gaps of the recipient governments are measured with reference to objective norms of revenue capacity and expenditure need. Although the grants-in-aid recommended by the Finance Commission's in India for States facing revenue deficit are based on their own assessment of the revenue gap of each state and not the budget actual or what the States project, the assessments cannot be said to have been invariant to the States' decisions regarding expenditure and revenue raising. To a large extent, this is because the starting point for revenue and expenditure projections of the Finance Commission has been the base year for which the actual ultimately provide the basis. In the end result, every time a Finance Commission is appointed, the projections of its predecessor are thrown into "the dustbin of history" and ultimately "history" dominates. The projections made by the Finance Commission, whatever be the norms they may adopt thus lose their power as signals for discipline.

The Planning Commission Transfers

The Planning Commission in India is charged with the responsibility of' enhancing productive public investments in the country by working out plan investments for each sector of the economy and each state based on the estimated resource availability. States work out their respective annual plans for each year and then planning commission approves them. However, the plan transfers suffer from a number of shortcomings. For example, the central assistance released through the planning commission is also in loan and grant form. The Gadgil formula 70:30 (10:90 in the case of special category states) loan-grant transfers create incentives for the states to assume debt in order to get the grant even though they otherwise may not have borrowed the funds because of their very high debt levels and for, other reasons. The Planning Commission's development projects create budgetary obligations on the states that are many times now shifted to the non-plan side as the states in their misconceived interest continue to treat these as plan expenditure, which prevents the Finance Commission from taking these into account when they make their recommendations.

The Gadgil formula, just as the Finance Commission Formula, is a mixture of expenditure need and fiscal capacity elements, which are again mixed with other objectives (i.e. tax effort, fiscal management, national objectives and special problems). The Finance Commission's transfers are much more equalizing than the Planning Commission's because the criterion of per capita income disparities is much more equalizing than the population criterion. The Finance Commission's formula weights income disparities much more heavily than the Planning Commission's formula (62.5 versus 25 per cent, respectively); and the Planning Commission weights population more heavily than the Finance Commission (60 versus 10 per cent, respectively). Furthermore, the Gadgil Formula is applied for allocation of only what is known as Normal Central Assistance (NCA). There are several schematic allocations going through the state plan channel, which have different basis for resource allocation.

Other Centrally Sponsored Transfers

Assistance provided to the states through central sector and centrally sponsored schemes are an important source of revenue for the states of India, and in some respects they are the most controversial form of transfers due mainly to its arbitrariness and discretion. They arc justified on the same basis as conditional grants are in other countries: addressing externalities / spillovers, pursuing national objectives, and so on, but it is generally recognized that there are too many schemes in India. These schemes provide a backdoor for the federal governments to micro manage decisions that are ostensibly the responsibility of the states. Thus, Centrally Sponsored Schemes burden the administrative capacity of the states and distort state decision-making and priorities. Furthermore, these schemes blur the lines of responsibility, particularly in minds of voters

9. Conclusions

The above analysis it is observed that the Finance Commission has earned appreciation as a useful fiscal institution for a federation, but it is also true that the successive commissions did not have an integrated approach to the total statutory transfers. But, the transfer system is also very complex and lacks transparency and coordination among the institutions in charge of implementing transfers, which together produce a cycle of distorting incentives. The Twelfth Finance Commission has addressed some of the issues related to the intergovernmental fiscal system, there is still an urgent need for the state and union government of India to strengthen and accelerate the reform of India's intergovernmental system. The similar process may be proposed in 13th finance commissions of India.

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