# NSE-IEA Keynote Speech

# Finance Commissions and State Welfare

Manoj Panda
Institute of Economic Growth

Ravishankar Shukla University, Raipur
28 Dec 2019

# Finance Commissions and State Welfare

- Thanks to NSE and IEA for inviting me to give this keynote speech at the IEA Annual Conference.

**Issues and Questions**

- Need for Central transfers through Finance Commission
- Quantum of transfer?
- How does FC recommendations affect state welfare?
    - ➢ Centre Vs All states;
    - ➢ Distribution among states
- Have FCs attained mandated assigned primary objective?
- State welfare: issues beyond FCs
    - ➢ depends also on investment
    - ➢ need for some new institution for coordination.

# Need for FC

- Constitution provides for division of revenue raising powers and expenditure responsibilities of the governments at the level of the Union (Centre) and the States.
- Seventh Schedule spells out the spheres of power and responsibilities of the two levels on consideration of comparative advantage at the respective levels,
- States have been assigned to carry out most of the development and welfare oriented programmes while their tax base is relatively small.
- An imbalance arises in this process between expenditure need and revenue raising capacity
- The resultant fiscal gap necessitates intergovernmental revenue transfer.
- Constitution provides for the institution of the Finance Commission set up every five years to recommend transfer of part of the revenue collected by the union to the states (Article 280)

# Nature of Imbalance

- On consideration of comparative advantage at the respective levels, the Union government is assigned on broad based and buoyant taxes: income tax, corporation tax and excise duties
- States have the authority to raise revenue which generally have lower base and are less buoyant: sales tax, stamp duties, entertainment tax, land revenue
- On the expenditure side, the Centre has the responsibility for areas of national importance such as defence, foreign affairs, foreign trade, money and banking, inter-state transport and communication,
- State governments have the primary responsibility for law and order, agricultural and industrial development, intra-state roads, electricity, health, education and other social sector services.
- In addition, both central and state governments are responsible for provisioning services in the concurrent list: both centre’s and States responsibility
- The third level local self-governments – municipalities and panchayats -provide public utility services water supply, sanitation, local roads, electricity etc.

# Types of Assistance to States

- Finance Commission is primarily formed to recommend

1. The distribution of net proceeds of specified Central taxes between the Centre and the states and determine allocation among states, and

2. The principles which should govern grants-in-aid to states.

- Besides, the President also refers additional context specific matters needed for sound public finance system to the Commission.
- There are of course other modes of fiscal transfers from Centre to states
- The Planning Commission, abolished in 2015, used to provide substantial resources to states for meeting Plan expenditure
- Several Centrally Sponsored Schemes (CSS), which continues in a modified form, is another means of transfer
- Centre also directly spends on certain items related to agriculture, infrastructure and social sectors
- This talk is basically confined to welfare implications of transfers through FCs and not on other modes of transfers

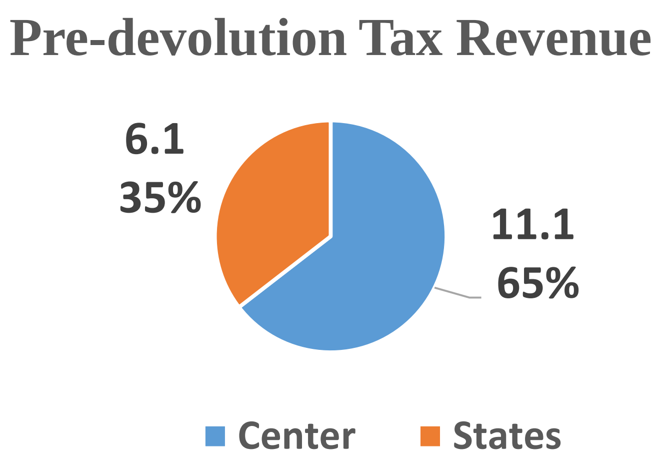
# FC Approach

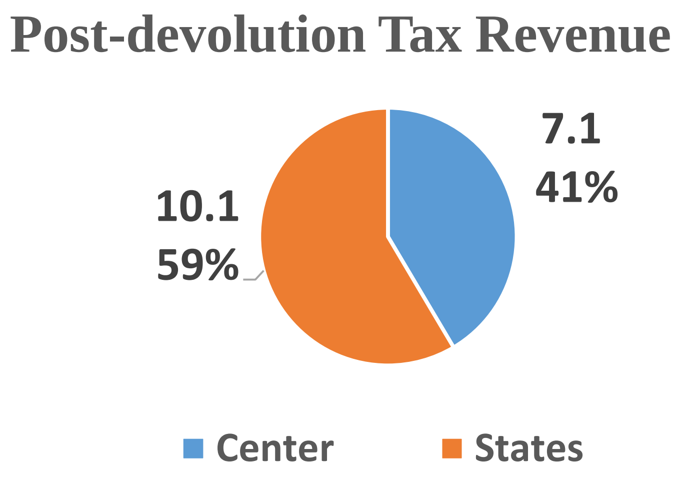
- The approach followed by Finance Commissions have been to make assessment for the award period of 5 years of:
  - Likely expenditure of the States to meet assigned responsibilities
  - Likely revenue receipts of Centre and states' own revenue
  - Centre's own expenditure need and ability to help
- They seek views of stakeholders: Centre, states, CAG, RBI, economists, industry etc.
- Design their own method of allocation as their assessment
- Make recommendations for
  - Vertical devolution: division between Centre and all States together, and
  - Horizontal devolution: Division of share of all states to each state
- Necessarily their task involves striking a balance among competing claims

# 14th FC Transfers

- Since Plan and non-Plan distinction in expenditure was abolished, the 14TH FC's ToR was wider to take a 'comprehensive account' of revenue requirement of states (not confined to 'non-plan').
- 14th FC in favour of a compositional shift to formula based devolution as against grants-in-aid. When formula based transfers found inadequate, grants-in-aid are provided.
- 14th FC increased share of states in divisible pool from 32% to 42%
- Factoring in above two considerations to compare with previous FCs, transfers by 14th FC increased from 39% to 42% of resources in the divisible pool.
- Overall, the 14th FC recommendations have led to a net gain for the states, partly due to increased tax/GDP ratio by the Centre and consequent increase in revenue collection under divisible pool.
- Share of general purpose transfers has increased has increased by about 10 percentage points to reach 72% in the last 3 years.
- IEG study shows that unconditional transfers to states are no less effective for social sector expenditure than conditional grants.

# Share of Centre and States in Total Tax Revenue and Devolution (% of GDP; Average of 2016-17 to 1918-19)




- AS a % of GDP, center and states collect 11.1% and 6.1% of tax revenue respectively prior to tax devolution
- The Centre thus accounts for 65% and states as a whole 35% of the total tax revenue collected in the country.

- Transfers from Centre to states have been of the order of 4% of GDP during first 3 years of $14^{th}$ FFC award period.
- This reduces the Centre's share in combined tax revenue from 11% to 7% and increased states' share from 6% to 10%.
- Post tax devolution, share of center and states nearly gets reversed

# Expenditure Pattern

| Centre | As Per Cent of Total Expenditure 2015-16 | 2016-17 (RE) | 2017-18 (BE) |
|---|---|---|---|
| B. DEVELOPMENTAL EXPENDITURE | 35.6 | 36.8 | 41.8 |
| Social & Community Services | 8.8 | 9.5 | 10.1 |
| -Education, art & culture | 4.1 | 3.9 | 4.0 |
| -Scientific services & research | 1.1 | 1.1 | 1.2 |
| -Medical, public health, sanitation & water supply | 0.9 | 1.3 | 1.6 |
| -Family welfare | 1.2 | 1.0 | 1.2 |
| Agriculture & allied services | 6.5 | 6.8 | 6.4 |
| -Rural development | 4.6 | 3.9 | 3.5 |
| Transport & Communications | 6.4 | 6.5 | 7.1 |
| Grants to States & UTs | 3.4 | 3.1 | 8.0 |
| NON-DEVELOPMENTAL EXPENDITURE | 59.4 | 56.9 | 56.9 |
| -Interest payments | 24.3 | 24.2 | 24.6 |
| -Defence services (net) | 12.4 | 12.4 | 12.3 |
| -Pension & other retirement benefits | 5.3 | 6.4 | 6.2 |
| -Subsidy to FCI | 7.7 | 6.8 | 6.8 |

| All States Combined | As Per Cent of Total Expenditure 2015-16 | 2016-17(RE) | 2017-18(BE) |
|---|---|---|---|
| A. DEVELOPMENTAL EXPENDITURE | 58.7 | 59.9 | 62.1 |
| Social & Community Services * | 28.9 | 30.3 | 31.4 |
| **-Education, art & culture** | 16.1 | 15.6 | 15.8 |
| **-Medical, public health, sanitation & water supply** | 6.3 | 6.6 | 6.7 |
| Agriculture & allied services | 10.5 | 10.9 | 12.2 |
| **-Rural development** | 4.7 | 5.1 | 4.9 |
| Power, irrigation & flood control | 11.2 | 10.5 | 10.2 |
| B. NON-DEVELOPMENTAL EXPENDITURE | 37.5 | 36.3 | 37.4 |
| Interest payments | 9.5 | 9.2 | 9.7 |
| Administrative service | 5.6 | 5.5 | 5.8 |
| -Police | 3.9 | 3.6 | 3.8 |
| 7. Pension & other retirement benefits | 9.0 | 8.5 | 9.3 |

Centre's Development expenditure : 36%

Non-development expenditure: 58%

States' Development Expenditure: 59%

Non-development Expenditure: 37%

# Components of Public Expenditure and Welfare

- Development Expenditure: Centre: 36%, All States: 59%
  - Education, art and culture
  - Medical, Public Health, sanitation, water supply
  - Agriculture and rural development
  - All these public services have direct and large impact on welfare of the people and incidence of poverty
- Non-development expenditure: Centre: 58%, All States: 37%
  - Administrative services, Defence, Law and Order, Foreign affairs, Trade and Monetary policy, subsidy
  - These (except subsidy) are pure public goods, but do not directly impact level inter-state welfare
  - Subsidy, classified as a non-developmental expd, has direct impact individual welfare
  - Some studies have shown that FC transfers are progressive in nature while other transfers are often regressive in nature

# Extent of help Vs. Revenue Gap

- The recommendations of the $14^{th}$ FC led to additional transfers of close to 1% of GDP.
- The Composition of total revenue expenditure: 54% during $13^{th}$ FC award period to 62% during first 4 years of $14^{th}$ FC.
- Given the nature of expenditure of Centre and states, award of FCs have been welfare increasing
- States' revenue expenditure rose sharply but own tax revenue did not.
- Hence, revenue gap (=Rev expenditure – Own Tax Revenue) of states about 8% of GDP
- Half of this gap gets bridged by FC transfers
- FC award helped states to maintain fiscal deficit below 3%

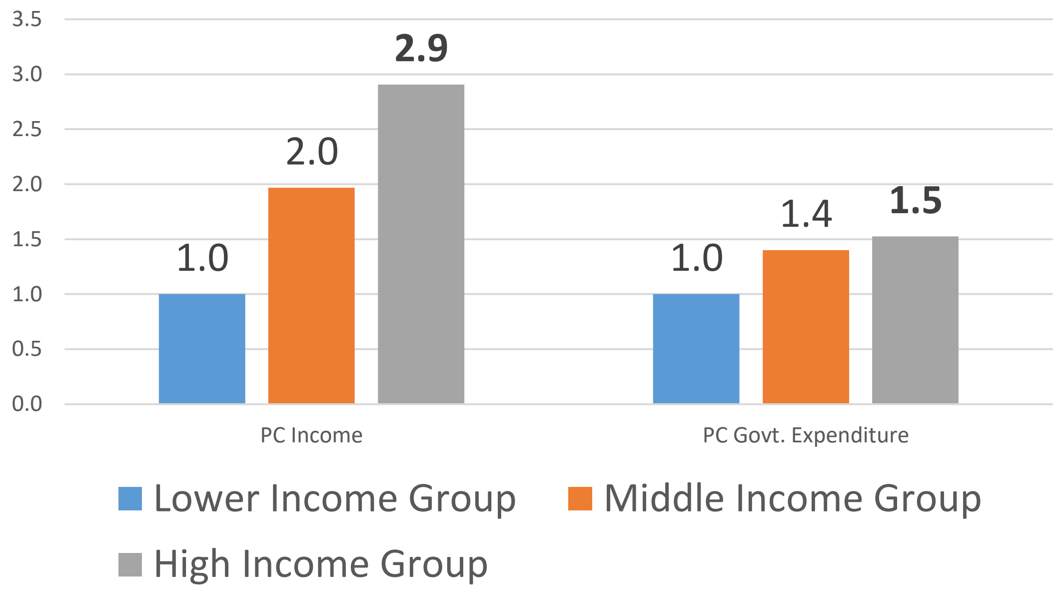
# Horizontal Equity

- FCs are also assigned the task of recommending distribution of total devolution to states across states
- This horizontal distribution have always been guided by the need to ensure a minimum level of public services across states in the federation, given the tax efforts by states
- This implies lower income states are given higher weights in the distribution consideration by the FCs.
- Per capita income distance from the richest state or some variation of it has been given considerable weights by recent FCs in horizontal distribution.
- This consideration has direct relevance to state welfare relative to that of others.
- Do FCs help Low income states more than middle or high income sates?
- States are divided into 3 groups of equal number by per capita NSDP.

## Income, public expenditure, FC transfers and Social Sector Expenditure (Rs. Per capita)

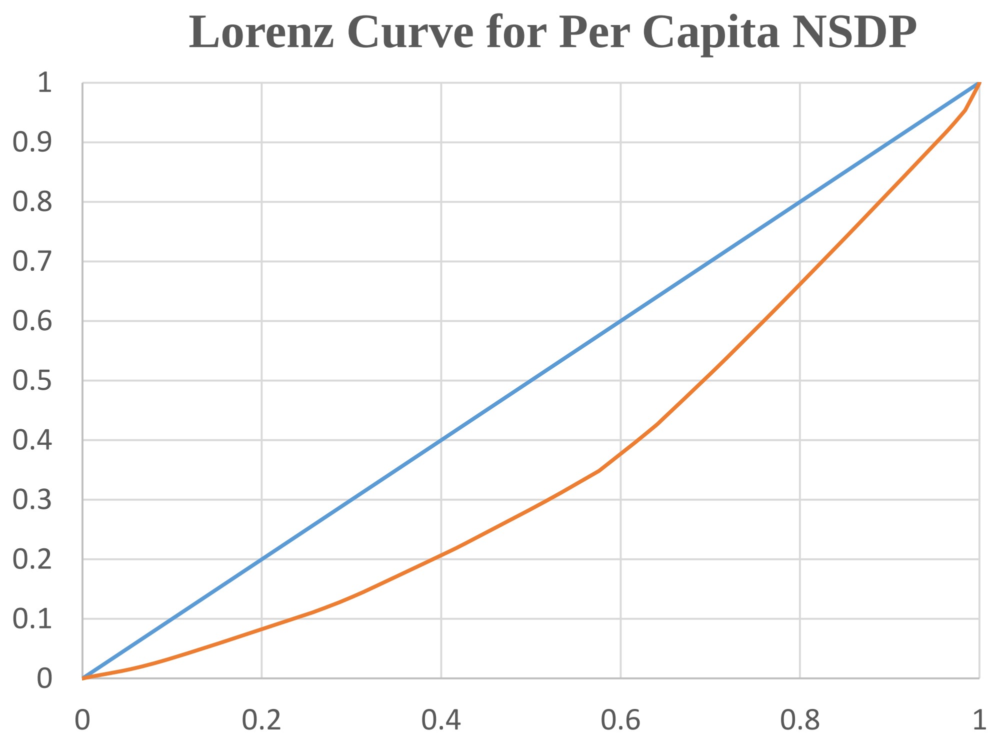
| | Per Capita | | |
|---|---|---|---|
| | Lower Income Group | Middle Income Group | High Income Group |
| Income | 56591 | 111309 | 164432 |
| Govt Expenditure | 13932 | 19502 | 21226 |
| FC transfer | 6206 | 5814 | 4109 |
| Social Sector Exp. | 5699 | 7606 | 8871 |

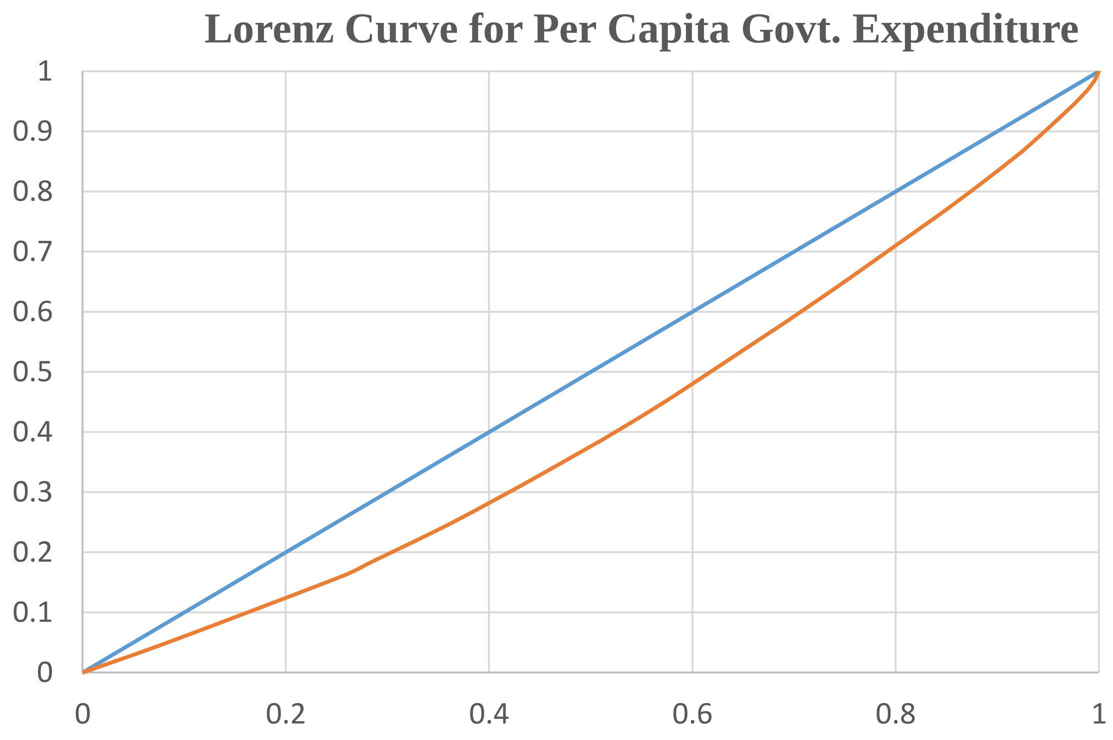
## Per Capita Income and Per Capita Govt. Expenditure by Low, Middle and High Income Group States (LIGS=1.00)




- **Income differences across the three group of states in the ratio of 1.0: 2.0: 2.9.**
- **State government expenditure differences are in the ratio of 1.0 : 1.4: 1.5**
- **Clearly, FFC transfer is having an equalizing impact in terms of reducing expenditure disabilities.**
- **It nearly abolishes the per capita govt expenditure differences between middle and high income group states and considerably reduces those between low income states and others.**

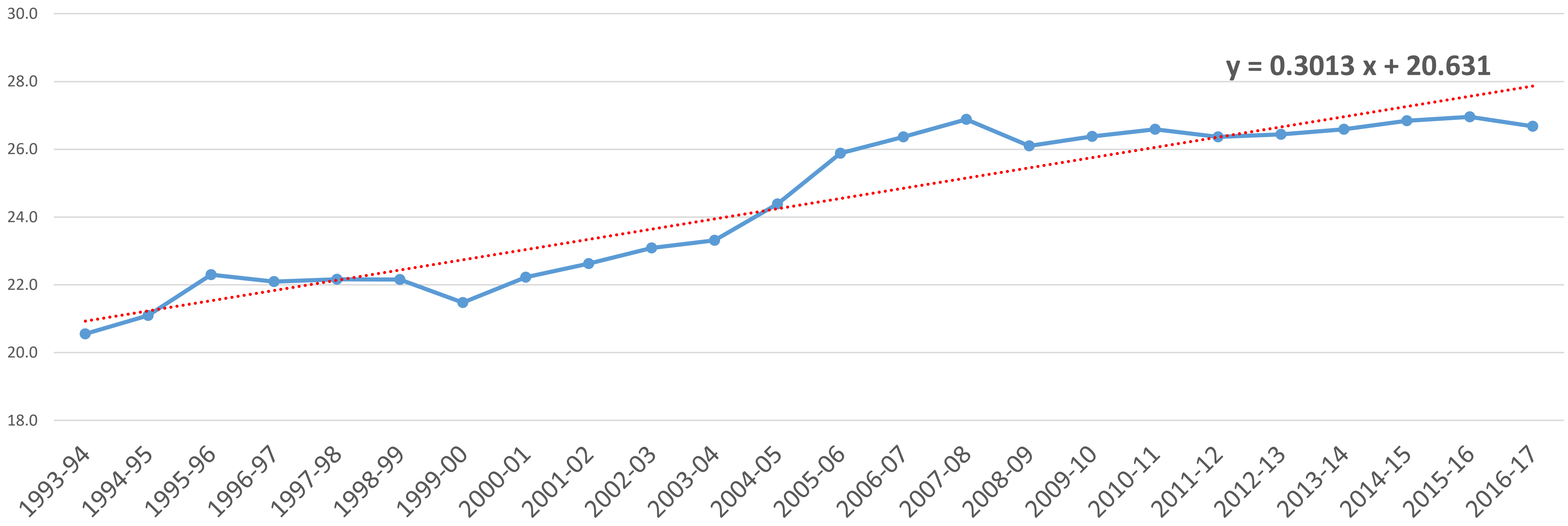
# Gets reflected more formally in Lorenz Curve for per Capita Income and Per Capita Government expenditure




Lorenz Curve shows per capita government expenditure distribution more equal than per capita NSDP across states ; GINI coefficient: 0.18 as against 0.27

# Rising Inter-state Inequality




Source: IEG (2019) Report Available at the FC website

- Gini coefficient in per capita GSDP of the states in India has shown an increasing trend over time. It was in a small range of 20 to 22 during 1993-94 to 1999-2000, but has increased thereafter to above 27 in 2016-17.

# Income Disparity

- Inter-state disparities are high and rising over time
- Per capita income of Bihar at Rs. 34500 is only 20% of that of Haryana and as low as 11% of Goa in 2016-17.
- Revenue earning capacity of a state is mainly determined by its income
- Per capita income distance from the richest state gets a significant weight (50% by 14$^{th}$ FC) and hence Per capita FC transfers are higher for low income states
- But, they only partly offset the revenue disabilities and per capita expenditure of low income states continue to be lower
- Using cross section data for 2016-17, we find that elasticity of social sector expenditure is **1.07 for FCT** and **0.75 for GSDP** (all in per capita terms)
- Thus, FC transfers do play a major role in reducing disabilities in SSE in low income and middle income sates.
- Admittedly, transfers alone cannot fully offset resource disabilities. Long run growth issues of low income states must be addressed so that the disabilities to generate revenue are reduced.
- Right now FCs do not attempt to cure disabilities they only provide compensation or relief.

# Subramanian (2018)

- It may not be out of context to mention a proposal made by former CEA Arvind Subramanian regarding approach of FC.
- Last year, Subramanian advocated to consider 4 different pots for FC allocation: (a) default pot, (b) redistributive pot, (c) risk sharing pot, and (d) incentive pot.
- Default pot returns a portion of the tax collected back to the states. The states might then collect them directly.
- Further, while most of the payment of corporate taxes are reported from head offices in big cities, business is carried out in different parts of the country. This is a conceptual as well as practical problem ignored by him.
- Other considerations are already present in FC recommendations in different forms in the horizontal devolution and grants-in-aid. On the whole, his proposal might turn out to be less progressive than the adopted by the past FCs.

# Investment Need of states

- Welfare depends on public service as well as on private purchasing power.
- FC allocation could have an impact on per capita income and consumption through the growth channel.
- FC transfers were confined to non-plan revenue expenditure
- Decision on Plan expenditures meant for investment and growth had been left to the Planning Commission
- After abolition of Planning Commission 2014-15, Centrally sponsored schemes are major forms of financial transfers to states for growth oriented programmes.
- These involved substantial discretion and, on the whole, generally found to be regressive transfers.
- CSS required matching financial contribution by states in several cases and forces states to change their priorities in expenditure pattern.
- Discretionary transfers have been often a source of discontent by state governments
- There have been very few detailed attempts to judge welfare impact of such transfers on the states

# …Investment needs

- Regional balanced development requires more than proportionate investment in low-income states compared to national average
- The Planning Commission did not succeed well on this front when it existed and the ‘plan’ expenditure prevalent then did not aim at removing infrastructure disabilities as a major objective.
- But at least there was a recognized institution to examine this problem.
- Finance Commissions, on the other hand, have been confined to revenue expenditure and not capital expenditure. Moreover, they explicitly try to overcome revenue disabilities and allocate resources for basic public services.
- In fact, FCs have also taken the view that capital expenditure should be financed by borrowing and not current transfers. This seems to be an extreme position without adequate logic.
- Experience over 6-7 decades have shown that government capital expenditure does not yield sufficient profit to pay back the loans even when the entire expenditure is not loan funded.
- A portion of the revenue must be kept aside for capital expenditure for removing physical infrastructure gap.

# Infrastructure Gap of low income states

- Since FC transfers are to overcome revenue disabilities and allocate resources for basic public services, there is a need for a regular institution and mechanism.
- Allocation of resources for physical and social infrastructure and distribution for creating potential for equitable growth in different states is a different exercise
- Former FC Chairman Vijay Kelkar’s Sukhomoy Chakravarty Memorial Lecture, Jan., 2019.
- CSS by individual ministries are not substitute for directly addressing relative infrastructure deficiencies of the states.
- Even the Gadgil-Mukharjee formula for Plan grant in the earlier regime put 60% weight on population for non-special category states and per capita income got only 25% weight.
- Not much convergence is seen among the various programmes, though often talked about by various Ministries

# Need for a New Federal Coordinating Institution

- Not much convergence is seen among the various programmes, though often talked about by various Ministries
- What is missing is a formal body that can coordinate the various CSS schemes with certain national and regional targets.
- The federal institution constituted in line with GST Council may be entrusted with such a task so much critical for state welfare.
- Another alternative is to make a subgroup of the FC a permanent body that would look into investment needs.
- No appropriate body to examine questions such as a 6% fall in investment rate after 2012-13.
- Revival of the investment rate obviously is critical for national as well as regional growth.
- Both conditional and unconditional grants are needed to achieve allocative and redistributive goals.

# Conclusion

- FCs have done a fairly good balancing job in reducing inequalities in capabilities of states for Public service delivery
- They have always gone through a process of consultation with all stake holders maintaining ‘stability and continuity’
- Need for a permanent Economic Council for investment need of states
- We may learn from organizational structure of GCT council
- Convergence in Centre-state perspectives critical for future growth of the nation with the spirit of cooperative federalism.
- May the spirit of consultation continue and help welfare enhancement.