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Transfer of Budgetary Resources to States

Is it North vs South or North and South?

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Do the southern states have valid concerns that they are unfairly treated in the allocation of budgetary transfers from the union? Or should state-specific concerns for fiscal stability be treated differently when union transfers provide only a partial picture of total financial flows to states?

In recent months, we have seen vociferous protests from some of the southern states on the issue of devolution of resources from the union government to these states. The claims of a denial of a fair share of resources from the national pool vis-à-vis those that benefit from the redistributive transfers of that pool is a complex issue. The shrill discussion on the subject in recent times has the potential to harm the economic interest of both the north and the south.

The core issue here is economic. While the economic analysis and tools have their own limitations in fully explaining this phenomenon, an economic perspective beyond what is being discussed in popular print and electronic media is necessary. This essay is an attempt to discuss these issues, particularly the fiscal issues that are at the moment missing from the mainstream debate on the north-south division of budgetary fund flows.

Financial flows to a state cannot be measured just by the budgetary flow of resources. There are non-budgetary flows of resources such as union government spending in a state, investments made by central public sector undertakings, the flow of bank credit, and private investment including foreign direct investments at the state level. An aggregate picture of all flows to each state is not readily available and sadly the discussion has only focused on budgetary fund flows.

It would not be an exaggeration to assume that a significant part of non-budgetary financial resources flow to the more prosperous regions of the country. This has contributed to the increase in fiscal capacity differentials and income inequality across states. Given the overall resource envelope and the constitutional assignment of functions to the union, such fiscal inequalities cannot be addressed by the mechanism of union-state resource transfers alone. This dilemma is not unique to the Indian Union. It is observed in other federal countries as well. What makes it more challenging for India is the far higher level of fiscal inequality amongst the Indian states, compared with other established federations of the world.

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Budgetary flows remain important components of financial transfers to a state and they are a critical determinant of state-specific fiscal balance, irrespective of the level of income of a state. From the perspective of fiscal stability, a decline in the fiscal flow of resources can be an exogenous shock to a rich and a poor state in similar ways. Concern for fiscal stability is different from the argument about unfairness in transfers. It needs to be emphasised that since Independence, the needs of fiscal stability in each state and fiscal equalisation across states have formed the basis of budgetary transfers to states.

These two needs continue to be at the core of fiscal transfers to and across states. The concerns of individual states do need deeper analysis. In some cases an appropriate resolution without undermining the redistributive role of transfers is probably necessary. The objective of fiscal equalisation is to strengthen the fiscal capacity of states to enable them to provide comparable levels of public services at comparable levels of taxation. Thus, by definition, fiscal equalisation is redistributive. Rather than blaming redistribution, separate policy instruments are necessary to address the concerns of individual states.

Constitutional framework and budgetary resource flows

Let us start with some basic facts about fiscal resource flows to the states. Sharing of union taxes based on the recommendations of the Finance Commission is the primary mode of budgetary resource transfers. It constitutes more than two-thirds of the total flow of budgetary transfers to the states. Grants from the union, allocated through various central schemes, constitute the rest. Central schemes are of two types: Centrally Sponsored Schemes and Central Sector Schemes. The former are financed on a co-sharing basis with the states contributing 40% of the total cost of the scheme. For northern and hilly states, the states' contribution is 10%. Central Sector Schemes are fully financed by the union government.

The quantum of resources borrowed by states to finance budgetary expenditure is also an important component of resource transfers from the aggregate pool of financial resources available in the country. The cost of debt servicing of such borrowing is borne by the states. This borrowing helps the states to enhance their fiscal space to undertake capital spending. Borrowing by states is governed by their respective Fiscal Responsibility Legislation (FRL), based on the borrowing limits proposed by the Finance Commission. Since 2020–21, as a response measure to the Covid-19 pandemic, the union government has also provided 50-year interest-free loans to the states for capital expenditure. The interim budget for the year 2024–25 has allocated Rs 1,30,000 crores for interest-free loans to the states.

Apart from these, there are Externally Aided Projects (EAPs) in the states funded by multilateral lending institutions. EAPs are mostly back-to-back loans and constitute a minuscule and insignificant part of the total budgetary resources and have no major relevance to the fund flow to the states and for that matter on India's general government (union and states together) fisc.

Unfairness in transfers

The argument about unfairness in the distribution of resources emanates from the fact that southern states contribute more to the union revenues and receive far less as transfers through the Finance Commission route, compared with their northern counterparts.

The union minister of state for finance in a reply to a question in Rajya Sabha on 5 December 2023 provided information about state-wise collection of various taxes. Discussions and debates on the issue so far have extensively quoted these numbers. The essence of the argument made by some of the southern states seems to suggest that since they contribute more to the national pool of taxes, they should be receiving more than what they receive now as devolution. Operationalising this demand of southern states would mean the origin of tax collection should be an important determinant of the devolution of taxes to states.

This issue is complex and requires careful analysis. To delve deep, we need to go back to history and find the reasons for why the 'collection' of taxes as an indicator of budgetary fund flow is not an appropriate measure for deciding on the quantum of devolution of taxes to individual states. Use of 'collection' as an indicator of devolution can further accentuate the already high levels of fiscal inequalities between the states. It is also incorrect to attribute tax collection to a state when tax bases are mobile, especially the direct tax bases. Payment of tax in a state does not necessarily mean that income has been generated in that state.

Dropping 'collection'

In the past, the contribution by states to the national taxes, called 'collection' was an important criterion for deciding on horizontal devolution of tax resources to the states. Collection as an indicator of tax sharing was introduced by the 1st Finance Commission and continued till the 9th Finance Commission. The weightage of collection in total devolution varied between 10% and 20%. This was also the period when devolution to the states was tax-specific, implying that all the taxes were not shared with the states. Until the 80th Amendment to the Constitution in 2000, only income tax and union excise duties were shareable with the states.

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The state-specific collection of taxes was dropped as a criterion for devolution by the 10th Finance Commission when it recommended that the sharing of the divisible pool should include *all* the taxes collected by the union. The 10th Finance Commission argued that

"(T)he generation of income, especially non-agriculture income, is a spatially interdependent activity. The linkages run through the input as well as the demand side. An input being produced in a specific place may be using inputs produced in various other locations. The income generated from the sale of this output also depends on the income of consumers who may be spatially dispersed throughout the country. The country as a whole represents a common economic space and market, and growing interdependence in economic activities has considerably weakened the case of locally originating incomes in the non-agricultural sector."

This also implies that a company may pay taxes in a state where its head office is registered even as its sales and profits might be generated mainly in other states. Since income generation is a spatially interdependent activity, use of collection for the purpose of tax sharing would be regressive and disproportionately benefit the high-income states and seriously undermined redistribution.

Migration

Post the 1991 economic reforms, this interdependence has only increased. It is not unreasonable to assume that market integrations and movements of various factors of production, including labour, across the country have increased at a fast-pace during the last three decades. Labour supply from poorer regions of the country to the richer regions has kept labour costs low in the destination state and has contributed to larger value addition in the destination states. This has also enabled more consumption demand in both the source and the destination states. Labour migration has created a large income multiplier and is contributing to economic growth, which, in turn, is working as a natural equaliser.

Since migration has its fiscal benefits for both the source and the destination states, a partial view of migration – that it benefits only the source-states – is harmful. However, migration also entails costs to the destination state. The major fiscal cost is the need to enhance provisioning of public services in destination states. Since rapid urbanisation and migration will move hand-in-hand, there is also a need to think of an appropriate way of financing the resource needs of states that are rapidly urbanising and also becoming attractive destinations for the migrants. The provision of fiscal resources for forward-looking changes in the economy and society is critical and should be considered as a strategic need, instead of as an issue of resource sharing between the south and the north. The support of the union government in this regard beyond Finance Commission transfers would be important for responding to the challenges and for harnessing the benefits of urbanisation.

'Discrimination', 'Penalisation', 'Reward'

Can the notion of 'discrimination' of some of the southern states be backed by data on budgetary transfers? Have the northern states and the rest of the country benefitted at the cost of the south? Is there something more to this narrative?

Let us examine how the shares of some states in tax revenue devolved from the Union have changed in the last two decades covering the award period starting with the 12th Finance Commission and ending with the 15th Finance Commission. The Finance Commission transfers are driven by equity considerations. The award of various Finance Commission's devolution formulae had one thing in common, that significant weightage was given to the 'distance' of per-capita income of states[1], followed by the size of population and other neutral indicators of need. The criteria used by the Finance Commissions since the 11th Commission can be categorised under three broad heads: need and cost disability (population, area, demographic change, and forest cover), equity (income distance, infrastructure distance, and fiscal capacity distance), and efficiency/performance (tax effort, fiscal discipline, and demographic performance).

Despite the element of high progressivity, the shares of devolution of the two most income-poor states of the country, namely, Bihar and Uttar Pradesh, have declined over time. As per the 12th Finance Commission award, the share of Uttar Pradesh in total tax devolution was 19.264%; it declined to 17.939% according to the recommendations of the 15th Finance Commission. Similarly, the share of Bihar in total tax devolution declined to 10.058% from 11.028% over the same period. The share of Odisha also declined from 5.161% to 4.528% during this period. The decline of tax devolution to these states happened despite a shift by the 15th Finance Commission in the use of the 2011 Census population instead of the 1971 Census population. The decline in share of most states mentioned here has been a secular decline.

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Amongst the major states, an increase in the share of tax devolution over this period was observed in Chhattisgarh, Haryana, Madhya Pradesh, Maharashtra, Punjab, Rajasthan, and West Bengal. The share of Gujarat declined marginally during this period.[2] However, the share of Tamil Nadu – one of the most prosperous states of the country – saw a sharp decline in share of tax devolution to 4.079%

from 5.305%, the share of Karnataka fell from 4.459% to 3.647%, and that of Kerala to 1.925% from 2.665% during this period. However, Kerala saw an increase in its share during the award period of the 14th Finance Commission.

One of the major reasons for the decline in Kerala, Karnataka, and Tamil Nadu's shares was the sharp increase in per-capita income ranking of these states in last two decades. This is evident from the comparable GSDP data provided by successive Finance Commissions.[3]

Revenue deficit grants

If the tax devolution is not sufficient to cover the pre-devolution deficit of a state, the shortfall in the revenue is covered by grants awarded by the Finance Commission. These 'post-devolution revenue deficit grants' are given to eliminate shortfall in assessed revenue receipts and revenue expenditure of a particular state. Revenue deficit grants are untied and by nature is like tax devolution. The revenue deficit grants are fixed in absolute amount and ensure certainty of resource flow to a state in the form of a grant. The assessed revenue deficit by the Finance Commission may be different than the actual revenue deficit of a state.

It is also to be noted that Kerala received revenue deficit grants to deal with the shortfall in tax devolution according to the assessments of both the 14th and 15th Finance Commissions. Though the combined share of Andhra Pradesh and Telangana also declined during this period, Andhra Pradesh received revenue deficit grants to deal with the decline in its share of tax devolution in the recommendations of the 14th and 15th Finance Commissions.

The decline in the share a tax devolution then is not the only indicator to examine the decline in budge ray resource flows through the Finance Commissions. A combined view of the share of revenue deficit grants and tax devolution is necessary.

Fiscal stability and resource need

It is evident from the data that the narrative of gain and loss seen through a north-south lens is erroneous. It is also important to note that the element of progressivity in the Finance Commission devolution formula has declined steadily over time. During the 11th Finance Commission award, the weightage given to income distance – the most progressive component of devolution – was 62.5%. This weightage declined over the award periods of subsequent Finance Commissions: it was 45% in the award of the 15th Finance Commission.

> The fiscal stability concerns of individual states need appropriate resolution and that requires thinking beyond the shares in tax devolution for the purpose of equalisation.

This overall decline in progressivity is not to imply that Finance Commissions are not concerned about equity. This decline in one component of the many factors that go into deciding allocation is a reflection of the concern Finance Commissions have attached to fiscal stability of states, irrespective of the level of per-capita income of a particular state.

If the income-distance remained at the level used by the 11th Finance Commission, states that saw sharp increase in per-capita income ranking in the last two decades would have observed a sharper fall in their shares of tax devolution. Having said that, the fiscal stability concerns of individual states need appropriate resolution and that requires thinking beyond the shares in tax devolution for the purpose of equalisation.

The way forward

The existing mechanisms of transfers in the form of tax sharing and grants are meant to provide fiscal space to the states for their revenue expenditure. There is no explicit mechanism to provide non-debt creating resources to the states for capital expenditure. They have to borrow from the market for this purpose. The limits on market borrowings are determined by state-specific FRLs. This is a restrictive view on how to finance public investment at the state level. The inability of the states to finance capital spending over and above the borrowing limits prescribed by the FRL is acting as a limiting factor for capital investment, especially for poorer (in terms of per-capita income) states.

A time-bound reduction in the revenue deficit can enhance capital spending at the state level, and greater flexibility to access market borrowing to states may help augment capital expenditure and growth. Since some of the high-income states also have a large deficit in their revenue account, a prudent management of their finances is critical for fiscal stability. To the extent the decline in tax devolution has contributed to the increase in revenue deficits of these states, this needs to be quantified and, if required, necessary support can be considered based on the past precedence of performance-incentives grants provided by the Government of India or various Finance Commissions.

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Finally, it appears that the horizontal devolution of resources is also about the element of progressivity that the current transfer system can optimally afford without creating unmanageable strains in union-state relations, because of the large dispersion in income inequality across states.

Addressing inequality in fiscal capacity across states through revenue expenditure equalisation will remain sub-optimal unless there is symmetric access to capital investment for balanced regional development. A comprehensive view of budgetary and non-budgetary flow of resources across states is necessary to understand the issue of under-development in some parts of the country. A view only through the budgetary lens is partial and unfair to poorer states.

Footnotes:

1 The greater the distance of a state's per capita income from that of the highest per capita income state (or the chosen level), the greater its share in devolution of resources.

2 For a detailed analysis of individual State share across various Finance Commissions refer to Pinaki Chakraborty (2021): "Covid Context and the Fifteenth Finance Commission: Balancing Fiscal Need and Macroeconomic Stability", https://www.epw.in/journal/2021/33/fifteenth-finance-commission/covid-19-context-and-fifteenth-finance-commission.html

3 For a detailed analysis of the per-capita income ranking across states refer to Chakraborty (2021) above.