REGIONAL DISPARITIES IN INDIA: ROLE OF FINANCE COMMISSION

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CERTIFICATE

I, Iti Tripathi, certify that the dissertation entitled **"REGIONAL DISPARITIES IN INDIA : ROLE OF FINANCE COMMISSION"** submitted by me for the degree of **MASTER OF PHILOSOPHY** is my bonafide work and may be placed before the examiners for evaluation.

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CHAPTER I

INTRODUCTION

India has many distinctive features. It is a diverse country. Its heterogeneity is made up of people of diverse ethnicity, language, culture and history. It exhibits glaring inter-state disparities with respect to development potentials, resource endowments, entrepreneurial abilities, geographic features etc.

India is also a federal country. Impelled by fears of disintegration and imbued with the vision of a strong united India, India's Constitution makers drew up a framework for the country's governance that Ambedkar, its main architect believed, had federalism as its "chief mark", even though it had a pronounced unitary bias.[1] This framework has served to hold the country together for the first 50 years after it gained independence, showing significant progress in several areas, but with the Centre assuming a more dominating role than what even the Constitution makers had envisaged.

Fiscal federalism is more than a mere constitutional arrangement for federal fiscal relations. Critical institutions that intermediate between the central, state and local governments are Finance Commission (a constitutional body), the Planning Commission, the Inter-State Council, the National Development Council and State Finance Commissions. While the Planning Commission is a permanent body, the central and state level Finance Commissions are set up with a normal periodicity of five years. Although the constitutional design of federal fiscal arrangements has pre-independence

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Notes:

1. Chelliah, Raja.J. (1991): 'Towards a Decentralised Polity', Fourth L.K.Jha Memorial Lecture, Fiscal Research Foundation, New Delhi.

roots, especially in the 1935 Act, the post constitutional arrangements have run a course of nearly fifty years, and constitute a dynamic and pulsating experimentation with fiscal federalism. This period has been characterized by momentuous changes in the economic environment both domestically and globally. Pressures and tensions, intrinsic in the growing developmental disparities among states, and widening gaps in the quality and extent of publicly provided services across states, are increasingly testing the stability of the federation[2]. But the heterogeneity and disparities that must be accommodated within the federal fiscal arrangements are phenomenal.

The nature and magnitude of inter-state disparities in India is qualitatively different from those of other developed nations in the following ways:

1. The depressed areas in India comprise a considerable part of the national economy, which necessitates a direct and significant participation of the government both in providing social services to the people and necessary physical infrastructure for growth.
2. Some of the depressed areas are endowed with rich resource base but lack necessary economic and social infrastructure and having structural rigidities such as factor immobilities, underdeveloped markets etc.
3. The existing economic disparities across the states are of very high order. For

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Notes:

2. Srivastava D.K. (2000), *Fiscal Federalism In India: Contemporary Challenges: Issues Before the Eleventh Finance Commission*, Har Anand Publication Pvt. Ltd

instance, the richest state (Goa) has a per capita Gross State Domestic Product, which is nearly 5 times as large as that of the poorest state (Bihar). In terms of area, the largest state (Madhya Pradesh) is almost 120 times as large as the smallest (Goa). In terms of their (1991) population, the largest state (Uttar Pradesh) is nearly 350 times the size of the smallest (Sikkim). The difference in fiscal variables representing capacity, effort, need and performance are also glaring.

4. The inter-regional income disparities continue to be very large. This is reflected in the high coefficient of variation in per capita SDP at constant prices, which was 31.2 in 1981, 34.8 in 1991 and 40.87 in 1999.

5. The division of responsibilities between the centre and the states is constitutionally defined and written quite elaborately. According to many scholars, the relatively elastic sources of revenues have been given to the centre. At the state level, the imbalance between resources and needs has led to a heavy fiscal dependence on the centre. This kind of imbalance has become an integral part of the federal transfer system in India.

6. Though the Constitution confers on each state government equal rights in the matter of raising revenues through taxes etc., the states have shown glaring variations in fiscal potentials and the rates of economic developments.

7. The policy of 'unity in diversity' allows for a series of unique relationships between the policies of the central and the state governments. These are often characterized by compromises, generally satisfying the interest's o vocal vested interests. These features are inherent in a federal system of government and probably tend to deter to some extent smooth functioning of centre-state relations.

Fiscal Federalism embodies the view that self –correcting welfare augmenting outcomes emanate in systems of multitiered inter-governmental structures through processes of co-ordination, cooperation and competition while providing autonomy to sub-national governments. Welfare is augmented by promoting equity and efficiency. It recognizes the essential dynamic nature of the surrounding economic and environment calling for efficient responses through suitable arrangements centralize for some functions and decentralized for others. The robustness of the constitutional design and institutional arrangements provides the necessary capacity for generating such responses in the face of changing circumstances.

The changing ground realities in and around the Indian economy posit several challenges to the working of fiscal federalism in India. The foremost contemporary challenge is that of growing disparity in the level of development, subsequently in fiscal capacities and levels of publicly provided services across states. Secondly, the stability of the federal arrangements remains under persistent challenge as exhibited in the constant demand for fragmentation of states, formation of non-viable states that get tapped into a permanent dependence syndrome, degenerate competition among states resulting in erosion of tax revenue and extremely inefficient use of public funds by all tiers of government. With market –orientation and globalisation of the Indian economy, changing with the onset of electronic commerce, the existing inter-state and inter-regional disparities are likely to be accentuated further, necessitating shifts in existing resource redistribution mechanisms of fiscal transfers.

In India, the uneven distribution of natural resources has itself created large severely underdeveloped regions in the country, which have been recently brought into sharp focus. The problem needs to be addressed by well thought-out strategies including deliberate transfer of resources to underdeveloped regions of the country. This is vital because proper growth of all regions of the country is essential for its prosperity in terms of political and social systems and for the economic viability of the nation itself.

STATEMENT OF PROBLEM

Economic growth together with social advancement is perceived as the most sustainable path of development. Social development, however, depends largely on the availability of well-developed social infrastructure, which acts as stimulant in economic growth. Social sector expenditures considered as an important part of egalitarian strategies designed to give a 'human face' to economic development address the issues of income distribution, regional disparities and employment generation. These expenditures would have both current as well as long term positive impacts on the quality of life in terms of human capital formation and development.

The role of transfers in harmonizing the principles underlying the distribution of resources needs to be appreciated in the context of regional disparities. Transfer mechanisms would need to differentiate between the 'ability-consistent efforts' and ability-enhancing efforts' of states.

Against this background, a study has been undertaken to explain the inevitability of the fiscal adjustment between the centre and the states in India. Central transfers, therefore, have come to be accepted as the most important and effective device of fiscal adjustments to check regional economic imbalances, promote economic growth and encourage states to mobilize larger revenues.

Keeping in view the crucial importance of the issues, this study aims to take in-depth analysis of various aspects of Finance Commission transfers to states to devise various measures to assess how far the mal-distribution of resources has been corrected and whether there has been a noticeable reduction in regional imbalances and changes in the relative placement of various states according to the degree of development. But before setting out the specific objectives of this study, it is worthwhile to critically review the existing literature on centre-state relations, particularly relating to Finance Commission. Many of these issues have been selected by the researchers for investigation in the past.

REVIEW OF LITERATURE

An overview of the voluminous literature available on centre-state financial relations indicates that till the late sixties, federal finance and an overview of the centre -state fiscal relations constituted the main focus of research.

Krishnaswamy's (1963) is one of the earlier studies, which discusses the first three Finance Commissions. He also describes the historical, administrative, political and other factors, which remained in the background for having the federal type government and economic planning in India. It is concluded that Finance Commission have made attempts to make states more solvent and self-reliant: yet, paradoxically the states are more dependent on the centre ever since the discretionary assistance grown in volume.[3]

The study of Lakdawala is another important study, which discusses the role of Finance Commission and the Planning Commission at length along with the theory of federal finance and its problems. This study concludes that the Finance Commission being an ad-hoc body and having its undefined role vis-à-vis the Planning Commission has not been able to fulfil its legitimate role. Even the Planning Commission's conditional grants have failed to achieve any significant purpose; they distort priorities of the states, undermine their resources use and create needless friction. It is then suggested that unconditional grants would b the most suitable general method for helping the development in the states spheres. "Loans...should pass business like tests" and should better be administered through the organisation of a Development Bank.[4]

Notes:

3. Krishnaswamy A. (1963): *The Indian Union and the States - A Study in Autonomy and Integration*, Pergaman press Oxford
4. Lakdawala D.T. (1967): *Union State Financial Relations*, Lalvani Publication House, Delhi

Bhargava discusses the financial adjustment in India as a part of his comprehensive study on public finance including the theory of federal finance. The fiscal adjustment process through different components of the Finance Commission transfers has been discussed in the historical background[5]. It is relatively an old study relating to the period immediately after independence. The study of Sastri documents the principles and procedures adopted by the Finance Commission to distribute the divisible pool of union tax revenues. It also details the procedure for measuring the tax efforts of the states. In this study the different aspects are discussed with special reference to the constitutional provisions.[6] The study of Zaveri brings out that the statutory grant-in-aid have not always benefited the backward regions.[7] A mention may also be made of an edited study by Nataraj and Sastry comprising of papers of a seminar held in 1973. It covers a wide range of issues relating to the financial matters, planning, political and constitutional aspects and other inter-state disputes.[8] Regarding transfers, it is suggested by V.K.R.V.Rao that the existing central dominance needs to be reduced may be by allowing the states to borrow liberally from the open markets or setting up a National Loan Corporation. Grants in aid may strictly be used for redressing regional imbalances. Inter-state Union Council is suggested to discuss all the issues relating to the centre state fiscal relations.[9]

Notes:

5. Bhargava R.N. (1967): *The Theory and Working of Union Finance In India*, Chaitanya Publishing House, Allahabad, Chapter 10 pp.123-58.
6. Sastri K.V.S. (1966): *Federal State Fiscal Relations in India.* Oxford press.
7. Zaveri J.J. (1969): Transfer of non-Plan Resources to States – A Suggested Approach. *Eco & Pol. Weekly*, June 7 (IV, 23)
8. Nataraj V.K. and N.N. Sastri (1975 Ed.): *New Perspectives in Central State Relations in India*, University of Mysore.
9. Rao V.K.R.V. (1973): " Centre-State Relations In India". In Nataraj V.K. and N.N. Sastri (1975 Ed.): Op.cit.

The different aspects of centre-state relations were also discussed in the Indian Economic Conference in 1972.Lakdawala in his key paper brings out three failures, relating to the unauthorized overdrafts, regressive distribution of transfers and widening regional inequalities in the matter of state services etc. The state's indebtedness, their financial autonomy, were the other issues addressed in that Conference. Lakdawala points out that transfers being in money terms may not achieve the intended objective unless proper conditions created and adequate supervision is ensured. [10]

The study by Aggarwal examines the constitutional as well as the non-constitutional grants which are devolved through he finance and the Planning Commissions and the different ministries. The main conclusions are: (i) The system of grants lacks coherence and conformity except in the case of statutory grants, (ii) states are heavily dependent on the central grants and (iii) while centre normally had the money it does not always have the same power as the states have to execute the projects.[11] However, this study excludes all other kinds of central transfers. Eapen, stresses on the fiscal capacity and the 'need' approach to be followed by Finance Commission for allocating the resources.[12]

Notes:

10. Indian Eco. Conference (1972): Centre State Financial Relations. Population Prakashan, Bombay.
11. Aggarwal P.P. (1959): *System of Grants in India*, Bombay
12. Eapen A.E. (1969): "A critique of Indian Fiscal Federation". *Pub. Fin.* XXIV, pp.537-57.

In the seventies, the institutional structure of central transfers was the principal theme of most of the studies, which critically examined the working of the Finance and Planning Commissions with regard to centre-states transfers. These studies have arrived at some important conclusions. For instance, Grewal discusses the general principles of inter-governmental transfers including the issue related to the unauthorized overdrafts, accommodation loans etc. This study concludes that the existing framework of transfers has developed from adhocism of the past having little coordination and defined goals of a federalism. As such it has resulted in sidetracking the problem of regional inequities. Therefore, it is suggested in this study that economic goals be defined be given as a general assistance and specific grants for the low-income states and specifically for reducing the inter-state inequalities. [13]

Among the various studies on Finance Commission, the study of Venu examines the recommendations of the first six Finance Commissions along with a brief survey of important features of other federations, different tools of fiscal adjustment and history of centre-state fiscal relations. It suggests the sharing of all the taxes in the divisible pool on equal basis and abolition of the grant in lieu of railway passenger fares and for 'revenue filling' along with abolition of the overdrafts and the small savings. Grants-in-aid should be used for equalizing purpose. [14]

Notes:

13. Grewal B.S. (1974): Fiscal Federalism in India, Research Monograph No.3, CPFFR, ANU – (1975) Centre State Financial Relations in India, Punjabi University Press.
14. Venu S. (1978): *The Finance Commission of India Institute For Financial Management and Research,* Madras.

Govinda Rao also examines the reports of the first seven Finance Commissions and concludes that the gap-filling approach violates not only the objective of equity but also efficiency as it exerts disincentive effect on the tax efforts and the expenditure economy of the states.[15] The impact of the Finance Commission transfers on the balanced regional development has been examined by Hemlata Rao. She demonstrates that statutory transfers up to the period 1969-70 having population as a basis have failed to bring equitable regional development in India.[16] In a detailed study on the Finance Commission by Thimmaiah, empirical evidence is given to show that the statutory transfers create a budgetary income effect but fail to create favourable expenditure substitution and budgetary substitution effects on the current budgets of the states. Tax shares and grants do not stimulated expenditures on essential public and social services. Even the states are not induced to tap their own resources. The effect of tax shares o per capita income of the state is consistently inequitable and it is aggravated compared to grants.[17] In their latest study, Thimmaiah and Rao further examine the methodology and the types of statutory transfers in the background of vertical and horizontal imbalances and economic disparities. They conclude that the magnitude of vertical imbalances has been increasing though it shows a downward trend in recent years. The Finance Commission transfers are relatively assured, but the assured component in itself is falling.

Notes:

15. Rao Govinda (1977) Federal Fiscal Transfers in India – Performance of Six Finance Commissions. *Eco & Pol. Weekly*, July – (XII, 31).
16. Rao, Hem, Lata (1979):
17. Thimmaiah G. (1976): Federal Fiscal System of Australia and India- Associating Publishing House Delhi Also see A Critique of Finance Commission, 1981.

However, these transfers are progressive though the degree is quite low. This study also makes some suggestions relating to the methodology, assistance for relief's and rehabilitation and non-plan capital gaps etc. and not favour advance plan assistance. Rather it suggests transfers through grants and the formation of the National Relief Fund, which should have contributions from the states and the centre on matching basis. [18]

Right from the early 80s the emphasis on central transfers has further sharpened. The whole of the institutional structure of the financial arrangements with added emphasis on ministerial transfers has become the central theme of studies on centre-state relations. The study by Dar (1981) focuses on the theoretical discussion on all the three institutions; the Planning Commission, The Finance Commission and Central ministries handling central transfers.[19] The study by Chelliah and associates has brought out that the central transfers have had a disincentive effect on the state revenues and have made them fiscally irresponsible. They empirically found that Finance Commission Transfers failed in mitigating inequalities prevailing in different services.[20] Secondly, that the centralization has grown over the period, although this has failed o achieve its objective of equity etc.

Notes:

18. Thimmaiah G. and Hemlata Rao (1985): *Finance Commission and Centre State Financial Relations:* Ashish Publishing House Delhi.
19. Dar R.K. (1981): *Recent Development in Federal Financial Relations.*
20. Chelliah R.J. and Associate (1981): *Trends and Issues in Indian Federal Finance*, Allied Publishers Delhi.

Another study by Bajaj et al demonstrates that the six relatively backward states have not been allocated required resources to make a dent on inter-state inequalities. It is inspite of the fact that these states have not lagged behind the centre or the developed states in tax efforts.[21] A recent study by George further confirms these conclusions. It states, ".. that all the agencies entrusted with the task of resources allocation-the Finance Commission, Planning Commission, the Union ministries and the financial institutions have without exception failed to bring succour to the poorer states. All the major instruments of regional policy have failed to arrest the widening trend in regional disparities in India." [22] In this context, it has been stressed by Lakdawala that the role of transfers can be limited if states do not mobilize more resources and show economies in non-plan expenditure.[23]

The study by Thimmaiah (1985) and that by Ansari.M (1985) further extend the scope of discussion on fiscal transfers from the centre to the states by including a discussion on central public sector investment, public sector bank advances to states and on determination of the market borrowing limits of the states. Some of the issues like inter-state disparities in the financial transfers to states, the operation of central loans, Gadgil formula and other principles used for distributing the market borrowings and overdrafts have been critically examined by Thimmaiah and alternatives suggested.

Notes:

21. Bajaj J.L, K. Sinha and O.P. Aggarwal (1985): *Finance Commission and Backward States- An Appraisal*, Print House, Lucknow.
22. George K.K (1988): *Centre-State Financial Flows and Inter-state Disparities*: Critique Books, Delhi.
23. Lakdawala D.T. (1986), " Plan Finances in Federal Economy" and Fiscal Readjustment and the Finance Commission". In R.K. Sinha (1986) *Centre State Financial Relations in India*, Deep and Deep Publishers, pp. 67-106 and pp.135-55.

Ansari while investigating the pattern of distribution and the degree of financial dependence of the states on the centre concludes that the degree of financial dependence is more in the case of poorer states, which may be attributed to relatively low level of investment expenditures incurred on per unit of public services.[24]

The idea of incorporating income distribution in the devolution formula was criticized sharply by many experts (Bagchi and Uma Datta Roy Choudhary, 1989). They wrote:" The principal objective underlying devolution in a federation that needs reiterating is to equalize or at least substantially reduce the sharp disparities may arise partly as a result of deficiencies in the revenue raising capacity of the poorer states and may also be due to variations in the costs of providing public services. The task of Finance Commission, it is fair to say, consists essentially of assessing the revenue deficiency and cost disabilities of the states on a comparable footing and that requires investigating what are the determinants of revenue raising capacity.." [25]

Notes:

24. Thimmaiah G. (1985): *Burning Issues in centre State Financial Relations*, Ashish Publishing House, Delhi. Ansari M.M. (1985); Flow of Financial Resources and Inter-state Disparities: Implications For a Federal Set-up. *Indian Eco. Journal*, July/Sep. (XXXIII, 1)
25. Bagchi A and Uma Dutta Roy Choudhary (1989): Poverty Measures as an Index of Backwardness and Their Relevance For Tax Devolution, *Eco & Pol. Weekly*, (April 15): pp.831-836

However in the 90s against the backdrop of the fast deteriorating fiscal situation and the fast changing economic environment with the opening up of the economy, the role of government was redefined. The more focus was on normative approach replacing the conventional gap-filling approach and conditional grants. Moreover, the flow of private investment gained importance to the states depending on its development.

A study by M.Govinda Rao and Vandana Aggarwal (1991) provided a methodology to estimate unit costs of public services and expenditure needs of the states based on the cost functions of five important public services. This was done keeping in mind the objectives of intergovernmental transfers either to offset fiscal disadvantages of the states or to upgrade specified public services to normative standards in the deficient states.[26]

Guhan (1995) and Verney (1995) made proposals for inculcating co-operative federalism and/or moving over to a confederate structure in India. Guhan set out an agenda for cooperative federalism underlining the need for joint effort of the governments at both levels to implement the 'new economic policy' initiated in 1991-92. [27]

J.V.M. Sarma's (1997) analysis suggests a unified way of looking at the fiscal gap and empirically estimates a fixed effects model for estimating the fiscal gap and works out federal transfers using an illustration covering fourteen major states. [28]

Notes:

26. Rao Govinda M. and Vandana Aggarwal (1991): Central Transfers to Offset Fiscal Disadvantages of the States: Measurement of Cost Disabilities and Expenditure Needs, *Indian Eco. Review*, (Vol.XXVI, No.1)
27. Guhan S. (1995):'Federalism and the New Political Economy in India' in Arora and Verney, ed. 1995.
28. Sarma J.V.M (1997): "Federal Fiscal Relations in India- Issue of Horizontal Transfers': *Eco & Pol. Weekly*, (July, 12, 1997)

In the contribution by Srivastava and Aggarwal (1994), the linkages between revenue sharing criteria used in India and the incentives for fragmentation of states that ensue from them was examined. They highlighted the importance of the nexus between the principles governing inter state and intra-state for allocation of resources in the design of fiscal transfers from higher to lower level governments. They have argued that if consonance is maintained between principles governing inter-state and intra state allocation of resources, the fragmentation inducing pressures would be mitigated and would therefore impart greater stability to the federal arrangements. The contribution by Aggarwal reviews the characteristics of several revenue sharing criteria in India which was based on an information base consisting of population and per capita incomes.[29] M.Govinda Rao in his contribution, critically examines rationale for inter-governmental transfers and evaluates the design of transfers envisaged by the finance Commissions in India in the context of equity and efficiency. [30] Coondoo, Majumdar and Neogi propose the use of a taxable capacity function for introducing a normative approach to estimation of fiscal gaps for purposes of determining fiscal transfers. [31]

Notes:

29. Srivastava D.K. and Aggarwal Pawan K. (1994). Revenue Sharing Criteria in Federal Fiscal Systems: Some Similarities and Differences: *Public Finance/ Finances Publiques*, Vol. 49, No.3 pp.440-59
30. Govinda Rao and Sen Tapas K. (1996): Fiscal Federalism In India- Theory & Practice, McMillan India Pvt. Ltd.
31. Coondoo, Majumdar and Neogi : Taxable Capacity Function: A Note on Specification, Estimation and Application: in Srivastava D.K (2000).: *Fiscal Federalism In India –Contemporary Challenges- Issues before the Eleventh Finance Commission,* Har Anand Publication Pvt. Ltd.

On the basis of Bagchi and Datta Roy Choudhary argument in 1989, Hiranaya Mukhopadhyay refuted and made an important implication that intra-state income inequality should be part of the devolution formula. The Finance Commission should look at total revenue raising capacity over a period and that depends on buoyancy. He argued that income distribution should not be ruled out from the devolution formula. [32]

Murty looked at the issue of designing inter-governmental transfers from a welfare maximizing perspective. He proposes what he calls a unified approach for tax devolution. From the analysis of the welfare function, he argues that welfare weights would depend upon both the initial level of the indices entering into the welfare function and their rates of change. He argues that welfare weights would depend upon both the initial levels of the indices entering into the welfare function and their rates change. He argued for using devolution criteria which gives due weight to incentives that will promote budgetary reforms and reduce inefficiencies. [33]

Rangarajan, a member of the Tenth Finance Commission (TFC) and former Governor of the Reserve Bank of India emphasised upon the need to take a normative view of revenues and expenditures of both the centre and the states. He advises, "the task is to devise a formula that redresses disadvantage but penalizes imprudence".

Notes:

32. Murty M.N: Tax Devolution in Cooperative Federalism: in Srivastava D.K (2000).: *Fiscal Federalism In India –Contemporary Challenges- Issues before the Eleventh Finance Commission,* Har Anand Publication Pvt. Ltd.
33. Mukhopadyay Hrinaya: Why Income Inequality should be a part of Devolution Formula: in Srivastava D.K (2000).: *Fiscal Federalism In India –Contemporary Challenges- Issues before the Eleventh Finance Commission,* Har Anand Publication Pvt. Ltd.

This issue was also put up by Raja Chelliah. Bagchi (member of Eleventh Finance Commission), too agreed about the normative assessment. He believes that"..in order that the transfer system does not provide an incentive for fiscal profligacy or does not create discrimination against the states that manage to live within means, in estimating the revenue and expenditure of the states. It would be necessary to follow some objective criteria or a "normative' basis instead of going merely by actual or historical trends". [34]

One major issue, which has come to the fore in the context of the EFC, relates to equity among the states and its relevance for purposes of central devolution. The report of the EFC has created considerable misgivings in some relatively better-off states on this score. It may be useful in the connection to refer to the note of Observations made by Amaresh Bagchi, member, appended to the report of the EFC. Bagchi has argued that if equalization of revenue capacity between the states is to be carried to its logical end, there is a need either to reduce that share of tax devolution in the total statutory transfers to allow more room for the deficit grants or to supplement the revenue deficit grants through equalisation grants to narrow the gaps in the revenue capacity of the states in providing at least some of the basic public services. [35]

Thus, there is a serious need to look into some of the old issues afresh and in wider perspective, and to examine the neglected issues, particularly regional disparities in India. The present study is an endeavour in this direction.

Notes:

34. Rangarajan, Chelliah and Bagchi: Overview of Issues: in Srivastava D.K (2000).: *Fiscal Federalism In India –Contemporary Challenges- Issues before the Eleventh Finance Commission*, Har Anand Publication Pvt. Ltd.
35. Government of India, *Report of the Eleventh Finance commission* (2000-2005), New Delhi.

OBJECTIVES OF THE STUDY

Balanced regional development has been the declared policy of economic planning. However, it has been observed that, inter-state disparities far from being reduced, have tended to exacerbate. The Constitution did anticipate the problem of inter-state disparities and introduced a system of fiscal transfers. Efficiency and equity in intergovernmental transfers depends on design and implementation of the system as well as institutional arrangements. The Finance Commissions may not be able to deal with institutional problems entirely. Even in the design of the transfer system, the Planning Commission and central ministries give about 53 percent of the transfers in the Eighth Five-Year Plan. Nevertheless, it is important to design the transfers given by the Finance Commissions to fulfil economic objectives of the intergovernmental transfers.

Thus the specific objectives of the proposed study may be stated now:

1. To review the regional disparities in India for the benchmark years 1981, 1991 and 1996.
2. To examine the various factors which help in explaining inter-state variations.
3. To classify the transfers according to their type, form and agency handling devolutions.
4. To overview the distribution of Finance Commission transfers across the states from Sixth FC onwards. It is done with a view to finding out how far the Finance Commission transfers have been instrumental in enabling the states to successfully achieve their stated planned objectives.
5. To examine and analyse the impact of Finance Commission transfers on income equalization.

6. To investigate the pattern of socio-economic development levels and analyse the impact of Finance Commission transfers in explaining regional imbalances across states.

DATA BASE

The study exclusively relies on secondary data, published by the Government or Government assisted research agencies. For basic public Finance data on states, the information supplied by various volumes of Reserve Bank Of India Bulletins was used. The same type of information was also available in the Combined Finance and Revenue Accounts of the Comptroller General Of India. However, Reserve Bank of India Bulletins was preferred for being relatively classified and having smaller publication lags compared to that by the Comptroller General Of India contained in the Combined Finance and Revenue Accounts. The study has also used supplementary data from various Reports of Finance Commissions, Planning Commissions, Report on Currency and Finance and Indian Public Finance Statistics.

The imbalance criterion used in this study sought to be measured with the help of 13 indicators. In this study we seek to develop indices of socio-economic development at the level of fourteen major states mainly for the years 1981,1991 and 1996. These indices will reflect the divergence of a state from all India average.

CHOICE OF INDICATORS

The choice of indicators depends on the researcher's own perception and approach to the problem, except the established ones. The basis should not only be the logic of mathematics but the conceptualisation of social reality. That should reflect the transformation of resource potential of any region/section of the society into development. The basic principle of the choice of indicators is not a detrimental in character. It depends on the specific condition of the society/region assumptions by the researcher and the methodology.

RATIONALE

All the indicators have their numerical expressions reflecting the developmental phenomenon in terms of quality through which the process of development is articulated for the purpose of identification, classification and regionalization.

TH-9574

The 13 development indicators are taken for computing composite index of socio-economic development:

1.Per capita NSDP at current prices

2.Population above poverty line (poverty ratios are subtracted from 100 to make it positive).

3.Sex Ratio

4.Literacy Rate (%)

5.Bank Branches per capita

6.Consumption of power per capita(KWH)

7.Telecom lines per 100 persons

8.Hospitals/Beds per capita

9.Percentage of Gross Irrigated Area to gross cropped area

10. Railways per 1000 square km.

11. Employment in Organised sector('000 nos.)

12. Credit-Deposit Ratio

13. Number of Villages electrified. (%)

These indicators are admixture of economic and social infrastructure covering major sectors namely: Agriculture, Banking, Electricity, Transport, Communications, Education, Health, etc. Each of which signifies socio-economic development. Most of the data have been collected from Statistical Abstract and Estimates of state Domestic Product of the Central Statistical Organisation (CSO), as well as various publications of the Centre for Monitoring Indian Economy (CMIE), mainly from Profiles of States (March 1997) and Profiles of Districts (October 2000). Data on Poverty has been taken from various National Sample Survey rounds. Data on Sex ratio, Infant Mortality rate and Literacy rate was collected from Census of India.

STUDY AREA

The proposed study covers all the 14 major states except special category states. The states included in the study are: Andhra Pradesh, Bihar, Gujarat, Haryana, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Orissa, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal.

The special category states are excluded from the analysis. It is included for some tables. As far as Special Category states are concerned, the main reasons for its exclusion is as follows:

When the original formula for the distribution of Central assistance for state Plans was approved by the National Development Council in September 1968, it was agreed that the requirements of Assam, Jammu & Kashmir and Nagaland should first be met out of the total pool of Central assistance. At the time of the Fifth Plan this list was extended to include Himachal Pradesh, Manipur, Meghalaya, Sikkim and Tripura making eighth states in all. In 1990 this became ten by including Arunachal Pradesh and Mizoram. Goa became a State in 1989-90 and was not considered as a Special Category State for the purpose of Central assistance for the State Plans as it happened to have the highest per capita income in the entire country. But the Finance Commissions treated Goa as a Special case and separate from the other non-special category states.

The Ninth Commission in this connection states as under:

"3.30. The States of Arunachal Pradesh, Himachal Pradesh, Jammu & Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura and also Assam form a distinct group requiring somewhat different treatment from what we accorded to the non-special category states. This applies to the state of Goa as well. Keeping in view the special features of the Special Category States and the historical background in which these states came to be constituted, we have adopted a liberal approach in assessing their receipts as well as expenditures..."

The tenth Commission also treated Goa as Special Category State.

These eleven states have 5.5 percent of population of the country (1991 census). For the reasons given above the Ninth and the Tenth Commissions' recommendations resulted in a transfer of resources to them of 15.4 percent of the total transfers for all 26 states.

Their comparison with the bigger states having large populations would be faulty as many of the districts in the bigger states have larger population that these states. Secondly most of them do not have time series data on many of the economic variables.

PERIOD

Balanced Regional development became an avowed objective of planning since the fourth five-year plan. Therefore, the proposed study pertains to the period 1974-75 onwards to 1999-2000 covering Sixth, Seventh, Eighth Ninth and Tenth Finance Commissions. The Reserve Bank of India started giving its detailed information on state finances following the revised classification for all the states on a comparative basis during this period. This period also covers the Fifth Five Year Plan followed by Sixth, Seventh and Eighth and also three years of Ninth Five Year Plan.

Thus this overall period would help in assessing the impact of devolutions through Finance Commission on regional disparities.

METHODOLOGY

The proposed study makes use of the different statistical tools. Regression analysis is the most common statistical tools used to work out the impact of Finance Commission transfer in explaining variations in the dependent variables, particularly on income equalization and on regional development. The step-wise regression is done in order to analyse the impact of per capita SDP, Population and tax effort on per capita transfers.

To analyse the progressivity of Finance Commission transfers, income elasticity was computed using double-log regression. Rank correlation and Pearson Correlation was done to find out the significant relationships between the variables.

Consistent with the objective of the study, the inequalities or disparities prevailing among the states in their socio economic development as well as in the Finance Commission transfers were examined through simple statistical methods used are:

Coefficient of Variation = Standard Deviation / Mean **X** 100 and

Disparity Ratio= maximum/minimum to analyse inter state variations.

In the present study, Principal Component Analysis (PCA)-a branch of factor analysis developed by Haggood and later on modified by M.N.Pal-has been used which is the most suitable and popular method among the social scientists. The PCA method of index construction offers a technique, which combines numerous components into one index so that states (or regions/units of study) on the index will be as similar as possible with respect to all the component characteristics, which were condensed into one index[36]. PCA reduces a large number of variables of indices into a smaller number of conceptual variables through the inter-correlations.

$$CI = \sum_{i=1}^{n} X^s W$$

$$\text{or } CI = X_1^s W_1 + X_2^s \ldots\ldots\ldots\ldots X_n^s W_n$$

where X^s = Standardised Values of the original figures of the vectors (indicators) of the matrix

W = factor loadings (weightage)

It can be clarified in a different way –

$$CI = \sum_{i=1}^{n} X_s \left(\sqrt{\lambda^2} K\right.$$

or $$X_1^S\left(\sqrt{\lambda_1^2}K_1\right)+X_2^S\left(\sqrt{\lambda_1^2}K_1\right)\ldots\ldots+X_n^S\left(\sqrt{\lambda_1^2}Kn\right)$$

where

X^s = Standardised figures

$\sqrt{\lambda^2}$ = eigen value (principal component)

K = Vector of the respective eigen value

$\sqrt{\lambda_1^2}$ = Largest eigen value (First Principal Component)

K_1 = Vector of the largest eigen value/first principal component.

This exercise has been done in two steps. Firstly, the factor scores were computed for composite index of development.

Finally, the factor scores have been grouped into four categories through the simple range method to categorise into different levels of development. To measure disparity, the range has been calculated.

36. M.J.Haggood (1934), "Statistical Method for Delineation of Regions Applied to Data on Agriculture and Population", *Social Force*, Vol.21

*Standardisation is done to get scale free figures or to get out of scale bias with the subtraction by mean and division by Standard Deviation.

LIMITATIONS OF STUDY

There are many constraints in this study. Time constraint comes in the forefront to carry out such an exercise, which does not have all the information in a single space. The empirical study in social science, especially the regional studies based on the secondary information come with many problems. A key factor limiting our selection and use of variables was the lack of availability of consistent data for all the states in the Union. If data for a given year was not available then the data for the closest available year was chosen. However in some cases data for 1996 year was not available in which case the most recent year possible has been selected. In selecting variables the primary consideration was to preserve the capital good and public good character of the concept of infrastructure.

However, the composite indices constructed do not reflect the true level of development of different sectors. It does not indicate the trend of a particular sector whether it has improved further or not over the period, because the values of composite indices may be smaller than that of the previous one.

For the analysis, a comparable series of NSDP prepared by the CSO has been taken. These estimates are attempted at specific requests from Finance Commission and Planning Commission. These estimates are prepared at current prices and they are not updated or revised when more up-to-date information becomes available later for the relevant years.

DESIGN

The study is divided into six chapters. After the introductory chapter I, Chapter II surveys the performance of states in social and economic environment reflecting the regional variations of a state. It also examines the states' finances in the recent years. Chapter III traces out the evolution of the existing institutional structure of central transfers in India. It also gives the factual position of the central transfers to pinpoint the background of the issues for empirical analysis.

By making use of Chapter III, Chapter IV shows the expost distribution pattern of Finance Commission transfers. The role of the usual devolving factors like income, population and tax- efforts are also examined in this chapter.

After taking note of inter- state variations in India composite index of development is constructed in Chapter V by taking into account 13 socio-economic indicators. It then gives the pattern of development and their extent as explained by Finance Commission transfers. It also analyses the impact of Finance Commission transfers on income equalization. Chapter VI summarises the major findings of the study.

CHAPTER II

REGIONAL DISPARITIES IN INDIA

Regional disparities in economic and social development across the regions and intra regional disparities among different segments of the society have been the major reasons for adopting planning in India since independence. Apart from massive investments in backward regions, various public policies directed at encouraging private investments in such regions have been pursued during the first three decades of planned development. While efforts to reduce regional disparities were not lacking achievements were disproportionately low. Considerable level of regional disparities remained at the end of the 1970s. The accelerated economic growth since the early 1980s appears to have been aggravated regional disparities. The ongoing economic reforms since 1991 with stabilisation and deregulation policies as their central themes seem to have further widened the regional disparities.

This chapter is particularly important to study the differences in performance among states in order to extract lessons about what works and what does not. A better understanding of the reasons for the superior performance of some states would help to spread success from one part of the country to the other. Some idea about the trends can be obtained and this is what has been attempted here with respect to overall economic disparities as well as social sectors and infrastructure differentials. This would help in devising strategies that can help to break the specific constraints that prevent the present poorly performing states from replicating the success of the better performers. The chapter is organised in four sections. To start with, Section II.1 overviews the literature in the Indian perspective; Section II.2 gives a bird's eye view of the size and structure of existing regional inequalities in relation to per capita income. Section II.3 deals in the size and structure of economic and social indicators. Section II.4 discusses state finances in recent years. Section II.5 discusses the role of government in regional policy.

Section II.1

REVIEW OF LITERATURE

Ever since man began to explore the world around him, differences among people and their ways of living have aroused great curiosity[1]. Regional inequities came into prominence soon after the industrial revolution. However systematic studies in this direction began only in the early twentieth century. Since the beginning of the mid-50s, several theories and models have been developed to provide theoretical frameworks for understanding regional economic problems.

Theoretical research on regional economic growth and convergence had to wait for about four decades after the pioneering work of Harrod-Domar and Solow came into force. Of course, it must be mentioned that the classic works of Myrdal (1957) and Hirschman (1958) dealt in quite detail about the causes of concentration of economic activities in a particular location or region. According to Gunnar Myrdal (1957) in whose formulation factor movements themselves were likely to be dis-equilibrating rather than equilibrating on account of the backwash effects.

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1. Smith D.M (1979), *Where the Grass is Greener, Penguin*, Middlesex.p.15

Labour migration was conceived as being highly selective, thus widening the initial disparities. Added to this was the gravitational pull exercised by initial centres of growth, generally urban centres, in attracting new investments[2]. Hirschman strongly propagated the case for governmental intervention to counteract the 'polarisation effects' of free market forces. The most obvious and less 'risky' approach is to endow the backward regions with good system of transportation, effective power stations and other SOC facilities as are available in the developed regions. Repatriation of income by migrants from backward areas and growth in demand for goods produced in the lagging regions are supposed to bring about a reversal in the trend of increasing regional economic disparities[3]. This inverse U-shaped pattern of regional disparities was borne out by the empirical statements from Kuznets (1957) and Williamson (1965), which state that as an economy grows, regional disparities diverge at first only to converge later. This inverted U-shaped curve is often known as Kuznets curve4. Williamson's contribution is an excellent piece of empirical work on the basis of a detailed international study based on time series data for 10 countries and cross sectional data for 24 countries[5]. Both approaches confirm the tendencies of regional inequalities first to increase and later to decrease with the process of national development.

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2. Myrdal Gunnar (1957): *Economic theory and underdeveloped regions*, The Penguin Press, London.
3. Hirschman A.C. (1958): *The Strategy of Economic Development*: New Haven
4. Kuznets S. (1957):' Quantitative Aspects of Economic Growth of Nations-II', *Economic Development and Cultural Change*, Vol. V, July
5. Williamson J.G. (1965): 'Regional Inequality and the Process of National Development', *Economic Development and Cultural Change*, Vol.13, No.4, Part II, July

Adelman and Morris (1973) have carefully analysed data from 74 underdeveloped countries for the period 1957-68 and indicated " the relationship between the level of economic development and the income share of the poorest 60 percent of the population is asymmetrically U-shaped. Both extreme economic underdevelopment are associated with greater income inequalities" [6].

In India, not much work has so far been done from a theoretical point of view. However, the empirical work conducted in India in the field of regional economics has been considerable. The pioneering work on the levels of regional development in India was carried out by Ashok Mitra (1961), for all the Indian districts on the basis of 63 indicators using Kendell's ranking method. He identified zones of backwash and spread effects. It was assumed that these areas of backwash and spread effects would set in motion forces of polarization. It was therefore decided to apply validity tests to verify this polarization[7]. It was on this basis of this work that the attention of the policy makers for the first time fell on the lagging backward regions.

Major studies about regionalisation started with the failure of Indian economy on the food front (Kundu 1980) [8]. In 1962, the Planning Commission tried to identify backward regions based on some indicators pertaining to socio-economic dimensions of development. The studies by Kundu (1980), Mishra (1985), Dholakia (1985) [9] and Hemlata Rao (1984) should be considered as important contributions in the field.

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6. Adelman and C.T.Mosrris (1973): *Economic Growth and Social Equity in Developing Countries*, Stanford University Press, Stanford, California.
7. Mitra A. (1964):'Levels of Regional Development', *Census of India*, Vol.I, Part 1-A (i), New Delhi.
8. Kundu A. (19800: *Measurement of Urban Development: A study of Regionalisation*, Popular Prakashan, Bombay
9. Mishra G.P. (1985) ed.; *Regional Structure of Development and Growth in India*, Vol.I, Ashish Publishing House, New Delhi.
   -Dholakia R.H. (1985): *Regional Disparities in Economic Growth in India*, Himalaya Publishing House, Bombay.

Kundu gave details of the methodological issues involved in the construction of composite indices and delineation of regional boundaries on the strength of the homogeneity criterion. In his study, urbanisation and the associated socio-economic development were considered for testing the relevance of the methods of regionalisation with special reference to the analysis of urban process in the north western meso regions- Rajasthan and Punjab- Haryana – for the years 1961 and 1971. Delineation was done on the basis of an aggregate composite index as well as distance statistics and shown by choropleth maps and tree diagram.

At the sub-national level, similar methods on elaborate statistical methods were used by M.N. Pal (1963), Singh(1972), Das Gupta (1974) and Tiwari (1985) [10]. Tiwari analysed inter-state disparities in the levels of development measured in terms of composite index of development constructed on the basis of 19 indicators of development. Dholakia, in Mishra (1985), considered 15 major states covering the period from 1960-61 to 1979-80 and studied growth differentials in per capita terms taking variables such as working population ratio, industrial structure of employment, capital intensity and capital and labour productivity.

10. Pal M.N. (1963); 'A Method of Regional Analysis of Economic Development with reference to South India', *Indian Journal of Regional Studies*, Vol. 5, pp.44-58
-Singh A.K. (1972):'States as Planning Regions', *Indian Journal of Regional Science*, Vol.4, No.1, pp.48-58.
-Dasgupta A.K. (1974): *Economic theory and Developing Countries*, Macmillan, London.
-Tiwari R.T. (1985):'Inter-Regional Disparities in the Levels of Development' in G.P. Mishra
- Sarker P.C (1989): Measurement of imbalances in Regional Development in India': Graphical Approach, *RBI Occasional Papers*, Vol.10, No.1

Taking 15 socio-economic indicators, Sarker (1989) studied the regional imbalances prevailing among 15 major states in or around the year 1984-85. Three graphical approaches used were referred to dendrogram, biplot and two-dimensional plot of the first two components based on cluster analysis, singular value decomposition method and principal component analysis[11]

Hemlata Rao (1984) considered 85 socio-economic development indicators to identify backward regions in Karnataka[12].

In the 90s, studies carried out by Kandpal (1990), Khanna (1990), Roy and Biswas (1990) and Roy Choudhary (1990) were presented at a conference of Indian Association for Research in National Income and Wealth during February 1990. All these studies, except the one by Uma Datta Roy Choudhary, dealt with state domestic product only for comparing disparities at state level. Even Roy Choudhary pointed out " per capita state domestic product is generally considered as almost the only satisfactory measure for determining the levels of economic development." She, however, identifies five crucial indicators of development such as (a) Literacy rate, (b) per capita power consumption, (c) life expectancy and (d) worker's ratio separately for manufacturing and secondary sectors. The tendency of deepening of inter-regional disparities was in evidence. But the traditional comparison state-wise income fails to reflect fully the socio-economic development that has taken place.

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11. Sarker P.C (1989): Measurement of imbalances in Regional Development in India': Graphical Approach, *RBI Occasional Papers*, Vol.10, No.1
12. Rao Hemlata (1984): *Regional Disparities and Development in India*, Ashish Publishing House, New Delhi.

The industrially backward regions began to be recognised by the Planning Commission through the reports of the Pandey Committee and the Wanchoo Committee. The main purpose was to disperse the process of industrial development to mitigate the problems of backwardness.

Dholakia (1994) concludes in terms of a study of 20 Indian states over the period 1960-61 to 1989-90 that there are marked tendencies of convergence of long-term economic growth rates for the states. He identifies 1980-81 to be the year of break in the trend of real incomes of states. Several of the lagging states started growing after this date while the leaders began to stagnate[13].

Cashin and Sahay (1996) too claim absolute convergence on the basis of data relating to 20 Indian states over the period at the same time that the dispersion of real per capita income increased during the period[14].

However, Marjit and Mitra as well as Ghosh et al report significant divergence across Indian States.

There study was not supported by Marjit and Mitra (1996) as well Ghosh et al (1998). They report significant divergence across the states[15].

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13. Dholakia R. (1994):'Spatial Dimension of Acceleration of Economic Growth in India, *Eco and Pol. Weekly*, (August), Vol. XXIX, No.35
14. Cashin P and R Sahay (1996): Internal Migration, Centre-State Grants and Economic Growth in the States of India, *IMF Staff Papers*, Vo.43 No.1 pp 123-71
15. Marjit S. and S Mitra (1996); Convergence in Regional Growth Rates: Indian Research Agenda, *Eco and Pol. Weekly* (August), Vol. XXXI, No.33

Ghosh, B.S. Marjit and C Neogi (19980; Economic Growth and Regional Divergence in India, 1960 to 1995, *Eco and Pol. Weekly* (June27-July3), Vol XXXIII, No.26

More recently, Rao (1999) made an interesting study on the issue of inter state variations in growth. This study focussed its attention not only on the question of convergence but also tried to examine the reasons for the observed pattern. They found the states to follow the divergent growth paths, which they try to explain in terms of other variables besides the initial level of income[16].

As the literature survey indicates, a consensus is yet to emerge on the convergence issue relating to the Indian states.

Section II.1

PER CAPITA NET STATE DOMESTIC PRODUCT AND REGIONAL DEVELOPMENT

Robert Lucas observed "...the problem of economic development..."is "...simply the problem of accounting for the observed pattern across countries and across time in levels and rates of growth of per capita income[17]. While this definition addresses explicitly the issue of comparative economic development of countries, it is equally relevant for the comparative study of development of regions within a given country, especially so for country as large as India, which is easily viewed as a collection of interconnected sub-economies viz., the states which comprise the country. The economic progress of a large country needs, so to speak, to be studied both from without as well as within..

16. Rao M Govinda, R T Shand and K.P. Kalirajan (1999): Convergence of Income across Indian States, *Eco and Pol. Weekly* (March 27-April 2), Vol.XXXIV, No13
17. Lucas, Robert E (1988): On the Mechanics Of Economic Development, *Journal of Monetary Economics*, Vol.22 , No1

The first compares the country with others, while the second might suggest explanations, should the first indicate large discrepancies in the country's relative economic performance. In other words, the presence of homogenous development or otherwise over regions making up countries could well provide important 'accounting' clues on disparities across nations.

The most common indicator of the economic development of a society is the per capita annual income generated by it. It is generally considered as the single most comprehensive measure for determining the level of economic development of a state. Official estimates of State Domestic Product are prepared by the respective states and published by the Central Statistical Organization (CSO). Working Group on State Income set up by the CSO laid down concepts, definitions and standard methodology for preparation of state income estimates for all sectors with a view to securing uniformity and the comparability of state income estimates. Thus, over a period of time, the estimates prepared by the states have become more uniform in concepts and methodology. However, due to differences in source material used due to varying time lags in the availability of basic data, estimates prepared by the states are still not strictly comparable.

There is also a comparable series of NSDP prepared by the CSO. These estimates are attempted at specific requests from Finance Commission and Planning Commission. These estimates are prepared at current prices and they are not updated or revised when more up-to-date information becomes available later for the relevant years. In this chapter we use the Net State domestic Product estimates at 1980-81 constant prices.

The state wise per capita NSDP indicates that Punjab is the highest and Bihar is lowest in the ranking. The ranks of the states have hardly changed over the years. It is noteworthy that Kerala, which has made great strides in social development, has the lowest per capita income among the better off states. It may perhaps convey an important message that high level of social development is achievable even at relatively low levels of per capita incomes. Indeed, the case of Kerala along with that of Sri Lanka has been noted internationally for achieving high levels of human development at relatively low level of economic development.

The growth rate for each state in each period is estimated using on a log linear trend in table II.1. The growth rate of the combined SDP of all 14 states taken together increased from 5.2 percent in the pre-reform period to 5.9 percent in the post reform period. This acceleration corresponds to a similar acceleration in the GDP growth as reported in the national accounts.

There is considerable variation in the performance of individual states, with some states growing faster than the average and other slower. The range of variation in the growth rate of SDP in the 1980s was from a low of 3.6 percent per year in Kerala to a high of 6.6 percent in Rajasthan, a factor less than 2. In the 1990s the variation was much larger from a low of 2.7 percent per year for Bihar to a high of 9.6 percent for Gujarat, a factor exceeding 3.5.

Table II.1.
Annual Rates of Growth of Gross State Domestic Product (SDP)

	1980-81 to 1990-91 (per cent per annum)	1991-92 to 1997-98 (per cent per annum)
High income states		
Punjab	5.32	4.71
Maharashtra	6.02	8.01
Haryana	6.43	5.02
Gujarat	5.08	9.57
Middle Income states		
Tamil Nadu	5.38	6.22
Karnataka	5.29	5.29
Andhra Pradesh	5.65	5.03
Kerala	3.57	5.81
West Bengal	4.71	6.91
Low Income states		
Rajasthan	6.60	6.54
Madhya Pradesh	4.56	6.17
Orissa	4.29	3.25
Uttar Pradesh	4.95	3.56
Bihar	4.66	2.69
ALL 14 states	5.24	5.94
GDP (National Accounts)	5.55	6.89

Note: The growth rates have been estimated fitting log-linear trends to the state SDP data in constant 1980-81 prices
Source: CSO and GDP from National Accounts.

The difference in performance across states become even more marked when we allow for the differences in the rates of growth of population and evaluate the performance in terms of growth rates in terms of per capita SDP. The variation in the growth rates of SDP in 1980s ranged from a low of 2.1 percent for Madhya Pradesh to a high of 4.0 for Rajasthan, a factor exceeding 1:2. In 1990s it ranged from a low of 1.1 percent per year in Bihar and 1.2 percent in Uttar Pradesh to a high of 7.6 percent per year in Gujarat, with Maharashtra coming next at 6.1 percent. The ratio between the lowest (Bihar) and the highest growth rate (Gujarat) is as much as 1:7.

The increased variation in growth performance in the 1990s reflects the fact that whereas for the economy as a whole, it actually decelerated sharply in Bihar, Uttar Pradesh and

Orissa, all of which had relatively low rates of growth to begin with and were also the poorest states. There was also deceleration in Haryana and Punjab, but the deceleration was from relatively higher levels of growth in the 1980s, and these states were also the richest.

It is important to note that the high growth performers in the 1990s ere not concentrated in one part of the country. The six states with growth rates above 6 percent per year are fairly well distributed regionally, i.e. Gujarat and Maharashtra in the west, West Bengal in the east, Tamil Nadu in the south and Madhya Pradesh and Rajasthan in the north. An interesting feature of the performance in the 1990s is that the popular characterization of the so-called BIMARU states (Bihar, Madhya Pradesh, Rajasthan and Uttar Pradesh) as a homogenous group of poor performers does not hold as far as economic performance is concerned. Bihar and Uttar Pradesh performed poorly, growing much slowly than the average, but the other two states of the group Rajasthan and Madhya Pradesh performed reasonably well.

The best way of measuring whether the pattern of growth in the 1990s has led to an increase in inter-state inequality is to construct a gini coefficient measuring inter-state inequality for each year given in table II.2.

Table II.2.

Trends in Gini Coefficient measuring Inter-state inequality

Years	Gini Coefficient
1980-81	0.152
1981-82	0.152
1982-83	0.152
1983-84	0.151
1984-85	0.154
1985-86	0.159
1986-87	0.157
1987-88	0.161
1988-89	0.158
1989-90	0.175
1990-91	0.171
1991-92	0.175
1992-93	0.199
1993-94	0.207
1994-95	0.214
1995-96	0.225
1996-97	0.228
1997-98	0.225

The coefficient was fairly stable up to about 1986-87, but began to increase in the late 1980s and this trend continued through the 1990s. The increase in the ginni coefficient from about 0.16 in 1986-87 to 0.23 in 1997-98 is a substantial increase.

Inter-state income differentials to large extent can be explained in terms of social economic indicators.

Section II.3

SOCIO-ECONOMIC INDICATORS AND REGIONAL DEVELOPMENT

1. Poverty Ratios

In analysing the poverty status of the states we rely on the estimates of the Expert Group on Estimation of Proportion and Number of Poor (Planning Commission, 1993), because it is believed that these estimates have better comparability over time and over space, though, in these estimates the level of poverty is higher than in the official estimates released by Planning Commission. The number of poor in each state and the share of the states in the total number of poor in the country are presented in table II.3.

Table II.3.

Percentage of Population in Poverty

	1983	1987-88	1993-94
High income states			
Punjab	16.18	13.20	11.77
Maharashtra	43.44	40.41	36.66
Haryana	21.37	16.64	25.05
Gujarat	32.79	31.54	24.21
Middle Income states			
Tamil Nadu	51.66	43.39	35.03
Karnataka	38.24	37.53	33.16
Andhra Pradesh	28.91	25.86	22.19
Kerala	40.42	31.79	25.43
West Bengal	54.85	44.72	35.66
Low Income states			
Rajasthan	34.46	35.15	27.41
Madhya Pradesh	49.78	43.07	42.52
Orissa	65.29	55.58	48.56
Uttar Pradesh	47.07	41.46	40.85
Bihar	52.22	52.13	54.96
ALL 14 states	43.80	39.92	36.25
ALL INDIA	44.48	38.86	35.97

Source: Planning Commission, Various NSS rounds

Six states with highest ratios of poverty in 1983 were Orissa, West Bengal, Bihar, Tamil Nadu, Madhya Pradesh and Uttar Pradesh in that order. All these states continued to be the states with highest ratio in 1987-88 also. Tamil Nadu and West Bengal went out of the list of six in 1993-94. All states experienced a decline in poverty over the 10-year period with only two exceptions –Bihar and Haryana, both of which show an increase. The increase in poverty in Bihar can be explained by the fact that per capita SDP in Bihar grew at less than 0.8 per cent per year between 1983-1993.

Table II.4. shows the coefficient of variation among the States in respect of poverty ratio. It can be seen that the disparity has increased over time except during the period 1983 and 1987-88, over which it has very slightly declined.

Table II.4.
Coefficient of variations and disparity ratio in Poverty

	Coefficient of variation	Disparity ratio
1983	33	4
1987-88	33.1	4.21
1993-94	34.52	4.6

2. Employment levels

It is widely known that organised sector employment in manufacturing reached a plateau in a short time. The organised employment increased marginally from 1466 thousand in 1981 to 1733 thousand in 1995. The increase in employment is highest in Maharashtra followed by West Bengal and Uttar Pradesh. But this increase in 90s should be viewed with caution. It is intriguing that the increase is reported when the industry was in recession in 1991-93. The nineties, under the structural adjustment programme witnessed the closures and disinvestments and greatly reduced investment in the public sector. Whereas upturn since then, is definitely responsible for increased employment in organised private sector. This is given in table II.5.

Table II.5.

Employment levels in Organised Sector ('000 nos.)

	HIGH INCOME	*1981*	*1991*	*1995*
1	Punjab	635	791	825
2	Maharashtra	3294	3648	3814
3	Haryana	506	602	638
4	Gujarat	1338	1660	1718
	MIDDLE INCOME			
5	Tamil Nadu	1886	2289	2383
6	Karnataka	1141	1447	1578
7	Andhra Pradesh	1446	1763	1957
8	Kerala	1017	1143	1174
9	West Bengal	2567	2465	2363
	LOW INCOME			
10	Rajasthan	882	1184	1203
11	Madhya Pradesh	1349	1669	1663
12	Orissa	563	773	801
13	Uttar Pradesh	2357	2677	2405
14	Bihar	1545	1663	1746
	ALL INDIA	**1466**	**1698**	**1733**
	CV%	**55.6**	**49.6**	**48.4**
	Disparity	**6.5**	**6.06**	**5.98**

Source: CMIE, Profiles of states, 1997

3. Social Indicators

Indicators of social development also present a picture of wide variations. Bihar, Orissa, Madhya Pradesh, Uttar Pradesh, Rajasthan and Andhra Pradesh are the states, which rank low in respect of most of the indicators of social development. Kerala comes out at the top. Tamil Nadu, Maharashtra, Punjab and West Bengal have improved their positions very fast over the last two decades. Thus the set of low ranking states in terms of social indicators intersects largely with the set of states, which rank low in terms of economic indicators as well. Bihar, Orissa, Uttar Pradesh and Madhya Pradesh are low ranking in terms of almost all the indicators. Table II.6. describe the position of the states in respect of selected indicators i.e. sex ratio, infant mortality rate, literacy rate.

Table II.6.

Levels of Social Development

	Sex Ratio		Infant Mortality Rate		Literacy rates	
HIGH INCOME	**1981**	**1991**	**1981**	**1991**	**1981**	**1991**
1 Punjab	878	882	89	61	46.36	58.51
2 Maharashtra	936	933	75	58	53.54	64.82
3 Haryana	870	863	103	69	41.65	55.85
4 Gujarat	941	934	112	72	49.9	61.29
MIDDLE INCOME						
5 Tamil Nadu	976	973	93	59	52.63	62.56
6 Karnataka	962	958	71	73	43.92	56.04
7 Andhra Pradesh	975	972	92	70	34.09	44.09
8 Kerala	1031	1036	40	17	78.85	89.81
9 West Bengal	911	917	159	63	46.32	57.7
LOW INCOME						
10 Rajasthan	918	910	105	84	28.37	38.55
11 Madhya Pradesh	940	931	142	111	32.24	44.2
12 Orissa	981	971	143	122	46.36	49.09
13 Uttar Pradesh	884	910	159	99	31.37	41.6
14 Bihar	945	911	103	75	30.25	38.48
ALL INDIA (Avg.)	**939**	**927**	**106**	**74**	**44**	**54.47**

Source: Census of India

The state wise sex ratio is the most revealing index of gender disparities among the states of the India union. The all India sex ratio of 927 females per 1000 males itself is a reflection of the neglect of women's health due to relatively lower economic and social value assigned to women, in general, in this country. Among the 14 states in our study eight have sex ratios above the national average and six below the national average. International experience indicates that as society develops economically the sex ratio turns more favourable to women.

Within India, however, this does not appear to hold good. The states with highest per capita income have lowest sex ratios. Punjab (third lowest) and Haryana (second lowest) in the country. Even the second and fourth richer states in the country Maharashtra and

Gujarat have sex ratios only marginally higher than the national average. The highest sex ratio is that of Kerala.

An important indicator of the quality of health care in a society is the infant mortality rate. The lower the IMR the better health care a state enjoys. The all India 14 states average is 74 which implies that out of every 1000 female infants born in the country, 74 will not survive till the first birthday. All the states with high level of income have IMR below the all-14 states average. The lowest IMR at 17 is that of Kerala, which is comparable to the level of income achieved by high income, developed states. The worst IMR figure are that of Orissa at 122 followed by Madhya Pradesh at 111.

The quality of human resource development is another critical determinant of growth and one would expect to find faster growing states to be the states with superior availability of human skills. Unfortunately, we do not have reliable measures of the educational attainment and skill level of the labour force in different states and the literacy rate of the population is therefore commonly used as a proxy for the quality of human resources.

Literacy levels in the slow growing states are distinctly lower than the average for all states. Literacy in Uttar Pradesh, Bihar and Orissa was very poor, the situation in Madhya Pradesh, Rajasthan and Andhra Pradesh at the start of the decade was only marginally better and yet these states showed a much better performance in the 1990s. Kerala has the highest literacy rate (89%) and Bihar has the lowest (38.5%). The poor performance of Uttar Pradesh, Bihar and Orissa cannot therefore be explained solely by the low levels of literacy reflect inadequacies in the human resources base of these states which must constrain growth performance.

Literacy rates have risen over time in all states, including the slow growing states of Bihar, Uttar Pradesh and Orissa. The absolute improvement in literacy (as a proxy for human resource development) should help improve the efficiency of resource use in these states but he continuing relative gap means that poorer states will continue to find it difficult to compete with the more advanced states in attracting investment.

Table II.7. shows the coefficient of variation among the States in respect of poverty ratio. It can be seen that the disparity has increased over time except during the period 1981 and 1991.

Table II.7.

Coefficient of variations and disparity ratio in social indicators

Indicators	Coefficient of variation		Disparity ratio	
	1981	1991	1981	1991
Sex ratio	4.8	4.7	1.2	1.2
Infant Mortality rate	32.6	34.6	4	7.18
Literacy rate	30	25	2.8	2.33

Variation has remained the same in respect of sex ratio. However, variation is widening in respect of infant mortality rate. Inter-state variations in respect of literacy rate have declined over the years.

4. Infrastructure and regional development

Availability of adequate infrastructure facilities is an important pre condition for sustainable economic and social development. Broadly, infrastructure can be physical, social or financial in nature. Energy, transport, irrigation, finance, communications, education and health are some important infrastructure facilities. Data on a few important infrastructure facilities in different states are presented in table II.8. for the recent year available.

Table II.8.

Consumption of power per capita is an indicator of the level of energy availability and energy consumption

It is noteworthy that the level of consumption of power per capita in all the states in the first group except Andhra Pradesh and Kerala, is well above the average, while Madhya Pradesh and Orissa[18] is well below the average.

The highest power consumption per capita in Punjab at 790 kWh is more than five times the level in Bihar at 145 kWh. While to a large extent the consumption level of power in a state is an indicator of the level of prosperity it may also reflect its availability and cost. Villages electrified are also an important indicator showing development in the rural India. Looking at the data, all the 14 states average is 91 percent. The high and middle-income states have almost achieved 100 percent or above the 14 states average electrification in villages except West Bengal. Among the low-income states all are below the 14 states average except Madhya Pradesh whose average is above the 14 states average.

Note: 18. The Orissa figure is somewhat out of tune with the ground realities of that state. Apparently the per capita average power consumption go inflated on account of inclusion of high tension industrial users like the aluminium industry in that state

TABLE II.8

LEVELS OF INFRASTRUCTURE

NON SPECIAL CATEGORY

	HIGH INCOM	Power Consp. per capita(KwH)	Villages Electrified(%)	Telecom Lines per 100 persons	Hosp/Bed per capita	% gross irr.area to gross cropped area	Railways per 1000sq.km.	Bank branches per capita	CDR
	High Income								
1	Punjab	790	100	5.34	109.69	94.8	42.08	10.69	38.6
2	Maharashtra	557	100	4.93	231.19	15.3	17.7	6.76	72.3
3	Haryana	508	97	3.18	62.34	77.2	35.01	7.48	48.2
4	Gujarat	686	99	3.75	197.11	28.9	27.2	7.68	42.9
	Middle Income								
5	Tamil Nadu	469	100	3.84	117.5	49.5	30.7	7.79	96.1
6	Karnataka	338	99	3.25	112.82	23.9	15.9	9.13	68.2
7	ndhra Prades	332	100	2.36	43.6	39.6	18.4	6.51	72.1
8	Kerala	236	100	4.66	134.3	13.6	27	10.15	44.3
9	West Bengal	197	77	1.86	90.2	28.7	42.5	5.53	46.1
	Low income								
10	Rajasthan	295	89	2.11	75.46	29.1	17.2	6.25	47.4
11	adhya Prades	368	94	1.38	43.97	22.3	13.3	5.68	51.4
12	Orissa	447	70	1.05	48.91	25.8	14.1	6.11	45.2
13	Uttar Pradesh	194	77	1.21	50.11	62.6	30.2	5.44	28.6
14	Bihar	145	71	0.58	44.9	43.2	30.2	4.96	27.5
	ALL INDIA 14	**397**	**91**	**2.82**	**97**	**40**	**25.8**	**7.15**	**52**

Source: CMIE, Profiles of States, March 1997 and Profiles of Districts, March 2000

The important point, however, is the fact that there is substantial inter-state variability in power consumption per capita.

A telecommunications line per 100 persons is a universally used indicator of the level of development of communications. The average of 2.82 telecom lines per 100 persons for 14 states is very low by international standards. Most of the East Asian countries have reached a level of 10 lines or more per 100 persons. The data indicate that there is considerable difference among the states in terms of telecom density. The telecom density in the country increased from 0.68 per 100 persons in 1991 to the present level 2.82 per 100 persons over 8-year period. The ongoing expansion programmes are likely to ensure a much higher telecom density in the coming years. Another point to be noted is that most of the existing telecom lines are in the major cities. The high telecom density of 5.34 per 100 persons in Punjab followed by 4.93 for 100 persons in Maharashtra and lowest telecom density of 0.58 per 100 persons in Bihar. The real task is to develop an efficient rural telecom system in the country.

Gross irrigated area is an important indicator of the level of agricultural development of a region. Assured irrigation being a precondition for modern agricultural practices, the level of labour absorption and productivity will critically depend on the quality of irrigation.

As compared to all India average of 36.5 percent of gross irrigated area to gross cropped area, six states have higher irrigated area and eight states have lower irrigated area. Punjab has the highest share of about 95% percent irrigated area, followed by Haryana (77.9 percent) and Uttar Pradesh (62.6 percent). It is to be noted that Uttar Pradesh has the highest irrigated area followed by Punjab. It is to be noted that percentage of irrigated area is high. Gujarat, Karnataka and Maharashtra have lower levels of irrigation mainly because of the comparatively lower irrigation potential in these states. Similarly, though the irrigation level in Tamil Nadu is only 50 percent, the state has almost exhausted its irrigation potential. The situation in Andhra Pradesh is not much different. On the other hand in states like Bihar, Orissa and Uttar Pradesh much more irrigation potential remains unexploited. Since a significant increase in productivity of agriculture in these states is essential for reduction of rural poverty, the importance of fully exploiting the irrigation potential in these states need special mention. This requires considerable public and private investment.

Railways per thousand square km are an indicator of the level of development of railway transport across the states. This may only be a partial indicator of transport development as road length per unit area and vehicle density per thousand persons are not included. Nevertheless, the railway per 1000 square km is an important indicator of overall quality of transport service in a state.

While the all-14 states average was25.2 per 1000 square km in 1996-97, it varied from a low of 13.3 in Madhya Pradesh to a high of 42.5 in West Bengal. While among the high and middle income group, states like Maharshtra, Karnataka and Andhra Pradesh has a railways per 1000 square km lower than the 14 states average. All states except Bihar and Uttar Pradesh had railways per 1000 square km lower than to the 14 states average.

Hospital per beds per capita varied from high of 231.2 in Maharashtra to low of 43.6 in Andhra Pradesh. The coefficient of variation is high indicating wide regional disparity across the states.

A lot of investible resources move across the states outside the government and size of such resources are increasing over time. Most of these resources move through banking operations. One useful indicator of such movements is the credit-deposit ratios. Credit-deposit ratio captures the discrepancy in credit absorption vis-à-vis deposit mobilization. Exceptions apart, credit-deposit ratios are much favourable to the high-income group as compared to low-income group. Tamil Nadu had a good ratio, followed by Maharashtra, Andhra Pradesh and Karnataka. The pattern emerges that the industrially advanced and high per capita income states have favourable ratios, one of the poorest state Orissa also has a favourable ratios. Of course this information does not reflect upon the absolute amount of resource flow but shows only the flow of resources in the relation to the states own savings (deficits). But it shows, at least, that the reverse flow of resources need not happen in case of all the states. Even under conditions of poverty if a mere conducive environment is created for investment resources will start flowing. This is a silver lining. The bank branches are fairly distributed across the states. It may need mention that this could be attributed to the banking sector policies pursued after nationalisation of the major commercial banks in the country in 1969.

The coefficient of variation and disparity ratio is given in the table 2.9. for the years 1981, 1991 and the recent available year of all the selected indicators of infrastructure development in India of 14 states.

Table II.9:

Coefficient of variations and disparity ratio in infrastructure indicators

Indicators	CV (%)	Disparity ratio
Consumption of power per capita (kWh)	48.02	5.45
Villages Electrified	13	1.43
Telecom lines per 100 persons	54.61	9.21
Gross irrigated area (%)	60.43	6.97
Railways per 1000 square km	38.43	3.2
Bank Branches per capita	24.89	2.16
Credit-deposit ratio	36.17	3.49
Hospitals per beds per capita	60.37	5.3

Section II.4

STATE FINANCES: RECENT TRENDS

The significance of State finances in a federal polity can be adjudged on three accounts viz. restoration of overall macroeconomic stability, attainment of growth with regional equity and strengthening monetary-fiscal coordination. Since 1991-92 following the macroeconomic crisis in 1990-91 aim at bringing about discipline and improvement in the management of the finances of the country, by bringing down the fiscal deficit and public debt in relation to GDP. The finances of State Governments, however have shown signs of deterioration in the 'nineties as compared to the ' eighties with the year 1998-99 witnessing a very high fiscal deficit of all State Governments account together. This brings the problem of state finances, which looms ominously large on the fiscal landscape, not only for the poorer performing states but also for all states. Acceleration in growth almost certainly calls for higher levels of public investment in critical social and economic infrastructure sectors by state governments. [19]

The state government finances have been undergoing severe strains over the last several years. The gap between expenditure and revenue receipts has been a major concern for the backward and weaker states, the more developed states have been enjoying buoyant revenues and managing their fiscal affairs rather well.

Relative performance of major states

There is great diversity among the 17 states in terms of size of population, which varies from 1.6 crores in Haryana to 13.9 crores in Uttar Pradesh. The per capita NSDP at current prices varies from Rs.4675 in Bihar to 18371 in Maharashtra.

A major aspect of economic reforms initiated in 1991 has been the greater role assigned to market forces in investment decisions. Failures to contain wasteful expenditure and reluctance to raise additional resources are the main problems of the States. Tax wars among the state governments to attract private investments in the wake of economic reforms as well as frequent elections and competitive populism on the part of political parties for power led to this. The net losses of SEBs have crossed Rs.10, 000 crs. The last blow has been the pay revision of employees forced upon the state governments by the centre's unilateral decision to implement Fifth Pay Commission Report. Consequently states are starved of funds to meet the essential investment needs in social and infrastructure sectors. Large borrowings are resorted to by several states just to meet current expenditure. All the indicators of fiscal health are deteriorating.

Notes:
19. N.J. Kurian: State Finances, *Eco and Pol. Weekly*, (May 8, 1999)

Table II.10.

In table II.10, the credit- deposit ratio of all commercial banks as on march 1998. The ratio is highest for Tamil Nadu as 96.1% while the states under low-income group was below all India average of 55.5%. The credit off take was better in middle-income states. Maharashtra is the only high-income states with high credit-deposit ratio. The overall credit deposit ratios of commercial banks have been coming down over the last few years due to recessionary conditions. Thus low credit deposit ratio in low-income states is a reflection of the fact that these states are unable to absorb a major share of the meagre deposits mobilized there.

Finances extended by all-India financial institutions like IDBI, IFCI, LIC, GIC and UTI constitute an important source of investible funds, state wise share of financial assistance disbursed by all-India financial institutions are presented in table. The unevenness of the distribution of the institutional credit across the states is evidenced from the fact that Maharashtra alone accounts for over 22% of such credit. Gujarat at the second place shares 13.2 % of such credit. For low-income states, which account for 43% of population has 19.5% share of the institutional credit.

The funds disbursed by State Financial Institutions are another main source of investment. The highest share is by Karnataka followed by Uttar Pradesh, Maharashtra and Tamil Nadu.

In the case of Central Public Undertakings gross block is highest for Maharashtra whereas it is lowest for Punjab, Kerala, Haryana and Rajasthan. However, industrialisation is increasing in other low and middle-income states. Thus to promote

TABLE II.10

DISBURSAL OF FINANCIAL ASSISTANCE FOR INVESTMENT

STATES	CREDIT DEPOSIT RATIO ON Mar-98	SHARE OF NANCIAL DISBURS BY ALL INDIA FINANCIAL INSTITUTIONS 1997	SHARE OF ASSISTANCE DISBURSED BY SFC, 1997	CENTRAL PUBLIC SECTOR UNDERTAKING (GROSS BLOCK)
HIGH INCOME				
PUNJAB	38.6	2.4	3.6	0.83
MAHARASHTRA	72.3	21	11.5	19.9
HARYANA	42.9	2.5	4.8	1.73
GUJARAT	48.2	13.5	9.3	7.59
MIDDLE INCOME				
TAMIL NADU	96.1	9	10.6	4.79
KARNATAKA	68.2	6.1	15.5	2.41
ANDHRA PRADESH	72.1	7.2	7.8	6.35
KERALA	44.3	1.7	4.4	1.69
WEST BENGAL	46.1	3.9	2.5	6.12
LOW INCOME				
RAJASTHAN	47.4	4.5	6.1	1.83
MADHYA PRADESH	51.4	5.1	3.2	6.94
ORISSA	45.2	1.8	3.7	5.59
UTTAR PRADESH	28.6	7.9	11.9	7.32
BIHAR	27.5	1.4	2	6.25
All INDIA 14	**52.06**	**6.29**	**6.92**	**5.67**

Source: Report on Currency and Finances 1997-98, Volume I balanced regional development, public enterprises are set up. The states in which the public sector enterprises are located by the central government became the beneficiaries due to increased employment opportunities, balanced growth of small and ancillary industries and most important resource mobilisation.

It is clear where there is high NSDP growth are associated with high levels of investments are Maharashtra and Gujarat.

Financing Pattern of State plans

The states plan outlays for 1998-99 as approved by Planning Commission and the structure of their financing for the 14 states are given in table II.11.

Table II.11

The approved plan outlays for 1998-99 can be seen to be significantly higher than anticipated outlays for most of the states. As a result, the total plan outlays for 14 states at Rs.69, 442 crore is over 41% higher than 1997-98. The states own funds however, received a further beating in 1998-99 as compared to the previous year. About 25% of the central assistance is diverted by the states for meeting the non-plan revenue expenditure. Only one state, viz., Karnataka expected to provide a positive contribution of own funds for plan financing. Haryana, Punjab, Tamil Nadu and Rajasthan are projecting more than 100% borrowings for financing approved plan. However, the borrowings were for few states for two reasons. Firstly, the implementation of Fifth Pay Commission has led to additional fiscal burden about Rs.20, 000crore per year for all the states. Secondly, the deceleration in the growth in central tax revenues.

Revenue Receipts

Revenues of the states can be broadly classified as tax and non-tax revenue in table II.12.

TABLE II.11

FINANCING PATTERN OF ANNUAL PLAN 1998-99

STATES	APPROVED OUTLAY AT CURRENT PRICES	%AGE SHARE OF CENTRAL ASSITANCE	%AGE SHARE OF OWN FUNDS OF THE STATES	%AGE SHARE OF BORROWINGS OF THE STATES
PUNJAB	2500	27.5	-57.3	129.8
MAHARASHTRA	11601	16.1	-0.1	84.1
HARYANA	2260	42.2	-42.6	100.4
GUJARAT	5450	25.9	-1.6	75.8
TAMIL NADU	4500	37.9	-54.9	117.1
KARNATAKA	5353	22.3	10.3	67.4
ANDHRA PRADESH	4679	65.7	-44.8	79
KERALA	3100	24.8	-18.1	93.3
WEST BENGAL	4595	59.5	-59.2	99.7
RAJASTHAN	4300	32.6	-36.7	104.1
MADHYA PRADESH	3700	56.4	-55.4	99
ORISSA	3084	52.1	-13.8	61.7
UTTAR PRADESH	10260	42.3	-21.8	79.5
BIHAR	3769	53.6	-28	74.4
AVERAGE	**4939.4**	**39.9**	**-30.3**	**90.4**

Source : Derived from data available in the Planning Commission, GOI

TABLE II.12

REVENUE RECEIPTS OF THE STATES IN 1998-99

STATES	TAX REVENUE			NON-TAX REVENUE				
	STATE'S OWN TAX REV.	STATE'S SHARE IN CENTRAL TAXES	TOTAL TAX REVENUE	STATE'S OWN NON TAX REVENUE	GRANTS FROM CENTRE	TOTAL NON-TAX REVENUE	TOTAL REVENUE	REVENUE DEFICITS/ SURPLUS
HIGH INCOME								
PUNJAB	3323.70	694.30	4018.00	2144.10	918.00	3062.10	7080.10	-2176.7
MAHARASHTRA	14637.40	2385.80	17023.20	3376.70	1730.70	5107.40	22130.60	-2741.6
HARYANA	3492.70	614.60	4107.30	1414.80	511.50	1926.30	6033.60	-1572.2
GUJARAT	8189.90	1782.80	9972.70	2055.90	1094.30	3150.20	13122.90	-1929.3
MIDDLE INCOME								
TAMIL NADU	9625.00	2409.00	12034.00	1058.40	1106.10	2164.50	14198.50	-2985.4
KARNATAKA	7280.10	1923.90	9204.00	1408.30	1556.00	2964.30	12168.30	-1396.6
ANDHRA PRADESH	8628.00	2999.50	11627.50	1987.00	2026.20	4013.20	15640.70	-1087.6
KERALA	4948.00	1839.20	6787.20	624.80	762.60	1387.40	8174.60	-1604
WEST BENGAL	5045.70	2692.10	7737.80	573.70	1700.40	2274.10	10011.90	-5866.5
LOW INCOME								
RAJASTHAN	4055.10	1964.30	6019.40	442.30	1376.40	1818.70	7838.10	-2933.5
MADHYA PRADESH	5179.30	3257.50	8436.80	1874.60	1989.70	3864.30	12301.10	-1952.2
ORISSA	1859.00	1664.50	3523.50	643.70	1046.70	1690.40	5213.90	-2104.4
UTTAR PRADESH	8090.20	6235.60	14325.80	1354.10	3120.10	4474.20	18800.00	-8665.9
BIHAR	3121.50	4400.00	7521.50	1638.10	1240.00	2878.10	10399.60	-3021.7
ALL INDIA 14	**6248.26**	**2490.22**	**8738.48**	**1471.18**	**1441.34**	**2912.51**	**11650.99**	**-2859.83**

Source: RBI Bulletine:State Finances

The absolute amount of own tax revenues of the states varies considerably across states from Rs. 416 crore in Jammu & Kashmir to Rs.14637 crore in Maharashtra. It is noteworthy that states like Gujarat and Karnataka collect more tax revenues than larger states like Bihar, Madhya Pradesh. Similarly, Tamil Nadu with less than 40% of population of Uttar Pradesh collects more tax revenue than the latter. Sharing of central taxes with the states worked out to just about one-third of the total tax revenues. There is deceleration in the growth of central tax revenues and hence the quantum of devolutions. With VDIS there is absolute decline in the devolved revenues. The total tax revenue of the states has increased. The total non-tax revenues of the states worked out to a little over 30% of their total revenue. States own non-tax revenue varies from Rs.442 crore in Rajasthan to Rs. 3376 crore in Maharashtra. There is a wide variation in the amount of own non-tax revenues among the states. However, the share in central taxes and grants from the centre are important for poor states and state's own tax and non-tax revenues for richer states.

Total Expenditure

The total expenditure and its components are in table II.13. It is clear from the table the revenue expenditure as a percentage of total expenditure was 65 percent in 1980-81, which increased to 78 percent in 1990-91, and further to 89.5 percent in 1998-99. There is decline in the capital expenditure. In the case of percentage share of development expenditure varies from 51.4 percent in Punjab to 70percent in Gujarat. This share is higher among middle-income states as compare to high and low income states. Punjab had the highest interest burden of 25.01% of the revenue expenditure.

TABLE II.13

TOTAL EXPENDITURE OF THE STATES IN 1998-99

STATES	REVENUE EXPENDITURE	CAPITAL EXPENDITURE	TOTAL EXPENDITURE	%AGE SHARE OF DEVELOPMENT EXPD.
HIGH INCOME				
PUNJAB	9256.79	3341.93	12598.72	51.48
MAHARASHTRA	24872.35	5325.84	30198.19	66.10
HARYANA	7605.87	1578.58	9184.45	66.87
GUJARAT	15052.24	3514.52	18566.76	70.80
MIDDLE INCOME				
TAMIL NADU	17183.94	2217.00	19400.94	61.87
KARNATAKA	13564.91	2189.26	15754.17	65.35
ANDHRA PRADESH	16728.36	4321.68	21050.04	64.01
KERALA	9778.66	1561.65	11340.31	64.28
WEST BENGAL	15878.51	3321.67	19200.18	62.07
LOW INCOME				
RAJASTHAN	11771.55	2955.43	14726.98	64.11
MADHYA PRADESH	14253.28	2108.76	16362.04	65.24
ORISSA	7318.28	1791.17	9109.45	61.65
UTTAR PRADESH	27465.89	5486.16	32952.05	56.42
BIHAR	13421.28	2224.75	15646.03	58.96
ALL INDIA 14	**14582.3**	**2995.6**	**17577.9**	**62.8**

Source: RBI Bulletine:State Finances

There has been an overall deterioration in the finances of almost all the states. However the financial position of most states is actually forcing a continuing squeeze of plan investment. To be fair it must be recognised that the problem of fiscal imbalance is not limited to states alone, but applies equally to its centre. Over the years, both the centre and the states have seen a burgeoning of non-plan expenditure in the face of inadequate buoyancy of revenues. They have responded by resorting to larger and larger volumes of borrowing to finance plan expenditure, which is shrinking as a percentage of SDP. The process has led to a steady build up of debt, which in turn has generated a rising interest burden. The extent of fiscal stress in the states is reflected in the trends in the ratio of interest payments to total revenue (tax plus non-tax revenue) given in table II.14.

Table II.14.

Interest Payment as Percentage of Total Revenue

States	1980-81	1990-91	1996-97
High income states			
Punjab	10.93	16.81	29.35
Maharashtra	5.41	10.12	12.70
Haryana	8.04	12.64	11.83
Gujarat	6.68	15.72	16.65
Middle Income states			
Tamil Nadu	7.11	8.95	12.33
Karnataka	6.54	11.19	12.55
Andhra Pradesh	6.45	11.02	16.42
Kerala	7.11	-14.17	17.95
West Bengal	9.97	15.25	23.58
Low Income states			
Rajasthan	10.59	13.66	20.54
Madhya Pradesh	6.82	11.28	13.74
Orissa	8.10	16.79	25.17
Uttar Pradesh	8.29	15.38	25.33
Bihar	10.84	17.44	17.62
ALL 14 states	7.74	13.12	17.56

Source: RBI data on State Budgets

For the 14 states as a whole the ratio of interest payments to tax revenues has increased from 7.7 percent in 1980-81 to 13.1 percent in 1990-91 and further to 17.6 percent in

1996. The 10 percentage point increase in interest payments over 17 years for the 14 states taken together has obviously squeezed the capacity of the states to finance normal developmental expenditure from current revenues. It has made them more dependent upon borrowing even as the level of plan expenditure as a percentage of GDP has declined. The problem is particularly acute in some states. Both Uttar Pradesh and Orissa have seen interest payments as a percentage of total revenues increase by 17 percentage points over 17 years. Interestingly, increase is much less in Bihar because Bihar has not tried to maintain the level of plan expenditure or development expenditure. Punjab has seen the largest increase in its interest ratio from 10.9 percent in 1980-81 to 29.4 percent in 1996-97 though this is partly due the burden of loans to handle security related expenditure in the 1980s. Madhya Pradesh, Tamil Nadu, Karnataka, Haryana and Maharashtra are in a reasonable in good condition. These states also have large current deficits, which have recently worsened because of the impact of large increase in civil service salary increase given at the time o implementing Fifth Pay Commission. However, they do not have such large accumulation of past debts and as such they are likely to find it easier to finance development expenditure in future.

Unless states finances can be put in order, there is little chance of the poorer states being able to undertake the substantial infrastructure financing needed to raise their rates of growth to reasonable levels. In fact the problem is not limited to the poorer states alone. The financial position of the other states has also deteriorated to a level where it will lead to a slowing down of their growth unless corrective action is taken.

Thus, the sharp imbalances between revenues and expenditure of States relative to Centre have widen over the years, this has inevitably necessitated larger dependence on resource transfer from the Centre to the States.

Section II.5

ROLE OF CENTRAL GOVERNMENT

In a federal set up a state is an important political and administrative unit which undertakes developmental activities and through which most of the Central Government's developmental programmers are implemented. States have their own resources and their own financial powers. Transfer of resources from centre to states takes place largely within a framework, which has explicit or implicit agreement of all the states, and hence there are severe limits to the 'disparity correcting powers' of such transfers. In the race of development, a certain degree of competition between the states also exists. With increasing emphasis on decentralized decision-making, Indian federalism will also become stronger, particularly in economic spheres. The precept "each to one's resources, to one's own capacities" will gain stronger grounds in this competitive run towards development.[20]

On the other hand, all the states are part of one national market, one national economy. Markets are expanding and with liberalization and reforms they will be playing increasingly larger role in allocation of resources between activities and between regions.

Notes:

20. Montek S. Ahluwalia: Economic Performance of States in Post Reform Period, *Eco & Pol. Weekly*, (May 6, 2000)

Markets sometimes reinforce the reverse flow of resources. Savings of poorer regions find more investment opportunities in economically vibrant regions. Flows of skills and talents have similar tendencies. Severe imbalances in development also cause large-scale movement of people, creating strains on the infrastructure of the host regions and also causing social and political tensions. These conditions have a potential for creating setbacks to development.

Given the severe resources problem of the poorer states, it is natural to ask whether the centre can provide additional financial help to the weaker states. The total resources devolved from the centre to the states through statutory devolution via the Finance Commission mechanism, together with non-statutory flow of central assistance through the Planning Commission already add up to substantial amount. The centres own fiscal position is also far from comfortable and this makes it difficult to envisage any significant expansion in these flows. In fact, the central government needs to take steps urgently to reduce its own fiscal deficit, which reached 5.6 percent of GDP in 1999-2000. A reduction in central fiscal deficit is necessary if real interest rates are to be reduced an outcome which would benefit the states both directly through its impact on interest rates and also indirectly via the effect on private investment.

While the scope of providing additional resources from the centre to help the poorer states is very limited, an issue, which has not received the attention it deserves, is whether the centre should introduce mechanisms which might improve the effectiveness of the resources it provides to the states. At present, central assistance in support of state plans is transferred by the Planning Commission as a 'block transfer' without any significant linkage to actual performance. This system of unconditional transfer could be replaced by a system in which a substantial part of the central assistance to the states is made available with a more explicit linkage to performance condition.

Rationale for Regional Policy

In order to accelerate the pace of development, it is imperative to develop necessary infrastructure, such as, the improvement of transport and communication network, water and power supply, the development of industrial estates and improvement of social services. While these facilities undoubtedly improve the living standards, it helps to attract investors from other regions. In fact, the problem of inter state disparities is the major concern of States and, therefore, every state operates its own regional development policies aimed at stimulating economic activity by providing financial and other suitable incentives. The federal government, however, has a responsible role to play in ensuring regional parity.

The main reasons are as follows:

1. While almost all the State Governments make a concerted effort to maximise their levels of economic development, their success is limited to the extent they can mobilise their own resources. When the problem is viewed at the All India level, in the interest of national integrity, the gaps in development between the States are, however, no less significant. It then becomes the task of the Central Government to devise the ways and means to reduce inequality between poor and rich states and at the same time not jeopardise the growth potentiality of any state.

2. When there are excessive differences in economic development and especially in levels of productivity, the factors of production, such as, labour and more so the capital tend to move in the more advanced regions creating concentration in the development pattern. With less than perfect mobility of labour, this often leads to wage differential between regions leading to imbalance, inflationary pressures and scarcity of factors of production. Similarly there are imperfections in the country's capital market as this market is mainly concentrated in the more developed states, thereby limiting the ability of the poorer states to mobilise voluntary savings to finance their development programmes. Therefore, Inter-state co-ordination is all the more essential through the intermediation of federal income transfers to ensure that the resources are equitably distributed as between the different States so that necessary infrastructure In all the States can be developed. National effort is vital, therefore, for ensuring that the incentives and the subsidies will be sufficient in the areas of greatest needs.
3. The persistence of huge Inter-State disparities imposes major economic and financial burdens on the Central Government. This has inevitably serious implications for national integration. It is precisely for this reason that one of the aims of the National Development Council has been to "ensure the fullest development of less advanced regions". In order to gain the active sympathy and support of all citizens who have to live and

work in these States, the Central Government must demonstrate its will and ability to contain the Inter-State inequalities within tolerable limits.

4. Last but not the least, the regional development issue is particularly important in the early stages of economic development chiefly for three reasons. First, the 'spread effects' in the poor economies are not stronger than the mature economies; and therefore, the uneven distribution of the benefits of developments may have serious social and political repercussions. Second, if the corrective measures are not taken in the beginning, any belated attempt for diverting resources from developed to underdeveloped states might create parochial tensions. Third, if the economy is left to the tendencies of free market forces, this might accentuate regional disparities. The role of national policies and programmes in reducing disparities is therefore important.

SUMMARY

The data presented and the analysis so far clearly establishes that there are considerable disparities in socio-economic development across the Indian states. A marked dichotomy between the high income and low-income groups of states has been emerging. The high income states are characterised by better demographic and social development, higher per capita incomes and more developed economies, lower levels of poverty, higher level of revenue receipts, and plan and non-plan expenditure, fiscally better off, higher private investment and significantly better infrastructural facilities.

The pressing requirement of low-income states is more investment in their social and infrastructure sectors. To improve the level of social services, massive investment in primary education and primary health services is required. Improvement in literacy, and health indicators like infant mortality rate will bring down the rate of growth of population. Stabilisation of population, especially in the 'BIMARU' states is an important pre condition for the sustained economic growth of that region. The experience of Kerala and to a considerable extent that of Tamil Nadu clearly indicate that even at comparatively lower levels of economic development measured in terms of per capita income, a state can enjoy comparatively higher levels of social development. Improvement in basic infrastructure facilities like power, irrigation, transport and telecommunication in the backward states is a pre-condition to improve the quality of life of the people and to usher in sustainable economic development in those states. Availability of assured power supply, developed transport system and modern telecommunication facilities are important factors to attract private investments into these states. Similarly development of the irrigation potential fully will go a long way in improving the productivity of agriculture and fully engaging rural workforce, which in turn will increase rural income and reduce rural poverty.

The recent trends in investments both public and private sector, indicate that if left unaltered by effective public interventions inter-state disparities are likely to get aggravate. The government of low-income states are fiscally weak and as such they are unable to find enough resources to meet these investment requirements. The high-income states are in a better position.

The problems in the finances of the State Governments have a bearing on the long-term sustainability of the fiscal situation. During the 'nineties, over 80% of the deficit of the State Governments was caused by structural factors. By and large high and middle-income states have achieved higher plan outlays during the Eighth plan and in the subsequent annual plans. The share of own funds in plan financing is coming down and the shares of borrowing in plan financing are steadily rising for all the states. The relative revenue receipts are more important for richer states and share in central taxes and grants from the centre for relatively poorer states. The revenue expenditure has increased and capital expenditure has declined across the states over time. The share of development expenditure has favoured middle-income states as compared to high and low-income states. The wide revenue gap has lead to increase in interest liability for few states. Thus fiscal deterioration has been exceptionally damaging in the case of low-income states and Bihar stands apart even among them.

A combination of various policy interventions in these areas would be needed to correct the impact of the present fiscal regime. The basic requirements for such changes are good governance; Decentralization of power and autonomy to local bodies and specialized institutions must accommodate a variety of conflicts emerging between centre and states. States would also have to make efforts to contain non-plan revenue expenditures, and to augment revenues through broadening tax base and cost recovery. Restructuring of Indian Public finances requires collective action of both layers of the Government namely the Central and the State Governments.

If the existing trends in differential rate of socio-economic development continue, regional disparities in India are bound to accentuate. Therefore, it is imperative that the present trends are arrested and preferably be reversed. This will require concerted efforts on the part of the concerned state governments and the centre.

CHAPTER III

INSTITUTIONAL FRAMEWORK OF CENTRE- STATE RELATIONS – FINANCE COMMISSION AND OTHER ASSOCIATED INSTITUTIONS IN CENTRE-STATE FRAMEWORK

Development, as a criterion of need is almost unanimously accepted by all. The progress of the nation depends, in real sense, on the development of the backward states. Development is an indicator of need of public services. Lesser the development larger would be the need for public investments and vice versa. Low development is closely associated with low income of the people, which sets the vicious circle of poverty rolling. In order to break this vicious circle flow of resources from federal government is crucial.[1] Federalism or the idea of multi-level governance is now widely acknowledged to be the best founding principles of polities around the world. The advantages of the federal form are manifold. It enables the constituent units to reap the benefit of strength in unity while retaining the identity and autonomy in organising their public sector in accordance with the wishes of their people-"the different advantages of the magnitude and littleness of nations".[2]

The issues in federalism assume importance in India in the context of proposals to amend the country's Constitution in the light of shortcomings revealed in its working and demands for autonomy emanating from various quarters. Impelled by fears of disintegration and imbued with the vision of a strong united India, a heterogeneous land of diverse languages, culture, ethnicity and history.

1. Hemlata Rao: Federal Fiscal Transfers: An Alternative Approach, *The Indian Economic Journal* Vol. no 41, No.1
2. Bagchi A. (2000): 'Rethinking Federalism'-Overview of Current Debates with Some Reflections in Indian Context, *Eco and Pol. Weekly* (August)

India's Constitution makers drew up a framework for the country's governance that Ambedakar its main architect believed had federalism as its chief mark even though it had a pronounced unitary bias.

The chapter is devoted to a review of the existing framework of Centre –State relations in India and its evolution over the period starting from 1861. More specifically, the main objectives are (I) to trace out the evolution of the existing institutional structure of central transfers and (II) to put together all types of central transfers, the devolution principles, terms and conditions attached to the resources transferred to States and so on.

Section III.1

INDIAN FEDERALISM: HISTORICAL BACKGROUND

Pre-independence Period

The existing Centre-State institutional structure in India has more than a century long history starting from 1861. A very complex set of historical and conjectural forces had worked together during the period. Four such influences of the pre-independence era need to be distinguished: (I) high degree of centralisation (especially up to 1858), (ii) slow evolution of the federal structure starting roughly with the year 1861, (iii) major catastrophes particularly in the first half of the twentieth century, World War-I (1914-1918), Great Depression of 1920-34, World War –II (1939-1945) and partition of 1947, (iv) changes introduced in the objectives of social policy. For instance, the objective in 1900 was that of a "police state", which gradually done "the welfare state" replace particularly to serve their own interests with the introduction of Montague-Chelmsford Reforms. [3]

There was a complete and exclusive Central control over provincial resources and expenditures when the British took over the East India company in 1858.[4] Provincial Governments had to raise revenues for the Central exchequer and no expenditure was allowed to be incurred without the sanction of the Centre. This extreme centralisation of powers and responsibilities did not work for long given the vast size of the country. Consequently, many changes were initiated in India's socio-economic process by the British rule. No doubt, these changes were designed to subserve the interests of the British, but these also opened the door for federalism in India.

The first step towards decentralisation appears to have been thought out in 1861 to overcome the recurring deficits in the imperial budgets especially during 1843-60. During these 26 years, only seven years showed surplus budgets. Functional financial federalism was brought into existence in 1870 as the government finances were further subjected to heavy strains during 1860-70. The charges under jail, registration, police, education, medical services, printing, roads and civil buildings were made over to the control of the provincial governments along with the departmental receipts under these heads.[5] Provision of fixed grants was made to local governments to maintain specific services.

3. Government of India (1988): *Report of Commission on Centre –State Relations* Part I, pp.252
4. Chand Phul (1986): "Federal Financial Relations in India- Evolution of Provincial Finance", *IJPA*, Jan/March (XXXII,1) pp.20-48
5. *Ibid*, pp. 22-23

The next step towards decentralisation was taken during 1877-81 with a view to making fresh revenue settlements with all the provinces. The settlements increased the provinces involvement not only in their own sources of revenues but also in dividing the heads raised within their jurisdiction.[6]

The system of quasi-permanent settlement was initiated in 1904. It gave further permanence to the provisional revenues and the revenues assigned to a province were not subject to alteration except in extreme necessity or when the resources were found disproportionate to the normal needs of a province.[7] It assumed a reasonable continuity of financial policy. However, the course starting with Mayo's Reforms in 1870, followed by the Strachey Scheme in 1877, the Ripon Baring Scheme of 1882, the Quasi-Permanent Settlement of 1904 and Minto- Morley Reforms of 1909-10 was merely transfer of powers and functions mainly for administrative expediency. Consequently the central control over taxation and expenditure was exercised with rigour.

The provisional settlements were made permanent in 1882 in which political considerations played an important role. Event the thrifty provinces were penalised.[8]

The different decentralising tendencies were further continued and consolidated in the Government of India Act 1919. It was the first major step towards provincial autonomy and federalism. It introduced a specific provision for making the independent classification of revenues and functions and abolished the system of divided heads.

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6. Krishnaswamy A. (1964): *The Indian Union and the States - A Study in Autonomy and Integration*, Pergamom Press, Oxford.
7. *Ibid.*
8. This act was a part of the Montague-Chelmsford Reforms (See Government of India 1988, *Report of Commission on Centre State Relations*, pp.252.

Under the devolution rules framed under the Act, customs, non-alcoholic excise including salt, general stamp duties, income tax and receipts from railways and ports and telegraphs were assigned to the Government of India. Land revenues, irrigation charges, alcoholic excise, forest receipts, court fees, duties, registration fees and certain minor sources of revenue were allocated to the provinces.[9] It was Montague Chelmsford Reform of 1920 which accepted the federal goal and marked the first step towards it. In the following years, the division of resources became more clear-cut without having shared heads.[10] The provincial and Central budgets were completely separated. The background principle for this division had been that the subjects in which the interests of the provinces predominate should be provincial.

However, the provincial list, further subdivided into 'reserved' and 'transferred', fell short of attaining the federal character as these ceased to be separate entities. The ultimate control through legislation still lay with the Central Government acting through the Secretary of State.[11] Provinces on their part suffered from large fiscal deficits because they had inelastic and insufficient sources of revenue and were not allowed to tax the industrial and commercial activities and Central imports. Therefore, Lord Layton in his survey of Indian finance, presented to the Simon Commission in 1929-30, recommended allocations and grants from Central revenues on the basis of 'origin' and 'population'. To avoid arbitrariness in the allocation of funds from the Centre to the

9. Gopal M.H. *op.cit.*
10. Bombwal K.R. (1963), *The Foundation of Indian Federalism*, pp 106-107
11. Krishnaswamy A. (1964):*op. cit*

provinces, the White Paper on Indian Constitutional Reforms of 1931 while contemplating a federation, recommended 50 to 75 percent of the net revenue derived from taxes on incomes other than agricultural income and from taxes on the income of companies.[12] However, Centre-State relations were never clearly worked out and the Indian states more or less remained outside the financial system of the rest of the country. The Government of India Act 1935 constituted the second important landmark in the fiscal history of India. This Act sought to introduce more changes on the lines of federal principles.[13] It divided the revenue resources into the following three categories: (I) exclusively federal, (ii) exclusively provincial including the agricultural income tax, (iiia) taxes levied by the federal Government but shared with the provinces or assigned to them, and (iiib) taxes levied by the federal government but collected and retained by the provinces. It envisaged not only the division of revenue sources between the federal and provincial governments but also grants-in-aid for the 'needy states'. Since many questions were left open, Sir Otto Niemeyer inquiry was appointed. He suggested 'collection' and 'population' as the factors to be considered in the distribution of central revenues.

The period of the Second World War witnessed great strains on Central finances. It tilted the balance of power in favour of the Centre as the rapidly rising railways' contribution was excluded from the distributable surplus. From the provincial share of income tax the centre was permitted to retain Rs. 4.5 crores every year till 1945-46.[14]

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12. *Ibid*
13. Lakdawala D.T. (1967*), Union-State Financial Relations*, Lalwani Publishing House, Delhi
14. Government of India (1988): *Report of Commission on Centre –State Relations* Part I, pp.252

The partition of India necessitated modification of the financial arrangements between the Centre and the provinces. The fixed provincial shares governed the distribution of amounts from 1947-50. But the provincial share of the receipts from the jute export duty was reduced from 62.5 to 20 percent because the partition reduced the jute growing areas.

Post- independence Period

After independence, the Constituent Assembly commenced its work against the background of surpluses with the provinces and financial stringency at the Centre. This Assembly sought the opinion of the Sarkar Committee (1947), the "Expert Committee on the Financial Provisions of the Constitution" and the "Indian States Finance Enquiry Committee (1948-49)". Keeping in view the recommendations of these committees, the Constituent Assembly held the view that:

(a) the allocation of sufficient financial power is a must for establishing a decentralised government system,

(b) the Central Government is the appropriate authority to levy a tax where uniformity of rates is an important consideration, and

(c) the equation of financial relations between the Centre and the States keeps on changing according to the needs of the time.

Therefore there must be a considerable built-in flexibility and dynamism in the institutional arrangements between the Centre and the States. Regarding the Government of India Act 1935, which was studied in depth, the Constituent Assembly favoured its retention and resisted from having any violent departure from the status quo.[15]

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15. Gopal M.H. (1963): *Studies in Indian Public Finance*, Rao and Raghvan: Mysore pp.22-28. Also see Hicks U.K. et.al. (1963): *Federalism and Economic Growth*, pp-113-50

The Constitution adopted by India after attaining independence with the objective of establishing a 'sovereign democratic republic' is federal in form, providing as it does for multi-level governance. It consists of the Union at the Centre and States at the subnational level, each with their own legislature, executive and specified powers and functions. Initially, the governmental levels recognised in the constitution were two- the Union and the States. By amendment carried out in 1992, local governments in villages and towns –the panchayats and municipalities- have also been accorded constitutional status.

For a country of India's heterogeneity made up of people of diverse ethnicity, language, culture and history, it was only appropriate that the constitution makers choose the federal form as the framework for governance. However, driven by fears, following the partition that accompanied independence of the country breaking up further on the one hand and the vision of a strong united nation on the other. The leaders who drew up the new India's Constitution built into it provisions that invested the Centre with a position of dominance. These detracted from its character as a true federation, in which, to quote "where powers are divided so that the general and regional governments are each within its sphere, coordinate and independent". Judging by this criterion, the governmental form created by free India's constitution has been characterised as 'quasi-federal'. In several respects, the unitary elements clearly overshadowed the federal attributes. (Dandekar 1987). [16]

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16. Bagchi A. (2001): 'Rethinking Federalism'-Overview of Current Debates with Some Reflections in Indian Context, *Eco and Pol. Weekly* (August)

While the Constitution clearly recognises the need for coordination among different levels of government in the matter of governance and provides for the creation of a forum for consultation among governments in the shape of an Inter-State Council (Article 263). The Council was not formed in the first forty years, despite strong recommendations by high-powered panels like the Administrative Reforms Commission and the Sarkaria Commission. For all practical purposes, federalism in India operated in the coercive form in the first four decades after independence. This was possible because although the powers and functions of the Union and the states were enumerated in separate lists in a schedule appended to the Constitution, the 'ownership' of the powers could not be said to be 'divided' in the real sense.

The Constitution makers opted for a strong Central Government with a federal set up. The most important was the adoption of planning as the strategy of development with the Centre taking the lead. The Planning Commission, a body set up through an executive order of the Centre started disbursing large central funds and approves development plans of the states. The objective of central planning was sought to be advanced by extending their ambit to states subjects through centrally sponsored schemes. [17]

However to look after the needs of the disadvantageous states and to provide them adequate resources on equitable and administratively feasible arrangements, the Constitution provided for the appointment of a Finance Commission.

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17. Chelliah and associates argue that the economic advantage of centralizing tax revenue is also important on another count because given the larger tax powers to the States, better off states would corner larger shares of revenues and consequently inter-state disparities may further accentuate. For details see Chelliah and associates (1981): *Trends and Issues in Indian Federal Finance*, Allied Publishers, Delhi.

This has been considered as one of the most unique features of the Indian Constitution as one finds no such institutions existing in older federations of the world[18].

The other important constitutional provision relating to the distribution of taxation power and revenues were incorporated in Part XII (Chapters I and II) of the Constitution of India. These constitutional provisions can be divided into three major categories:[19]

The first category, gives a clear division of heads of taxation between the Centre and the States. The Union has 13 heads having entries 82 to 92B, whereas the states have 19 heads having entries 45 to 63. It may be mentioned that there is no head of taxation in the Concurrent list and as such, the residual powers of taxation vest in the Union. The borrowing powers of the states are defined in Article 293.

The second category deals with the distribution of revenues and sharing of resources between the Union and the States in the manner described below:

i) Levied by the Union but collected by and assigned to the States in which collected. The proceeds shall form part of Consolidated Funds of India (Article 268).

ii) Levied and collected by the Union (Article 269(1)) but assigned to the states in which levied (Article 269(2)). Article 269 enlists eight taxes and duties.

iii) Levied and collected by the Union but shared with the states (Article 270). The tax on non-agricultural income does not form part of the Consolidated Fund but any surcharge on it does (Article 271).

18. A somewhat similar Institution is the Commonwealth Grants Commission of Australia. However, there are significant differences between these two institutions in regard to their status and field of operation. The Australian Commonwealth Grants Commission, unlike the Indian Finance Commission, which makes recommendations for devolutions to the states, is an advisory body established by an act of Parliament to recommend special grants to the claimant States. See, Government of India (1973): *Report of the Finance Commission*, p.10

19. Government of India (1988), *ibid*, pp.252-53

iv) Levied and collected by the Union but shared with the states. If Parliament by law so provides (Article 272). For instance, the Union excise duties form part of the Consolidated Fund of India and the sharing of these proceeds depends upon parliamentary legislation.

The third category empowers the Union Government through parliament to provide each year grant-in –aid of the revenue to the States in need of assistance (Article 275). Further under Article 282, the Union as well as the States may make for any public purpose. A State like Union can also borrow upon the security of the Consolidated Fund of the State from within the territory of India. However, a state has to seek consent under Article 293(4) from the Government of India. The government at the Centre may impose conditions while giving consent. The Government of India can also make loans to any state or give guarantees in respect of loans raised by any state, so long as the limits fixed under Article 292 are not exceeded.

It may be mentioned that Article 246 read with the Seventh schedule of the Constitution of India also enumerates the development functions of the Centre and the State Governments. The functions of the Centre relate to defence, atomic energy, railways, airways, national highways, shipping and navigation, post and telegraphs, currency, finance and exchange, foreign and inter-state trade and basic industries, etc. The states responsibilities include public law and order, local administration, education and public health, fisheries, rural development including agriculture, etc. The Concurrent jurisdiction includes forests, economic planning, population and family planning, commercial monopolies, labour disputes, education and social legislation, etc.

With the initiation of the new economic policy in the nineties, the Centre's role has undergone a radical change. The economic policy regime is now considerably liberalised and the central public sector too is poised for major changes through disinvestments and privatisation. However, the state still demands for its autonomy. Thus, the choices have to be made in keeping with the diversity of the country's regions and their history.

Section III.2

FISCAL FEDERALISM:

PREVALENT CENTRE-STATE FISCAL INSTITUTIONS

Fiscal federalism cannot be divorced from the existing Centre-State financial Institutions. This is because the quantum of resources has risen to almost a plateau and the states have mounted a joint attack on the Centre for its dominant financial position and asking for rearrangement of Centre-State fiscal relations. The Centre also feels incapacitated to set its fiscal house in order without the States' cooperation. These institutions facilitating financial transfers from the Centre to the State Governments can be put into two categories:

1. Institutions handling statutory, Plan and Ministerial transfers. These are Finance Commission, Planning Commission and Central Ministries.
2. Institutions handling other transfers, namely the institutional finance developed by Central owned and controlled financial institutions and banks.

The different federal instruments deployed for fiscal transfers are statutory transfers (tax shares and grants-in-aid); plan transfers (plan grants and plan loans); and ministerial grants and loans.

There is a strong centripetal bias in the constitutional structure of Centre-state fiscal relations in India. Over the period, centralization of fiscal powers has grown. The Centre has encroached on the State's areas of operation by amending the Constitution many times, and by floating a number of Central Plan schemes. Much of these are achieved by Planning Commission and through Centrally sponsored schemes falling within the purview of the states. As a result, the degree of centralization of revenue and expenditure in India is found to be of a very high order, making the states heavily dependent on the Centre. The nature of Central financial transfers to States has created conflict and controversies between the Centre and the State.

FINANCE COMMISSION

APPOINTMENT

Finance Commission is a statutory body with a quasi-judicial character appointed after every five years under Article 280 of the Constitution by the order of President. Its chief function is to make recommendation on:

a) The distribution between the centre and the states of net proceeds of shareable taxes which are to be, or may be divided between them. It is called '*vertical sharing*'.

b) Allocation between the States of the respective shares of such proceeds. It is called '*horizontal sharing*'.

c) The principles which should govern the grants in aid of revenues of the States out of the Consolidated Fund of India and the sums to be paid to the states which are in need of assistance by way of grants in aid of their revenues under Article 275 of the Constitution.

d) In addition to making recommendations, the Commission may suggest changes, if any to be made in the principle governing the distribution among the states of:

   i) the net proceeds in any financial year of the additional duties of excise leviable under the Additional Duties of Excise Act 1957 (Article 58)

   ii) the grants to be made available to the states in lieu of the tax under the repealed Railway Passenger Fares Tax Act 1957 (article 57).

e) Any other matters, which may be referred to the Commission by the President in the interests of sound finance.

For the first time the Govt. had expanded the terms of reference of Eleventh Finance Commission to suggest ways and means to restructure public finances of both Centre and States in order to achieve macroeconomic stability. The following factors were considered:

(a) The widening gap in States could be bridged only with determined efforts by the state government to raise revenue through better tax effort i.e. the states should consider Agriculture income tax to widen the tax base. This was rejected by Centre.

(b) The poor return on capital invested and negligible recovery of cost of services by way of user charges is indexed with inflation to allow for automatic revision of rates. It has made out a case for autonomous tariff commission for revision of railways and power tariff administer prices and an independent body for regular revision of royalties on minerals.

(c) Poor returns on Investment made by State Govt. in companies.

(d) The Commission calls for structural changes both in revenue raising and expenditure. It has suggested pruning of subsidies, downsizing Govt. comprehensive structure reforms for PSUs, cap on borrowing and guarantees in the 5-year fiscal restructuring plan.

(e) For Central Govt., EFC has suggested priority-based expenditure, tightening of expenditure on salaries, pensions, interest payments and subsidies.

(f) The Commission has drawn a bold step agenda for fiscal consolidation at the Central and state levels and to achieve zero revenue deficit for all the states by 2004-05

Over the past 50 years, ten Finance Commission have been appointed whose recommendations have been accepted and implemented. It would be appropriate at this juncture to evaluate the performance of the ten Finance Commissions in achieving the main objective of reducing the vertical and horizontal federal fiscal imbalances in India.

TYPES OF FINANCE COMMISSION TRANSFERS:

Finance Commission transfers are given in the form of (a) tax shares, (b) Grants, (c) Grants-in-aid and (d) others.

(a) Tax shares: These come from income tax (under article 270 of the Constitution) and Union excise duties (under article 272). The income tax is obligatorily shareable whereas the union excise duties are permissively shareable between the centre and the states.

(b) Grants: These are given in lieu of tax on railway passenger fares property tax imposed on agricultural property. The latter is not in operation now.

(c) Grant-in-aid: These are given under Article 275 for general purposes. Capital grants were recommended for upgradation of levels of administration by the seventh finance Commission and the health and education sectors by the Eighth Finance Commission treating them as essential non-plan earmarked capital requirements of the less developed states.

(d) There are some other duties imposed under Article 268 and 269. These are statutorily shareable with the states. The duties imposed under Article 268 comprising stamp duties in respect of bills of exchange, cheques, debentures, letters of credit, policies of insurance, etc. Under Article 269, the duties are leviable only at the discretion of and collected by the Centre but are assigned to the states. Inter-state sales tax and estate duty are the only taxes presently imposed and collected and assigned to the states. [20]

Finance Commission's recommendations on transfers comprising tax shares, grants in lieu of other taxes and grants-in-aid are transfers on the revenue accounts of the states. These transfers are given to the States in the form of awards for five years.

PURPOSE OF TRANSFERS

The general purpose of the Commissions has been to follow the principles of justice in, what is called, the vertical division of resources between the Centre and the States. In the horizontal distribution of these resources among the States equity has to be taken into consideration in view of the disparate levels of development of different states.

For this purpose, the two main instruments were progressive formulae for the distribution

20. For background details, see *Reports of the Study Team on Centre-State Relationship*, Vol.I, Administrative Reforms Commission, 1968

of the divisible pool and grants-in-aid under Article 275. The Commissions and the States have been in agreement that the more important instrument of transfer from the Centre to the States should be the devolution of taxes with the grants-in-aid playing a residuary role. While some element of equity was introduced into the process of distributing devolved taxes among the states, efficiency had also to be given due consideration in this. The main instrument to help the poorer and the less developed states was grants-in-aid under Article 275.

Statutory transfers, in general have essentially gone to meet the non-plan recurring expenditures.

They set out three basic principles on which their approach was based.

i) a fair apportionment of revenue resources between the Centre and the States;

ii) preserving the fiscal autonomy of the states; and

iii) ensuring inter-state equity without penalising "fiscal prudence, tax effort and growth impulses".

Tax shares are used to supplement the revenue base of the States.

The grants-in-aid are given for meeting

(a) To fill fiscal gaps (reduction in) revenue deficit;

(b) to narrow disparities in the availability of various administrative and social services (like education, medical, public health and welfare of Scheduled castes, Tribes and others backward classes) between developed and less developed States;

(c) Special problems including natural calamities or any other peculiar circumstances or matters of national concern; and

(d) To upkeep and maintain the assets created earlier.[21]

In addition there also has been a practice followed by various Finance Commissions to make large disbursements to allow non-Plan surpluses with States for Plan funding.

DEVOLUTION PRINCIPLES[22]

Each Finance Commission is free to adopt its own formula for determining the entitlements of the various governments. A variety of factors such as contribution in income tax, population, per capita income distance criterion, income inverse criterion, backwardness, poverty, tax effort, post-devolution deficits. They have been used in different combinations and weights by the different Finance Commissions. Gap filling approach that is recommending grants under Article 275 to fill the non-Plan revenue gap left after the devolution of the shareable taxes of the States has been another notable feature of almost all the Finance Commissions. Table III.1, III.2 and III.3 shows evolution of criteria , Criteria for distribituion of income tax and union excise duties.

A. In the case of income tax, the State's share is 77 percent and it is distributed among the states on the following formula:

   The criteria and relative weights for determining inter-se share of States under Eleventh Finance Commission are Population (10percent), distance (62.5 percent), area (7.5 percent), index of infrastructure (7.5 per cent), tax effort (5 percent) and fiscal discipline (7.5 percent)

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21. The Second Finance Commission innovated the concept of margin money for financing the natural calamities and built into the State budgetary requirements. The Seventh Finance Commission made the provision of Central assistance over and above the margin money by recommending a ceiling of expenditure for droughts on the one hand, and floods, cyclone, earthquakes on the other. This practice continued with modification on the manner of funding the margin money by the centre particularly in the Eighth Finance Commission (For further details, see *Report of the Eighth Finance Commission*, 1984, pp.68-73)
22. For more details, *Report of the Ninth Finance Commission*

Table III.1

EVOLUTION OF CERTAIN CRITERIA

CRITERION	SIXTH	SEVENTH	EIGHTH	NINTH(I)	NINTH(II)	TENTH
POPULATION	25	25	25	25	25	20
REVENUE EQUALISATION		25				
PER CAPITA INCOME DISTANCE METHOD			25	50	33.5	60
POVERTY RATIO		25		12.5		
INCOME ADJUSTED TOTAL POPULATION	25	25	50	12.5	12.5	
INDEX OF BACKWARDNESS					12.5	
INDEX OF INFRASTRUCURE						5
TAX EFFORT						10
AREAS ADJUSTED						5

Source: Reports of Finance Commissions

Table III.2

CRITERIA FOR DISTRIBUTION OF INCOME TAX

MISSION	POPULATION	CONTRIBUTION	PER CAPITA INCOME		POVERTY RATIO	INDEX OF	AREA ADJUSTED	TAX EFFORT
			DISTANCE	INVERSE				
SIXTH	90	10#						
VENTH	90	10#						
IGHTH	22.5	10#	45	22.5				
INTH (I)	22.5	10#	45	11.25	11.25			
INTH (II)	22.5	10#	45	11.25		11.25@		
TENTH	20		60			5*	5	10

\# Assessment
@ Backwardness
*Infrastructure
Note: Under Eighth and Ninth Commissions, the same formula was used for '90 per cent of income tax' and 'total of Union excise duties'. Under the Tenth Commission, same formula was used for both the taxes

Table III.3

CRITERIA FOR DISTRIBUTION OF UNION EXCISE DUTIES

MISSION	POPULATION	REVENUE EQUALISATION	PER CAPITA INCOME		POVERTY RATIO	INDEX OF	AREA ADJUSTED	TAX EFFORT
			DISTANCE	INVERSE				
SIXTH	75		25					
VENTH	25	25		25	25			
IGHTH	25		25	50				
INTH (I)	22.5		50	12.5	12.5			
INTH (II)	25	16.5 for deficit states	33.5	12.5		12.5@		
TENTH	20		60			5*	5	10

@ Backwardness
*Infrastructure

B. In the case of the Union Excise duties, the States share is 47.5 percent and it is distributed in the following manner:

C. In the case of Additional excise duties in lieu of sales tax, the States' share in consumption of these goods is considered.

D. The grants in lieu of tax on railway passenger fares are distributed on the basis of the average proportion of the non-suburban passenger earnings in each state (in the years 1984-85 to 1987-88) to the aggregate non-suburban earnings of all the States.

TERMS AND CONDITIONS

Tax shares are given to the States on 'unconditional' basis and the States are free to spend those the way they decide. Grant-in-aid, on the other hand, has a little different history. They have generally been found of specific and tied nature particularly after the Sixth Finance Commission. For instance, the Tenth Finance Commission has proposed upgradation grants both for developmental needs such as drinking water facilities in primary schools and girls education, and non-developmental sectors like police, fire services, jails, treasuries and accounts, record rooms for States other than those with pre-devolution non-plan revenue surpluses. It appears to have gone beyond its strict terms of reference in proposing grants to local bodies.

STATES VIEW

Reviewing the earlier Finance Commissions

A cursory survey of the literature particularly relating to States' own meetings on Centre-State relations and memoranda submitted to the different Finance Commissions reveals that FC has not been above criticism in the matter of the nature and design of transfers.··· The general criticism relate to the following:

(i) Finance Commission awards are fixed for five years or for longer periods expected now onwards in the light of Tenth FC recommendations. There is no any scope as such for flexibility and manoeuvrability required on the one hand, and the deficiencies, which may emerge during the period and require rectification on the other. For instance, the values of FC awards get eroded if inflation rises too high. Deficits would further persist if revenues or even incomes do not grow at assumed rates.

There is, thus, a need to design a channel or a mechanism, which could adequately admit and address to such situations.

(ii) The devolution principles in general and the gap-filling methodology of the Finance Commissions continued to be under heavy attack. The factors used in distributing transfers have been varied across the different Finance Commissions. For instance, Income adjusted total population, distance of per capita income from the State with highest income were introduced by the Seventh FC, poverty by the Ninth FC, and area, infrastructure criteria by the Tenth FC.

Tenth FC in its attempt to rationalise the tax devolution formula deployed the same criteria for allocating income tax and Union excise duties, and also offered an outline of an alternative scheme of devolution. The latter proposes that 26% of the divisible pool may be assigned towards the States' share in income tax, Union excise duties and grant in lieu of railway passenger fare tax. There will be a further assignment of 3% of the divisible pool to the States towards the additional excise duties in lieu of sales taxes, which would require an amendment to the Constitution.

How much the different factors or their sets have contributed in achieving progressivity is an important question and needs to be analysed before further exploring the new determinants. It is because, in spite of the sophistication introduced by the different Finance Commissions in their approach of devolution, the end result has been the weakening of the progressivity, encouragement to fiscal imprudence and perpetuity of fiscal disabilities.

Gap-filling approach continues to be the most dominant method with all the Finance Commissions. As a result, high income States with pre-devolution surpluses ended up further with higher surpluses. The needy States, on the other hand, have complained for having not been given adequate funds to meet their needs15. For instance, all the special category States consistently ended up with post-devolution deficits in the Eighth, Ninth and Tenth Commissions.

FC has to redefine the principles to find out a methodology, which encourages deficit States to cover their deficits by cutting down unnecessary expenditures and mobilising more resources, and rewards the fiscally prudent States. How 'special problem' be gauged and grants are made available to States is another area of concern

In the matter of reassessing of the forecasts of revenue and expenditures of the Centre and States, generally, all the Finance Commissions have come under severe criticism. The divergences between the actuals and estimates both for the Centre as well as States as brought out by Bagchi are revealing.

Such a situation is explainable in two ways, though both have to be taken up seriously. One, some of the important factors having a close bearing on revenues and expenditures over the period have somehow been left out or ignored; or norms and assumptions used were unrealistic. Tenth FC, for instance, have been criticised for having used questionable assumptions on many items of non-plan expenditures such as subsidies, rate of return from public sector investments etc. and ignored the financial liabilities arising out of Fifth Pay Commission recommendations. Two, the norms or assumptions used by the Finance Commissions, explicitly or implicitly, had some normative thinking assuming that both the Centre as well States would improve their fiscs by reducing the income tax evasion, cutting down the unnecessary fiscal concessions, increasing rate of returns on investments already made, rationalising expenditures by the Centre on Centrally Sponsored Schemes and extending the tax net by imposing tax on services and so on. But that did not happen in reality.

In view of this, the FC must have a comprehensive view of all the socio-political developments which are likely to affect economic resources in the near future along with using realistically normative assumptions on revenues and expenditures which are further affected by political expediency characteristics of both the Centre as well as States. (iii) Finance Commission normally refrains from going beyond the non-plan-revenue-expenditure in its study and therefore, the full view on State finances is sidetracked. This restriction whether prescribed or self-imposed is more of a customary nature and not a constitutional issue. But the fact remains that it turns out a good source of confusion.

Keeping in view this, there is a serious need for ensuring that: (a) FC and Planning Commission work in close and regular coordination and, (b) the plan periods and award periods are fully synchronised.

(iv) States have also viewed with serious concern the Centre's non-acceptance of Finance Commissions recommendations. It happened in the case of recommendations given by the Third, the Seventh and the Eighth Finance Commissions. Centre's view is that it is not bound to accept all the recommendations of the Finance Commission, as these are the recommendations to the administrative machinery.

It has been pointed out by the Sarkaria Commission that these incidents should be avoided as they erode the prestige of the FC and make the functions of the Commission look like a "routine balancing exercise".

(v) Centre has also been criticised for having not been made serious efforts to collect revenues under heads 268 and 269, and giving sufficient weights to pressures on States' finances due to the payment of dearness allowances arising out of the revisions of employees' pay scales, removing operational irritants in the release of plan assistance for natural calamities and assistance for administration upgradation and so on.

Many of these questions are no doubt of functional nature and need to be looked into afresh in the changed scenario.

(vi) The FC has continued to be subjected to extreme casualness by the Union Government. The case of delays in appointments transfers, not making it a permanent body and so on has been often cited.

The report of the EFC reflects contradictions of reconciling the requirements of economic democracy with the macroeconomic norms dictated by global finance capital.

EFC identifies three reasons for unsustainable expenditure expansion: Periodic upward revision of govt. wage bills because of "Pay Commission"; increasing interest burden because of greater reliance on market borrowings by the govt.; and growing explicit and implicit subsidies. EFC attack first and third factor and accept the second one.

EFC expects that tax revenue will increase with enhanced tax effort by the states. Raising tax-GDP ratios requires more than just political will. More taxation is probably greater anathema to large capital than the much-maligned large fiscal deficits. The largest element of Central Revenue expenditure, which is inflexible downward. The EFC suggests the only way to get out of public debt is to reduce deficits.

The EFC has actually set the clock backwards and moved away from greater devolution. It has made provision for about 37.5% and 28 % of the net tax revenues of the Centre must be shared by the states. EFCs formula differs from the TFCs. The most unjustified change of all comes in the form of the introduction of a new element –fiscal discipline. The weight is 7.5% and that of tax effort is halved to 5% which is unfair and arbitrary because it imposes on all the state govt. a certain conception of fiscal viability which is part of the Central governments current approach and reduces the reward for tax effort which is a much more transparent and equitable consideration. It goes against the basic tenets of decentralisation and is therefore in opposition to greater fiscal federalism in itself.

PLANNING COMMISSION

The Planning Commission, a non-political and permanent apex body for national economic planning. It came into existence on March 15, 1950, by a resolution of Parliament. It derives its justification and indispensability from the Preamble of the Constitution, which resolves, inter alia, to secure to all the citizens "Justice-Social, Economic and Political". In fact, the Constitution lists a number of subjects like regulation and development of industries, inter-state rivers and other educational institutions of national importance wherein planning has an important role to play. It assumes further importance in a country like India where the revenues and functions are divided between the Centre and the States on the one hand, and macro level planning has been adopted as an important instrument to achieve growth, equity and social justice in the country on the other.

The role of the Planning Commission in resource transfers to the states appears to be more than the Finance Commission's though it draws heavily on the Finance Commission calculations regarding the States' revenues, non-plan expenditures, non-plan surpluses for Plans, etc. The Planning Commission considers not only the existing basis of taxation but also the rates, public borrowings including external borrowings and other capital receipts and deficit financing. These issues in fact, are of considerable importance in the overall context of the monetary, fiscal and economic policies of the nation. An important feature of the Plan transfers is that they are discussed at the meeting of the National Development Council and ordinarily consensus is expected on the matter of Plan transfers.

PURPOSE OF PLAN TRANSFERS

Plan transfers are expected to meet the general plan needs of the States so that they are encouraged to undertake Plan development at their own level in such a manner that the objectives of economic planning like growth, balanced regional development, etc, are easily achieved.

The transfers made for the Centrally sponsored and Central Plan schemes are given in the overall development context of the nation.[23]

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23. The various schemes pushed through the Central Plan and Centrally sponsored programmes are viewed in the wider perspective of socio-economic transformation of the country. They relate to poverty alleviation, employment generation in rural areas, health and family welfare, welfare schemes for Scheduled Castes and Scheduled Tribes and programmes of National concern which have inter-state implications such as power transmission, etc. These programmes to a large extent are funded by the Centre itself.

Plan assistance given under 'Additionality' is given to:

i) to encourage the states to identify projects which may be financed by the outside agencies like World Bank, etc.,

ii) involve the States to cooperate in project preparation and their timely implementation,

iii) ensure a regular and sufficient flow of financial assistance for identified projects.

Similarly, assistance for hilly areas, border areas and Scheduled Caste and Schedule tribes etc. is given keeping in mind the special needs of these areas.

TYPES OF PLAN TRANSFERS

Plan assistance may be divided into:

i) assistance for area programmes namely,

(a) Hill areas which cover the North-Eastern States, Jammu & Kashmir, Sikkim, Himachal Pradesh and parts of Assam, Uttar Pradesh, west Bengal, Tamil Nadu and Western Ghats covering Maharashtra, Karnataka, Kerala and Goa;

Tribal areas;

(b) North Eastern Council established in 1974-75 comprising Assam, Manipur, Meghalaya, Nagaland, Tripura, Arunachal Pradesh, Mizoram, and the Union territories;

(c) Border Areas Development Programmes;

(d) Others like Desert Development Programmes, etc.

ii) Assistance for externally aided projects also known as assistance under 'Additionality';

iii) Assistance under the modified Gadgil Formula essentially earmarked for the States Plan.[24]

It may be pointed out that the Central assistance to the state's plans is given in the form of loan grant ratio of 30:70 except in the case of a special category states namely, Arunachal Pradesh, Himachal Pradesh, Jammu & Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura, wherein this ratio is 10:90.[25]

For other programmes, there is no such pre-determined division of assistance into grants and loans.

DEVOLUTION PRINCIPLES

In the case of Central Plan assistance, the Planning Commission employs the modified Gadgil formula on the divisible pool after taking out the proportion for:

i) the externally aided projects;

ii) the special Central assistance for sub plans for hill, tribal and border areas;

iii) Special category states;

iv) the North eastern Council.

The percentage share of Central assistance for these categories in the Seventh Plan were about 13,5, 24 and 2 respectively.

The distribution formula, originally evolved in 1968, has been modified in 1980 and 1990 by the National Development Council. The different factors used in developing assistance and their respective weighted are shown in table[26]

24. Government of India (1988), *op.cit.*
25. It is important to note that these States do not really lag behind in terms of per capita incomes but lack necessary physical and non-physical infrastructure for socio-economic services, which is relatively difficult to build up.
26. Ramalingam R. and Kurup K.N. (1991): "Plan Transfers to States-Revised Gadgil Formula: An Analysis", *Eco and Pol. Weekly* (March, 2-9)

Table III.4

Factors used in financial devolutions	Original Weights	Modified weights	Revised Weights
1. Population	60	60	55
2. Per Capita Income below National Average	10	20	25
3. Per Capita Tax Effort	10	10	0
4. Special Problems	10	10	15
5. Continuing Major Irrigation and Power Scheme	10	0	0
6. Fiscal Management	0	0	5

Note: Original Gadgil Formula was used in Fourth (1969-74) and Fifth Plan; Modified in Sixth and Seventh Plan and Revised in Eighth Plan

- Special problems relate to floods and droughts, tribals, desert, environment, urban slums, coastal areas, sparse or thickly populated areas.

Nevertheless, special Central assistance for hill and tribal area sub-plans is allocated by the National Development Council's approved formula in which:

i) population proportion of Scheduled Tribes gets 50 percent weight;

ii) area occupied by Scheduled Tribes population 30 percent weight;

iii) the inverse proportion of State income gets 20 percent weight.

Similarly, Central assistance for sub-plan hill areas of Assam, Uttar Pradesh, West Bengal and Tamil Nadu is distributed on the basis of hill area and population with equal weights. In the Western Ghat regions as Maharashtra, Karnataka, Kerala and Goa, the central assistance is allocated on the basis of area (75 percent weight) and population (25 percent weight).

Assistance under 'Additionality' was made systematic in 1975-76. A state participating in a foreign project will get extra resources to the tune of 70 percent of the aid disbursements. [27] This percentage may vary from project to project depending upon the funding agency. However, the loan and grant components remain fixed at 70 percent and 30 percent.

TERMS AND CONDITIONS:

Liberal pattern of assistance is extended under the special Central assistance category for sub-plans for hill and tribal areas, North-Eastern Council and Western Ghat programmes and component plans for Schedule Castes etc. For State Plans, Central Plan assistance is conditional and the States are not permitted to deploy these transfers on any other project. However, under the Gadgil formula, total assistance earmarked to a State gets divided into grants and loans. Loans carry an interest rate of about eight percent per annum (effective from 1.6.1985) [28]

STATE'S VIEW

State's main complaints relate both to the functioning of the Planning Commission and the Plan transfers. Some of the important points are: [29]

i) States argue that they are insufficiently involved in national planning which begins with the working groups and preparation of the approach paper.

The opinion on the contrary is that some of the states either do not participate or remain indifferent to the working groups set up by the Planning Commission to study the different problems being faced by the country.

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27. Centre's total resource pool. (Government of India (1988), *op.cit.*
28. The block loans are repayable in 15 annual equal instalments of principal together with interest on outstanding principal commencing from the next financial year. For more details, see Ministry of Finance (1985), *Statistical Statements on* Finance *and Plan of States and Union Territories.*
29. For more details see, Government of India (1988), *op.cit.*

However state's participation needs to be encouraged as that can be very useful in different working groups constituted for the study of financial resources, Major and medium Irrigation Programmes, Command Area Development Programme, Flood Control, Power, Consumer Durables and Light Engineering Industries, Employment Strategy, Concept and Estimation of Poverty Line and so on.

ii) The role of National Development Council is ineffective.

It is argued by the States that even after the reconstitution of Planning Commission in 1967, the recommendation of Administrative Reforms Commission continue to suffer from the conferencing procedures, viz., inadequate and short duration of meetings of the council and other standing and special committees, insufficient time given to states for crystallising their views. Further it is pointed out that agenda papers circulated by Planning Commission do not show plan strategy, alternatives and even consider the other policy questions in detail.

These issues can be sorted out by calling joint meetings of both the centre as well as of the states.

iii) Planning Commission enjoys the excessive powers in planning decisions and therefore it is branded to be working as a 'limb' of Union government.

It is further argued that it minutely scrutinises the state plan proposals relating to the financial resources and sectoral programmes. It may be pointed out that given the resource crunch at the national level Planning Commission's rigorous exercise to estimate the plan size may not be a bad practice. Further, the scrutiny of the state plan schemes is also considered important because state plan proposals generally aggregate too much more than the estimates of financial resources available for the plan. As a result proposed outlays normally exceed the agreed limits.

The Planning Commission is expected to follow an unbiased approach while scrutinising the state schemes and estimating their plan size after considering the statutory allocations to the states. The norms to estimate non-plan surpluses, the estimates of additional resource mobilizations to which the market borrowing and negotiated loans along with central plan assistance etc.)

iv) Unfavourable terms and conditions at which the central assistance is made available to the states.

The states argue that external project assistance included in state plans is not made available at terms at which the centre gets.

The Union government on the other hand finds many merits in keeping the terms and condition uniform for distributing the external assistance to the states. It avoids hardships to states, which may arise from frequent fluctuations in terms and conditions and quantum of external assistance, exchange rates and higher interest burden due to the decline in the overall external assistance.

It is further argued that the weighted rate of interest on Centre's internal and external borrowings is 9.9 percent whereas the rate of interest on central loans made available to the states at the rate of 8.75 percent. This further declines to 5.1 percent if capital grants are also included to work out the weighted rate of interest.

CENTRAL MINISTRIES AND THEIR TRANSFERS

Central Ministries under 'Miscellaneous Financial provisions' of the Constitution assist States in financing their specific expenditures without necessarily consulting either the Planning Commission and/or the Finance Commission. These transfers are normally termed as non-plan and non-statutory and /or discretionary as the funds made so available come outside the purview of the State Plan framework. [30]

TYPES OF MINISTRIAL TRANSFERS:

These transfers are given in four forms:

i) Scheme-wise transfers which essentially cover Central Plan schemes, Centrally sponsored and non-plan schemes;

ii) Small saving loans,

iii) Ways and means advances recoverable within a year and given by the Central Government;

iv) miscellaneous loans including Reserve Bank of India's norms and secure ways and means advances and overdrafts, gap and special accommodation loans;

v) assistance for meeting relief expenditures. [31]

PURPOSE OF MINISTRIALTRANSFERS

The scheme wise transfers are justified in terms of their national importance.[32] The

30. George G.G. and Gulati I. S(1988):"Discretionary Transfers in India-A Review, *Eco and Pol. Weekly*
31. ibid
32. Lakdawala feels national interest dictates that Central schemes should be looked after as left to themselves or operated through the general mechanism of Plan assistance to the states, they may not bring adequate results, For more details, see Government of India (1988), *op.cit.*

purpose of the small saving loans and ways and means advances to fill up the non-plan gaps so that the Central Plan funds and other funds rose by the states for Plan financing are not utilised for other purposes.

IMPORTANCE OF MINISTRIAL TRANSFERS

Scheme-wise transfers are the most discussed category of transfers in the literature. The different schemes covered here may belong to the Union List or the Concurrent List or State List. Thus, it covers a wide range of schemes relating to education, agriculture, road infrastructure, natural calamities, improvement of roads, upgrading the salaries of the teachers, relief and rehabilitation of displaced persons and other contingent problems arising from time to time, and for police, housing etc. These schemes appear to have assumed substantial importance in the priorities of the Central Government. The Ninth Finance Commission in its first report finds about 262 such ongoing schemes having an outlay of about Rs.18, 000 crores during the Seventh Five Year Plan. [33]

Small saving loans are the important long-term loans whereas the other loans are of relatively short-term duration.

DEVOLUTION PRINCIPLES:

In the case of scheme-wise transfers, it is normally said that there is no fixed rule or criterion to distribute funds from the Centre to the states. These may be given in the form of non-plan loan and non-plan grants, and this loan-grant ratio is not fixed. It could be 100 percent grant or 100 percent loan. It may be mentioned here those terms of

33. For more details see, Government of India (1988), *op.cit.*

discretionary transfers are relatively more liberal than those of Plan transfers if adjusted for the grant component. The Central Plan Schemes are totally funded by the Centre whereas the same is not true in case of the Centrally sponsored schemes. The discretionary content of the Centre is great in the funding of these schemes. The loan-grant ratio varies from scheme to scheme which are normally discussed at the time of their announcement to the states.

The distribution of small savings loans is based on certain predetermined basis. Three-fourths of the small savings collected by the states are given to them in the form of capital loans. These carry a moratorium of five years and are repayable in 25 years. The States are also given incentive of half percent on every five percent raised by the State above the national average of net collections.[34]

The assistance for natural calamities over and above what a State gets from that computed in the non-Plan revenue budgetary gaps for grants by the Finance Commission is considered discretionary.

TERMS AND CONDITIONS

The discretionary grants given for Central and Centrally sponsored schemes may be treated purely as discretionary whereas the same cannot be said about the discretionary loans. A substantial part of these transfers are also given in the form of small saving loans and ways and means advances. Their distribution is based on certain well laid

34. *Rajamannar Committee Report* (1971)

down principles. The normal ways and means advances (WMA) are available to all the states at their request and subject to some limits related to the minimum balances kept with the Reserve Bank of India. These were 40 times of the minimum balance of Rs.13 crores in 1982. The special ways and means accommodation are given against the hypothecation of the Central Government securities subject to a limit. It was 20 times of the minimum balance of Rs.13 crores in 1982. These loans are recoverable within a year and carry a 5.25 percent rate of interest. From November 1993, the normal WMA have been revised from 56 times to 84 times and special WMA limits from 20 times to 32 times of the minimum balance required to be maintained by a state government with the Reserve Bank of India.[35]

The scheme of overdrafts in which the states draw cheques on the Reserve Bank of India in excess of what they are authorised to borrow at particular time is stopped now.[36]

STATES VIEW

The States appear to have appreciated the spirit of the Central and Centrally sponsored schemes. However, their reservations have equally been strong and categorical about these schemes. Their criticisms relate to the following:

i) The states are not consulted in deciding these schemes;

ii) The matching principles on which these schemes are given distort the States Plans because they come at a time when the States have already committed their resources;

iii) These schemes do not take into account the local diversities and local problems;

35. For more details see, Government of India (1988), *op.cit,* p.310
36. Most of these points have been considered by the Administrative Reforms Commission as early as 1967 and by the NDC in 1971 and 1979, For more details, see Government of India (1988), *op.cit.*

iv) These schemes reduce the general pool of resources available for distribution according to the Gadgil Formula;

v) The Union Ministries tend to build their own empires with the support of concerned State Departments. This creates problems of coordination in planning and finding resources.[37]

Section III.3

OVERALL FACTUAL POSITION

After having described the operational aspects of the institutional framework of central transfers in India, it would be quite revealing and useful to outline the actual distribution of central transfers.

The analysis of distribution pattern of central transfers is important to bring out the comparative picture of the financial allocations from the centre to the states. The institution wise allocations are given in table III.5.

During the periods under review, transfers under the aegis of the Finance Commissions have been the main devolution agency in transferring budgetary transfers to the states. Analysis of equity and efficiency consequences of Finance Commission transfers is important, because it constitutes the largest component of explicit central transfers to the states were given on the recommendations of the Finance Commissions. However, sharp growth of discretionary transfers since early 1980s under the Garibi Hatao slogan and the 20-point programme of Indira Gandhi have reduced the importance of statutory transfers. Thus, during the period 1974-79, the share of the Finance Commission was about 43.70 percent in the central aggregate transfers. It declined to 41 percent in the Sixth Plan

37. Government of India (1987), *ibid*

TABLE III.5

FINANCIAL TRANSFERS FROM CENTRAL GOVERNMENT TO STATE GOVERNMENT UNDER THE INSTRUMENTALITIES OF FINANCE COMMISSION, PLANNING COMMISSION AND AT THE DISCRETION OF UNION MINISTRIES

(Rs.crores)

Five-Year Plans	Finance Commission Transfers				Planning Commission Transfers		Discretionary Transfers		
	Tax Shares	Grants	Total	% to Total Financial Transfers	Total	% To Total Financial Transfers	Total	% To Total Financial Transfers	Total of All Financial Transfers
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Fifth Plan (1974-79)	8257	2773	11048	43.01	7722	30.55	6683	26.44	25278
Sixth Plan (1980-85)	21335	1711	22888	41	16099	29.34	16267	29.65	25278
Seventh Plan (1985-90)	49465	9113	58578	43.77	38729	28.94	36523	27.29	54862
Eighth Plan (1992-1997)	132009	19215	151224	47.09	94292	29.35	75558	23.54	133829

NOTES:

Finance Commission transfers includes tax shares, all grants-in-aid under Article 275 and grants in lieu of tax on railway fare.

Planning Commission transfers include plan grants under Article 282 and loans under Article 293 for state sector plans only under Gadgil Formula.

Discretionary transfers include grants under Article 282 and loans under Article 293 for Centrally sponsored and Central sector schemes, plus small savings loans, loans for clearing overdrafts and other ad hoc assistance

Ways and Means are excluded

Source: R.B.I.Bulletins

further and then rose to 47.09 percent in the total budgetary transfers in the Eighth Plan. The shares of the planning Commission and the Central Ministries were about 29.35 and 23.54 percent respectively. Nevertheless, as far as transfers, as distinguished from loans are concerned the major portion flows through the recommendations of the Finance Commission.

One may infer from the above table that with general decline in the transfers devolved from Planning commission and other discretionary transfers and rise in the devolution of transfers through finance commission, it appears to have contained progression during the period.

The institutional structure underlying the central transfers in India seen along with the factual position of transfers to the states. It shows there are various instruments available exclusively to and used by the centre to make transfers to the states. This may be a reasonable indicator of centre's potential control over the transfer mechanism employed for making transfers to the states. However, the existing degree of centralisation may be said to be the product of four different factors:

i) The Constitutional division of tax revenues is essentially based on the Government of India Act 1935 which could not visualise the implications of planning and the growth of regionalism with the added dimensions of massive violence, subversion in some parts of India, etc.

ii) That scheme was based on the assumption that centre should be strong and tax system has to be devised accordingly.

iii) Emphasis after independence has been more on faster growth and financial autonomy, which remain relatively, ignored.

iv) The glaring inter-state disparities were not well adjusted in the centre-state relations.

The distribution of transfers across the states has been quite inequitable. Thus, different transfers carry a different degree of progressiveness or regressiveness. This may be due to the different devolution principles employed by the different agencies to transfer resources to the states.

Among the three budgetary transfers, the proportionate share of statutory transfers is larger i.e. about 47.09 percent. This is followed by plan transfers and discretionary which have 29.35 and 23.54 percent shares respectively. How these shares have changed over the years is an interesting aspect as it shows the inter-play of the underlying devolution principles employed by different institutions facilitating transfers to the states.

If one reviews the institutional structure of central transfers, its constitutional provisions, the distribution principles etc., one notices some discretionary elements, uncertainty and even ad-hocism in the matter of central transfers along with heavy dependence of the states on the centre. These appear to have become an inherent part of the transfer mechanism in India. Some of the important aspects are discussed below:

In the case of Finance Commission transfers, only income tax and some estate duties are obligatorily shareable. However, the actual proportion of obligatorily shareable income tax to be made over to the states is left unspecified, leaving it to the Finance Commission to recommend it and Parliament to accept. For a significant part of the tax shares, the centre is not obliged to share it with the states. Articles 275,278 and 282 of the Constitution do suggest grant-in-aid but the amount, kind and direction of this assistance are decided by the Union. Further, some of the taxing powers of states are restricted where centre's approval is necessary. Under article 251 and 254 centre prevails in the case of conflict of legislation. Under Articles 285 and 289 Union enjoys complete exemption from state taxation but reciprocity is not equally complete. This notwithstanding, the share in taxes is the most preferred category of transfers by the states in view of its statutory and condition free status and buoyancy. In the case of plan transfers modified Gadgil formula is applicable only in the case of transfers for state plans. These transfers come to about 50 percent of the total state plan transfers. The allocation of other components is not as foolproof as it is noticed in the case of allocation by Gadgil formula.

One may notice an element of uncertainty in the financial allocations made to the states by the centre. In the case of statutory transfers on finds that the distribution of the tax shares is quite certain and also that it contains some built-in buoyancy. The estimates of the shareable tax like income tax and others like excise duties and estate duties are tentatively known at the state level and the states are certain to get at least the same as they obtained in the last year. Normally, states are not left with any kind of doubt about what they are going to get and as such their shares goes to them regardless of where they spend it on and how they perform. Therefore, as noticed by Bhabtosh Datta, states in most cases may get larger than the amounted expected. Of course, the same cannot be expected in case of grant-in-aid whose allocation is based on many considerations and only a few states get them. Thus Finance Commission's transfers being relatively assured and certain seems to be one of the major reasons for which states have shown preferences for these transfers.

On the contrary, in the case of plan transfers, uncertainty is much larger because the funding of the state plan considerably depends on the internal and external resources available with the centre. The whole state plan assistance is dependent on the approval of the Planning Commission as a whole. The financial support would be reduced in proportion to the cut in the agreed plan outlay. Uncertainty increases still further with the discretionary transfers. Since the varying matching principle is used in the financial allocation for the schemes, uncertainty looms large with respect to the type of schemes and determining the states shares etc. The same is for relief assistance for natural disaster etc.

The heavy fiscal dependence on the centre arises because constitutionally centre holds all the internal and external resources, whereas the states have been given larger responsibilities for the welfare of their people compared to the resources placed at their disposal. Their need for resources for development grows faster than their own revenues, which have made them perpetually dependent on the centre. However, centre does its duty by devolving a considerable part of the resources at its disposal. But a significant part of these resources go to the states in the form of loans. Loans have to be repaid by the states and their growing share in central transfers imply heavier burden on the state finance. This issue has assumed great importance.

SUMMARY

The existing practice of resource transferring is quite complex. Multiple agencies (Finance and Planning Commissions, Central Ministries) use different methodologies, evolve different types of transfers and attach different terms and conditions. As noted, the resource flows through the Finance Commission and Planning Commission account for a substantial share of state resources. Though their overall effects are highly beneficial to the fiscal health of the states, there are certain adverse effects of such flows on state finances.

Since the Finance Commission approach to revenue deficit is gap-filling approach this diminishes the incentive of the states to raise revenue receipts and revenue expenditure. In other words, there is an implicit premium on fiscal profligacy.

The continuing expenditure on plan schemes beyond the five year plans become the committed expenditure of the states and add to their fiscal burden. Since there is a premium on plan expenditure, state governments have a tendency to under-fund maintenance expenditure to inflate plan size. This results in poor maintenance of public assets created in the past and poor quality of public services, which are outside the plan. A further complication is due to steep increase in the revenue component of plan expenditure over the years. While the grant-loan ratio of central assistance is still 30:70, the revenue share of state plan expenditure has crossed 50 percent. As a result, the debt-servicing burden of the states has gone up significantly.

As a result, such fiscal transfers have failed to achieve well-defined national economic objectives, such as that of progressive equalization in current expenditure and offsetting fiscal disadvantages of the states. Nor do the States feel encouraged to undertake any welfare improving reforms in their budgetary policies. They overestimate their resources to get the largest transfers from the Planning Commission and underestimate resources when presented to the Finance Commission. The existing Centre-State institutions and forums lack dynamism and mechanisms of coordination to solve inter-State and Centre-State problems.

CHAPTER IV

DISTRIBUTION OF STATUTORY TRANSFERS IN INDIA

Last chapter reviewed the institutional structure of central transfers in India in the last chapter. It is found that the designing of inter-governmental transfers is fairly complicated in India in view of the wider inter-state differences in economic endowments and levels of income than found elsewhere in the federal world. It is further compounded by the active role of the central government in the economic development through centralised planning.

The focus of the study is on the transfers recommended by Finance Commissions although those recommended by the Planning commission and other discretionary grants and loans from the central government also form a substantial portion. Fiscal transfers from the centre to the States can be examined along three dimensions: (i) between the centre and the states; (ii) distribution among the states; (iii) the balance between devolutions and grant.

An attempt is made in this chapter to look into: (a) the approach that specifies item-wise criteria for vertical revenue sharing in Section IV.1;(b) the near-subjective identification of and assignment of weights to the factors determining the shares in Section IV.2; (d) the gap filling approach in Section IV.3; (c) the pattern of statutory transfers to the states from Sixth Commission (1974-79) to Tenth Commission (1995-2000) in Section IV.4; (d) The relative role of states' income, population and tax efforts as factors in explaining the devolution of statutory transfers to the states in Section IV.5. The basic purpose is to critically analyse the existing distribution pattern of Finance Commission transfers.

Section IV.1

VERTICAL REVENUE SHARING

As regard the vertical sharing the main issues boil down to the differences in the shares in respect of the two major shared taxes, income tax and the union excise duties. The interpretation and translation of the constitutional provisions by successive commissions into the magnitudes of the vertical shares is difficult to understand. The exercise seems to be more on trial and error basis rather being based on any scientific analysis. Not only the recommended shares differ between income tax and the union excise duties, there is a lack of consistency over time as well.

Table IV.1. compares the vertical shares recommended by the Finance Commissions.

Table IV.1.

Shares to States in the Shareable Taxes

(percent)

Finance Commissions	Income Tax	Basic Excise Duties
Sixth (1974-79)	80	20[1]
Seventh (1979-84)	85	40[1]
Eighth (1984-89)	85	45[1,2]
Ninth (1989-90)	85	45[1,2]
Ninth (1990-95)	85	45[1,3]
Tenth (1995-2000)	77.5	47.5[4]

Notes: (1) All excisable commodities
(2) 5 percent earmarked for deficit states
(3) 7.425 percent (16.5 percent of 45) earmarked for deficit states
(4) 7.5 percent earmarked for deficit states
Source: Reports of Finance Commissions

During the Eighth and Ninth Finance Commissions, the income tax share was 85 percent and the excise duty was 45 percent. Of the latter, the Eighth Finance Commission earmarked 5 percent for the deficit states while the Ninth Finance Commission earmarked to 7.425 percent. The Tenth Finance Commission reduced the income tax share to 77.5 percent and has offset the reduction by increasing the excise share to 47.5 percent. In the net, taking the two taxes together, there is no increase in the state's share. Of the excise share, 7.5 percent has been earmarked for deficit states. The periodic enhancement of the share has been partly owing to the shrinkage of the divisible pool as a result of the increases in the income tax exemptions and incentives and the non-inclusion of corporation tax and the general surcharge.

The Commission has based its recommendation to reduce the income tax share from 85 to 77.5 percent with a countervailing 2.5 percent point increase in the excise share on the consideration that the centre being the authority which levies and administers the income tax "should have a significant and tangible interest in the yield". The implication that the centre has lost interest in the levy and the collection of income taxes because such a high proportion of it has to be shared with the states is a sad comment of the centre-state co-operation.[1]

As regards the union excise the recommended vertical share initially went down from 40 percent in First Commission to 20 percent in Third Commission partly because of widened divisible pool due to increased coverage. However, as the states dependence on the centre went up, the Seventh Finance Commission thought it fit to restore the share to 40 percent. Since then the share has been rising and the Tenth Finance Commission recommended 47.5 percent.

The stagnancy in vertical sharing clearly disregards the growth in the needs of the states

1. S. Guhan (1995), Report of the Tenth Finance Commission: *Economic & Political Weekly*, (April 22, p 877,

over two decades. Although, in the current fiscal scenario, the Tenth Finance Commission might not have been able to significantly improve the vertical sharing it could have at the very least maintained the shares available to all states during the Seventh and Eighth Finance Commissions.

Closely related to the issue of differential vertical sharing is the non-inclusion of other central taxes in the divisible pool. The main complaint has been that the states are deprived of sharing the more productive and buoyant taxes. The item-wise sharing will perpetuate the present hide and seek game played by the centre and the states. A more radical approach is needed whereby in the centre-state sharing one takes note of the resource flows accruing to the centre in their totality and sharing is done on objective and equitable basis both between the centre and the states and between states.[2]

There is no reason in equity or in economics, which demands that different principles should be adopted depending upon the constitutional obligation to share a given tax. The same should be adopted for both income tax and union excise.[3]

Table IV.2. gives the total transfers recommended by the ten Commissions under devolutions and grants in absolute terms. Since the revenues of the Central Government were growing in monetary terms during these fifty years, any analysis of the total quantum as such would not be significant.

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2. George & Gulati (1984), p.24, *Essays in Federal Fiscal Relations*, Centre For Development Studies
3. Chelliah R.J (1981): *Trends and Issues in Indian Federal Finance*, Allied Publishers, ND

Table IV.2.

Components of Federal Transfers Under Finance Commission Recommendations

(Rs crores)

	Tax Devolution	Grants	Total Transfers
First	362	50	412
	(88)	(12)	(100)
Sixth	7099	2510	9609
	(74)	(26)	(100)
Seventh	19233	1609	20843
	(92)	(8)	(100)
Eighth	35683	3769	39452
	(90)	(10)	(100)
Ninth	99668	20031	119699
	(83)	(17)	(100)
Tenth	206343	20300	226643
	(91)	(9)	(100)

Note: Figure in brackets are percentage of total transfers
Source: Reports of Finance Commission

Over the years the proportion of grants in the total transfers has tended to decline. The Ninth Finance Commission had tried to reverse the trend but Tenth Finance Commission apparently did not think it necessary to go in that direction. There is a limit to which the devolution formula can take care of the needs of the poorer states and that limit seems to have been reached. However the proportion of tax shares have increased as compared to grants.

A better comparative picture emerges if the States' shares are expressed as percentage of the GDP. This is given in table IV.3.

Table IV.3.

Tax – GDP Ratios

Commissions	Years	Gross Central Taxes	States' share in Central taxes	Col.4 as % of Col.3
1	2	3	4	5
First	1952-57	4.48	0.70	15.62
Second	1957-62	5.50	1.01	18.36
Third	1962-66	7.48	1.13	15.11
Fourth	1966-69	7.15	1.27	17.76
Fifth	1969-74	7.96	1.86	23.37
Sixth	1974-79	9.47	1.89	19.96
Seventh	1979-184	10	2.72	27.20
Eighth	1984-89	10.97	2.77	25.25
Ninth	1990-95	10.23	2.75	26.88
Tenth	1995-2000	10.32	2.72	26.36

Source: Indian Public Finance Statistics, 1999-2000

The increase in the quantum of transfers under the Fifth Commission which was in terms of percentage of GDP, from 1.27 as recommended by the Fourth Commission to 1.86 by the Fifth Commission was due to the inclusion of advance tax collections under income tax and special excise duties under excise of the divisible pool. This got adjusted by the time of the Sixth Commission. The share of the States in the tax proceeds of the Centre increased from about 16 percent in the First Commission to 20 by the Sixth commission. The next significant step-up came with the Seventh Commission due to the doubling of the percentage of the proceeds of the excise duties to be distributed to the states from 20-40 in one jump. Thereafter, the States' share roughly ranged between 25 to 26 percent of the gross central taxes. This formed the basis for the percentage recommended by the Tenth Finance Commission under their 'Alternative Scheme of Devolution'. Under this, the revenue from all major central taxes would be grouped into a single pool and 29 percent of its total would be devolved to states.

Our basic approach to vertical resource sharing has been influenced by the view that it would be in the interest of better centre-state relations if all central taxes are pooled and a proportion devolved to the states. There is considerable merit in moving to such a system, as it would make the vertical sharing simple and transparent. It also gives greater freedom to the centre in choosing tax policy measures in an integrated manner. If a proportion of all taxes go to the states, any apprehensions of bias in the choice of tax measures will be allayed. Therefore we have proposed alternative devolution scheme. (Tenth Finance Commission, 1994:6)

The government also seem to be favouring such a reform. This can be regarded as a welcome first step to bring in the much-desired reform in this respect. In fact, while assessing the pros and cons of such a step goes even a step further and recommends the inclusion of plan grants and specific purpose grants as well into the divisible pool: "... except for natural calamities, grants for specific purposes such as up gradation, special problems and local bodies are not logically sound or practically necessary.[4]

Thus in so far as the vertical sharing is concerned there appears to be a concerted effort to integrate different components of transfers.

Section IV.2

HORIZONTAL SHARING

The most discretionary aspect of the tax has been the use of differential criteria for determination of horizontal shares from income tax and excise duties as also the assignment of differential weights.

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4. S.Guhan (1997), Centre State Fiscal Transfers-Beyond the Tenth Finance Commission, *Economic & Political Weekly*, Feb15, p.353,

Basically the criteria used are:

i) population;

ii) transformation of income such as 'distance' and 'inverse' (income adjusted population)

iii) developmental indicators such as poverty, backwardness and infrastructure

iv) contribution and

v) tax effort.

As observed by the Tenth Commission the criteria for determining the inter se shares of states have tended to converge since the Seventh Commission. Yet, the selection of a particular set of factors and the weights assigned to them for determining the shares largely remained subjective and continue to be 'gamble on the personal views of five persons or a majority of them'. [5]

"The tax devolution is recommended mainly on the basis of general economic indicators and not fiscal disadvantage per se...".[6]

There is an inbuilt imbalance between the expenditure responsibilities and the revenue sources of the state governments. An important aspect of the devolution of central tax revenues under finance commission dispensation is that it has an inbuilt bias in favour of fiscally weak states. Population and per capita income of the state get high weightage in the distribution formula. A state with large population and lower per capita income gets a higher share in the central tax revenues. The gap between revenue receipts and revenue expenditure is another parameter, which decides the level of state's share. As a result the

5. Dissent note to the Report of the Fourth Finance Commission as quoted by Guhan (1995) *Eco and Pol. Weekly.*

6. Rao & Sen (1996), *Fiscal Federalism in Indian* Macmillan India, ND

central tax share constitutes a major revenue source for the backward states. While it constitutes about one-third of the total tax revenues of all the states taken together. It accounts for more than 50 percent of the total tax revenues of less developed states like Bihar and Orissa, but their share is less than 20 percent of the total tax revenues of more developed states like Gujarat, Haryana, Maharashtra and Punjab.[7]

In horizontal sharing progressivity is a central consideration i.e. relatively lower per capita incomes vis-à-vis corresponding shares in population. Table IV.4. compares the progressivity under the various Finance commissions for horizontal sharing under the two shareable taxes. For convenience the states have been grouped under broad income categories. Horizontal sharing became progressive only from Seventh Finance Commission onwards because of a large increase in excise shares, which were subject to stronger redistributive criteria in comparison to income taxes.

Table IV.4.
Horizontal sharing in Sixth to Tenth Finance Commissions

(Percent)

Income Categories	1971 Population Shares			Weighted Shares in IT and Basic Excise, excluding earmarked shares for deficit states				
	Sixth	Seventh and Eighth	Ninth and Tenth	Sixth	Seventh	Eighth	Ninth	Tenth
High Income[1]	18.604	18.596	18.542	18.52	15.600	13.109	13.816	12.871
Middle Income[2]	33.192	33.179	33.082	33.19	32.653	32.248	32.751	31.787
Low Income[3]	43.242	43.225	43.098	43.40	46.824	49.455	48.335	49.008
Special Category[4]	4.962	5.000	5.278	4.89	4.953	5.188	5.098	6.334
	100.000	100.000	100.000	100.00	100.000	100.000	100.000	100.000

Notes: 1. Punjab, Maharashtra, Haryana, Gujarat
2. Tamil Nadu, Karnataka, Andhra Pradesh, Kerala, West Bengal
3. Rajasthan, Madhya Pradesh, Orissa, Uttar Pradesh, Bihar
4. Goa, Arunachal Pradesh, Himachal Pradesh, Mizoram, Nagaland, Manipur, Sikkim, Meghalaya, Assam, Jammu & Kashmir, Tripura

Source: Reports of Finance Commissions

7. N.J. Kurian (2000), Widening Regional Disparities in India- Some Indicators: Eco. *& Pol. Weekly, (Feb,12)*

It shows that compared to its predecessors the Eighth Finance Commission redistributed away from the high income states to the low-income states leaving the share of the middle-income states about the same. The Ninth Finance Commission's formula was slightly less progressive than that of the Eighth Finance Commission. Progressivity in the Tenth Finance Commission is better than in the Ninth Finance Commission. Compared to the previous commissions, special category states have been distinctly benefited in the Tenth Finance Commission.

The trends brought about in the table IV.4, indicates that given stagnant vertical shares horizontal progressivity fluctuates within a narrow band. This is to be expected since, without periodical increases to vertical shares, the scope for redistributive transfers among states in different income groups is bound to get constrained in a context of competitive federalism.

Section IV.3

GAP FILLING APPROACH

It is interesting to note that the Seventh Finance Commission, in which Prof. Raj Krishna had, for the first time, argued for the case for grants as a more suitable instrument for equitable distribution among the States, was the Sixth Finance Commission under which the percentage of grants out of total transfers fell from 26 to 8 percent. Thereafter, it stabilised at about 10 percent. The higher percentage of 17 percent under the Ninth Finance Commission was due to plan revenue expenditure having been taken into account. The justification for the fall under the Seventh Commission was that greater progressivity had been brought into the formulae for the distribution of the proceeds of the devolved taxes themselves. It was, therefore, felt that there was no need to use a higher percentage of grants as a tool for achieving this purpose. The States themselves preferred devolution to grants as a tool for this purpose. The states themselves preferred devolution to grants because this gave them a share in a tax source, which had buoyancy, unlike grants, which would be fixed for five years.

To understand the basis for this, we must look at table IV.5. which gives the pre-devolution surpluses/deficits.

Table IV.5.

The richest States have the largest such surpluses, though not necessarily with any direct correlation. The fact that at the end of the process of statutory transfers, these states are still left with large surpluses only means that the transfers themselves could not fully neutralise their initial advantage. This, however, cannot be adopted as the end objective of transfers. In a federal set up we cannot postulate that states that come with an initial advantage will necessarily suffer in all dispensations. There will then be no incentive for them to remain in the Union. Prof.Raj Krishna in his Minute of Dissent to the report of the Seventh Finance Commission states that, "since the whole Indian nation is a Commonwealth, the better endowed States should not grudge small reductions in their large surpluses for the sake of improving substantially the financial position of their weaker neighbours."

The States cannot be deprived of their initial advantage, for whatever historical, geographical, natural or social reasons it may have accrued. All that we can postulate is that, in distributing the common pool of divisible resources, the initial disadvantages of

TABLE IV.5

(Rs.crore

NON-PLAN REVENUE DEFICIT/SURPLUS BEFORE DEVOLUTION

	STATES	SIXTH	SEVENTH	EIGHTH	NINTH	NINTH	TENTH
	NON SPECIAL CATEGORY						
	HIGH INCOME						
1	Punjab	186.5	390	1147.6	152.6	-114.8	-1385
2	Maharashtra	40.5	1290.7	3790.5	1304.5	5489.2	11407.8
3	Haryana	124.1	370.1	966	128.8	1374	3466.2
4	Gujarat	-24	164.1	1034.1	13.7	563.3	2264
	MIDDLE INCOME						
5	Tamil Nadu	-354	-849	774.1	-303	-1717.1	-3299.4
6	Karnataka	-124.5	1.2	351.7	302.1	708.8	4039.5
7	Andhra Pradesh	-723.4	-579.8	-846	-592.3	-2286.3	-15191
8	Kerala	-473.4	-531.1	-635.4	-314.6	-2916.8	-3734.5
9	West Bengal	-750.7	-857.3	-3034.3	-653.2	-4679	-10004.8
	LOW INCOME						
10	Rajasthan	-536.5	-663.2	-1240.6	-613.5	-5100.2	-7309.6
11	Madhya Pradesh	-383.1	-422.6	-801.8	-630.6	-5306.5	-7015.9
12	Orissa	-520.3	-952.2	-1663.8	-566.7	-4792.3	-9152.5
13	Uttar Pradesh	-1058.9	-1258.9	-2113.6	-1232.8	-14225	-31525.4
14	Bihar	-677.9	-1057.5	-3152.5	-411	-7095.4	-21785.7
	SPECIAL CATEGORY						
15	Goa				-41.3	-505.1	-599
16	Arunachal Pradesh				-135.7	-827.4	-1642
17	Himachal Pradesh	-204.1	-317.4	-713.8	-239.2	-1792.5	-4460.9
18	Mizoram				-153.2	-1017.3	-1702.4
19	Nagaland	-135	-236.3	-484	-153.2	-1240.6	-2681
20	Manipur	-126.9	-184.1	-422.7	-142.1	-1081.8	-2012.3
21	Sikkim		-36.2	-92.6	-27.9	-241	-659.9
22	Meghalaya	-86	-129.3	-341.3	-107.3	-814.4	-1827.5
23	Assam	-421.6	-410.1	-1444.5	-544.3	-3529.9	-7740.5
24	Jammu & Kashmir	-215	-358.7	-995.4	-428.3	-3300.4	-6997.8
25	Tripura	-130.2	-196.3	-502.5	-179.2	-1422.7	-2775.9
	Deficit	**-6945.5**	**-9040**	**-10420.8**	**-7469.4**	**-63892**	**-142118**
	Surplus	**351.1**	**2216.1**	**8064**	**1901.7**	**8135.3**	**21177.5**
	ALL INDIA(total)	**-6594.4**	**-6823.9**	**-2356.8**	**-5567.7**	**-55757**	**-120940.5**

SOURCE:REPORTS OF FINANCE COMMISSION

some States will be taken into account and adequately compensated. This initial disadvantage may not always be due to external circumstances. To the extent this was due to inefficiencies, this must be corrected by rewarding efficiency. Broadly speaking, in our country, the fact that some states are more developed than others is partly due to their initial historical and geographic advantages and better natural endowment. Similarly, the States that are backward are not so due to lack of effort or inefficiency. However, while pre-devolution surpluses may not reflect efficiency, pre-devolution deficits do reflect, in some cases at least, financial impropriety and mismanagement. The Finance Commissions have tried to do the best they could in balancing these various factors.

It can be seen from the table IV.5, the pre devolution surpluses have been going down. More equity has been imparted to the formulae for distribution of resources among the States. Yet, the inter-se position has not changed. The states use their financial resources in a less efficient manner. It has now become common to both the more developed and the less developed States. It has spread to the Centre also. The result has been that distribution has served to achieve distribution inefficiencies and not to diminish disadvantages.

Another limiting factor has been the separation of plan and non-plan expenditures. The Finance Commissions having had to deal with non-plan expenditure alone means that the deficits can only be brought to zero. If Article 275 grants have to be used for deliberately leaving surpluses, plan expenditure has to be taken into account or expenditure of a plan type like upgradation grants. On the other hand, the Gadgil formula has no way of correcting the imbalance in the approach of the Finance Commission. The Ninth

Commission termed this as a " basic flaw in the present system of federal fiscal transfers."

To the extent that the devolution of the shareable taxes leaves revenue deficits in the non-plan accounts of certain states, the Finance Commission recommends grants under Article 275 to fill the residual gap given in table IV.6.

Table IV.6

Table IV.7. shows the relative financial status of the major status of the major states over the time span of five Finance Commissions.

Table IV.7.

Financial Status of states – Sixth to tenth Finance Commissions

Category	Sixth Finance Commission	Seventh Finance Commission	Eighth Finance Commission	Ninth Finance Commission (1990-95)	Tenth Finance Commission
Pre devolution Deficit states	Gujarat, Tamil Nadu, Karnataka, Andhra Pradesh, Kerala, West Bengal, Rajasthan, Madhya Pradesh, Orissa, Uttar Pradesh, Bihar	TamilNadu, Andhra Pradesh, Kerala, West Bengal, Rajasthan, Madhya Pradesh, Orissa, Uttar Pradesh, Bihar		Andhra Pradesh, Kerala, West Bengal, Rajasthan, Madhya Pradesh, Orissa, Uttar Pradesh, Bihar	TamilNadu, Andhra Pradesh, Kerala, West Bengal, Rajasthan, Madhya Pradesh, Orissa, Uttar Pradesh, Bihar
Pre devolution Surplus States	Punjab, Maharashtra, Haryana, Gujarat	Punjab, Maharashtra, Haryana, Gujarat, Karnataka	Punjab, Maharashtra, Haryana, Gujarat, Tamil Nadu, Karnataka	Maharashtra, Haryana, Gujarat, Karnataka	Maharashtra, Haryana, Gujarat, Karnataka
Post devolution Deficit states	Andhra Pradesh, Kerala, West Bengal, Orissa, Rajasthan, Uttar Pradesh	Orissa	Rajasthan, Orissa, West Bengal	Rajasthan, Orissa, Uttar Pradesh	Andhra Pradesh, Rajasthan, Orissa, Uttar Pradesh, Bihar

Source: Reports of Finance Commissions

TABLE IV.6

(Rs.crores)

ARTICLE 275 GRANTS FOR COVERING REVENUE DEFICITS

STATES		SIXTH	SEVENTH	EIGHTH	NINTH	NINTH	TENTH
NON SPECIAL CATEGORY							
	HIGH INCOME						
1	Punjab						
2	Maharashtra						
3	Haryana						
4	Gujarat						
	MIDDLE INCOME						
5	Tamil Nadu						
6	Karnataka						
7	Andhra Pradesh	205.9					686.5
8	Kerala	208.9					
9	West Bengal	234.9		233.9			
	LOW INCOME						
10	Rajasthan	230.5		10.2	38.8	486.4	33.5
11	Madhya Pradesh						
12	Orissa	304.7	136.9	111.7	57.1	528.5	371.7
13	Uttar Pradesh	198.9				348.6	982
14	Bihar	106.3					333.1
	TOTAL(NON-SPECIAL)	**1490.1**	**136.9**	**355.8**	**95.9**	**1363.5**	**2406.8**
	SPECIAL CATEGORY						
15	Goa				16.7	166.6	77.3
16	Arunachal Pradesh				70.4	302.8	307.6
17	Himachal Pradesh	161	207.1	206.2	98.7	523.1	772.2
18	Mizoram				80.7	379.8	331.2
19	Nagaland	128.8	218.4	178.7	79.8	458.7	529.8
20	Manipur	114.5	146.3	139.2	66.8	371.7	350.9
21	Sikkim		35.7	32.8	13.9	84.7	105.7
22	Meghalaya	74.6	92.6	110.9	47.6	256.2	316.4
23	Assam	254.5			140	560.3	712
24	Jammu & Kashmir	173.5	199.6	288.7	191.9	1083.1	1184.1
25	Tripura	112.5	136.6	163.1	81.6	466	488.8
	TOTAL(SPECIAL)	**1019.4**	**1036.3**	**1119.6**	**888.1**	**4653**	**5176**
	ALL INDIA	**2509.5**	**1173.2**	**1475.4**	**984**	**6016.5**	**7582.8**

SOURCE:RBI BULLETINS

Gujarat, Haryana, Karnataka and Maharashtra have consistently maintained their position as pre-devolution surplus states while Punjab has slipped from this category in the Ninth and Tenth Finance Commissions. At the other end of the spectrum, as might be expected in a scenario of stagnant tax shares, more and more states have regressed into the post-devolution deficit category. They include the low-income states of Orissa and Rajasthan in the earlier Commissions and Uttar Pradesh and Bihar in the later ones. Two middle-income states, West Bengal in the Eighth Commission and Andhra Pradesh in the Tenth Commission, have also had this dubious distinction. Apparently, the case of Andhra Pradesh is to be explained by the combination of partial prohibition and large food subsidies.

Table IV.8. shows the tax sharing and deficit financing via earmarked tax shares and Article 275 grants under the different commissions.

Table IV.8

Comparing table IV.6 and table IV.8, tax shares have played a lesser role vis-vis deficit financing in the Seventh Commission as compared to Eighth and especially in the Ninth Commissions. The pattern in the Tenth Finance Commission restores the practice in the Eighth.

There is no reason why deficit states should not be called upon to cover an appropriate part of their deficits through resource mobilization and expenditure reduction. However, Tenth Finance Commission has not departed from the gap filling approach of its predecessors. Despite being required under one of its terms of reference to take into account the potential for raising additional taxes in the states, the Tenth Finance Commission has not attempted specifically estimate this potential instead it has been

TABLE IV.8

TAX DEVOLUTIONS AND REVENUE GAP GRANTS

(Rs.crores)

	STATES	SIXTH COMMISSION 1974-79	SEVENTH COMMISSION 1980-84	EIGHTH COMMISSION 1984-1989	NINTH COMMISSION 1989-90	NINTH COMMISSION 1990-95	TENTH COMMISSION 1995-2000
	NON SPECIAL CATEGOR						
	HIGH INCOME						
1	Punjab	169	419.5	611.1	184.2	1515.2	3160.4
2	Maharashtra	711.5	1714.1	2617.3	860.5	6036.4	12859.8
3	Haryana	120.7	308.6	428	137.1	1131.1	2555
4	Gujarat	368.6	963.9	1417.2	422.1	3394.7	8015
	MIDDLE INCOME						
5	Tamil Nadu	538.5	1476.4	2443.1	839.4	6008.2	12622.5
6	Karnataka	383.6	1005	1713	560.3	3962	10034.6
7	Andhra Pradesh	776	1503	2754.8	848.7	6575.5	17012.4
8	Kerala	479.9	766.2	1258.9	404.4	2919.1	7217
9	West Bengal	823	1572.6	3054.5	851.59	6260.8	14104.9
	LOW INCOME						
10	Rajasthan	563.9	883.5	1548.4	613.5	5100.2	10288.8
11	Madhya Pradesh	543.6	1533.9	2788.1	909.6	6534.5	15275.5
12	Orissa	577.3	952.2	1673.3	566.7	4792.3	9155.1
13	Uttar Pradesh	1349.1	3202.7	5915.6	2046.7	14225.1	34508.7
14	Bihar	844.7	2149.9	4005.8	1373	9670.5	23635.6
	TOTAL(NON-SPECIAL	**8249.4**	**18451.5**	**32229.1**	**10617.79**	**78125.6**	**180445.3**
	SPECIAL CATEGORY						
15	Goa				41.3	505.1	601.4
16	Arunachal Pradesh				135.7	827.4	1667.6
17	Himachal Pradesh	204.1	317.4	736.9	239.2	1792.5	4516
18	Mizoram				153.2	1017.3	1729.6
19	Nagaland	135.6	236.3	504.2	153.2	1240.6	2727.2
20	Manipur	128	184.1	438.4	142.1	1081.8	2040.5
21	Sikkim		36.2	96.3	27.9	241	667.8
22	Meghalaya	87.5	129.3	353.8	107.3	814.4	1851
23	Assam	439.6	496.9	1467.2	544.3	3529.9	7776.1
24	Jammu & Kashmir	232.3	358.7	1026.9	428.3	3300.4	7088.8
25	Tripura	132.2	196.3	520.8	179.2	1422.7	2814.6
	TOTAL(SPECIAL)	**1359.3**	**1955.2**	**5144.5**	**2151.7**	**15773.1**	**33480.6**
	ALL INDIA	**9608.7**	**20406.7**	**37373.6**	**12769.49**	**93898.7**	**213925.9**

SOURCE: RBI BULLETINS

subsumed under the tax buoyancy estimates. The result is that a middle income state like Andhra Pradesh with a per capita income 60 percent higher than and per capita own tax revenue 3.4 times that of Bihar gets a per capita deficit grant of Rs 157.8 which is 2.7 times that of Bihar's entitlement of Rs.59.1.[8]

In other words, the Tenth Finance Commission has failed to sort out the fiscally disadvantaged (Bihar) by filling alike the residual revenue account gaps for both of them. In the process, it has missed the opportunity to operationalise its own exhortations for greater fiscal discipline.

A striking feature of the dispensation of the Tenth Finance Commission is the disparity in per capita revenue surpluses after devolution. The table IV.9 shows the revenue surplus per capita for the states of the non-special category.

Table IV.9.

The highest is Haryana (Rs.3649) while the lowest is that of Orissa (Rs1). Such disparities in the per capita revenue surplus are not a new phenomenon. But the gap seems to be much wider under the Tenth Finance Commission' award than ever before. Given the unequal starting position, the richer states could make larges plan investments resulting in imbalances in the pattern of development itself.

Notes:

8. In 1987-90, the per capita NSDP of Andhra Pradesh was Rs 3455 and that of Bihar was Rs.2135. In the same period the per capita tax revenue of Andhra Pradesh was Rs 333 and for Bihar it was Rs 99. With a 1971 population of 43.5 million Andhra Pradesh gets a revenue deficit grant of Rs. 686.45 crore while Bihar with a population of 56.53 million gets a deficit grant of Rs. 333.06. Vide Annexure V.1, V.3, V.4 and Table 2. at p 54 of the Report of the Tenth Finance Commission.

TABLE IV.9

PER CAPITA SURPLUSES

(RS.)

	STATES NON SPECIAL CATEGORY	SIXTH	SEVENTH	EIGHTH	NINTH (1989-90)	NINTH (1990-95)	TENTH
	HIGH INCOME						
1	Punjab	262	482	1047	201	691	875
2	Maharashtra	149	479	1021	345	1460	3074
3	Haryana	244	525	1079	206	1522	3658
4	Gujarat	129	331	719	128	958	2488
	MIDDLE INCOME						
5	Tamil Nadu	45	130	665	111	769	1669
6	Karnataka	88	271	556	232	1038	3129
7	Andhra Pradesh	12	172	356	60	645	274
8	Kerala	3	92	245	35	1	1197
9	West Bengal	16	131	4	36	232	602
	LOW INCOME						
10	Rajasthan	10	64	90			677
11	Madhya Pradesh	39	270	381	53	186	1248
12	Orissa	26		4			1
13	Uttar Pradesh	33	175	34	73		214
14	Bihar	11	156	122	138	298	214
	Average	**76**	**252**	**452**	**135**	**709**	**1380**

SOURCE: Reports of the Finance Commissions

It may legitimately be asked should the Finance Commission's transfers be expected to equalize the revenue surpluses. Prima Facie the answer would seem to be no. After all, the primary objective of the revenue transfers is to correct the fiscal deficiencies of the states so that the levels of essential public services do not differ too much across regions and not to neutralize the differences in endowments. The fact, however, remains that the capacity of a state to provide the basic services depends crucially on their infrastructure, physical and human and if the levels of public services are to be equalized or made comparable, massive investments would be required to build up infrastructure in backward areas.

Section IV.4

PATTERN OF STATUTORY TRANSFERS

Transfers through Finance Commission may be divided into tax transfers and grants-in-aid of revenues of States. In a country with sharp disparities in income levels across the states, it is taken as axiomatic that federal transfers ought to be progressive. While this expectation is natural, the presumption that the transfers must be progressive is not logical.

Admittedly, by and large states with poor fiscal capacity should receive more than others but such progressivity should be incidental, resulting from their fiscal disadvantages and not an end in itself. Unfortunately, Finance Commissions in India have tended to be persuaded by consideration of progressivity as such rather than trying to see how the fiscal capacities can be equalized. Hence, the attempt to introduce a host of criteria even in tax devolution and every Finance Commission tries to do one better than its predecessor by appearing to be more progressive.

Table IV.10 presents the state wise total transfers recommended by the Sixth and subsequent Finance Commissions broken up under 'tax devolution' and 'grants'. Each Commission has adopted certain criteria for devolution.

Table IV.10.

The percentage of transfer has remained almost same with marginal decrease from 85.8 percent in Sixth Finance Commission to 84.5 percent in tenth Commission for non-special category states. However for special category states the transfers has increased from 14.5 percent in Sixth Finance Commission to 15.45 percent in Tenth Finance Commission. Taking the last commission, baring Bihar, all the other four states in low-income states lose by significant amounts from Ninth Finance Commission. A fairly hefty increase in middle and special category states has occurred. However coefficient of variation has increased from 83.6 in Sixth Finance Commission to 93.06 in Tenth Finance Commission with marginal decrease of 1.11 from Ninth Finance Commission indicating a weakening of redistributive effect. In effect tax shares have been regressive in their redistributive impact whereas grants-in-aid have been progressive.

Given the fact that the States are of widely varying sizes, population and Gross Domestic Product, a more meaningful comparison can be made if we take transfers on a per capita basis. The statewise distribution of Finance Commission transfers is illustrated in the maps IVa to IVe indicating the percentage share of each group in total Finance Commission transfers.

TABLE IV.10
FINANCE COMMISSION TRANSFERS

(Rs.crore

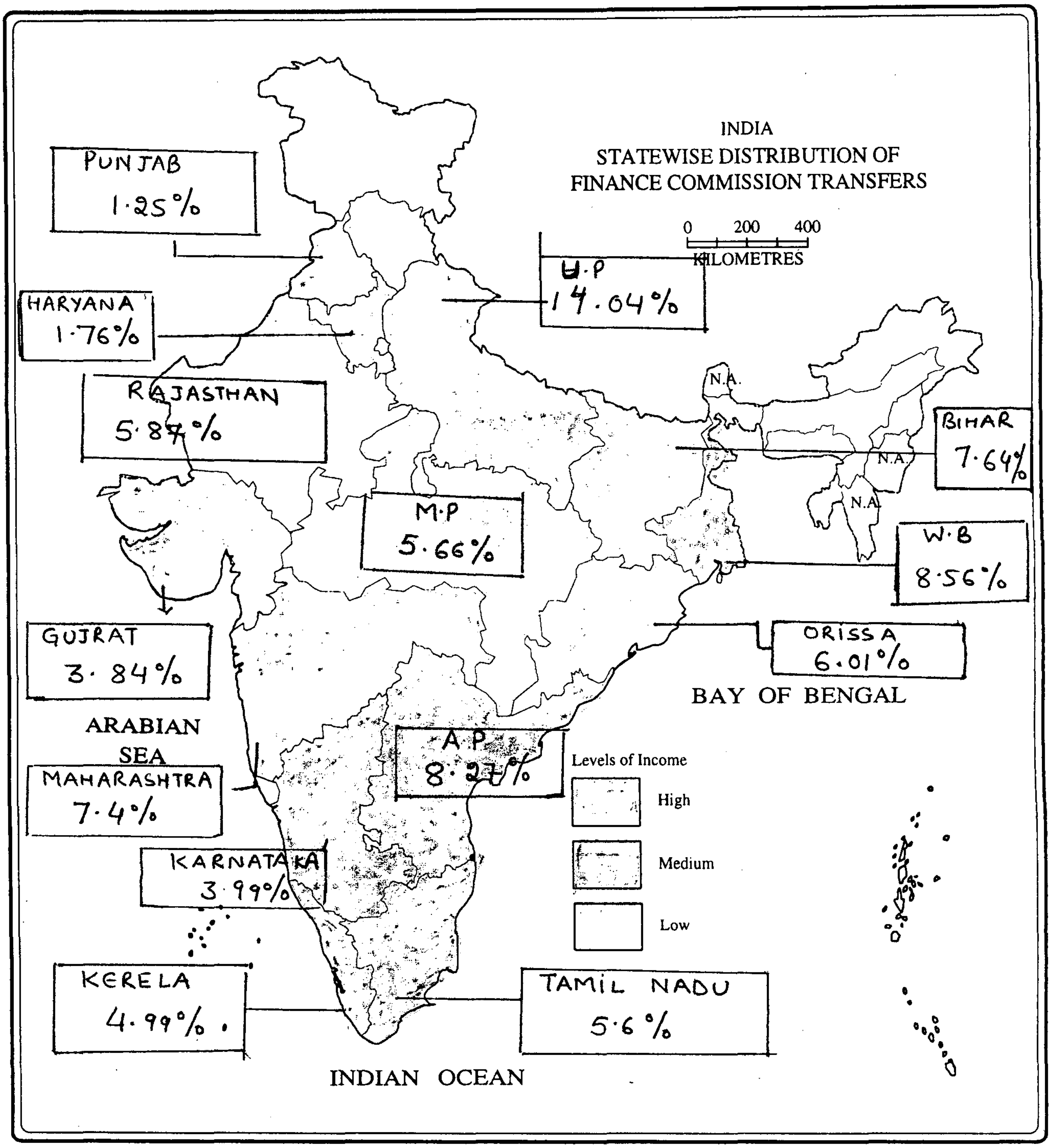
	STATES	SIXTH COMMISSION				SEVENTH COMMISSION			
					%OF ALL				%OF ALL
	NON SPECIAL CATEGORY	TAXSH	GRANTS	TOTAL	STATES TRANS	TAXSH	GRANTS	TOTAL	STATES TRAN
	HIGH INCOME								
1	Punjab	169		169	1.76	419.5		419.5	2.01
2	Maharashtra	711.5		711.5	7.4	1714.1		1714.1	8.22
3	Haryana	120.7		120.7	1.25	308.6		308.6	1.48
4	Gujarat	368.6		368.6	3.84	963.9		963.9	4.62
	MIDDLE INCOME								
5	Tamil Nadu	538.5		538.5	5.6	1476.4	27.1	1503.5	7.21
6	Karnataka	383.6		383.6	3.99	1005		1005	4.82
7	Andhra Pradesh	570.1	205.9	776	8.07	1503	18.7	1521.7	7.3
8	Kerala	271	208.9	479.9	4.99	766.2	4.2	770.4	3.7
9	West Bengal	588.1	234.9	823	8.56	1572.6	24.5	1597.1	7.66
	LOW INCOME								
10	Rajasthan	333.4	230.5	563.9	5.87	883.5	19.2	902.7	4.33
11	Madhya Pradesh	543.6		543.6	5.66	1533.9	63.7	1597.6	7.66
12	Orissa	272.6	304.7	577.3	6.01	815.3	169.1	984.4	4.72
13	Uttar Pradesh	1150	198.9	1349	14.04	3202.7	112	3314.7	15.9
14	Bihar	738.4	106.3	844.7	7.64	2149.9	63.9	2213.8	9.68
	TOTAL(NON-SPECIAL)	6759	1490	8249	85.85	18315	502	18817	90.28
	SPECIAL CATEGORY								
15	Goa								
16	Arunachal Pradesh								
17	Himachal Pradesh	43.1	161	204.1	2.12	110.3	214.8	325.1	1.56
18	Mizoram								
19	Nagaland	6.8	128.8	135.6	1.41	17.9	222.7	240.6	1.15
20	Manipur	13.5	114.5	128	1.33	37.8	156.2	194	0.93
21	Sikkim					0.5	36.4	36.9	0.18
22	Meghalaya	12.9	74.6	87.5	0.91	36.7	97.5	134.2	0.64
23	Assam	185.1	254.5	439.6	4.57	496.6	21.7	518.3	2.49
24	Jammu & Kashmir	58.8	173.5	232.3	2.42	159.1	217.9	377	1.81
25	Tripura	19.7	112.5	132.2	1.37	59.7	140.2	199.9	0.96
	TOTAL(SPECIAL)	339.9	1019.4	1359	14.15	918.6	1107.4	2026	9.72
	ALL INDIA	7099	2510	9609	100	19233	1610	20843	100
	Average	284.0	100.4	384.3		769.3	64.4	833.7	
	Coefficient of var.	107.3	65.9	83.6		109.13	121.2	98	

	STATES	EIGHTH COMMISSION				NINTH COMMISSION (1989-1990)			
					%OF ALL				%OF ALL
	NON SPECIAL CATEGORY	TAXSH	GRANTS	TOTAL	STATES TRAN	TAXSH	GRANT	TOTAL	TATES TRAN
	HIGH INCOME								
1	Punjab	611.1	35	646.1	1.64	184.2	94.4	278.6	2.04
2	Maharashtra	2617.3	18.1	2635.4	6.68	860.5	56.5	917	6.71
3	Haryana	428	11.2	439.2	1.11	137.1	27.8	164.9	1.21
4	Gujarat	1417.2	71.8	1489	3.77	422.1	14.4	436.5	3.19
					13.2				13.15
	MIDDLE INCOME								
5	Tamil Nadu	2443.1	21.9	2465	6.25	839.4	32.7	872.1	6.38
6	Karnataka	1713	15	1728	4.38	560.3	15.6	575.9	4.22
7	Andhra Pradesh	2754.8	141.7	2896.5	7.34	848.7	52.8	901.5	6.6
8	Kerala	1258.9	29.3	1288.2	3.26	404.4	6.6	411	3.01
9	West Bengal	2820.6	629.4	3450	8.74	851.6	103.3	954.9	6.99
	LOW INCOME								
10	Rajasthan	1538.2	138	1676.2	4.25	574.7	76.6	651.3	4.77
11	Madhya Pradesh	2788.1	169.6	2957.7	7.5	909.6	44.8	954.4	6.99
12	Orissa	1561.6	348.1	1909.7	4.84	509.6	109.1	618.7	4.53
13	Uttar Pradesh	5915.6	189.4	6105	15.47	2047	116.7	2163	15.84
14	Bihar	4005.8	214.6	4220.4	10.7	1373	82	1455	10.65
	TOTAL(NON-SPECIAL)	31873	2033	33906	85.94	10522	833	11355	83.12
	SPECIAL CATEGORY								
15	Goa					24.6	22.4	47	0.34
16	Arunachal Pradesh					65.3	85.9	151.2	1.11
17	Himachal Pradesh	530.7	243.7	774.4	1.96	140.5	114	254.5	1.86
18	Mizoram					72.5	98	170.5	1.25
19	Nagaland	325.5	201.9	527.4	1.34	73.4	97.8	171.2	1.25
20	Manipur	299.2	169.9	469.1	1.19	75.3	73.6	148.9	1.09
21	Sikkim	63.5	40.9	104.4	0.26	14	17.3	31.3	0.23
22	Meghalaya	242.9	139	381.9	0.97	59.7	52.1	111.8	0.82
23	Assam	1251.7	355.8	1607.5	4.07	404.3	158.5	562.8	4.12
24	Jammu & Kashmir	738.2	381.5	1119.7	2.84	236.4	238.6	475	3.47
25	Tripura	357.7	203.5	561.2	1.42	97.6	85.4	183	1.34
	TOTAL(SPECIAL)	3809.4	1736.2	5545.6	14.06	1264	1044	2307	16.88
	ALL INDIA	35683	3769	39452	100	11785	1877	13662	100
	Average	1427.3	150.8	1578.1		471.4	75.1	546.5	
	Coefficient of var.	101.38	101.65	93.51		104.4	69.28	90.96	

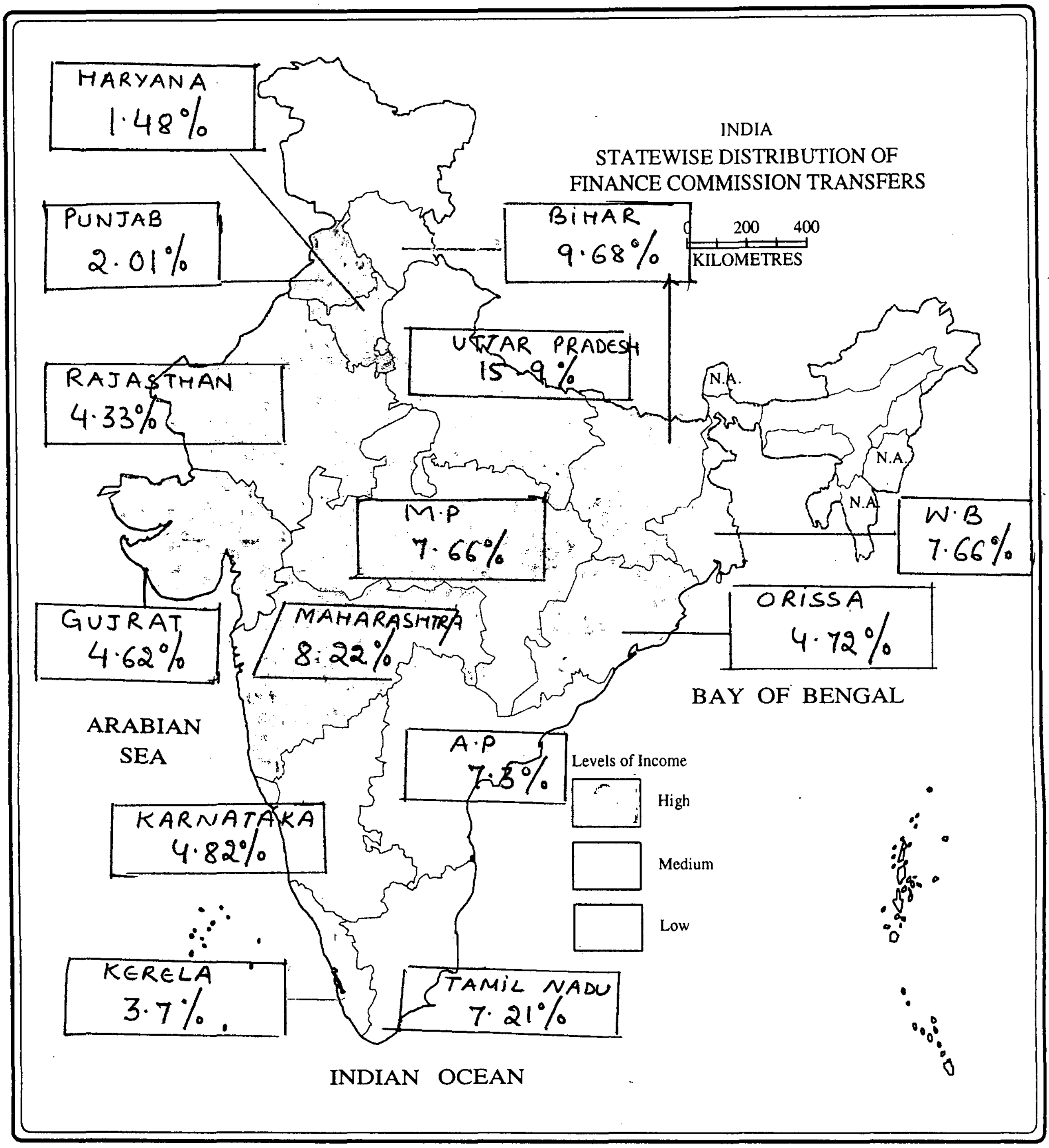
	STATES	NINTH COMMISSION (1990-1995)				TENTH COMMISSION			
					%OF ALL				%OF ALL
	NON SPECIAL CATEGORY	TAXSH	GRANT	TOTAL	TATES TRAN	TAXSH	GRANTS	TOTAL	ATES TRA
	HIGH INCOME								
1	Punjab	1515	158.9	1674.1	1.58	3160.4	429.1	3589.5	1.58
2	Maharashtra	6036	165	6201.4	5.85	12859.8	849.3	13709.1	6.05
3	Haryana	1131	63.7	1194.8	1.13	2555	238.1	2793.1	1.23
4	Gujarat	3395	318.7	3713.4	3.5	8015	860.6	8875.6	3.92
	MIDDLE INCOME								
5	Tamil Nadu	6008	190	6198.2	5.85	12622.5	738.1	13360.6	5.89
6	Karnataka	3962	101.3	4063.3	3.83	10034.6	486.2	10520.8	4.64
7	Andhra Pradesh	6576	663.7	7239.2	6.83	16325.9	1755.6	18081.5	7.98
8	Kerala	2919	528.8	3447.9	3.25	7217	504.8	7721.8	3.41
9	West Bengal	6261	1149	7409.4	6.99	14104.9	875.5	14980.4	6.61
	LOW INCOME								
10	Rajasthan	4614	1912	6525.6	6.15	10255.3	1145.6	11400.9	5.03
11	Madhya Pradesh	6535	1309	7843.3	7.4	15275.5	1818.5	17094	7.54
12	Orissa	4264	1259	5523	5.21	8783.4	923.2	9706.6	4.28
13	Uttar Pradesh	13877	3573	17449.1	16.45	33526.7	2632.2	36158.9	15.95
14	Bihar	9671	1506	11176.1	10.54	23302.5	1353.1	24655.6	10.88
	TOTAL(NON-SPECIAL)	76762	12897	89659	84.55	178039	14610	192648	84.55
	SPECIAL CATEGORY								
15	Goa	338.5	170.5	509	0.48	524.1	98.1	622.2	0.27
16	Arunachal Pradesh	524.6	310.2	834.8	0.79	1360	408.4	1768.4	0.78
17	Himachal Pradesh	1269	590.6	1860	1.75	3743.8	1017.9	4761.7	2.1
18	Mizoram	637.5	383.5	1021	0.96	1398.4	403.6	1802	0.8
19	Nagaland	781.9	462.4	1244.3	1.17	2197.4	595.6	2793	1.23
20	Manipur	710.1	375.4	1085.5	1.02	1689.6	447	2136.6	0.94
21	Sikkim	156.3	95.9	252.2	0.24	562.1	136.8	698.9	0.31
22	Meghalaya	558.2	263.7	821.9	0.77	1534.6	354.3	1888.9	0.83
23	Assam	2970	986.7	3956.3	3.73	7064.1	1264	8328.1	3.67
24	Jammu & Kashmir	2217	1141	3358.7	3.17	5904.7	1417.4	7322.1	3.23
25	Tripura	956.7	477.2	1433.9	1.35	2325.8	547.4	2873.2	1.27
	TOTAL(SPECIAL)	11120	5258	16377.6	15.45	28304.6	6690.5	34995.1	15.45
	ALL INDIA	87882	18154	106036	100	206343	20300	226643	100
	Average	3515.3	726.2	4241.5		8253.7	812.0	9065.7	
	Coefficient of var.	95.79	107.4	94.15		96.48	70.46	93.06	

SOURCE: RBI BULLETINS

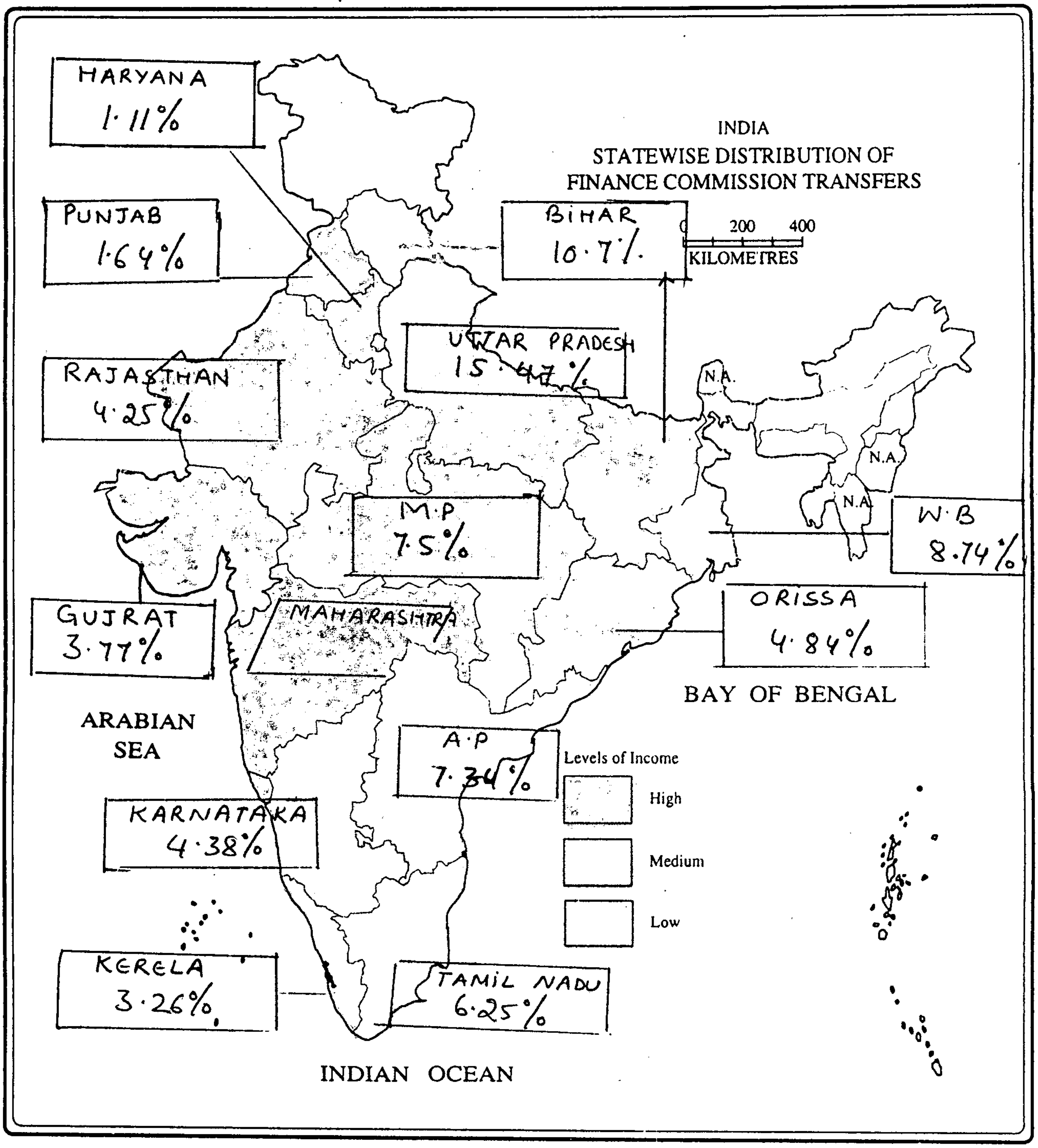
IVa SIXTH FINANCE COMMISSION



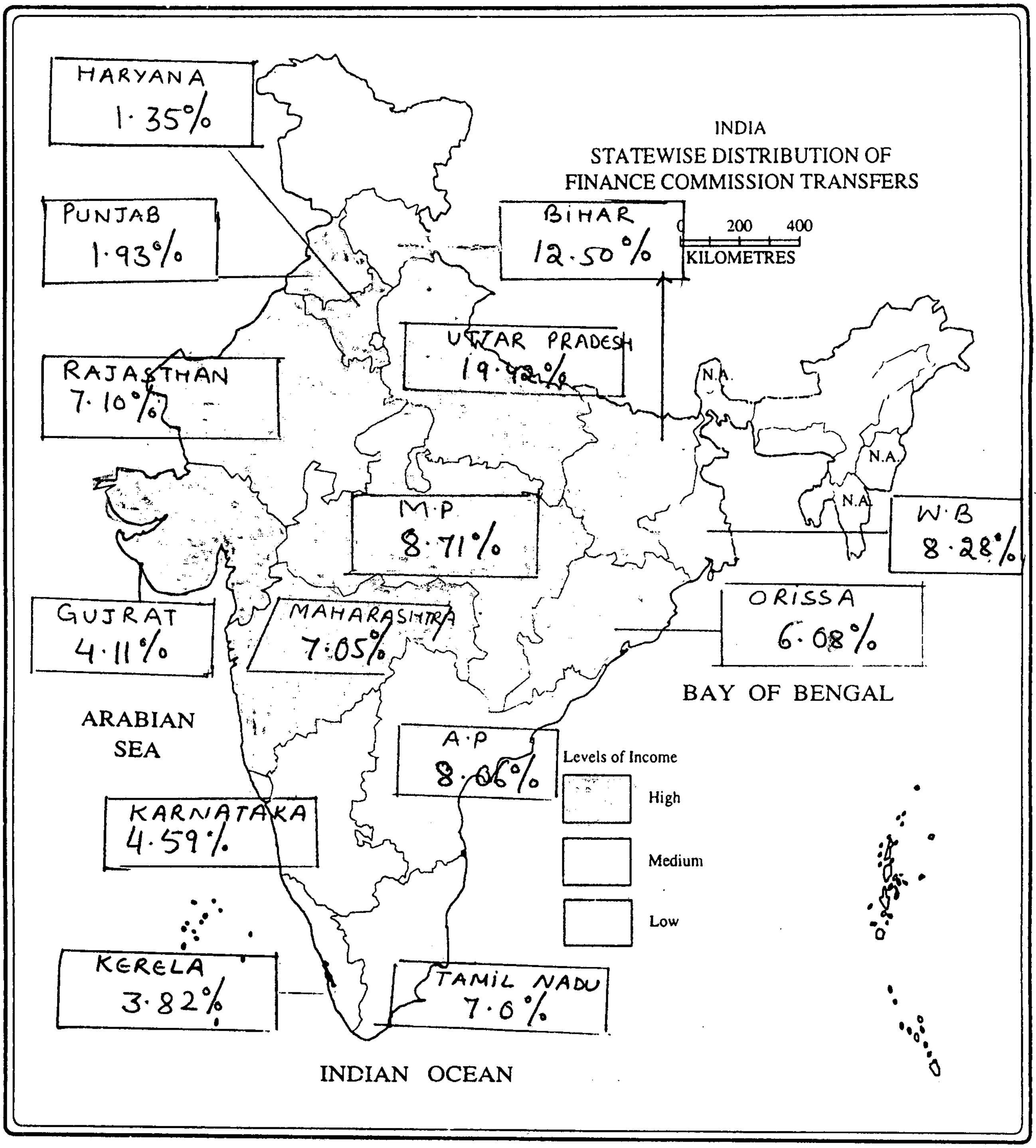
IV b Seventh Finance Commission



IV-c EIGHTH FINANCE COMMISSION



IVd NINTH (1989-1995) FINANCE COMMISSION.



The Tenth Finance Commission.

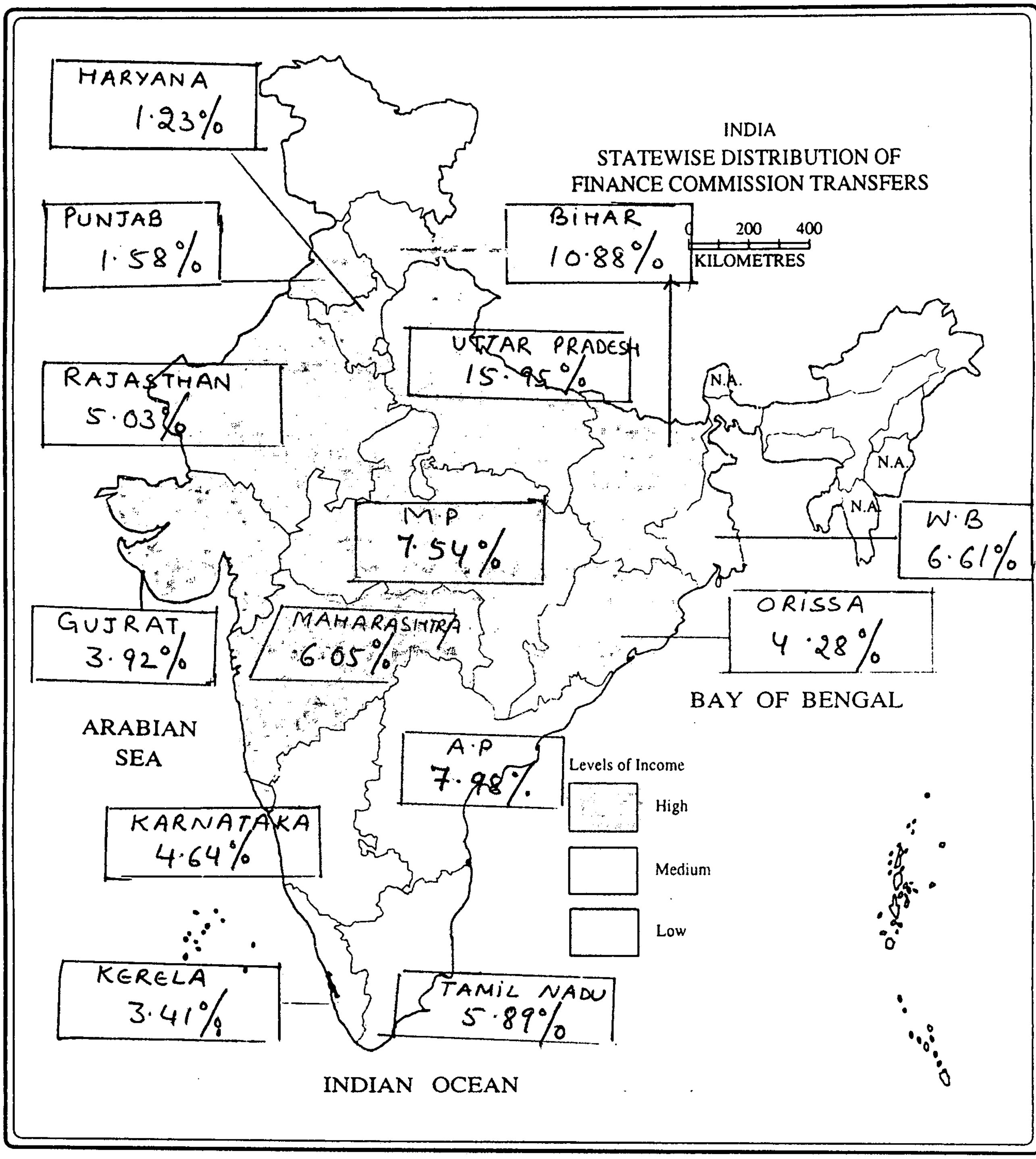


Table IV.11. gives the total per capita transfers recommended by each Commission.

Table IV.11

From this table it appears that States with the highest per capita surplus are the states with the highest per capita income. On the other hand, the poorest states are left with the least per capita surpluses after the process of transfers. Most of this criticism of our arrangements for federal fiscal transfers is based on this striking contrast. It shows the actual per capita transfers on the basis of recommendations of the Commissions.

Looking at the pattern of Finance Commission transfers per capita low and middle income states are better placed compared to the high income counterparts. The coefficient of variation in Tenth Finance Commission is less than the Ninth Finance Commission and this is largely due to changes made in the distribution formula for grants. Overall, if one goes by coefficient of variation the Tenth Finance Commission's dispensation is less progressive. The main gainers are middle and low-income states. Here there is a fair amount of correlation between the transfers and the needs of the states in that the highest transfers have gone to the poorest States.

Nevertheless, the situation at the end of the process is such that the richer States are left in a better position. This is mainly because the criteria used for inter-se distribution of tax shares among the states tended to favour better off states than the poorer states though successive Finance Commission aimed at giving more share to the poorer states.

TABLE IV.11

PER CAPITA TRANSFERS

(RUPEES)

	STATES NON SPECIAL CATEGORY	SIXTH COMMISSION	RANK	SEVENTH COMMISSION	RANK	EIGHTH COMMISSION	RANK	NINTH(1989-90) COMMISSION	RANK	NINTH(1990-95) COMMISSION	RANK	TENTH COMMISSION	RANK
	HIGH INCOME												
1	Punjab	125	10	310	12	364	11	110	13	902	12	1558	13
2	Maharashtra	141	7	340	11	417	10	137	11	962	11	1629	12
3	Haryana	120	11	307	13	331	12	106	14	875	13	1552	14
4	Gujarat	138	8	361	5	416	8	124	12	996	10	1940	11
	GROUP A(AVG.)	**131**		**329.5**		**382**		**119.25**		**933.75**		**1669.75**	
	MIDDLE INCOME												
5	Tamil Nadu	131	9	358	7	505	6	173	6	1241	6	2260	8
6	Karnataka	131	9	343	10	461	8	151	10	1067	9	2231	9
7	Andhra Pradesh	179	5	346	9	514	5	158	8	1228	7	2558	3
8	Kerala	225	2	359	6	495	7	159	7	1147	8	2480	5
9	West Bengal	186	4	355	8	560	3	156	9	1147	8	2072	10
	GROUP B(AVG.)	**170.4**		**352.2**		**507**		**159.4**		**1166**		**2320.2**	
	LOW INCOME												
10	Rajasthan	219	3	343	10	452	9	179	4	1489	2	2338	6
11	Madhya Pradesh	131	9	368	3	534	4	174	5	1252	5	2308	7
12	Orissa	263	1	434	1	635	1	215	1	1817	1	2892	1
13	Uttar Pradesh	153	6	363	4	534	4	185	3	1283	4	2481	4
14	Bihar	131	9	382	2	573	2	196	2	1383	3	2737	2
	GROUP C (AVG.)	**179.4**		**378**		**545.6**		**189.8**		**1444.8**		**2551.2**	
	AVERAGE(A+B+C)	**160.3**		**353.2**		**478.2**		**156.2**		**1181.5**		**2180.4**	
	ALL INDIA(TOTAL)	**2093.6**		**4591**		**6245.4**		**2033.2**		**15344.2**		**28484.8**	
	Coefficient of var.	**30.1**		**9.3**		**18.8**		**21.8**		**23.0**		**20.8**	

SOURCE: RBI BULLETINS

* STATES HAVE BEEN CATEGORISED ACCORDING TO PER CAPITA NSDP TAKEN BY TENTH FINANCE COMMISSION

Section IV.5

STATUTORY TRANSFERS AND THEIR CONVENTIONAL DETERMINANTS

Theoretically, speaking, the allocation of Finance commission transfers to states in India appear to have remained essentially determined by the factors like income of the state, its population size, its tax effort and lately poverty ratio in the states. The first three variables have always remained important considerations in the allocation of statutory transfers to the states for the following reasons:

1. Per capita SDP is considered the most important and appropriate composite criterion of both backwardness and fiscal capacity. Its expost relationship with transfers thus, would indicate whether the allocation of transfers across the states is regressive or progressive.[9]
2. Population, in general has been considered a broad measure of the needs of the states. It is being widely used by the Finance Commission and Planning Commissions. Seventh Finance Commission observes that population is well recognised element in the relations between the centre and states and between states inter se, and is difficult to be replaced. [10] Chelliah has also justified its use particularly to reduce regional disparities. [11] However, Hicks and C.H. Hanumantha Rao have got many reservations for using the financial devolutions to the states[12].
3. Tax efforts are one of the variables, which are employed in the financial devolutions to the states to encourage them to mobilize large revenues from within their economies.

9. This appears to be the most accepted terminology.
10. Government of India (1978): *Report of the Finance Commission*, p.82
11. Chelliah R.J. et al (1981): *Trends and Issues in Indian Federal Finance*, Allied Publishers
12. Hicks, U.K.(1974): Federal Finance in a development Economy. F.M.U Lectures. Also see, Hanumantha Rao (1988): Centre-state Financial Relations: A perspective for National Integration Zakhir Hussain Memorial Lecture, Feb 8.

Thus one may hypothesize the definitional relationship between per capita SDP, population size and the tax efforts (TXEF: state's own tax revenue as percentage of SDP) and per capita Finance commission transfers and their different components by expecting the following signs:

VARIABLE	EXPECTED SIGNS	EXPECTED DISTRIBUTION
1. SDP, PER CAPITA	-	PROGRESSIVE
2. POPULATION	+	NEED-BASED
3. TAX EFFORTS	+	EFFORT REWARDING

The above mentioned theoretical relations, in this section are tested by looking at the directional change with the help of Commission wise correlations and the extent of variations in statutory transfers as explained by these variables jointly particularly in the recent years.

Table IV.12.

Correlation between Transfers and their Determinants

Finance Commission Transfers, per capita	SDP per capita	Population (size)	Tax Efforts
Sixth	-0.29	-0.183	-0.443
Seventh	-0.79	0.256	-0.74
Eighth	-0.864	0.479	-0.57
Ninth	-0.78	0.22	-0.59
Tenth	-0.89	0.32	-0.42

It makes apparent the following:

1. The correlation between statutory transfers taken as whole and income levels of the states though shows a negative relationship with per capita income and turns out to be statistically significant after Sixth Finance Commission. Thus it exhibits progression in its distribution.
2. Population most used factor to reflect the need of the state or its backwardness also turn out to be inversely related to per capita statutory transfers in Sixth Commission whereas there is directional change from negative to positive in other later Commissions, although the relationship is not statistically significant. However the negative relationship with the Sixth Finance Commission transfers does not mean that states with larger population do not get larger transfers in absolute terms. Rather it is the other way round, both the budgetary flows and population size move together. The point that needs to be stressed here is that when the size of the population increases, the Finance Commission transfers do increase but the increase translated into per capita terms becomes smaller compared to increase in the population. Thus, population is need based index i.e. states with larger population do get larger Finance Commission transfers in absolute terms.
3. The tax effort variable is negatively associated throughout with per capita transfers. In the Seventh, Eighth and Ninth Finance Commission it turns out to be significant. The negative relationship obtained between the finance commission transfers to states and tax efforts is surprising because in the allocation of financial transfers to states, the tax effort is given weightage so that states are encouraged to mobilize larger revenues from their economies. However, one reason could be that per capita income

is more predominant factor as compare to state's own tax revenue making it negative or else the per capita factor in transfers giving it a neutral effect making the relationship between tax effort and per capita transfers more dilute.

From the above discussion, one may conclude that the different factors used independently to make devolutions to states do not show any significant in the directional change except in the case of per capita income.

Another related aspect to the directional change of the variables (i.e. income, population and tax efforts) considered in the allocation of central transfers is their 'accountability' i.e. the extent of explained variations in explaining the inter-state variations in the Finance Commission transfers.

For this purpose, the following regression equations are computed:

Per capita transfers= f (per capita SDP, Population and tax efforts) N=14

Sixth FC/POP = 350.87 –17.33TXEFF- 11.33POP – 0.12PCNSDP Adj. R^2= 0.199
(1.324) (1.726) (1.151)

Seventh FC/POP =454.03–10.78TXEFF – 0.04PCNSDP Adj.R^2= 0.546
(1.559) (1.449)

Eighth FC/POP = 767.55– 0.147*PCNSDP –17.705TXEFF Adj.R^2= 0.754
(4.928) (1.554)

NinthFC/POP = 2308.07 – 0.260*PCNSDP –47.253**TXEFF- 26.273POP Adj.R^2= 0.667
(3.957) (1.968) (1.686)

Tenth FC/POP = 3610.8– 0.324*PCNSDP - 18.724POP Adj.R^2= 0.799
(6.768) (1.029)

TXEFF(state's own tax revenue as percentage of SDP) = Tax efforts; POP= Population; PCNSDP= per capita income

'*' significant at 5 percent level; '' significant at 10 percent level**

Two important points emerge from the above equations:

One, the variables used in the devolution criteria do not account for much of the inter-state variations in statutory transfers. Among the three factors considered here, population does not enter the equation when seventh and eighth Finance Commissions are taken and population and tax effort do not yield the desirable signs. The explanatory power is not very high in Sixth Finance Commission but it increased in the subsequent Commissions with highest being in Tenth Finance Commission.

Second, the variables differ quite a lot in their roles in explaining the inter-state variations in transfers. However, except per capita income none of the other variables are statistically significant.

It is clear from the above observations that although theoretically Finance Commission are supposed to follow the devolution principles, nevertheless in practice they do not yield the envisaged relationships. To quote Guha,"...the Finance Commission has not been required to keep the Gadgil formula in mind and is free to recommend its scheme of devolution as if the formula did not exist. In fact the centre has in one stroke and unilaterally, wiped out a set of decisions arrived at the federal conclave of the NDC over the period of two decades."[13]

13. Guha. S. (1988): Issues Before the Ninth Finance Commission: On Closing The Pandora's Box', *Eco. & Pol.Weekly*, Feb 6 (XXIII, 6), p.254

SUMMARY

This chapter examines (i) the vertical sharing of income tax and union excise duties between the centre and the states; (ii) the horizontal sharing of such tax sharing inter se among the states; (iii) the gap filling approach; (iv) the distribution pattern of Finance Commission transfers and (v) the role of population, tax efforts and per capita income in explaining the inter-state variations. This is done to find out how progressive and regressive the statutory transfers would be?

It can be seen from the study, the share of the states in the tax proceeds of the Centre increased from Sixth to Seventh Commission due to the doubling of the percentage of proceeds of excise duties to be distributed to the states. Thereafter it remained between 25 to 26 percent of the Gross Central taxes.

The states with the highest per capita surplus are the states with the highest per capita income. On the other hand, the poorest states are left with the least per capita surpluses after the process of transfers. Most of the criticism for federal fiscal transfers is based on this striking contrast.

However one can see the pre devolution surpluses have been going down. More equity has been imparted to the formulae for distribution of resources among the states. Taking the view of Finance Commission Transfers per capita, the inter se position has not changed. Although the proportion of transfers have been increasing making the richer states better off and poorer states worse off. This is mainly because the tax shares have been regressive in their redistributive impact whereas grants-in-aid have been progressive.

Over the period, one finds that all the rich states have improved their ranks, whereas the same is not observed in the case of poorer states. However the distribution pattern of statutory transfers does not turn out to be progressive. The devolution principles do not respond to the needs of the states and the progressive element is shrinking. The only element which shows progressiveness is per capita income. Rest of the variables like population and tax effort do not yield the definitionally expected signs. One finds that states are not rewarded for their efforts of raising the resources, the allocations do not appear to be need based nor flow to the poorer states. Although, population changes its sign after Sixth Finance Commission.

The statutory transfers have got a better potential for carrying out the progressivity objective as the Finance Commission has been changing its methodology with a review to responding to the needs of the time. Thus, the Finance Commission has been able to maintain progressivity through various methods like increasing the tax shares to the states by enlarging the divisible pool, making allocations for bringing the non-capital gaps, giving grants for upgradation of levels administration, introducing objectivity in assistance for natural calamities, increasing revenue gap grants by 5 percent and linking of 5 percent of the divisible pool of union excise duties to the assessed revenue deficits of the states and so on. This must not be taken to mean that the existing institutional structure of the central transfers to continue to be progressive forever as this would depend on the degree of responsiveness of the various Finance Commissions.[14]

14. For instance, the Eighth Finance Commission States "... In the discharge of its functions, the Finance Commission has to perform a balancing exercise almost at every time." *Report of the Eighth Finance Commission*, Also see *Report of The Finance Commission*, 1969,p.13

The approach of the Indian Finance Commissions has so far been to concentrate only on the common factors such as population, poverty, backwardness etc. and some how relate the fiscal devolutions to these factors. The state specific factors are altogether ignored. Also the weights assigned to the common factors are prone to subjective determination. Further the devolution criteria differ for different portions of the devolution funds. Finally the gap filling grants in aid determination fails to make any distinction between the capacity factors on the one hand, and the state specific behavioural and the temporary random factors on the other.

The experience of the last four decades shows that the system of federal transfers in India while providing a mechanism for addressing the vertical and horizontal imbalances significantly has run almost into a dead end primarily because of two factors:

(i) the approach of the Finance Commissions in tackling the tasks set for them and

(ii) the dichotomy between the plan and the non-plan segment s of the government budgets.

For all the sophistication in the devolution formulae the transfers have resulted in providing the relatively better placed states with surpluses for development expenditures on a much larger scale than those who need the funds more. It is therefore not surprising that regional inequalities not only in per capita incomes but also in public services persist. On the other hand revenue accounts of both the centre and the states are suffering from acute chronic imbalances. Correction of the situation calls for a restructuring of the powers and functions of the centre and the states towards lessening of centre's involvement in activities, which belong more to the states. Federal transfers should focus mainly on redressing the fiscal disability of the poorer states.

CHAPTER V

IMPACT OF FINANCE COMMISSION TRANSFERS: EMPIRICAL ANALYSIS

The previous chapter described the distribution pattern of finance commission transfers across the states. The chapter did not discuss the prevailing regional disparities with respect to income, economic and social indicators nor did it analyse the role of Finance commission transfers in correcting the vertical imbalances and to reduce the regional inequalities in the financial resources, per capita income and economic and social development. This chapter is devoted to a discussion of the above issues. This chapter is organized in three sections. Section V.1 examines the Finance Commission transfers tended to narrow down inter-state inequalities in per capita income. Section V.2 gives a bird's eye view of the level of existing socio-economic development. Section V.3 finds out to what these regional inequalities have been mitigated or exaggerated by Finance Commission transfers.

Section V.1

FINANCE COMMISSION TRANSFERS AND INCOME EQUALIZATION

Federal transfers, in order to fulfil the objective of equity, should be equalizing in terms of narrowing down the gap in fiscal resources, regional inequalities and per capita income.

We shall turn to another important parameter influencing the pace of regional development. In Hirschman's analytical framework (1958), growing regional inequalities tend to generate counter –pressures on the State to give greater attention to development of the lagging regions. One of the very important channels through which State policy can influence the level of regional development is through public expenditure. In a federal set up like that of India, the two basic components of public expenditure are

(i) expenditure incurred by the Central Government and

(ii) expenditure incurred by the constituent State Governments[1]

There is an inbuilt imbalance between the expenditure responsibilities and the revenue sources of the state governments. The institutions through which a part of these resources get transferred to or invested in the states are the Finance Commission awards, the plan assistance by the Planning Commission, the investment by the non-governmental public sector under takings, the central and centrally sponsored schemes and the public sector financial institutions (excluding commercial banks). The founding fathers of the Indian Constitution were aware of this fact and ensured a comprehensive scheme of devolution of central tax revenues through the mechanism of Finance Commissions

There is a feeling that transfer of resources from the Centre to the States has not been equitable, particularly in case of channels belonging to the second category. In case of the former category, the criteria used by the Finance Commissions have increasingly incorporated indicators of backwardness in their awards. This is particularly true of the Eighth Finance Commissions and subsequent ones. But in the second category of financial resources transfers, despite the Gadgil formula, there is a lot of discretionary element available to the Centre, which can be used in a non-equitable manner. (Ramalingam & Kurpa, 1991)[2]

One way in which the validity of the above assertion can be tested is to examine the pattern of relationship between per capita devolution of resources and per capita SDP.

1. Ashok Mathur: Regional Development and Policy in India: A Long Term Perspective, in G.K.Chaddha, *Policy Perspective in Indian Economy*, Har Anand Publications, New Delhi 1994, p.111
2. ibid. p.113

There are at least four studies, which have estimated such relationships between per capita SDP and per capita devolution. The earliest on is by K.R.G. Nair (1982), which assessed this relationship upto Seventh Finance Commission. The coefficient found was not significant. Pradhan Prasad (1988) estimated similar relationship for the period 1970-75, but he related per capita SDP and the percentage of Finance Commission transfers to SDP. Gulati & George study (1987) shows the correlation for the period 1979-84 emerged to be (-0.55). The rank correlation was taken out by Amaresh Bagchi et al. (1988) for four periods namely 1970-71, 1975-56, 1980-81and 1985-86 are all negative being –0.27, -0.45, -0.40, and 0.57.[3] Raja J. Chelliah et al. (1992) shows correlation for the periods 1975-76, 1980-81, 1985-86 and 1988-89 taking 14 major states were negative being –0.2705, -0.8399, -0.6855 and –0.3212[4]. A negative correlation would indicate the existence of a progressive tendency of financial devolution for it implies that states which are relatively more than the better off states, and vice versa.

One way of judging the progressivity of the total transfers would be to see the correlation between per capita transfers and per capita incomes. Per capita NSDP is taken, as indicator of revenue raising capacity of the states; equalization of revenue capacity requires transfers to be inversely related to SDP.

The issues involved, however, are complex. Table V.1 shows the actual per capita transfers on the basis of recommendations of the Commissions and Table V. 2 shows the ranking of per capita income[5].

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3. ibid. p.113-115
4. Raja. J. Chelliah et al. (1992), Issues before Tenth Finance Commission, EPW, Nov'21, 1992, p.2547
5. NSDP comparable series is prepared by the CSO. These estimates are attempted at specific requests from Finance Commission and Planning Commission. These estimates are prepared at current prices and they are not updated or revised when more up-to-date information becomes available later for the relevant years.

TABLE V.1

PER CAPITA TRANSFERS

(RUPEES)

STATES NON SPECIAL CATEGORY		SIXTH COMMISSION	RANK	SEVENTH COMMISSION	RANK	EIGHTH COMMISSION	RANK	NINTH(1989-90) COMMISSION	RANK	NINTH(1990-95) COMMISSION	RANK	TENTH COMMISSION	RANK
	HIGH INCOME												
1	Punjab	125	10	310	12	364	11	110	13	902	12	1558	13
2	Maharashtra	141	7	340	11	417	10	137	11	962	11	1629	12
3	Haryana	120	11	307	13	331	12	106	14	875	13	1552	14
4	Gujarat	138	8	361	5	416	8	124	12	996	10	1940	11
	GROUP A(AVG.)	**131**		**329.5**		**382**		**119.25**		**933.75**		**1669.75**	
	MIDDLE INCOME												
5	Tamil Nadu	131	9	358	7	505	6	173	6	1241	6	2260	8
6	Karnataka	131	9	343	10	461	8	151	10	1067	9	2231	9
7	Andhra Pradesh	179	5	346	9	514	5	158	8	1228	7	2558	3
8	Kerala	225	2	359	6	495	7	159	7	1147	8	2480	5
9	West Bengal	186	4	355	8	560	3	156	9	1147	8	2072	10
	GROUP B(AVG.)	**170.4**		**352.2**		**507**		**159.4**		**1166**		**2320.2**	
	LOW INCOME												
10	Rajasthan	219	3	343	10	452	9	179	4	1489	2	2338	6
11	Madhya Pradesh	131	9	368	3	534	4	174	5	1252	5	2308	7
12	Orissa	263	1	434	1	635	1	215	1	1817	1	2892	1
13	Uttar Pradesh	153	6	363	4	534	4	185	3	1283	4	2481	4
14	Bihar	131	9	382	2	573	2	196	2	1383	3	2737	2
	GROUP C (AVG.)	**179.4**		**378**		**545.6**		**189.8**		**1444.8**		**2551.2**	
	AVERAGE(A+B+C)	**160.3**		**353.2**		**478.2**		**156.2**		**1181.5**		**2180.4**	
	ALL INDIA(TOTAL)	**2093.6**		**4591**		**6245.4**		**2033.2**		**15344.2**		**28484.8**	
	Coefficient of var.	**30.1**		**9.3**		**18.8**		**21.8**		**23.0**		**20.8**	

SOURCE: RBI BULLETINS

* STATES HAVE BEEN CATEGORISED ACCORDING TO PER CAPITA NSDP TAKEN BY TENTH FINANCE COMMISSION

TABLE V.2

PER CAPITA STATE DOMESTIC PRODUCT

(RUPEES)

	STATES	SIXTH	RANK	SEVENTH	RANK	EIGHTH	RANK	NINTH	RANK	TENTH	RANK
	NON SPECIAL CATEGORY										
	HIGH INCOME	**1967-70**		**1973-76**		**1976-79**		**1982-85**		**1987-90**	
1	Punjab	953	14	1486	14	2250	14	4013	14	6996	14
2	Maharashtra	677	12	1349	12	1670	12	3384	13	5369	13
3	Haryana	836	13	1399	13	1895	13	3043	12	5284	12
4	Gujarat	671	11	1134	11	1590	11	2919	11	4602	11
	MIDDLE INCOME										
5	Tamil Nadu	591	9	942	7	1165	8	2142	7	4093	10
6	Karnataka	541	6	1045	10	1202	9	2461	10	3810	9
7	Andhra Pradesh	528	5	928	6	1006	5	2053	6	3455	6
8	Kerala	583	8	948	8	1162	7	2144	8	3532	7
9	West Bengal	630	10	1033	9	1247	10	2230	9	3750	8
	LOW INCOME										
10	Rajasthan	472	3	853	5	1127	6	1820	4	3092	4
11	Madhya Pradesh	457	2	776	3	895	3	1860	5	3299	5
12	Orissa	550	7	793	4	918	4	1728	3	2945	3
13	Uttar Pradesh	482	4	715	2	870	2	1713	2	2867	2
14	Bihar	389	1	645	1	755	1	1323	1	2135	1
	TOTAL(AVERAGE)	**597**		**1003**		**1268**		**2345**		**3945**	

SOURCE:REPORTS OF FINANCE COMMISSION

Here there is a fair amount of correlation between the transfers and the needs of the states in that the highest transfers have gone to the poorest States. Nevertheless, the situation at the end of the process is such that the richer States are left in a better position.

One way of judging the progressivity-equity of the total transfers would be to see the correlation between the ranks according to per capita transfers with the rank according to the per capita incomes in V.3. The ranking of the non-special category States according to per capita transfers (descending order) and per capita incomes (ascending order) is shown in the Table V.1 and V.2.

Table V.3

Rank Correlation of Per Capita Transfers With Per Capita Incomes:	
Sixth Commission	**(-) 0.257**
Seventh Commission	**(-) 0.787**
Eighth Commission	**(-) 0.800**
Ninth Commission (1989-1990)	**(-) 0.950**
Ninth Commission (1990-1995)	**(-) 0.944**
Tenth Commission	**(-) 0.903**

The transfers from the Sixth Commission onwards have a negative relationship with per capita income but significantly high from the Seventh onwards. The progressivity is much more pronounced in the recommendations of the Ninth and Tenth Commissions.

In this section, equity implications of Finance Commission transfers to states in India are analysed in terms of elasticities of total statutory transfers with respect to per capita SDP across states. Such an analysis is not entirely satisfactory for, the objective of the transfers system is to offset both revenue and cost disabilities of states. Analysis in terms of elasticities ignores cost disabilities across states. Besides, per capita SDP at best, is only an imperfect indicator of revenue capacity. Nevertheless, income elasticity gives a broad indication of the equity in the distribution of transfers.

We have sought to measure the redistributive effects of Finance Commission transfers among the states by relating the per capita federal transfers and their components to the per capita incomes of the state in a double –log regression. The regression coefficient (b), which gives the constant income elasticity, is taken as a measure of progressivity if $b<1$; and conversely, of regressivity if $b>1$.

Further, a value of coefficient less than zero ($b<0$) would imply higher per capita finance commission transfers on an average to the poorer states. Hence in order to answer the above question, it will be sufficient to test the hypothesis that elasticity is less than zero. For this analysis, the State incomes estimated by CSO for each finance Commission have been used. The logarithmic values of per capita Net State Domestic Product (per capita income) of the 14 non –special category States as the independent variable and per capita Finance Commission transfers (tax devolutions plus grants for covering non-plan revenue deficits) as the dependent variable to see the progressivity of per capita transfers.

The results are:

Commission	Regression Results	Regression Coefficients
Sixth Commission	**log T =**	**2.983 - 0.285 y**
Seventh Commission	**log T =**	**3.268 - 0.241 y**
Eighth Commission	**log. T =**	**4.232 - 0.504 y**
Ninth Commission	**log.T =**	**4.290 - 0.626 y**
Ninth Commission	**log.T =**	**4.955 - 0.562 y**
Tenth Commission	**log. T =**	**5.502 - 0.605 y**

Note:T = a +b y; where
T: Per capita Finance Commission Transfers,
Y: Per Capita NSDP,
A and b are constants.
Log T = log a + b log y
The value of b is income elasticity

The distribution of transfers under the Finance Commissions – Sixth to Tenth shows a negative relationship with per capita incomes. It indicates a progressive bias in these transfers, as the coefficients are not significantly different from zero, the contention that higher per capita transfers have been given to the poorer states. This indicates that for a one percent increase in per capita incomes, the estimated decline in per capita transfers ranged from 0.24 under the Seventh Commission to 0.56 under the Ninth Commission and 0.60 under the Tenth Commission.

From the Sixth Commission onwards the Commissions have been using the per capita income, in one form or the other, as one of the factors to be taken into account in the distribution of the divisible pool. In some cases, the population figure has been adjusted for per capita income and a factor known as the Income Adjusted Total Population has been used. If one content with this one factor, then it alone can be used for inter-state distribution –a 'robust criterion' as Guhan described it. Then we will get a hundred percent correlation.

The finding that the Finance Commission transfers per capita have not been regressive does not, however, necessarily mean that they are free from the elements of inequity in respect of certain poorer states. The indices of Finance Commission transfers for each states from Sixth Commission onwards computed in relation to the all-States average transfers.

It is clearly evident from the Table V.4; the three poor states of Uttar Pradesh, Bihar and Madhya Pradesh received per capita transfers, which were significantly lower than the state, all 14 states average during Sixth Commission. The high-income states like Gujarat, Mahahrashtra received higher transfers as compare to the lowest income state Bihar. However the trend changed from Seventh Commission onwards showing progressiveness. In Seventh Finance Commission only Rajasthan received transfer less than the state average followed by middle-income states like Karnataka and Andhra Pradesh. In the Ninth Finance Commission all low-income states were covered but middle-income states like Karnataka, Kerala and West Bengal were still lagging. The Tenth Finance Commission covered almost all the states giving more transfers to low and middle-income states as compare to high-income states. All the Finance Commissions from Seventh Commission onwards, Punjab the highest income state received the lowest and Bihar being the lowest income states received the highest transfers.

However, every Commission have felt that per capita income, by itself, would not be an adequate measure for inter-state distribution among the states. The funds that were being distributed, whether they be a share in the tax proceeds or article 275 grants, were intended to

TABLE V.4.

INDICES OF PER CAPITA TRANSFERS

HIGH INCOME	SIXTH	SEVENTH	EIGHTH	NINTH	TENTH
Punjab	29	31	27	26	26
Maharashtra	121	128	109	97	100
Haryana	20	23	18	19	20
Gujarat	63	72	61	58	65
MIDDLE INCOME					
Tamil Nadu	91	112	102	97	97
Karnataka	65	75	71	63	76
Andhra Pradesh	132	113	120	113	131
Kerala	81	57	53	54	56
West Bengal	140	119	142	116	109
LOW INCOME					
Rajasthan	96	67	69	102	83
Madhya Pradesh	92	119	122	122	124
Orissa	98	73	79	86	71
Uttar Pradesh	229	247	252	272	263
Bihar	143	165	174	175	179
	100	100	100	100	100

be used for achieving certain economic and social goals, which, in the view of the Commission, would help reduce the inter-state differences in the levels of development. In such a case, a direct indicator of the particular sector in which certain States were considered to be backward would be a better criterion than overall per capita income. For instance, Kerala is below the non-special category States' average per capita income. But in respect of every major social indicator it leads the country. In such a case other factors have to be taken into account in the distribution of funds from a common pool. If, for instance, it was felt that the economic infrastructure had to be strengthened in some States or levels of human development in some other, then indicators like roads for 100sq. kms. or percentage of literacy or percentage of Scheduled Castes or Scheduled tribes etc. would be better criteria than per capita income. Once some other factor is introduced in the formula for distribution, naturally the end result would be different from distribution on the basis of per capita income alone. The other criteria may not work in the same direction as per capita income. Therefore, it would not be logically correct to expect 100 percent correlation of distribution with per capita income, having deliberately introduced other criteria. This has to be borne in mind in judging the overall result of the distribution recommended by the Commission.

Progressivity – Equity Link

Another related question, in the context of bringing progressivity is the role of bringing equity in the living standards of the people living different states in India. Since, statutory transfers cover social infrastructure and other administrative services, these at best may bring equity in the non-plan expenditures, assuming these are made further progressive in the future. These transfers are also liked by the states, as these are free from strings as well as uncertainty. These enter the revenue budgets of the states and they can adjust their current expenditures accordingly. But the enhanced transfers by the Finance Commission transfers may marginally contribute towards overall regional equity for: (i) these funds are normally used to maintain capital assets (ii) the states may not feel encouraged to raise more funds from within as they treat these as their constitutional rights (iii) the Finance Commission has been escaping from the responsibility of bringing regional development. The Seventh Finance Commission, for instance, states, " If anyone is to be blamed.. for the widening economic disparities between the states, it is Planning Commission".[6]

Even the Ninth Finance Commission reiterates, "this is a task which the Planning Commission and the states jointly endeavour to undertake." [7]

The Finance Commission may partly be justified in shifting away its responsibility of bringing regional development to the Planning Commission. This is because the Planning Commission for making its own plan transfers takes any non-plan surpluses that are left with the states into account.

Thus, the progressivity in the distribution of plan transfers has to assume importance in future to make a dent on regional inequalities in the context of achieving the overall progressivity. This is a Herculean task especially in the existing institutional structure in which different devolution principles appear to come into conflict with each other in the process of achieving the different objectives simultaneously. In the absence of a unified

6. *First Report of the Finance Commission* (1989-90), p.47

7. Streetan, Paul and M.Lipton (1969, ed.): *Crisis of Indian Planning*. ELBS, London, p.52

approach and some accountability rules, it may become further difficult with an increase in the number of political parties governing the states, as the general consensus on the devolution principles may not be easily arrived at platform like the National Development Council.

Section V.2

LEVELS OF SOCIO-ECONOMIC DEVELOPMENT

The regional disparity is not easily definable as in the context of economic development as it has many interpretations. It may refer to regional differences in the absolute level of economic activity at a particular time suggesting there is a greater concentration of economic development in some regions than in others, or in the rate of economic growth or in both. Regional differences in per capita income, which are often the focus of discussions about regional disparity, are the result of all the above stated regional differences.

However, it may be mentioned that per capita income is not a complete measure of development even if it turns out to be closely associated to the varying aspects of life. Per capita income refers to the result of the change rather than the process of change. It hides how the income is distributed in the economy, how it is actually utilised, what is its required minimum level etc. It fails to reflect the upgradaation of the quality of life that has taken place due to economic development. Thus, per capita income needs to be supplemented by other indicators.

Therefore, in India, particularly from the Second Plan (1956-61) onwards, the public policies especially of the central government have tended to become more oriented towards general welfare objectives. For instance, distributional issues were explicitly recognised in the second plan. Poverty reduction as an objective came distinctly in the late 1960s and so on. Over the period, government's concern has grown explicitly for the problems like mass poverty, inequitable income distribution, environmental and ecological imbalances, social crimes, unemployment, illiteracy, population growth etc.

The fulfilment of the objective of equity may also be construed to mean the mitigation of disparities in the levels of development. In fact some Finance Commissions have given to themselves the specific objective of mitigating disparities in respect of certain services.

The Commissions have used certain indices of backwardness devised by them as a more precise criterion for distribution of devolved taxes, than even population or income adjusted total population. The First Finance Commission sought to mitigate the disparities in respect of primary education. The Third Commission mentioned the percentage of Scheduled Castes and Tribes and Backwardness Classes in the population, as a factor that should be taken into account in determining the share to be allocated to the states. One of the majority recommendations of the third Finance commission sought to equalize expenditures on communication services, though the Government of India did not accept this.

The Fourth Commission took the following factors into account but did not indicate how the share was worked out (i) per capita gross value of agricultural, production; (ii) per capita value added by manufacture; (iii) percentage of workers to the total population; (iv) percentage of enrolment in classes I to V, to the population in the age group 6-11; (vi) population per hospital per bed; (vii) percentage of rural population to total population; and percentage of the population of Scheduled Castes and Tribes to total population.

The Fifth Commission took the following six factors: (i) scheduled population; (ii) number of factory workers per lakh of population; (iii) net irrigated area per cultivator; (iv) length of railways and surfaced roads per 100 sq.km; (v) shortfall in number of school going children as compared to those of school going age and; (vi) number of hospital beds per 1000 population. The Sixth Finance Commission recommended as considerable amount of transfers for raising the levels of certain administrative services and social services in the states where these services were below the all-state average.

The Ninth Commission worked out a composite index of backwardness combining two indices viz., population of Scheduled Castes and Scheduled Tribes and the number of agricultural labourers in different States.

The Tenth Commission evolved an index of infrastructure consisting of five sub-sectors for economic infrastructure viz., agriculture, banking, electricity, transport and communications; and two for social infrastructure consisting of education and health.

In these circumstances there is a need to develop a generally acceptable welfare function. The search for such a function is an endless but meaningful attempt to obtain new information that will be useful to evaluate the past, guide the action of the present and provide basis for socio economic planning for the future.[8] An attempt is made to construct a welfare function in this section. A variety of socio-economic indicators may be used to define a welfare function.

However number of studies has been conducted on disparities across Indian States. Among them, the studies published by Hemlata Rao, R.T.Tiwari and R.H.Dholakia may be

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8. Liu, Ben Chick, Thomas Mulvey and Chang Tzchttsich (1986): "Effects of Educational Expenditure on Regional inequality in the Social Quality of Life", American Journal of Economics and Sociology April (XLV.2): 130-143

mentioned. R.H.Dholakia in G.P. Mishra (1985) has analysed inter-state variations in growth in terms of per capita income on the assumption that per capita income is a function of three factors: worker rate, industrial structure and capital intensity and productivity. The study by R.T.Tiwari is addressed to the analysis of inter-state disparities in the levels of development measured in terms of a composite index of development conducted on the basis of 19 indicators of development. Hemlata Rao has constructed composite index of development based on 51 variables belonging to 18 sectors and used 'factor analysis' for studying general and social developments. Sarker (1994) studies the link between regional imbalances and plan outlays. He discovers a strong link between development (measured in terms of 14 variables including per capita consumption of electricity, percentage of villages electrified, per capita expenditure on health, effective literacy rates, etc.) and per capita plan outlays for the different states. He employs principal component analysis to construct a composite index of development according to which Punjab scores the highest and Bihar the lowest. But in all the studies, they have attempted to develop the composite index and ranked the states accordingly.

Horizontal imbalances in India, viewed at in any way, are serious even after eight 'five year plans', which had balanced regional development as one of their major objectives.

The equity objective is often sought to be met by using one or more of other variables representing relative backwardness, e.g. the share of disadvantaged population in the total, a composite index of infrastructure and a composite index of human and infrastructure development. This is given in table V.5.

Table V.5

INTER-STATE DISPARITIES: OVERVIEW OF SELECTED INDICATORS

STATES	REL. INFRASTRUCTURE INDEX (1993-94)	HUMAN DEVELOPMENT INDEX	PERCENTAGE SC/ST IN 1991 TOTAL POPULATION	REVENUE RECEIPTS/REVENUE EXPENDITURE 1995-96(%)	INFRASTRUCTURE INDEX (FINANCE COMMISSION)*
HIGH INCOME STATES					
PUNJAB	191.4	713.1	28.32	92.01	187.57
MAHARASHTRA	107.0	643	20.36	96.45	112.80
HARYANA	141.3	599.5	19.75	73.53	137.54
GUJARAT	122.4	545.3	22.33	97.47	124.31
MIDDLE INCOME STATES					
TAMIL NADU	144.0	487.3	20.21	97.15	149.10
KARNATAKA	96.9	477.2	31.90	100.73	104.88
NDHRA PRADESH	96.1	339.7	22.24	93.04	103.30
KERALA	157.1	744.9	11.02	93.09	178.68
WEST BENGAL	94.2	417.6	29.22	85.51	111.25
LOW INCOME STATES					
RAJASTHAN	83	229.4	29.73	91.58	75.86
ADHYA PRADESH	75.3	186.3	37.82	94.77	76.79
ORISSA	97	213.2	38.41	82.22	81
UTTAR PRADESH	103.3	109.5	21.25	86.67	101.23
BIHAR	81.1	133.4	22.22	87.24	81.33

Source:
1) CMIE, Profiles of States, March 1997, Mumbai
2) EPW Research Foundation (1994) " Social Indicators of Development for India-II", EPW, May 21
3) Census of India
4) Reserve Bank of India Supplement on State Finances 1997-98
5) Report of Eleventh Finance Commission, Annexure VI.5, TCA. Anant, K.L. Krishna and Uma Datta Roy Choudhary (1999), Measuring Inter state Differentials.

While the choice of the variables reflect the desire for levelling social economic inequalities, these also reflect subjective judgements regarding the areas requiring urgent attention. If so, revenue sharing may not be the right tool to meet this objective, as the effects of revenue sharing are similar to unconditional grants. Given state preferences, varying parts of the transferred resources are likely to 'leak out' and get spent on other services than desired. A much better way of ensuring higher expenditures by states in the desired areas-be it infrastructure or social welfare- would be to provide conditional grants.

An attempt has been made in this section to study the regional imbalances prevailing in the 14 major states of India on the basis of more comprehensive set of indicators (13 indicators) such as per capita NSDP, percentage of persons above poverty line, literacy rate, sex ration, bank branches per capita, credit-deposit ratio, power consumption, telecom lines, hospital per bed per capita, railway lines per 1000 sq.km, percentage of gross irrigated area to gross cropped area, number of villages electrified and employment in organised sector. This is done in a more rigorous manner through the use of advanced statistical techniques for presenting multi-variate data using Principal Component analysis to develop composite index of socio-economic development index.

The composite index representing different variables included herein are shown on the following table

Table V.6

The table shows the following

1. It shows that Punjab continued to occupy the first position in the development list and Bihar occupied the last position for all the benchmark years. The

TABLE V.6

FSCORES AND RANKS OF STATES IN SOCIO-ECONOMIC DEVELOPMENT

STATES	1981 LEVELS OF SOCIO-ECONOMIC DEVELOPMENT	RANKS	1991 LEVELS OF SOCIO-ECONOMIC DEVELOPMENT	RANKS	1996 LEVELS OF SOCIO-ECONOMIC DEVELOPMENT	RANKS
Punjab	1.6168	1	1.88561	1	2.03923	1
Maharashtra	1.12881	3	0.94117	4	0.73385	5
Haryana	0.92752	4	1.06872	3	0.94654	3
Gujarat	0.5692	6	0.80747	5	0.91002	4
Tamil Nadu	0.68715	5	0.37345	7	0.35188	6
Karnataka	-0.19594	7	0.39335	6	0.22683	7
Andhra Pradesh	-0.41315	8	0.31214	8	0.17992	8
Kerala	1.287182	2	1.1566	2	1.07507	2
West Bengal	-0.7834	9	-0.85539	12	-0.91603	10
Rajasthan	-0.88302	10	-0.48593	9	-0.9937	12
Madhya Pradesh	-1.00631	13	-0.51887	10	-0.45529	9
Orissa	-0.72158	11	-1.30238	13	-1.11077	13
Uttar Pradesh	-0.78005	12	-0.72238	11	-0.96252	11
Bihar	-1.43322	14	-1.55137	14	-1.77488	14
Range	**3.05**		**3.44**		**3.81**	
Disparity Ratio	**-1.13**		**-1.22**		**-1.15**	

states offering the best socio-economic development are Punjab, Kerala, Haryana, Maharashtra, Gujarat and Tamil Nadu. The states at the other end are Rajasthan, Madhya Pradesh, Uttar Pradesh, West Bengal, Orissa and Bihar.

2. States differ widely in their ranks. Punjab remains the highest in the ranking, followed by Kerala and Haryana. For instance, it is noteworthy that Kerala, which has made great strides in social development, has the lowest per capita income among the better off states. Indeed, the case of Kerala along with that of Sri Lanka has been noted internationally for achieving high levels of human development at relatively low level of economic development. Haryana has rose to third position in 1991 from fourth position in 1981. Orissa and Bihar are placed at the lowest in the hierarchy. Rest of the states are have remained in the same position. However, the looking the pattern of development, Andhra Pradesh and Karnataka has shown improvement though its rank remained the same. West Bengal has slide down to position twelfth in 1991 and tenth in 1996.

Another way of identification of the backward states is through principle component. According to Ashok Mathur (1994)[9] regionalization can easily be done picking the districts with negative factor scores. This criteria keeps aside the districts with negative values. The following table V.7 gives the list of backward states based on the negative figures for the principle components. The table shows the increased incident of relative backwardness in the states of India due to the regional biasness in the development.

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9. Ashok Mathur: Regional Development and Policy in India: A Long Term Perspective, in G.K.Chadha, *Policy Perspective in Indian Economy*, Har Anand Publications, New Delhi 1994, p.78

TABLE V.7

NUMBER OF STATES WITH NEGATIVE FSCORES (1981-1996)

S.NO.	1981	1991	1996
1	KARNATAKA	WEST BENGAL	WEST BENGAL
2	ANDHRA PRADESH	RAJASTHAN	RAJASTHAN
3	WEST BENGAL	MADHYA PRADESH	MADHYA PRADESH
4	MADHYA PRADESH	UTTAR PRADESH	ORISSA
5	UTTAR PRADESH	ORISSA	UTTAR PRADESH
6	ORISSA	BIHAR	BIHAR
7	RAJASTHAN		
8	BIHAR		

TABLE V.8

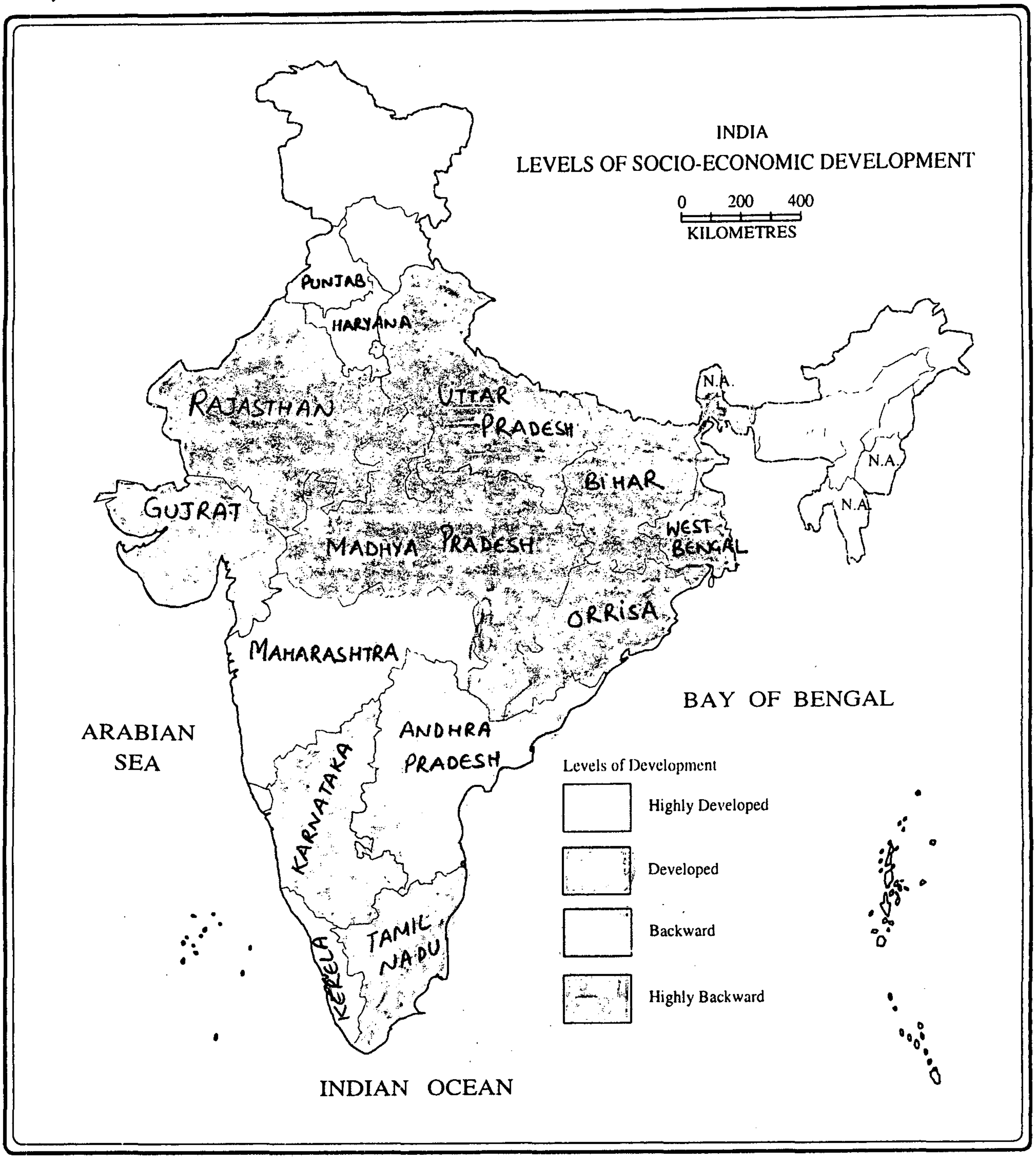
F SCORES AND LEVELS OFSOCIO ECONOMIC DEVELOPMENT

YEAR	CLASS SIZE	LEVELS OF SOCIO-ECONOMIC DEVELOPMENT							
		HIGHLY DEVELOPED		DEVELOPED		BACKWARD		HIGHLY BACKWARD	
		UPPER LIMIT	LOWER LIMIT	UPPER LIMIT	LOWER LIMIT	UPPER LIMIT	LOWER LIMIT	UPPER LIMIT	LOWER LIMIT
1981	0.762508	1.6168	0.854295	0.854295	0.09179	0.09179	-0.670715	-0.670715	-1.43322
1991	1.119848	1.88561	1.026365	1.026365	0.16712	0.16712	-0.692125	-0.692125	-1.55137
1996	0.953528	2.03923	1.0857025	1.0857025	0.132175	0.132175	-0.821353	-0.8213525	-1.77488

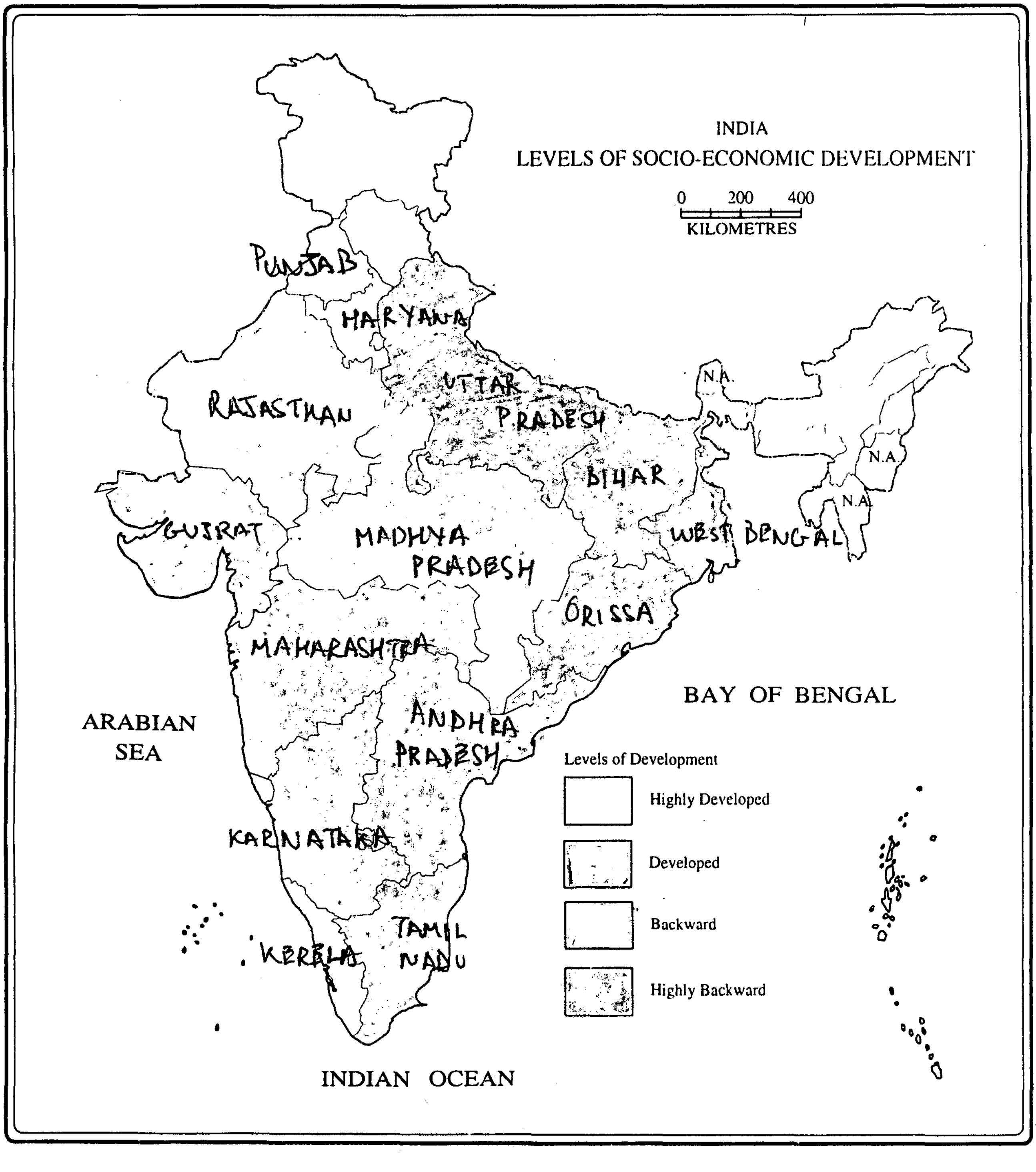
TABLE V.9

LEVELS OF SOCIO- ECONOMIC DEVELOPMENT			
LEVELS OF DEVELOPMENT	1981	1991	1996
HIGHLY DEVELOPED	PUNJAB KERALA MAHARASHTRA HARYANA	PUNJAB KERALA HARYANA	PUNJAB KERALA
DEVELOPED	TAMIL NADU GUJRAT	MAHARASHTRA GUJRAT TAMIL NADU KARNATAKA ANDHRA PRADESH	HARYANA GUJRAT MAHARASHTRA TAMIL NADU KARNATAKA
BACKWARD	KARNATAKA ANDHRA PRADESH	RAJASTHAN MADHYA PRADESH	RAJASTHAN MADHYA PRADESH
HIGHLY BACKWARD	WEST BENGAL RAJASTHAN ORISSA UTTAR PRADESH MADHYA PRADESH BIHAR	UTTAR PRADESH WEST BENGAL ORISSA BIHAR	WEST BENGAL UTTAR PRADESH ORISSA BIHAR

Va 1981

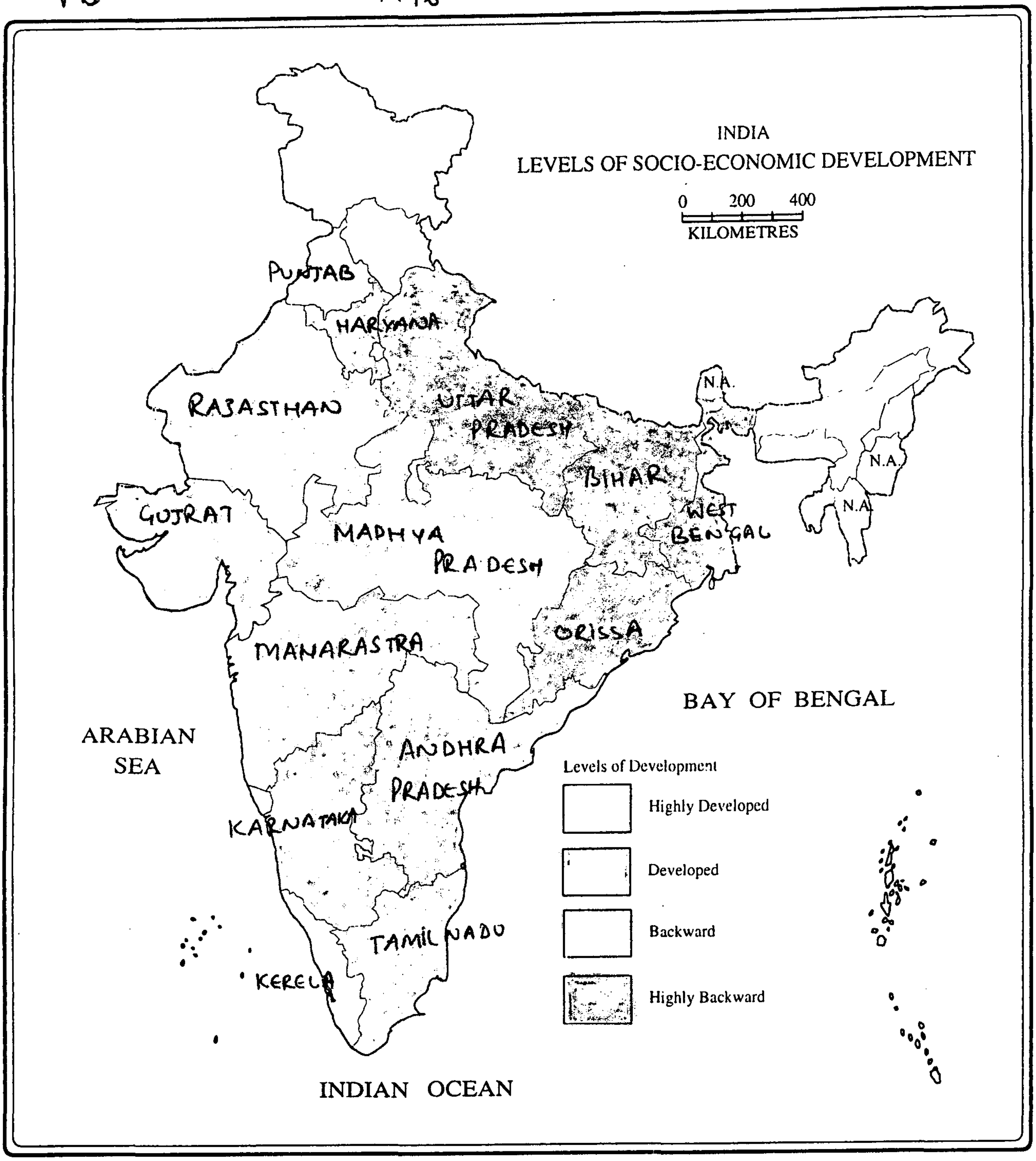

INDIA
LEVELS OF SOCIO-ECONOMIC DEVELOPMENT
0 200 400
KILOMETRES
PUNJAB
HARYANA
RAJASTHAN
UTTAR PRADESH
N.A.
N.A.
N.A.
BIHAR
GUJRAT
MADHYA PRADESH
WEST BENGAL
ORRISA
MAHARASHTRA
BAY OF BENGAL
ARABIAN SEA
ANDHRA PRADESH
KARNATAKA
Levels of Development
Highly Developed
Developed
Backward
Highly Backward
TAMIL NADU
KERELA
INDIAN OCEAN

Vb 1991



INDIA
LEVELS OF SOCIO-ECONOMIC DEVELOPMENT
0 200 400
KILOMETRES
PUNJAB
HARYANA
UTTAR PRADESH
RAJASTHAN
N.A.
BIHAR
N.A.
N.A.
GUJRAT
MADHYA PRADESH
WEST BENGAL
ORISSA
MAHARASHTRA
BAY OF BENGAL
ARABIAN SEA
ANDHRA PRADESH
Levels of Development
Highly Developed
KARNATAKA
Developed
Backward
TAMIL NADU
KERALA
Highly Backward
INDIAN OCEAN

V6 1996


INDIA
LEVELS OF SOCIO-ECONOMIC DEVELOPMENT
0 200 400
KILOMETRES
PUNJAB
HARYANA
RAJASTHAN
UTTAR PRADESH
BIHAR
N.A.
N.A.
N.A.
WEST BENGAL
GUJRAT
MADHYA PRADESH
ORISSA
MANARASTRA
BAY OF BENGAL
ARABIAN SEA
ANDHRA PRADESH
KARNATAKA
TAMIL NADU
KERELA
Levels of Development
Highly Developed
Developed
Backward
Highly Backward
INDIAN OCEAN

However, classifying the states according to its FScores in tables V.8 and V.9 and regions are identified in maps Va, Vb and Vc.

In 1981, Punjab, Maharashtra, Haryana turns out to be highly developed states, developed ones are Tamil Nadu and Kerala, backward states are Gujarat, Karnataka, backward states were Andhra Pradesh, West Bengal, Rajasthan, Orissa, Uttar Pradesh, Madhya Pradesh and SBihar. The list has completely changed over the period of 15 years except Punjab and Kerala being the highly developed states followed by Maharashtra, Haryana, Gujarat and Tamil Nadu, Karnataka and Andhra Pradesh as developed ones. Rest of the states are still backward in their socio-economic development level.

Section V.3

IMPACT OF FINANCE COMMISSION TRANSFERS ON DEVELOPMENT

From the discussion, on the preceding sections, it may be concluded that Finance Commission transfers are intended to improve the level of development in the states, which show considerable variations in the level of development.

There are reasons to look into how much variations in the level of development are explainable by the Finance Commission transfers. This is important from social scientist's point of view. A social scientist may like to know which of the regions are getting the greatest benefits and how far the financial resources are allocated to improve the quality of life of the people living in different states.

Generally speaking, statutory transfers are likely to contribute towards improving the socio-economic profile of states by particularly improving the service standards of developing states. Such kind of transfers would ultimately improve in building up human capital in the states. Since human capital is seen in improving the overall health of the region, its link on the general socio-economic infrastructure may appear to be worth investigating.

Consistent with the objective of the study, the impact of Finance Commission on the development process in the states, regression is the tool mainly employed for this purpose.

To study the development process as a whole 'composite index of development' is developed through the principal component analysis (PCA), taking all the development indicators as mentioned in Section V.2 and discussed in detail in chapter II for the benchmark years 1981, 1991 and 1996.

Comparing table V.6 with V.1 would give the clue that the states with the higher per capita cumulative Finance Commission transfers could become relatively more developed states but on the contrary the states are still underdeveloped.

However, looking at the correlation between indices of socio-economic development with the per capita transfers.

Table V.10

Correlation between composite index of socio-economic development with

Per Capita Finance Commission Transfers

SIXTH FINANCE COMMISSION	**(-) 0.23348**
SEVENTH FINANCE COMMISSION	**(-) 0.72864**
EIGHTH FINANCE COMMISSION	**(-) 0.82922**
NINTH FINANCE COMMISSION	**(-) 0.73257**
TENTH FINANCE COMMISSION	**(-) 0.72422)**

It indicates negative relationship reflecting that as development of a particular state increases the per capita transfers decreases. The per capita transfers are given to underdeveloped states.

To test the hypothesis we have tried to quantify the contribution of finance commission transfers to changing the level of development states are explained in a linear regression equation of the following type is fitted, taking the composite index of development as dependent variable and finance commission transfers.

Composite index of socio-economic development = a + b (FC TRF) + U

Where FC TRF is Finance Commission transfers on Per capita basis and U is an error term.

REGRESSION EQUATIONS		
1	$I_1 = 0.3517 - 0.0028FC_6$ (0.47701)	R^2=0.020 F= 0.220
2.	$I_2 = 7.7620 - 0.0217^*FC_7$ (2.8368)	R^2= 0.369 F= 8.0474*
3.	$I_2 = 4.72 - 0.009^*FC_8$ (4.262)	R^2= 0.58 F= 18.17*
4.	$I_3 = 3.09 - 0.0028^*FC_9$ (3.1449)	R^2= 0.425 F= 9.89*
5.	$I_3 = 3.289 - 0.0014^*FC_{10}$ (2.767)	R^2= 0.356 F= 7.658*

Note: * at 5% significant level
I_1, I_2, I3= FScores in 1981, 1991 & 1996
F_6, F_7, F_8, F_9, F_{10} = Sixth, Seventh, Eighth, Ninth & Tenth FC transfers per capita

The regression equations computed above shows an inverse relationship and composite index showing different levels of socio-economic development in different regions. To put in simple words, more developed regions are getting less per capita transfers. This relationship turns out to be significant particularly in the Eighth and subsequent Finance Commissions.

In the Sixth Finance Commission the impact of Finance Commission transfers was negligible. However, it increased to 58 per cent in Eighth Finance Commission i.e. only 58 percent of the development could be explained by Finance Commission transfers per capita.

It again declined to 43 percent in Ninth Finance Commission and then to 35 percent in Tenth Finance Commission.

These equations make evident that there are factors other than Finance Commission transfers, which are better in explaining the inter-state variations in level of socio-economic development. These factors (excluded) may include plan transfers, central ministries transfers and other market-oriented transfers particularly from All India Financial Institutions.

The other explanation could be that states considered statutory as their legal entitlements, which are unconditional, and states may prefer to use it as a part of their own revenues to meet their non-plan revenue expenditures.

Over the past 25 years of the study period, the low-income states could not improve their positions in the development hierarchy as expected. Particularly Orissa and Bihar continued to remain at 13th and 14th position. As a result these transfers are not utilised for building up socio-economic infrastructure required for development.

SUMMARY OF EMPIRICAL FINDINGS

Finance Commission transfers distributed to the states from Sixth Finance Commission and subsequent Finance Commissions have been found to be progressive in their distributional impact. In other words, the poorer states in general seem to have got proportionately higher transfers, which led to mitigation of income differentials. However, the income elasticity turns out to be less than zero implying higher transfers are devolved to poorer states.

One of the major points of the study is that the influence of Finance Commission transfers towards the development of the states would be quite considerable. The composite index of development was explained in terms of per capita Finance Commission transfers in simple regression model and it was observed that in the Eighth Finance Commission, per capita transfers could explain 58 percent of the development index. Thus, apart from Finance Commission transfers other transfers from Planning Commission. Discretionary transfers and other market driven transfers from All India Financial Institutions are needed in explaining inter-state variations of the states.

The analysis of ranking of states on the basis of the combined component scores for all the three bench mark years showed Punjab highly developed states followed by Maharashtra and Kerala. Bihar and Orissa remained the least developed states. However negative scores indicate backwardness of the state, West Bengal among middle-income states, and all the low-income states comprising of Rajasthan, Madhya Pradesh, Orissa, Uttar Pradesh and Bihar remained backward.

However, the specific measures taken by the government of India seem to have had impact on the problem of regional imbalances, though somewhat tardy. To speed up the process of balanced regional development, concerted policy actions including the indicated improvement in the Finance Commission transfers in association with other financial transfers to relatively less developed states are urgently called for.

CHAPTER VI

CONCLUSION

The present study deals with regional disparities in India and role of Finance Commission. The main objectives of the study were to study the inter-state patterns in the levels of socio-economic development for the benchmark years 1981, 1991 and 1996; analyses the pattern of Finance Commission transfers from Sixth Finance Commission to Tenth Finance Commission; and examines the impact of Finance Commission transfer on income equalization and on regional imbalances.

This study has covered ground related to three facets of regional development in India. First, it has tried to put together evidence regarding trend of inter-State disparities in terms of key economic and social indicators. The other area of investigation undertaken in this study pertains to the success of regional policy in achieving greater spatial equity. In this context, the devolution of resources from the centre to the states, particularly from Finance Commission, has been examined. Thirdly, the impact of the Finance Commission transfers on regional inequalities using composite index of development and per capita income, a major indicator of economic development.

The 'Principal Component Analysis' have been used to see the levels of development across 14 states. Regression analysis is done to work out the impact of Finance Commission transfers in explaining variations on income and regional disparities. Other statistical tools used were coefficient of variation, range and disparity ratio.

Some of the broad conclusions of this study which emerge from the analysis are as follows:

(a) Regional Disparities in India

Firstly, there has been widening of the inter-state inequalities for the benchmark years 1981, 1991 and 1996 as reflected by the coefficient of variation of various socio-economic indicators. A marked dichotomy between the high income and low-income groups of states has been emerging. This is reflected in the high coefficient of variation in per capita SDP at constant prices, which was 31.2 in 1981, 34.8 in 1991 and 40.87 in 1999.

The high income states are characterised by better demographic and social development, higher per capita incomes and more developed economies, lower levels of poverty, higher level of revenue receipts, and plan and non-plan expenditure, fiscally better off, higher investment and significantly better infrastructure facilities.

The pressing requirement of low-income states is more investment in their social and infrastructure sectors. To improve the level of social services, massive investment in primary education and primary health services is required. Improvement in literacy, and health indicators like infant mortality rate will bring down the rate of growth of population. Stabilisation of population, especially in the 'BIMARU' states is an important pre-condition for the sustained economic growth of that region.

The experience of Kerala and to a considerable extent that of Tamil Nadu clearly indicate that even at comparatively lower levels of economic development measured in terms of per capita income, a state can enjoy comparatively higher levels of social development.

Improvement in basic infrastructure facilities in the backward states is a pre-condition to improve the quality of life of the people and to usher in sustainable economic development in those states.

Secondly, the difference in fiscal variables representing capacity, effort, need and performance are also glaring. The government of low-income states are fiscally weak and as such they are unable to find enough resources to meet these investment requirements. The high-income states are in a better position. However, the problems in the finances of the State Governments have a bearing on the long-term sustainability of the fiscal situation. During the 'nineties, over 80% of the deficit of the State Governments was caused by structural factors. The wide revenue gap has lead to increase interest liability for few states. Thus fiscal deterioration has been exceptionally damaging in the case of low-income states and Bihar stands apart even among them.

If the existing trends in differential rate of socio-economic development continue, regional disparities in India are bound to accentuate. Therefore, it is imperative that the present trends are arrested and preferably be reversed. This will require concerted efforts on the part of the concerned state governments and the centre.

(b) Role of Finance Commission

The study analyses some of the issues in the working of federal system in India. This comprises of transfers from the Finance Commission, a constitutional body, the Planning Commission a permanent body and other central ministries transfers. Needless to say, our study does not cover the entire gamut of Centre-State financial relations; in particular it has left out the impact of Planning Commission transfers and other central ministries transfers. The Finance Commission, play its due responsibility along with the Planning Commission in addressing the problem of growing of regional disparities. However, the Finance Commission is better positioned compared to the Planning Commission in the Indian federal set up.

Thus, an attempt has been evolved to analyse the role of Finance Commission, in general and its impact on regional disparities in particular.

The statutory transfers have got a better potential for carrying out the progressivity objective as the Finance Commission has been changing its methodology with a review to responding to the needs of the time. Thus, the Finance Commission has been able to maintain progressivity through various methods like increasing the tax shares to the states by enlarging the divisible pool, making allocations for bringing the non-capital gaps, giving grants for upgradation of levels administration, introducing objectivity in assistance for natural calamities, increasing revenue gap grants by 5 percent and linking of 5 percent of the divisible pool of union excise duties to the assessed revenue deficits of the states and so on. This must not be taken to mean that the existing institutional structure of the central transfers to continue to be progressive forever as this would depend on the degree of responsiveness of the various Finance Commissions.

After all these permutations and combinations, more and more financial resources came to be handed over to the state governments without ensuring minimum level of essential public services to the people. This amounted to violating the allocative efficiency criterion as well as horizontal federal fiscal equity principle because relatively better-off states got substantially more non-plan revenue surpluses. But even these states have not been able to achieve uniform standards of essential public services within their own boundaries. This is the net result of the 'gap-filling approach'.

The federal financial transfers, which were made, on the recommendations of the past ten Finance commissions have not been able to help the poorer states consistently. It has been found that the distribution of a share in the income tax, union excise duties and additional union excise duties has been inequitable between states in the sense that richer states have been receiving much higher amount as well as share than the poorer states whereas the grants-in-aid under Article 275 has gone more in favour of the poorer states. This was only expected because the grant-in-aid under Article 275 is given only when the states face non-plan revenue deficit after receiving the tax shares. The criteria used for inter se distribution of tax shares among the States tended to favour better off states than the poorer states though successive Finance Commissions aimed at giving more shares to the poorer states. In effect, the tax shares have been regressive in their redistributive impact whereas grant-in-aid has been progressive. As a matter of fact, this should only be expected from the methodology of the Finance Commission itself.

The Finance Commission turns out to be progressive in terms of per capita income however, the variables like population and tax effort do not yield the definitionally expected signs. The sign of population becomes positive after Sixth Finance Commission but it is not significant in the regression equation. Tax effort on the other hand, gives negative relationship indicating that states are not rewarded for their efforts of raising the resources. The allocations do not appear to be need based nor flow to the poorer states.

The reviewing of functioning of Finance Commissions indicates that though the latter Commissions from Seventh Finance Commission onwards tried to provide greater attention to backwardness problem, the progressivity has been insufficient to bring major changes in the levels of economic development in poor states. Till the Sixth, the Finance Commissions as constitutional body have not done enough justice to the backward states to the extent expected. They had mostly confined, unless otherwise specifically included in the terms of reference-to the non-plan revenue gap of the states without looking at their overall budgets.

(c) Impact of Finance Commission

Finance Commission transfers distributed to the states from Sixth Finance Commission and subsequent Finance Commissions have been found to be progressive in their distributional impact. Analysis in terms of income elasticities ignores cost disabilities across states. Per capita SDP is only imperfect indicator of revenue capacity. Nevertheless, income elasticity gives a broad indication of the equity in the distribution of transfers. In other words, the poorer states in general seem to have got proportionately higher transfers, which led to mitigation of income differentials. The income elasticity turns out to be less than zero implying higher transfers are devolved to poorer states.

One of the major points of the study is that the influence of Finance Commission transfers towards the development of the states would be quite considerable. Using Principal Component Analysis, the composite index of development was computed. The analysis of ranking of states on the basis of this index for all the three bench mark years showed Punjab highly developed states followed by Kerala. Bihar and Orissa remained the least developed states. However negative scores indicate backwardness of the state, West Bengal among middle-income states, and all the low-income states comprising of Rajasthan, Madhya Pradesh, Orissa, Uttar Pradesh and Bihar remained backward.

The impact of Finance Commission transfers per capita was analysed on the levels of socio-economic development in simple regression model. It was observed that in the Eighth Finance Commission, per capita transfers could explain 58 percent of the development index. Thus, apart from Finance Commission transfers other transfers from Planning Commission, Discretionary transfers and other market driven transfers from All India Financial Institutions are needed in explaining inter-state variations of the states.

The empirical results show that the federal financial transfers recommended by the past ten Finance Commissions have not been significantly equalising in India. These findings go to prove that the past Finance Commissions' pious hope has not been realised in actual practice.

CONCLUDING REMARK

Thus, after 50 years of Independence, what was expected to be achieved by the successive Finance Commissions came to be passed on to the Planning Commission after realising the dismal failure of the past ten Finance Commissions. Consequently, the United Front government decided to expand Basic Minimum Services, under which safe drinking water, rural sanitation, primary health, primary education, housing for the poor, rural roads, public distribution system and urban slum improvement, were identified as essential at the turn of the 20th Century and additional Central assistance was provided to the states through the Planning Commission to enable them to expand these services so as to equalise by the end of this Century.

The Planning Commission has decided to make Basic Minimum Services Programme, as an important part of the Ninth Five Year Plan so that at least by the end of this century the Indians, wherever they live, will enjoy certain essential basic public services.

POLICY SUGGESTIONS

1. Despite the balanced regional development being a common objective for the commissions, it is pursued through equity by ignoring the plan expenditure, which is very much a leveller of regional disparities.
2. The states and centre have been able to submit different estimates of receipts and expenditures to Planning Commission and Finance Commissions as the plan and award periods never coincided. Unless the synchronization of the time periods is

ensures, the whole exercise by the two commissions cannot achieve the purpose satisfactorily.

3. The state's resource gap has been rapidly rising particularly after the early 80s. The two basic reasons being a slow growth in tax revenue and capital receipts while the expenditure, particularly the non-plan expenditure is growing at a much faster rate. This has been making the states to depend on the central assistance most of which has been in loans form. The burden of repayment is growing leading to a reduction in net central assistance. Inadequate central assistance is making the states to procure markets. The per capita debt burden has been rising. The position of the centre is no better, either. Its 65 percent of tax revenue is being spent annually towards interest on its debt. Hence, there exists an urgent need to follow fiscal discipline by both layers of government.
4. There ought to be an enforcement agency with respect to the utilisation of statutory grants recommended to the states to ensure the realisation of the objective of achieving a reasonable standard of social and administrative services.

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