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# AWARD OF THE NINTH FINANCE COMMISSION: LESSONS FOR KARNATAKA

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# Award of the Ninth Finance Commission: Lessons for Karnataka

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The discussion on the Report of the Ninth Finance Commission, belying general expectations, has been somewhat subdued. This is surprising particularly in view of the changes in the approach and methodology adopted by the Commission. However, some important issues have been raised recently in separate articles in *The Economic Times* by T.R. Satish Chandran (TRS for short; May 23) and G. Thimmaiah (GT, June 28 and 29) while exploring the reasons for the decline in the relative share of Karnataka State resulting from the award of the Ninth Finance Commission as compared to those of the previous Commissions.

TRS, in his incisive analysis concludes: (i) the recommendations of the Ninth Finance Commission have been on the whole unfavourable to the States as their share in total Central revenues has shown a decline, (ii) Karnataka has fared worse as its relative share too has declined; (iii) the main reason for Karnataka's loss is the continuation of the progressive bias introduced in the transfer schemes since the Seventh Commission and more importantly, greater accent on progressivity with the introduction of higher weight to revenue deficits of the States in the distribution of Union Excise Duties; this factor has effectively increased the relative role of grants vis-a-vis the tax devolution. Therefore, Karnataka which espoused the cause of equity in fiscal transfers, can hardly object to the general approach adopted by the Ninth Finance Commission (iv) the adoption of normative approach

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to and changes introduced in the method of assessment has not materially affected the State's share. and (v) the basic lesson to Karnataka is that, "...in the State sector, the future development of the State will be governed largely by States' own effort". GT on the contrary contends, "These are very sweeping statements which cannot go undisputed both in the interest of truth and in the interest of Karnataka". In his view, the "distorted" approach and the "arbitrary" "hybrid" methodology employed by the Commission has been an important factor responsible for reducing Karnataka's share in the transfers. Being a seeker of truth and interested in Karnataka as well and, additionally, to some extent involved in developing the methodology used by the Commission, I feel impelled to offer a few comments on some of the observations of the two authors.

Let us first deal with TRS's conclusion that the States as a whole came off badly at the hands of the Ninth Finance Commission because it recommended only 20.8 per cent of Central revenue as non-Plan transfers as against the Eighth Finance Commission's recommendation of 22.65 per cent. Exclusion of Plan deficit transfers and deriving the share of the States on that basis, in my view incorrect. After all, Eighth Finance Commission's recommendation too included upgradation grants which was, in fact, treated by the Planning Commission as a Plan resource while finalising the Seventh Five Year Plan. The Ninth Commission has called these as developmental grants and instead of earmarking them, it has allowed the flexibility to the States in utilising them for any of the Plan schemes in consultation with the Planning Commission. Again, it has been stated clearly in the Report that these grants are in addition to the grants receivable by the States under the Gadgil formula (Para 2.28). As the aggregate transfers recommended by the Commission as a percentage of Central revenues is more or less the same as that of the Eighth Commission, it is possible for the States to argue for the same or even a larger share of Central revenues by way of Plan transfers. In fact, while estimating the deficit, the

Commission itself has assumed that Gadgil formula grants would grow at 10 per cent per year over the levels prevailing in 1989-90. It is true that the magnitude of Plan deficit grants recommended by this Commission is higher than the upgradation grants recommended by the previous Commissions. Besides, they follow a different distribution pattern from that of Gadgil formula assistance. Yet, it would be preferable to consider the Finance Commission transfers as a total package rather than breaking them into Plan and non-Plan components. Of course, it is possible to argue that even the constancy in the share of Central revenues does not ensure offsetting vertical imbalances in view of States' expenditure needs growing faster than the Central revenues. But that is a different matter.

In any case, the issue of offsetting vertical imbalance is not a Central theme of the two papers and therefore, does not call for any further comments. The central question that both TRS and GT address in their papers is the reason for the decline in the share of Karnataka State under the Ninth Commission's award in comparison with those of the earlier Commissions. TRS has conclusively shown that the State's share has revealed a consistent decline since the Sixth Commission's dispensation on which, there cannot be a second view. However, there is an element of inaccuracy in the magnitude of the decline. For example, according to TRS, the State's share under the Ninth Commission's award at 3.83 per cent is lower than the share under the Eighth Commission's award (4.38 per cent) by about 0.55 percentage points. This is true only if one goes by the figures given in the Eighth Commission's Report. However, if the item, 'net interest liability grants', given to the deficit States according to the Eighth Commission's recommendation is also taken account of, the share of the State under the Eighth Commission's award is lower at 4.23 per cent. The Ninth Commission's award for 1989-90 too resulted in the State's share of 4.22 per cent. As the second report of the Commission does not separately provide for the net interest liability grants, for purposes of comparison, the State's share according to the Eighth Commission's award should be taken at 4.23 per cent and not at 4.38 per cent. Accordingly, the recommendations of the Ninth Finance Commission has resulted in the decline in the share of the State by 0.40 points. Even this, by any reckoning is substantial warranting a detailed scrutiny.

Before we explore the reasons for the decline, it would be useful to go into the controversy as to whether the methodology employed to make normative assessment by the Commission is biased against the State, thereby contributing to the decline in the share. While TRS, as mentioned earlier, thinks that the method of assessment has not materially affected the shares, GT thinks otherwise. GT's conclusion rests fundamentally on the argument that the non-Plan surplus/deficit positions arrived at by the Commission are not consistent with his logical constructs. GT constructs the logical possibilities that, the States with higher than normative spending and lower than normative revenue raising performances should have non-Plan deficits; those with lower than normative spending and higher than normative revenue raising performances should have surpluses, while those with higher than normative spending and higher than normative revenue raising performances could have either a balanced or a surplus budget and finally, those with lower spending and lower revenue raising performance should have a deficit. As in the Commission's assessment, the States' non-Plan revenue deficit/surplus positions are not consistent with this, GT argues that the normative approach adopted by the Commission is erroneous. The crucial question is, why should the normative deficits/surpluses be related to the actual performances of the States?

A State profligate in spending and lax in raising revenues may actually have a deficit (though this is not always true) but normatively, it may be considered a surplus State. In this case, the Commission would not consider the actual deficit but the normative surplus. The normative deficits and surpluses are related to the levels of revenue capacity and expenditure needs and not to the actual performances of the States in raising revenue and spending. There is no way the normative surplus/deficit positions can be determined a priori on the basis of States' performances. Therefore, GT's claim of logical inconsistency in the Commission's assessment is not valid. In fact, even the actual (as against normative) deficit/surplus positions can not be determined a priori, (on the basis of the State's revenue and expenditure performances) unless the initial levels of revenues and expenditures are known. GT's charge of logical inconsistency, and the assertions flowing therefrom such as distortions, some States receiving a bonanza and some others being penalised based on this analysis, do not bear scrutiny and in fact, reveal a total lack of appreciation of what the normative approach seeks to achieve i.e., fairness in the federal transfers.

Let us now go into GT's specific objections on the method of assessment adopted by the Commission. For this, it is useful to deal with the assessment of tax revenues, non-Plan expenditures and Plan revenue expenditures separately. In the case of both tax revenues and expenditures, the stages of assessment involved estimation of taxable capacity and expenditure need in the initial year, applying growth rates to arrive at the estimates for the base year and making projections for the period of the award. On the estimation of taxable capacity, GT does not seem to object to the modified representative tax system approach employed by the Commission per se. However he seems to imply that the Commission gave up the covariance model and employed the modified representative tax system approach because of the criticisms from various quarters. That, in fact, is inaccurate. GT is aware that the experts consulted by the Commission had generally suggested the continuation with the covariance model, but as tax-wise estimates had to be derived and data on longer time-series were not available for use in the covariance model, this method was employed (Para B4.12).

On the methodology employed to make normative projections of tax revenue, it is not clear what GT's specific objections are. He merely asserts that this is a 'questionable' exercise. Is it the application of trend rates of growth on initial year estimates that is questionable? or is it the adoption of 11 per cent growth rate for projection for the period of award? Estimating capacity directly for the terminal period is not possible in the absence of the projection of tax base variables; either one should employ a macro-econometric model for estimating the values of these tax base variables or one should take their trend values and project them. The first option is clearly infeasible and as for the second, there is hardly any difference to the estimates whether trend values of the variables are substituted or trend growth rates are applied to the estimates of the initial years. This is true also of the method employed to estimate expenditures. Even this issue was discussed by the Commission in its meeting with the experts and it is only in the absence of any better method, growth rates had to be applied to the initial year estimates to obtain the base for projection. In any case, it is not enough to assert that the method is not scientific. GT has not demonstrated anywhere, how the so called 'arbitrary', 'hybrid' method yields biased results so as to reduce the share of Karnataka State.

Now let us take up his objections on the adjustments made for prohibition policy. On the issue of whether or not the tax revenues in the States following prohibition policy should include the potential revenue from State excise duty, opinions are clearly divided. But considering that the previous Commissions did not take account of any revenue, as they merely applied 'normative' growth rates in the existing base, this Commission may be said to have done well to include 30 per cent of the potential from the tax. There are some who would argue for total exclusion just as GT argues for its full inclusion. Ultimately, it is a matter of judgement. The rationale behind the inclusion of 30 per cent could be that even if prohibition results in loss of revenue from the state excise duty, the income saved from abstaining from consuming alcoholic drinks could be used for the consumption of other goods, thereby enhancing the potential from other taxes. Also, one can take that this is a transitional phase wherein some portion of the potential revenue from State excise duty is taken account of and after a period, the burden of prohibition policy would be entirely left to the States. This is not to argue for the prohibition policy. But this is a subject under the Directive Principles of State Policy and cannot be dealt with purely on revenue considerations. Again, the crucial issue is how has it adversely affected Karnataka's share as compared to the approach of the previous Commissions? If anything, in principle it is possible to argue that the inclusion of 30 per cent of potential from State excise duties in the States following prohibition policy, to the extent it goes to reduce their share of transfers, should have served to enhance the shares of other States including Karnataka.

Other possible objections on the assessment of non-Plan revenues and expenditures can be the differential growth rates adopted for projecting revenues and non-Plan expenditures, the adoption of norms in a phased manner and the averaging of the deficits estimated by normative and conventional approach in cases where the former are lower. The first was considered necessary by the Commission to phase out the revenue deficits, - as a general policy to contain expenditures of the Centre and the States. The second and the third type of adjustment was made to minimise hardship to the States adversely affected by the sudden adoption of the normative approach. However, it is not possible to establish that these adjustments have adversely affected the share of Karnataka State in any manner. In fact, if any thing, the normative assessment, particularly on the expenditure side, has yielded favourable results though this could not be translated in terms of higher share to the State.

This is not to claim that the methodology employed by the Commission has no arbitrary elements. In fact, there is a lot of room for improvement, some of which have been detailed by the present author elsewhere (*Economic and Political Weekly, June 9, 1990*). A number of these adjustments are arbitrary and sometimes even contradictory. In fact, serious objections can be raised on the method of assessing Plan revenue expenditures employed by the Commission and on the method of providing for salary revision. Yet, it cannot be shown that the adjustments have been subjective so as to reduce the share of Karnataka State. Thus, TRS's conclusion that the normative assessment of revenues and expenditures has not materially affected the State's share is valid. So also his observation that so long as the approach of increasing the proportion of transfers related to fiscal disadvantages of the States rather than determined on the basis of general economic indicators continues, the State's share would continue to erode.

What then, are the reasons for the decline in the share of Karnataka. TRS has already listed some of them. One of the important reasons cited by him is the introduction of greater degree of progressivity, particularly, by earmarking larger share of Union Excise Duty for the deficit States. However, this can explain only a small part of the decline in the share. Therefore other important reasons, which, in the interest of better financial planning in the State, we ought to be aware of.

Logically, a fall in the share of Karnataka over a time period can occur if there are (a) increase in the number of claimants to the share; (b) change in the methodology of transfer which implies: (i) increase in the relative role of grants vis-a-vis tax devolution, (ii) alteration in the formula of tax devolution, and (iii) change in the methodology used for assessment and (c) change in the relative economic circumstances of the State. Let us examine the relevance of each of these factors.

Let us take the number of claimants. The Eighth Finance Commission, had to make transfers to 22 States. But in 1987, the three new states of Arunachal Pradesh, Goa and Mizoram came into existence. Although these are small States having only 0.3 per cent of population of the country, the Ninth Commission had to give as much as 2.2 per cent of the transfers to them. If pro-rata adjustment is made, Karnataka's own loss on account of the three new States works out approximately to 0.08 percentage points. This is out of the total fall of 0.40 percentage points estimated for the State under the Ninth Commission's award as compared to the Eighth Commission's dispensation.

As regards change in the methodology of transfers is concerned, as pointed out by TRS, the most important reason for the decline in the State's share is the earmarking of a larger share of Union Excise Duties to the deficit States. It may be recalled that 16.5 per cent of the 45 per cent excise duties, is distributed on the basis of the pre-devolution deficits. Thus 7.425 per cent is earmarked to the deficit States as compared to 5 per cent earmarked by the Eighth Commission, and this additional 2.425 per cent share has been taken out of the 'distance from the highest SDP' criterion. Accordingly, the percentage point difference on account of this factor works out to 0.13 out of the total of 0.40.

This still leaves a large part of the decline (almost 0.19 percentage points) unexplained. This large magnitude of erosion in the share of the State cannot be rationalised merely in terms of the changes in economic circumstances in the interregnum. A detailed scrutiny of all the causal factors leads us to conclude that the most important factor causing the erosion of the State's share is the use of the new series of SDP in the second Report of the Commission as against the old series employed in its first Report. The difference between the two series is particularly significant in the case of Karnataka. In fact, Karnataka's SDP is 113.7 per cent of all-States' average according to the new series, whereas, under the old series it was lower at 105 per cent. It may also be seen from the table that the relative shares of the States both under 'inverse' and 'distance' formulae vary significantly if the new series is adopted in the place of old. In Karnataka's case, the share shows a significant decline under both the formulae. By giving appropriate weights to SDP to the portion of income tax and excise duty distributed by using the two formulae, we can estimate the percentage point decline in the transfers on account of the use of the new series. Our computations show that the State would have gained as much as 0.17 percentage points in the share if instead of the new series, the old series was taken to determine the State's tax devolution. In other words almost 0.17 percentage point decline in the share of the State can be explained primarily by the adoption of the new SDP series in the place of old. This is besides the effect of higher SDP on the assessment of normative tax revenues of the State.From the point of view of the Commission, however, there can be little choice as it would be improper to reject the new series in favour of the old in the absence of strong reasons to believe that the former is decidedly inferior. The difference between the two series is something that officials in the State might ponder over.

It is important for the policy makers in the State or for that matter for all States where the share has suffered a decline to diagnose the specific reasons for the decline in the share of transfers. Unfortunately, GT's analysis throws little light on the issue. Although, understandably well intended from the viewpoint of the State, little purpose is served by ill-founded assertions such as that the methodology of assessment adopted by the Finance Commission is the major culprit. Such unsubstantiated allegations would neither serve the interests of Karnataka nor would it be helpful in the evolution of a more scientific approach to federal transfers. What is needed from scholars interested in this area of economics is a dispassionate analysis to identify the causal factors underlying the erosion in the State's share to help the State in better financial planning, and constructive criticisms towards improving the Commission's methodology in the interest of a healthy fiscal federalism devoid of subjectivity, apprehensions and mistrust.

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**Shares of States' in Tax Devolution According to the Ninth Finance Commissions' Award Under Old and New SDP Series**

| | IATP Old Series | IATP New Series | | Distance Formula Old Series | Distance Formula New Series | | States' Share Due to the Use of SDP factor(both inverse and distance) in Tax Devolution Old Series | New Series | |
|---|---|---|---|---|---|---|---|---|---|
| | (%) | (%) | Diff. (New-Old) | (%) | (%) | Diff. (New-Old) | (%) | (%) | Diff. (New-Old) |
| Andhra Pradesh | 7.432 | 7.835 | 0.40 | 7.942 | 8.415 | 0.47 | 2.743 | 2.903 | 0.16 |
| Arunachal Pradesh | 0.068 | 0.063 | -0.00 | 0.067 | 0.059 | -0.01 | 0.024 | 0.021 | -0.00 |
| Assam | 2.707 | 2.903 | 0.20 | 2.926 | 3.104 | 0.18 | 1.010 | 1.074 | 0.06 |
| Bihar | 14.915 | 15.750 | 0.83 | 14.624 | 14.763 | 0.14 | 5.220 | 5.330 | 0.11 |
| Goa | 0.066 | 0.066 | 0.00 | 0.048 | 0.047 | 0.00 | 0.019 | 0.019 | 0.00 |
| Gujarat | 3.150 | 3.392 | 0.23 | 2.158 | 2.883 | 0.73 | 0.846 | 1.057 | 0.21 |
| Haryana | 1.159 | 1.220 | 0.06 | 0.738 | 0.961 | 0.22 | 0.296 | 0.361 | 0.06 |
| Himachal Pradesh | 0.556 | 0.608 | 0.05 | 0.583 | 0.652 | 0.07 | 0.203 | 0.226 | 0.02 |
| Jammu & Kashmir | 0.711 | 0.717 | 0.01 | 0.728 | 0.744 | 0.02 | 0.255 | 0.259 | 0.00 |
| Karnataka | 4.765 | 4.402 | -0.36 | 5.013 | 4.498 | -0.53 | 1.741 | 1.571 | -0.17 |
| Kerala | 3.631 | 3.682 | 0.05 | 3.875 | 3.939 | 0.06 | 1.341 | 1.362 | 0.02 |
| Maharashtra | 5.606 | 5.503 | -0.10 | 3.064 | 3.130 | 0.07 | 1.300 | 1.309 | 0.01 |
| Meghalaya | 0.202 | 0.191 | -0.01 | 0.217 | 0.205 | -0.01 | 0.075 | 0.071 | -0.00 |
| Manipur | 0.209 | 0.180 | -0.03 | 0.226 | 0.191 | -0.03 | 0.078 | 0.066 | -0.01 |
| Madhya Pradesh | 8.477 | 8.281 | -0.20 | 9.122 | 8.852 | -0.27 | 3.151 | 3.062 | -0.09 |
| Mizoram | 0.072 | 0.069 | -0.00 | 0.077 | 0.073 | -0.00 | 0.026 | 0.025 | -0.00 |
| Nagaland | 0.062 | 0.084 | 0.02 | 0.057 | 0.089 | 0.03 | 0.021 | 0.031 | 0.01 |
| Orissa | 4.335 | 4.576 | 0.24 | 4.700 | 4.949 | 0.25 | 1.622 | 1.718 | 0.10 |
| Punjab | 1.283 | 1.249 | -0.03 | 0.824 | 0.841 | 0.02 | 0.330 | 0.331 | 0.00 |
| Rajasthan | 4.993 | 5.235 | 0.24 | 5.396 | 5.577 | 0.18 | 1.862 | 1.931 | 0.07 |
| Sikkim | 0.031 | 0.030 | -0.00 | 0.031 | 0.030 | -0.00 | 0.011 | 0.011 | -0.00 |
| Tamil Nadu | 7.453 | 7.112 | -0.35 | 8.048 | 7.609 | -0.44 | 2.778 | 2.632 | -0.15 |
| Tripura | 0.300 | 0.323 | 0.02 | 0.324 | 0.342 | 0.02 | 0.112 | 0.119 | 0.01 |
| Uttar Pradesh | 20.637 | 19.069 | -1.57 | 21.516 | 20.055 | -1.46 | 7.483 | 6.965 | -0.52 |
| West Bengal | 7.148 | 7.347 | 0.20 | 7.494 | 7.798 | 0.30 | 2.605 | 2.702 | 0.10 |
| Total | 100 | 100 | 0 | 100 | 100 | 0 | 35.16 | 35.16 | 0 |

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