Deficit Fundamentalism *vs* Fiscal Federalism: Implications of 13th Finance Commission's Recommendations

Pinaki Chakraborty

Working Paper No. 2011-81

January 2011

National Institute of Public Finance and Policy
New Delhi
http://www.nipfp.org.in

Deficit Fundamentalism *vs* Fiscal Federalism: Implications of 13th Finance Commission's Recommendations

Pinaki Chakraborty*

Abstract

* The author is Professor at National Institute of Public Finance and Policy, New Delhi. Email:pinaki@nipfp.org.in

The Thirteenth Finance Commission's recommendation to increase the vertical share of tax devolution to states will help, but its horizontal distribution formula leaves much to be desired. One, its design is such that two of the four key indicators are in conflict with each other. Two, the Commission's revised road map for fiscal consolidation at the centre and the states, which recommends state-specific, year-wise, fiscal adjustment paths, not only limits the fiscal manoeuvrability of states but also impinges on their fiscal autonomy. Three, its design of the grant for elementary education has the potential to reduce the expenditure of states rather than augment it. The need to look at intergovernmental transfers from the right perspective of federalism, where the states and the centre are seen as equal partners in development and not from a narrow technocratic viewpoint, cannot be stressed more.

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The institution of the union finance commission (UFC) as a statutory body to act as an independent arbiter in matters relating to transfer of resources from centre to the states is a unique feature of Indian federalism. Although there are multiple channels of transfers operating simultaneously in India, the largest shares of resources to the state is devolved through the UFC.[1] This special issue's purpose is to discuss and debate the implications of the recommendations of the Thirteenth Finance Commission (THFC). The papers in this issue cover all aspects of the THFC's terms of references (TOR), commented on by well-known scholars in their respective fields, to put the body's recommendations into perspective. My endeavour in this paper is to give a broad overview of the key features of the THFC award (2010-15) and their implications for the states. The important recommendations of the THFC can be categorised under the following heads:

- Enhanced vertical devolution from 30.5 to 32 per cent of divisible pool of taxes.
- Revised road maps for fiscal consolidations at the centre and the states.
- Suggested design of goods and services tax (GST).
- A large number of sector and state specific grants.
- Grants for local bodies amounting to 2.5 per cent of the central pool of taxes

This paper examines what some of these recommendations mean for the states, given their overall operating fiscal constraints and the fiscal inequality across them. The paper also considers whether states will be able to adhere to the fiscal restructuring paths proposed by the THFC for them and what their fiscal implications will be. Towards this, it undertakes a detailed review of the finances of two states and constructs their future fiscal profiles in accordance with the norms proposed by the THFC for fiscal consolidation from 2010-11 to 2014-15.

Apart from the introduction, the paper has five sections. *Section 1* evaluates THFC's recommendations relating to tax devolution and its horizontal distribution principle from the equity and efficiency perspectives. *Sections 2* and *3* analyse the implications of the revised road maps for fiscal consolidations recommended for the states. *Section 4* analyses one of the major state-specific grants – grants for elementary education, its design and implications. *Section 5* summarises the findings and draws conclusions.

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[1] The other channels of transfers include the Planning Commission and various central government ministries. Planning Commission transfers are in the form of plan grants, and ministry specific transfers are in the form of various centrally sponsored schemes.

1. Tax Devolution: Vertical Quantum and Horizontal Distribution

As mentioned, the THFC has enhanced the vertical share of tax devolution to states from the 30.5 per cent recommended by the Twelfth Finance Commission (TWFC) to 32 per cent. If we look at the horizontal distribution of this transfer, the aggregate share of low-income states[2] has remained more or less stagnant at 54 per cent during the award periods of the Eleventh Finance Commission (EFC), the TWFC and the THFC (*Table 1*). While the share of middle-income states has declined sharply, that of high-income states increased from 9.75 per cent to 11.19 per cent during the award period of the TWFC, but has declined marginally to 10.94 per cent in the THFC award. The aggregate share of special category states has increased from 7.29 per cent to 9.6 per cent during this period. In other words, despite attaching high weightage to the "income distance" or "fiscal capacity index" to achieve fiscal equity, the horizontal distribution formula has failed to increase the aggregate share of devolution to low-income states. In the specific context of some of the low- and middle- income states, their shares in the UFC devolution have continued to decline, imposing a huge fiscal strain on their finances.[3] It has been pointed out that one of the major reasons for the low level of per capita development expenditure in low-income states and in many of the middle-income ones is the failure of the transfer system to offset the fiscal disabilities of these states (Rao and Singh, 2002) despite having apparently progressive principles of transfers.

Table 1: Tax Devolution

	Union Finance Commission		
	Eleventh	**Twelfth**	**Thirteenth**
Low income states	53.762	53.788	53.618
Middle income states	29.189	26.842	25.839
High income states	9.75	11.199	10.943
Special category states	7.299	8.171	9.600
Non-special category states	92.701	91.829	90.400
Total	100	100	100

Source: Report of the Finance Commissions (2000, 2004, 2009).

[2] The group of low-income states is Bihar, Uttar Pradesh, Madhya Pradesh, Orissa, Rajasthan, Jharkhand, and Chhattisgarh. The group of middle-income states is West Bengal, Andhra Pradesh, Karnataka, Kerala, and Tamil Nadu and the group of high-income states is Gujarat, Punjab, Maharashtra, Haryana, and Goa. This grouping is done by taking the average comparative per capita gross state domestic product (GSDP) from 2004-05 to 2006-07 in ascending order, which is provided in the Report of the THFC (Finance Commission 2009; subsequently Report).

[3] This is the case with Bihar. Its share in tax devolution has consistently declined over the award periods of the EFC, the TWFC and the THFC. *See,* Chakraborty (2010).

The horizontal distribution formula of the THFC has four different indicators, each with a different weight assigned to it – area (10%), population (25%), fiscal capacity distance (47.5%) and index of fiscal discipline (17.5%). Fiscal capacity distance is a new indicator, which replaces the income distance used by earlier UFCs, with the rationale that it better reflects fiscal capacity. The fiscal capacity distance in a way benchmarks states according to their tax capacity, down from the state with the highest fiscal capacity and a prescriptive tax effort. The THFC has worked out the average tax to gross state domestic product (GSDP) ratios separately for general and special category states and applied the group-specific averages to obtain the potential tax effort. This has been used to estimate the per capita fiscal capacity at comparable levels of taxation. It has then computed the fiscal distance (weight of 47.5%) of each state by the distance of its estimated per capita revenue from that of Haryana. The distance so computed defines the per capita revenue entitlement of each state based on fiscal distance. But it is worth noting what an editorial in the *Economic & Political Weekly* observed:

> Although, this is an interesting innovation and the THFC claims that this is a more direct way of estimating fiscal capacity than the income distance method, it is important to remember that the relationship between income and tax is non-linear because of the differences in the taxable consumption basket between high, middle and low income states. Also, as the central sales tax (CST) continues to exist, there is significant tax exportation taking place from the producing high-income states to the consuming low-income states. Thus, the new horizontal formula creates an inherent bias against the low income states (2010).

Area and population are neutral indicators of need, while fiscal capacity distance as explained above tries to equalise the fiscal capacity differences across states. On the other hand, the index of fiscal discipline tries to capture the efficiency in fiscal management by comparing the own revenue to total revenue expenditure ratio of the states at two different points of time. The index of fiscal discipline is worked out with 2005-06 to 2007-08 as the reference years, and 2001-02 to 2003-04 as the base years.

The existence of fiscal capacity distance and an index of fiscal discipline in the same formula contradict the objective of achieving horizontal equity. The reason being that while fiscal capacity distance tries to enhance the fiscal capacity of states, the index of fiscal discipline tries to limit their expenditure in relation to their own revenue. This, in practice, could conflict with each other. One needs to remember that if the objective of fiscal equalisation is to provide "comparable levels of public services at comparable levels of taxation", it cannot be achieved by an index of fiscal discipline defined as own revenue to revenue expenditure ratio. It needs some measure of expenditure equalisation taking into account total revenues, including devolution and grants. If the objective is to equalise fiscal capacity, the index of fiscal discipline and fiscal capacity in the same formula may send conflicting signals to the states. Finally, given the large-scale inequality in government expenditure in per capita terms, it is critical that the principle of devolution primarily be driven by equity considerations, especially when a large number of specific-purpose transfers is anyway given to enhance the efficiency of government expenditure and also for state-specific needs. To put this issue in perspective, we have tried to examine what the distributional change in devolution across states would be if the index of fiscal discipline criterion is eliminated, and the assigned share of the index is assigned to the fiscal capacity distance. The result is in *Table 2*.

As the table shows, under the new formula, the share of devolution to low-income states increases quite significantly while the shares of high and middle-income states decline. Bihar's share under the new formula would be 12.659 per cent against 10.197 per cent recommended by the THFC. Similarly, the share of low-income states like Chhattisgarh, Jharkhand, Madhya Pradesh, Orissa, and Uttar Pradesh would go up significantly while there would be a decline in the shares of high- and middle-income states, particularly those of Maharashtra, Tamil Nadu, and Gujarat. It is also important to note that the fiscal capacity distance criterion penalises states with lower than average tax effort for inefficiency by taking the group-specific average tax effort, not their actual tax effort, in estimating fiscal capacity distance. In other words, if the fiscal distance is estimated with actual tax effort instead of the average, the distance would be higher for those with a lower tax effort. In turn, these states would benefit from higher transfers. Thus, also having an index of fiscal discipline in the horizontal distribution formula penalises the states twice.

Table 2: Horizontal Distribution Formula: Alternatives and Outcome

	States	THFC Share		
		With fiscal discipline criterion (1)	Without fiscal discipline criteria (2)	Difference (1-2)
1	Andhra Pradesh	6.937	6.627	-0.310
2	Arunachal Pradesh	0.328	0.327	-0.001
3	Assam	3.628	4.045	0.417
4	Bihar	10.917	12.659	1.742
5	Chhattisgarh	2.470	2.512	0.042
6	Goa	0.266	0.245	-0.021
7	Gujarat	3.041	2.276	-0.765
8	Haryana	1.048	0.765	-0.283
9	Himachal Pradesh	0.781	0.760	-0.021
10	Jammu & Kashmir	1.551	1.691	0.140
11	Jharkhand	2.802	3.033	0.231
12	Karnataka	4.328	3.865	-0.463
13	Kerala	2.341	1.897	-0.444
14	Madhya Pradesh	7.120	7.596	0.476
15	Maharashtra	5.199	3.637	-1.562
16	Manipur	0.451	0.472	0.021
17	Meghalaya	0.408	0.435	0.027
18	Mizoram	0.269	0.272	0.003
19	Nagaland	0.314	0.325	0.011
20	Orissa	4.779	4.876	0.097
21	Punjab	1.389	0.990	-0.399
22	Rajasthan	5.853	6.045	0.192
23	Sikkim	0.239	0.244	0.005
24	Tamil Nadu	4.969	4.130	-0.839
25	Tripura	0.511	0.553	0.042
26	Uttar Pradesh	19.677	21.229	1.552
27	Uttarakhand	1.120	1.222	0.102
28	West Bengal	7.264	7.272	0.008
	All States	**100.000**	**100.000**	**0.000**
	Special category states	9.600	10.346	0.746
	General category states	90.400	89.654	-0.746

Note: Basic Data from the *Thirteenth Finance Commission's Report*.

2. Revised Roadmap for Fiscal Consolidation

One of the most significant components of the THFC's recommendations is the revised roadmap for fiscal consolidation at the centre and the states. The basic concern of this road map is to bring down the fiscal deficit to 3 per cent of gross domestic product (GDP), separately at both the centre and the states, by the end of 2014-15. As mentioned earlier, the THFC appears to have been seriously concerned about the fiscal expansion that took place in 2008-09 and 2009-10 to combat the slowdown in India's economic growth caused by the global financial crisis and decided to emphasise the need for both levels of government to bring down their level of fiscal deficit to 3 per cent of GDP. The centre and all the states, barring West Bengal and Sikkim, had a Fiscal Responsibility and Budget Management (FRBM) Act when the THFC submitted its report. The THFC has recommended that the states incorporate their new target into their existing Acts or introduce it if they do not have one. The THFC's revised road map for fiscal consolidation is not fundamentally different from what was proposed by the TWFC as far as the level of fiscal deficit is concerned. The only difference is alternative fiscal adjustment paths for states with relatively high fiscal imbalances, with mandated deficit reduction targets for every year to arrive at a fiscal deficit of 3 per cent of GSDP by the end of 2014-15. Now, two fundamental questions arise at this point. One is the feasibility of bringing down the fiscal deficit within the time frame specified by the THFC and the use of deficit reduction as a condition for the release of state-specific grants that the Commission has recommended. The other is the appropriateness of the proposed road map when it is assessed against the backdrop of the fiscal autonomy guaranteed by the Indian Constitution to the states.

To start with the first question, we need to recall that the deficits in 2008-09 and 2009-10 were particularly due to a decline in revenue because of the slowdown in economic growth, coupled with an increase in expenditure. The latter was necessitated by various stimulus packages and the revision of pay scales in accordance with the recommendations of the Sixth Pay Commission (2008). Although these shocks were transitory in nature, the adjustment path could be much longer than what has been suggested by the THFC. Among the general category states, the THFC has suggested a different fiscal adjustment path for Kerala, Punjab, and West Bengal, the states with high levels of fiscal deficits. Of the 11 special category states, different fiscal adjustment paths have been suggested for six — Jammu and Kashmir, Manipur, Mizoram, Nagaland, Sikkim, and Uttarakhand. The level of adjustment for all the states starts from 2011-12. In effect, there is only one year, 2010-11, to bring down the fiscal deficit to a manageable level of 3.5 per cent except for Jammu and Kashmir and Mizoram where lower fiscal deficit reduction targets have been proposed.

The THFC's base year for estimating these adjustment paths is 2007-08. As many are aware, 2007-08 was dubbed the best year of fiscal prudence by both the centre and the states with the actual fiscal deficit remaining much lower than the targets proposed under their fiscal responsibility legislations. But one cannot deny that the deficit increased significantly in 2008-09 and 2009-10 (*Table 3*). So taking 2007-08 as the base year for the fiscal adjustment path, leaving aside two out of the ordinary years of fiscal imbalance, is not justified from the viewpoint of practical management of state finances as well as the implications of the fiscal contraction proposed to be achieved within just a year, especially for states with large fiscal imbalances. For example, according to the THFC's proposed fiscal adjustment path, Punjab's fiscal deficit for 2007-08 was 3.5 per cent and this has to be maintained at the same level of GSDP in 2011-12. But if we look at Punjab's level of fiscal deficit in 2009-10 (budget estimate), it is 5.3 per cent of GSDP. If Punjab has to bring down the fiscal deficit to 3.5 per cent in 2011-12, as proposed by the THFC, the level of deficit reduction will have to be 1.8 per cent in just one year, 2010-11. In the case of West Bengal, the reduction will have to be even higher at 2.3 per cent of GSDP as there has been a sharp increase in the state's deficit according to the budget estimates for 2009-10. For special category states, the problem is even worse as their levels of fiscal and revenue deficits were much more than those of general category states in relation to their respective GSDPs for 2008-09 and 2009-10. Given their narrow tax base, they have to contract their level of expenditures much more than the general category states if they have to comply with the fiscal adjustment path proposed by the THFC.

As mentioned, the problem is compounded as reduction in the deficit has been linked to transfers of state-specific grants. This kind of selective approach towards specific states is unfair and subjective. As evident from *Table 3*, Kerala, Punjab and West Bengal had fiscal deficits in 2007-08 of 3.68 per cent, 3.32 per cent and 3.75 per cent of GSDP respectively, while those of Uttar Pradesh and Jharkhand were much higher. It can be asked why the same fiscal adjustment path has not been recommended for Jharkhand and Uttar Pradesh as well. In short, this type of selective approach is unjust and arbitrary.

Finally, it is mandatory that each state adheres to its fiscal adjustment path if it wants to avail itself of state-specific grants. To quote the THFC, "To facilitate implementation of the above road map, we recommend that the states' enactment/amendment of their FRLs incorporating the above targets should be a conditionality for release of all state-specific grants". To put it differently, if the states are not able to follow these road maps despite their best efforts, they will lose out on a large volume of transfers. The total state-specific grants proposed by the THFC add up to Rs 27,945 crore. The biggest beneficiaries of these state-specific grants would be poorer states such as Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Orissa, Rajasthan, and Uttar Pradesh. Together, their share accounts for 37.24 per cent of the total state-specific grants, or Rs 10,406 crore. Kerala, Punjab, and West Bengal together will lose Rs 4,683 crore if they are not able to adhere to the proposed fiscal adjustment paths specified for each of them by the THFC. It is also unfortunate that the THFC's fiscal consolidation road map has endorsed the same target of deficit that was proposed by the TWFC instead of allowing states the flexibility of deciding what their sustainable level of fiscal deficit would be, given state-specific economic growth and the interest rate on debt as specified in Domar's (1944) condition of sustainability and the level of primary deficit. Such a straitjacketed approach to fiscal reforms and sustainability not only undermines the fiscal autonomy of the states, but also could result in mindless cuts in development expenditure to achieve the proposed targets.

Table 3: Revenue and Fiscal Deficits of States: A Comparison

(As a percentage of GSDP)

States	Revenue Deficit			Fiscal Deficit		
	2007-08	2008-09 (RE)	2009-10 (BE)	2007-08	2008-09 (RE)	2009-10 (BE)
I. Non-Special Category						
1. Andhra Pradesh	-0.05	-0.56	-0.57	2.68	2.81	3.85
2. Bihar	-4.05	-2.60	-4.04	1.49	5.68	2.44
3. Chhattisgarh	-3.83	-1.10	-0.71	0.16	2.37	2.25
4. Goa	-0.96	-0.43	1.59	3.14	4.61	6.33
5. Gujarat	-0.70	-0.08	0.94	1.56	2.89	2.90
6. Haryana	-1.45	-0.03	1.59	0.83	2.05	4.02
7. Jharkhand	2.14	-0.83	0.33	8.98	4.95	5.11
8. Karnataka	-1.58	-0.28	-0.37	2.24	3.44	2.74
9. Kerala	2.28	1.96	1.38	3.68	3.33	2.61
10. Madhya Pradesh	-3.57	-2.04	-1.00	1.95	3.45	3.79
11. Maharashtra	-2.50	-0.62	0.89	-0.48	2.36	3.33
12. Orissa	-3.99	-0.62	1.69	-1.24	2.10	4.28
13. Punjab	2.76	2.40	3.42	3.32	4.31	5.29
14. Rajasthan	-0.94	0.14	0.60	1.94	3.22	3.58
15. Tamil Nadu	-1.49	0.00	0.27	1.21	2.73	3.13
16. Uttar Pradesh	-1.00	-1.03	-0.34	4.01	5.16	5.05
17. West Bengal	2.68	3.66	4.54	3.75	3.67	5.82
II. Special Category						
1. Arunachal Pradesh	-19.11	-16.97	6.61	-0.41	22.37	21.12
2. Assam	-3.60	-2.38	7.07	-1.10	2.75	12.38
3. Himachal Pradesh	-2.64	-0.91	-0.63	1.71	5.14	3.89
4. Jammu and Kashmir	-6.97	-9.66	-12.16	8.21	6.68	5.78
5. Manipur	-20.79	-17.78	-13.79	-1.74	7.46	5.91
6. Meghalaya	-2.22	-5.43	-2.00	2.53	1.30	5.63
7. Mizoram	-3.96	-6.53	-4.39	11.86	10.16	5.22
8. Nagaland						
9. Sikkim	-15.28	-22.66	-14.21	2.79	13.21	15.39
10. Tripura	-8.35	-6.55	-2.92	0.16	6.66	10.74
11. Uttarakhand	-1.79	-1.49	0.47	4.89	3.88	4.57

Note: (-) sign indicates surplus in deficit indicators
RE: Revised Estimates; BE: Budget Estimates
Source: *State Finances: A Study of Budgets of 2009-10*, Reserve Bank of India.

3. Implications of Revised Roadmap: Comparing Two States

In this section we have quantified the implications of the revised road map for two states, *viz*., Bihar and Kerala. The rationale behind the selection of these two states is as follows.

- Bihar is on the bottom rung of per capita income with a low level of development spending and a low fiscal imbalance.
- Kerala is a fast-growing middle-income state with high per capita development spending and a high fiscal imbalance.
- Given the differences in initial conditions between these states, it is important to examine and compare the differential implications of the fiscal adjustment paths proposed by the THFC for them.

It is worth mentioning that there have been significant increases in development spending in recent years in both the states. In this context, we need to examine if it would be possible for Bihar to follow the proposed path of fiscal adjustment without decreasing much-needed development spending. To address this, we first need to see what the likely fiscal situation will be in Bihar and Kerala during the award period of the THFC if they continue with their present fiscal policy stances. The base year of projection is 2010-11 (budget estimate) and we have made following assumptions.

- Tax revenues are expected to grow at their present buoyancy-based growth rates.
- Non-tax revenues are likely to grow at their observed trend growth rate.
- Central transfers are assumed to grow according to their observed trend growth rate.
- Interest payments are assumed to grow at the average effective rate of interest for the year 2010-11.
- Other components of expenditure are assumed to grow at their respective trend growth rates.
- For the entire projection period, the GSDP of Bihar and Kerala are assumed to grow at 14 per cent and 13.7 per cent per annum respectively in nominal terms.[4]

As *Table 4* shows, if the present fiscal policy stance of the Government of Bihar continues, the state will in no way be near the THFC's proposed fiscal adjustment path. Although the revenue surplus of the state will increase from 3.90 per cent of GSDP to 4.97 per cent of GSDP between 2010-11 and 2014-15, the fiscal deficit will go up from 2.73 per cent to 6.02 per cent and the debt to GSDP ratio will go up to 38.63 per cent by the end of 2014-15. One also needs to find out what the possible reasons are for such a

[4] It has to be noted that the annual average nominal rate of growth of GSDP of Bihar from 2004-05 to 2008-09 has been 16.8 per cent.

huge increase in the fiscal imbalance. As evident from the table, both social and economic services expenditures as a percentage of GSDP show a sharp increase and the capital expenditure to GSDP ratio also rises sharply from 6.63 per cent in 2010-11 to 11.58 per cent in 2014-15. In other words, the increase in deficits will primarily be due to an increase in the development expenditure of the state, provided the growth of expenditure remains at the observed level used for the projection. Given low development spending (in per capita terms) *vis-à vis* other states and corresponding physical and social infrastructure deficits, such an increase in government expenditure would not be possible if the THFC'S proposed fiscal consolidation path is stuck to, unless state revenue increases accordingly, which is unlikely given the low resource base of the state.

We have estimated the alternative fiscal scenario to see the level of contraction in development revenue expenditure required to adhere to the path of fiscal consolidation proposed by the THFC. The latter is shown in *Table 5*. As can be seen from the table, if the fiscal deficit has to be at 3 per cent as specified in the fiscal adjustment path of the THFC's revised road map for fiscal consolidation, development expenditures on social and economic services are expected to fall sharply between 2010-11 and 2014-15. If the entire burden of adjustment falls on capital expenditure, it would increase much less compared to the base scenario. As a percentage of GSDP, the increase would be from 6.63 per cent to 8.26 per cent during this period. The outstanding debt to GSDP ratio will fall from 36.45 per cent to 31.54 per cent. So if the Government of Bihar has to adhere to the fiscal consolidation path proposed by the THFC, it has to happen through a cut in development spending.

Table 4: Base Scenario: Business as Usual Fiscal Adjustment Path

(As a percentage to GSDP)

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Revenue receipts	25.01	25.46	28.07	29.13	30.32	31.65	33.13
Own tax revenues	4.68	5.47	6.32	6.23	6.14	6.06	5.97
Own non-tax revenues	0.87	0.65	0.72	0.79	0.88	0.97	1.08
Central transfers	19.45	19.33	21.02	22.10	23.30	24.62	26.08
Revenue expenditure	21.62	25.34	24.17	25.90	27.81	30.12	32.89
General services	7.98	9.46	9.18	9.51	9.82	10.28	10.91
Interest payments	2.85	2.80	2.68	2.71	2.70	2.83	3.12
Pension payments	2.64	3.18	3.49	3.69	3.89	4.11	4.34
Social services of which	9.29	10.68	10.59	11.55	12.67	13.99	15.54
Education	5.06	5.84	5.61	5.77	5.93	6.10	6.27
Health	0.78	0.96	0.93	0.93	0.93	0.93	0.93
Economic services	4.34	5.20	4.40	4.84	5.33	5.86	6.44
Capital expenditure	5.29	6.68	6.63	7.57	8.69	10.02	11.58
Total expenditure	26.91	32.02	30.79	33.47	36.50	40.14	44.48
Revenue deficit	-3.39	-0.12	-3.90	-3.23	-2.50	-1.52	-0.24
Fiscal deficit	1.90	6.57	2.73	4.34	6.18	8.49	11.34
Outstanding debt	35.63	38.15	36.45	36.31	38.04	41.86	48.06

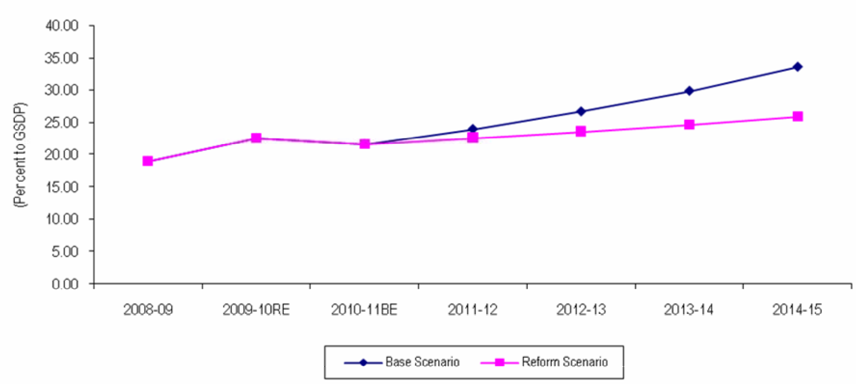
Table 5: Reform Scenario: Fiscal Adjustment Path Compliant with TFC Recommendations

(As a percentage to GSDP)

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Revenue receipts	25.01	25.46	28.07	29.13	30.32	31.65	33.13
Own tax revenues	4.68	5.47	6.32	6.23	6.14	6.06	5.97
Own non tax revenues	0.87	0.65	0.72	0.79	0.88	0.97	1.08
Central transfers	19.45	19.33	21.02	22.10	23.30	24.62	26.08
Revenue expenditure	21.62	25.34	24.17	25.90	27.71	29.80	32.20
General services	7.98	9.46	9.18	9.51	9.72	9.95	10.21
Interest payment	2.85	2.80	2.68	2.71	2.60	2.51	2.42
Pension payment	2.64	3.18	3.49	3.69	3.89	4.11	4.34
Social services of which	9.29	10.68	10.59	11.55	12.67	13.99	15.54
Education	5.06	5.84	5.61	5.77	5.93	6.10	6.27
Health	0.78	0.96	0.93	0.93	0.93	0.93	0.93
Economic services	4.34	5.20	4.40	4.84	5.33	5.86	6.44
Capital expenditure	5.29	6.68	6.63	6.23	5.60	4.85	3.93
Total expenditure	26.91	32.02	30.79	32.13	33.32	34.65	36.13
Revenue deficit	-3.39	-0.12	-3.90	-3.23	-2.60	-1.85	-0.93
Fiscal deficit	1.90	6.57	2.73	3.00	3.00	3.00	3.00
Outstanding debt	35.63	38.15	36.45	34.97	33.68	32.54	31.54

The development spending gap that would emerge due to this can be seen in *Figure 1*. As evident, if the present fiscal stance continues, the development expenditure to GSDP ratio will increase from 21.61 per cent to 29.24 per cent during the award period of the THFC. If the THFC-compliant path is followed, the increase in development spending will be from 21.61 per cent to 25.92 per cent during the same period – much lower than the base scenario.

Figure 1: Development Expenditure Path: Alternative Scenarios



The Kerala story is different. Here too, we estimate what the situation will be if the present fiscal situation continues, how the debt profile will behave and whether that will be sustainable because the state's large fiscal imbalance has prompted the THFC to suggest a separate and specific fiscal adjustment path for it. According to the proposed fiscal adjustment path, Kerala has to eliminate its revenue deficit to GSDP ratio by 2014-15 and bring down the fiscal deficit GSDP to ratio to 3 per cent by 2013-14. However, in Kerala, there has been substantial fiscal correction in the financial years 2008-09 and 2009-10 (revised estimate) and this is expected to be the case in 2010-11 (budget estimate) as well. Kerala's medium-term fiscal plan (MTFP) for 2010-11 to 2012-13 proposed a fiscal correction path, which targeted reduction of revenue deficit to 0.88 per cent of GSDP and fiscal deficit to 3.5 per cent of GSDP by the end of 2012-13.

To get a clear idea about the fiscal correction path in the medium term, independent of what is proposed in Kerala's MTFP, we have estimated the movement of key fiscal indicators, based on the assumption that the current fiscal situation will continue in that period as well. Our period of projection is from 2011-12 to 2014-15 and the base year is 2010-11 (budget estimate). The resulting fiscal path (as a percentage to GSDP) is shown in *Table 6* and termed, the base scenario. As seen from the table, if the present fiscal situation continues, there will be a marginal improvement in revenue receipts and a sharp decline in revenue expenditure, primarily due to a decline in general services expenditure because of a sharp decline in interest payments. Projections based on past growth also show a marginal decline in social and economic services expenditures to GSDP ratio in the revenue account, while the capital expenditure to GSDP ratio shows marginal improvement. The movement of these key variables, in turn, will result in a steady decline in the revenue deficit and the emergence of a revenue surplus by the end of the 2013-14, a steady decline in the fiscal deficit to GSDP ratio to 1.6 per cent of GSDP by the end of 2014-15, and a steady decline in the debt to GSDP ratio to 20.1 per cent by the end of 2014-15. Thus, the alarm bell rung by the THFC about the deteriorating fiscal situation of the state appears to be incorrect. Disregarding the fact that Kerala has improved its fiscal balance significantly in recent years, the THFC has imposed a fiscal adjustment path that has little relevance to the state.

Table 6: Fiscal Profile and Debt Sustainability: Medium Term Perspective (The Base Scenario)

(As a percentage to GSDP)

	2010-11 BE	2011-12	2012-13	2013-14	2014-15
Revenues	**12.7**	**12.9**	**13.1**	**13.2**	**13.4**
Own Tax Revenues	**8.5**	**8.6**	**8.7**	**8.7**	**8.8**
Sales tax	6.2	6.2	6.2	6.2	6.2
State excise duties	0.8	0.8	0.8	0.8	0.8
Stamp duty and registration fees	0.9	1.0	1.0	1.1	1.2
Other taxes	0.7	0.7	0.7	0.7	0.6
Own Non-Tax Revenues	**0.9**	**0.9**	**0.9**	**0.9**	**0.9**
Central Transfers	**3.3**	**3.4**	**3.5**	**3.6**	**3.7**
Tax devolution	2.0	2.0	2.1	2.1	2.1
Grants	1.3	1.3	1.4	1.5	1.5
Revenue Expenditure	**14.2**	**13.9**	**13.5**	**13.1**	**12.6**
General Services	**6.2**	**6.2**	**6.0**	**5.8**	**5.6**
Interest payments	2.4	2.3	2.1	1.9	1.7
Pension	2.2	2.2	2.2	2.2	2.1
Other general services	1.6	1.7	1.7	1.8	1.8
Social Services	**5.3**	**5.2**	**5.1**	**5.0**	**4.9**
Education	2.7	2.6	2.6	2.5	2.4
Medical and public health	0.8	0.8	0.8	0.7	0.7
Other social services	1.8	1.8	1.8	1.7	1.7
Economic Services	**1.6**	**1.5**	**1.4**	**1.3**	**1.2**
Compensation and Assignment to LBs	**1.1**	**1.1**	**1.0**	**1.0**	**0.9**
Capital Expenditure	**2.0**	**2.1**	**2.2**	**2.2**	**2.3**
Capital outlay	1.7	1.7	1.8	1.8	1.9
Net lending	0.3	0.4	0.4	0.4	0.5
Revenue Deficit	**1.5**	**1.0**	**0.4**	**-0.2**	**-0.8**
Fiscal Deficit	**3.5**	**3.1**	**2.6**	**2.1**	**1.6**
Primary Deficit	**1.1**	**0.8**	**0.5**	**0.2**	**-0.1**
Outstanding Liabilities	**32.0**	**29.0**	**26.0**	**23.0**	**20.1**

Kerala's fiscal adjustment path compliant with the THFC's revised road map for fiscal consolidation is presented in *Table 7*. If the state follows the targeted path of fiscal deficit reduction proposed by the THFC, the capital expenditure will go up to 3.6 per cent of GSDP by the end of 2014-15, with a revenue surplus emerging in 2013-14 and continuing thereafter. This substantiates our earlier observation that the level of fiscal correction in Kerala in the last four years has been significant and a continuation of the same trend will result in a reduction in fiscal deficit much below its Fiscal Responsibility

Act (FRA) target. The reform scenario proposed should help the state enhance the fiscal space for higher capital expenditure without violating THFC-proposed norms. However, this would also mean that Kerala should amend its FRBM Act to revise the target of fiscal deficit reduction to 3 per cent instead of the 2 per cent it stands at today.

These two case studies bring out the unjust, arbitrary and, to a great extent, futile nature of the exercise called “revised road map for fiscal consolidation” proposed by the THFC, which has a uniform deficit reduction target of 3 per cent of GSDP for all states by the end of 2014-15, and specifies the path of fiscal adjustment to be followed by individual states. If the current fiscal stance is allowed to continue, by the terminal year of the THFC award, Bihar’s fiscal deficit would be more than two times higher than what is proposed by the THFC and Kerala’s would be almost half of what is proposed. This implies that to comply with the norm, Bihar has to reduce its expenditure by around 3 per cent of GSDP and Kerala can enhance its expenditure if it so decides. But if we compare the proposed state-specific fiscal adjustment paths, Bihar has stricter norms than Kerala because, as per the THFC’s assessment, Kerala is a state with higher fiscal imbalance and it requires reducing its deficit gradually.

Table 7: Fiscal Profile and Debt Sustainability: Medium Term Perspective (The Reform Scenario)

(As a percentage to GSDP)

	2010-11 BE	2011-12	2012-13	2013-14	2014-15
Revenues	**12.7**	**12.9**	**13.1**	**13.2**	**13.4**
Own Tax Revenues	**8.5**	**8.6**	**8.7**	**8.7**	**8.8**
Sales tax	6.2	6.2	6.2	6.2	6.2
State excise duties	0.8	0.8	0.8	0.8	0.8
Stamp duty and registration fees	0.9	1.0	1.0	1.1	1.2
Other taxes	0.7	0.7	0.7	0.7	0.6
Own Non-Tax Revenues	**0.9**	**0.9**	**0.9**	**0.9**	**0.9**
Central Transfers	**3.3**	**3.4**	**3.5**	**3.6**	**3.7**
Tax devolution	2.0	2.0	2.1	2.1	2.1
Grants	1.3	1.3	1.4	1.5	1.5
Revenue Expenditure	**14.2**	**13.9**	**13.5**	**13.1**	**12.8**
General Services	**6.2**	**6.2**	**6.0**	**5.9**	**5.8**
Interest payments	2.4	2.3	2.1	2.0	1.8
Pension	2.2	2.2	2.2	2.2	2.1
Other general services	1.6	1.7	1.7	1.8	1.8
Social Services	**5.3**	**5.2**	**5.1**	**5.0**	**4.9**
Education	2.7	2.6	2.6	2.5	2.4
Medical and public health	0.8	0.8	0.8	0.7	0.7
Other social services	1.8	1.8	1.8	1.7	1.7
Economic Services	**1.6**	**1.5**	**1.4**	**1.3**	**1.2**
Compensation and Assignment to LBs	**1.1**	**1.1**	**1.0**	**1.0**	**0.9**
Capital Expenditure	**2.0**	**2.5**	**3.0**	**3.1**	**3.6**
Capital outlay	1.7	2.1	2.6	2.6	3.1
Net lending	0.3	0.4	0.4	0.4	0.5
Revenue Deficit	**1.5**	**1.0**	**0.5**	**-0.1**	**-0.6**
Fiscal Deficit	**3.49**	**3.5**	**3.5**	**3.0**	**3.0**
Primary Deficit	**1.1**	**1.2**	**1.4**	**1.0**	**1.2**
Outstanding Liabilities	**32.0**	**29.3**	**27.2**	**24.9**	**23.1**

These kinds of wide differences between norms and actual performance arise because we do not have state-specific sustainable levels of deficit. It is obvious that given the debt sustainability condition, the level of sustainable deficit would be a combination of the growth rate, interest rate, and primary deficit. As these are quite different in different states, the estimated levels of sustainable deficit would have been different in Bihar and Kerala had such an approach been adopted by the THFC. Once the sustainable deficit is known, then it is a question of adopting the right fiscal policy options to achieve that sustainable deficit in a particular state. This arbitrary 3 per cent target will not only make the states take *ad hoc* policy options in terms of fiscal sustainability but also seriously undermine the whole idea of growth and sustainability if it results in cuts in growthpromoting government expenditure, as appears to be what is most likely in Bihar and probably many other states. This analysis also brings out that the objective of bringing in fiscal discipline in a multilevel fiscal system should be based on state-specific fiscal needs, which are intimately linked to growth.

4. Sector and State Specific Grants

The THFC has recommended a large number of state-specific grants. Apart from non-plan revenue deficit grants, these include state-specific performance grants; grants for universalising elementary education; environment-related grants, for forests, renewable energy, and water sector management; incentive grants to improve the quality of public expenditure; grants for maintenance of roads and bridges; and grants for state-specific needs. As these grants are conditional, their actual utilisation will largely depend on meeting grant-specific conditionalities.

One of the major components is the grant for elementary education, amounting to Rs 24,068 crore. The conditionality attached to the release of this grant is that states have to maintain the growth of their own expenditure on elementary education at 8 per cent per annum during the THFC's award period. The state-wise growth of expenditure on elementary education is given in *Table 8*. If we take recent years, the all-state expenditure on elementary education grew at the rate of 14.6 per cent between 2004-05 and 2007-08. This is much higher than the 8 per cent prescribed by the THFC. However, the big question at the moment is whether states will be able to maintain this high growth in education expenditure given the fiscal constraints imposed by the revised road map for fiscal consolidation. It may so happen that with THFC-imposed fiscal constraints, many states may actually have a lower expenditure despite having the grants for elementary education. The design of the grant is such that most of the states would still be eligible for it if they bring down their own expenditure from the current level. This is contrary to what an equalisation grant is expected to do – augment expenditure for a particular service in a specific jurisdiction where it is low.

Coming to the quantum of grants provided, the grant for elementary education proposed by the THFC is much higher than what was proposed by the TWFC[5], which was pegged at Rs 10,172 crore. The full equalisation requirement as per the TWFC norm worked out to Rs 67,811 crore for its award period (Chakraborty, 2005). Thus, the THFC grant at Rs 24,068 crore is only around 36 per cent of the full equalisation requirement as per even the TWFC norm, that too in nominal terms. The TWFC grant was also better in terms of its design and helped the states to augment their expenditure on education.

It is also important to note that the THFC has based the grant for elementary education on *Sarva Shiksha Abhiyan* (SSA) norms and recommended a grant of 15 per cent of the estimated expenditure of each state on the SSA. The rationale given by the

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[5] For partial equalisation of the per capita education and health expenditures of selected states, the TWFC also gave grants.

THFC is that this grant will augment state resources and provide adequate fiscal space to implement the *Right to Education (RTE) Act, 2009*. It will also help the states to provide for the anticipated increase in their share of the SSA to 50 per cent by the terminal year of the Eleventh Five-Year Plan (2007-12). This is *ad hoc* and arbitrary. Instead of depending on the SSA norms and justifying its grant on the grounds that the contribution of states for the SSA will go up, the THFC should have revised its own norms for complete equalisation and given the grants required by states. This kind of partial approach towards equalisation may not have the desired outcome. It can at best tinker at the margin. As there are strict norms set for fiscal consolidation and adherence to those norms is mandatory for the states to avail themselves of state-specific grants, the scope for states to increase their expenditure to bridge whatever gap there is in providing elementary education appears impossible in the short run and the grants as transfers will serve only a very limited purpose. There is also the danger of states bringing down their expenditure growth to 8 per cent per annum to adhere to the fiscal constraint imposed by the THFC and avail themselves of this grant.

Table 8: State wise Growth of Elementary Education Expenditure

(percentage per annum)

State	2004-05	2005-06	2006-07	2007-08	Trend growth rate
I. Non-Special Category					
Andhra Pradesh	4.6	14.7	12.1	9.2	12.0
Bihar	11.2	43.6	17.1	12.6	23.0
Chhattisgarh	19.9	6.5	22.7	30.4	19.7
Goa	11.1	18.0	9.3	16.0	13.8
Gujarat	16.7	2.5	17.0	15.1	11.9
Haryana	15.5	13.7	17.1	8.6	13.5
Jharkhand	41.7	13.7	11.0	32.1	17.8
Karnataka	21.0	8.9	14.9	21.0	14.8
Kerala	3.5	5.0	16.9	14.0	12.3
Madhya Pradesh	8.9	17.4	22.3	-2.7	12.8
Maharashtra	11.8	3.8	16.8	9.2	10.5
Orissa	4.0	11.7	6.7	43.9	18.3
Punjab	0.4	5.0	-3.4	7.7	2.3
Rajasthan	9.3	23.8	4.0	11.7	12.0
Tamil Nadu	10.5	3.5	30.5	10.4	15.8
Uttar Pradesh	16.3	26.0	22.0	19.9	22.5
West Bengal	23.1	18.5	12.8	14.2	14.9
II. Special Category					
Arunachal Pradesh	11.0	6.6	21.0	19.9	16.2
Assam	3.2	-0.2	3.3	10.2	4.2
Himachal Pradesh	5.0	11.5	26.1	15.0	18.2
Jammu and Kashmir	0.6	14.3	17.4	5.2	12.7
Manipur	1.6	20.7	8.9	4.8	11.0
Meghalaya	11.9	3.8	9.5	36.6	15.1
Mizoram	14.9	19.2	0.4	12.8	9.5
Nagaland	4.2	20.2	16.7	5.0	14.1
Sikkim	15.8	15.6	6.8	18.1	12.7
Tripura	4.2	-20.8	5.8	-4.2	-5.8
Uttarakhand	8.0	8.5	8.9	13.4	10.1
All State	**12.2**	**13.4**	**15.7**	**14.4**	**14.6**

5. Conclusion

On the basis of the above analysis, it can be concluded that although the increase in the vertical share will help the states, the horizontal distribution formula does not appear to have made any significant departure from the past in terms of greater progressivity of transfers. Also, as explained, the design of the horizontal distribution formula is such that the fiscal capacity distance and the index of fiscal discipline are in conflict with each other and serve opposite purposes – while the former tries to increase the capacity of states to spend more, the latter tries to limit their expenditure in relation to own revenues. Both the indicators together in the same formula penalise states twice over for the same reason. The design of the grant for elementary education is such that it has the potential to reduce the expenditure of states instead of augmenting it.

On the revised road map for fiscal consolidation, it needs to be emphasised that suggesting state-specific, year-wise, fiscal adjustment paths not only limits the fiscal manoeuvrability of states but also impinges heavily on their fiscal autonomy. This approach of the THFC seriously compromises the idea of the Finance Commission itself, which, in accordance with the spirit of the Constitution, is required to protect the fiscal autonomy of states. It is high time that India as a federal country starts seriously thinking about how to get out of this kind of technocratic approach to a subject that goes beyond the deficit numbers and a very narrow idea of fiscal prudence. The prime issue here is nurturing federalism in the country by correcting vertical and horizontal imbalances without compromising fiscal autonomy, and that cannot be done in a dictatorial way. Even though the Finance Commission is an independent arbiter, it should refrain from making recommendations that clamp down heavily on the fiscal autonomy of states. Mute acceptance of these recommendations by the states and their adherence to them is also surprising. Is there a way out from this? The answer probably lies in a deeper understanding of the complex issue of intergovernmental transfers and a corresponding change in the approach of future Finance Commissions. It is overdue that the issue of intergovernmental transfers be looked at not from a narrow technocratic perspective or from an implicit view of a benevolent centre giving funds to begging states, but from the right perspective of federalism where the states and the centre are treated as equal partners in development.

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