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Southern States Dependency on Central Transfers– An Analysis

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Abstract: ***A portion of revenue receipts of States is from central government in the form of share in taxes and grants based on recommendations of the Central Finance Commission and other channels. The share of total transfers from the centre in the total revenue receipts of the states or revenue expenditures indicates the extent of state's dependency on the transfers from the centre. This study examines the dependency of Southern states, viz., Andhra Pradesh, Karnataka, Kerala and Tamil Nadu, on Central Fiscal Transfers. It particularly focuses on the role of transfers through tax devolution under the recommendation of the Finance Commissions. The analysis of dependency is then extended to total transfers that are given in the form of share in Central taxes, Finance Commission grants, plan grants and other grants. The analysis with respect to southern States covers the period from 1995-96 to 2012-15. The objective of this paper is to examine the changes in the central share as per the recommendations of the successive Finance Commissions as well as the dependency of the States on Central transfers.***

Keywords: Central Transfers, Grants, Tax Shares

1. Introduction

The Indian federation differs from the developed federations in many important respects. India is a vast country with wide inter-regional differences in economic endowments as well as levels of income, and is faced with conflicting tendencies of centralisation and decentralisation. The centralisation designed to reduce inter-regional disparities and the decentralisation designed to meet the diverse patterns of demand. Besides, the Indian economy is faced with severe inter-jurisdictional competition, underlining the need for utmost cooperation among various jurisdictions.

The low levels of income and wide inter-regional disparities have necessitated governmental intervention not just in the provision of public services; the government has taken the major responsibility for economic development of the country by taking up the role of both a catalyst and an entrepreneur. The multi-level planning has brought forth additional complexities in the fiscal arrangements in terms of heavy fiscal dependence of the States on the Centre, high degree of vertical and horizontal tax and expenditure spillovers and multiplicity in inter-governmental transfer schemes with overlapping and ambiguously defined objectives (Grewal, 1975)

The fiscal position of the State governments has continued to deteriorate as there has been a rapid increase in their expenditure on the one hand and the revenue receipts lagging behind on the other hand. Hence, State governments are becoming more and more policy dependent as well as fiscally dependent on Central government. The fiscal containment movement, by undermining State governments' independent revenue bases, is providing one more large push toward fiscal dependence. Alongside increased fiscal dependence, the accumulating impact of great number of federal mandates on state governments is institutionalizing increasing policy dependence as well. States have been more depending on high cost borrowing for financing their plans, with very little own funds and decelerating central assistance. As a result, the interest burden has been rising. There has been a steady increase in the share of revenue expenditure across the states over time.

It is necessary to keep a federation's transfer system constantly under review in order to identify its strengths and weaknesses and correct at least the glaring deficiencies that come to notice as otherwise social and economic development and even the stability of the country as a nation may be in peril [1].

One of the criticisms voiced by the states has been that the transfers have not been adequate to bridge the vertical gap. A larger proportion of central revenues, it is contended, should have devolved than has taken place in view of the inherent limitations of their tax power relative to their expenditure responsibilities under the constitution [2]. Thus, the vertical and horizontal imbalances that all federal systems have to face remain large and the transfer system has not been able to redress them adequately or satisfactorily.

The existence of wide inter-regional differences in the levels of development itself under lines a significant role for inter-governmental equitable transfer schemes, as the nexus between levels of development and resource endowments seems to be tenuous in most cases. In such a situation, equitable transfers at the expense of richer States may not necessarily result in lower economic growth.

In general, the economic justifications for intergovernmental transfers in a federal system have been grounded on the objectives of achieving allocative efficiency (Breton, 1965), equity in distribution (Buchanan, 1950), fiscal balance (Musgrave, 1961), and competitive equality among governments (Breton, 1995). Apart from these, inter-governmental transfers have also been suggested to enable sub-national governments provide minimum standard of outlay for services considered to be merit goods by the national government (Musgrave, 1976).

With the above back drop the present study examines transfer of funds by the central government of India through

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Finance Commission, Planning Commission and discretionary transfers through various union ministries and agencies. Low taxing power and high expenditure responsibilities make the state governments dependent on the central government for resources. Hence, transfer from the centre covers large part of revenue of the state governments.

2. The Review of Literature

The studies of Rao and Singh (1998a), Rao (1998b), Rao (2000), Bajpai and Sachs (1999), Sen and Trebesch (2004)) on state finances and the intergovernmental transfer mechanism in India indicates that the vertical and horizontal imbalances in the federal transfer mechanism and how the design of transfer system can be improved to distribute resources equitably. Ma (1997) evaluated the intergovernmental transfer mechanism of different countries and suggested methods of determining fiscal capacities of provinces.

Rao (2002) and Bajpai and Sachs (1999) examined the situation of state finances in India. Rao (2002) finds that situation of state finances deteriorated after 1990-91. State finances in India are adversely affected by low buoyancy of central transfer. Bajpai and Sachs (1999) find that reform of the state fiscal system is necessary in order to reduce expenditure and increase revenue. They find that inefficient intergovernmental transfer mechanism in India is responsible for fiscal indiscipline at the state level. Rajaraman and Visstha (2000) find that an increase in non-matching grants to panchayats affects the tax effort negatively in districts of Kerala. GR (2001) argued that the negative relationship between tax effort and grants is arrived by Rajaraman and Visstha (2000) because of their assumption that population size represents tax capacity. Assuming the same tax effort over the districts in Kerala they have shown that the negative relationship between tax revenues and grants obtained by Rajaraman and Visstha (2000) rather represent the negative relationship between grants and taxable capacity.

The study by Sinelnikov, Kadotchnikov, Trounin and Schkrebela (2001) relates the rules applied in intergovernmental transfer mechanism for the Russian economy and its impact on the regional optimal tax and expenditure.

3. Methodology

This paper examines the dependency of Southern states, viz., Andhra Pradesh, Karnataka, Kerala and Tamil Nadu, on Central Fiscal Transfers. It particularly focuses on the role of transfers through tax devolution under the recommendation of the Finance Commissions. The analysis of dependency is then extended to total transfers that are given in the form of share in Central taxes, Finance Commission grants, plan grants and other grants. The analysis with respect to southern States covers the period from 1995-96 to 2014-15. The data collected from State Finances - A study of Budgets, published by Reserve Bank of India, and also Handbook of Statistics on Indian Economy 2016-17, of RBI publication. Simple tools like averages and percentages were used to examine the dependency of Southern States.

4. Objective

The objective of this study is to examine the changes in the central share as per the recommendations of the successive Finance Commissions as well as the level of States' dependency on Central transfers.

5. Hypothesis of the Study

It is hypothesised that the Developed states like Kerala and Tamil Nadu are less dependent on Central transfers than the other southern states viz., Karnataka and Andhra Pradesh. (Based on HDI in 2015 the order of selected four states is Kerala, Tamil Nadu, Karnataka and Andhra Pradesh [3]

6. Analysis

The average proportion of Central Tax Share and Grants in Revenue Receipts has been presented in Table – 1. It is clear from the Table that the share of central taxes of Andhra Pradesh state is highest among the Southern States followed by Kerala, Karnataka and Tamil Nadu. During the 12th Finance Commission period there was marginal increase in the tax share with regard to all three southern states except Karnataka. The highest proportion of grants has been received by Andhra Pradesh except Karnataka during 12th Finance Commission and lowest by Tamil Nadu. The Hypothesis is not accepted in this respect why because the developed state Kerala is depending on central transfers more than Karnataka State.

Table 1: Average Proportion of Transfers In Revenue Receipts

Years	Andhra Pradesh			Karnataka			Kerala			Tamil Nadu		
	Tax Share	Grants	Total	Tax Share	Grants	Total	Tax Share	Grants	Total	Tax Share	Grants	Total
1995-00 (10th FC)	23.57	`12.96	36.53	17.81	8.23	26.04	19.15	8.96	28.11	17.69	7.77	25.46
2001-05 (11th FC)	18.62	12.64	31.25	16.48	9.96	26.44	17.39	8.81	26.20	14.98	8.33	23.31
2006-10 (12th FC)	19.64	12.67	32.31	15.23	13.07	28.30	17.52	10.96	28.49	15.70	10.72	26.42
2010-15 (13th FC)	18.83	12.67	31.50	15.57	11.54	27.11	15.34	9.01	24.36	14.72	9.70	24.42

Source: State Finances - A study of Budgets, RBI Publication, various issues.

The Twelfth Finance Commission (TFC) submitted its Report at the end of 2004 in the backdrop of a severe fiscal stress affecting government finances, particularly states finances in India. The Report contained, apart from the recommendations concerning the core tasks regarding tax devolution and grants, a detailed roadmap for the restructuring of India's public finances including an incentive linked debt-relief scheme for the states. Government finances have shown significant improvements since then. The targets of achieving a fiscal deficit and

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revenue deficits under the restructuring programme seem well within reach for the central as well as the state governments. Many states have enacted fiscal responsibility legislations and others are following suit. In spite of these achievements, the fiscal transfers system in India requires further reforms concerning both its vertical and horizontal dimensions [4].

The average proportions of Central Tax Share and Grants in Revenue Expenditure has been presented in Table – 2. It may be observed from the table that Andhra Pradesh is receiving more transfers from the centre than other thee southern states. More than 30 per cent of its revenue expenditure met from the central transfers during 10th and 13th Finance Commission periods. During 12th Finance Commission period it is even more to the extent of 45 per cent of its revenue expenditure. But except in case of Karnataka during 12th Finance Commission period in all three states during 10th, 11th, 12th and 13th Finance Commission period times received funds less than 30 per cent. As hypothesised the dependence of Kerala and Tamil Nadu is less than the other two states in all selected Finance Commission Periods.

Table 2: Average Proportion of Transfers In Revenue Expenditure

Years	Andhra Pradesh			Karnataka			Kerala			Tamil Nadu		
	Tax Share	Grants	Total	Tax Share	Grants	Total	Tax Share	Grants	Total	Tax Share	Grants	Total
1995-00 (10th FC)	20.86	11.45	32.31	16.69	7.62	24.31	15.96	7.48	23.43	15.57	6.81	22.38
2001-05 (11th FC)	16.50	11.20	27.69	15.10	9.09	24.20	13.16	6.68	19.84	13.31	7.43	20.74
2006-10 (12th FC)	28.31	17.55	45.86	16.38	14.04	30.41	14.93	9.34	24.27	16.35	11.19	27.54
2010-15 (13th FC)	18.43	11.83	30.26	16.16	11.96	28.12	12.81	7.47	20.28	14.52	9.50	24.02

Source: State Finances - A study of Budgets, RBI Publication, various issues.

Table 3 shows the details of average proportion of revenue receipts, revenue expenditure and central transfers as percentage of NSDP at current prices (2011-12 prices) of selected states. The percentage share of revenue receipts in NSDP of Andhra Pradesh is highest (ranged between 22.78 per cent on average during 10th FC period and 28.67 per cent on average during 12th FC period) followed by Tamil Nadu, Karnataka and Kerala during all selected FC periods. While considering the revenue expenditure the highest is by Andhra Pradesh followed by Kerala, Tamil Nadu and Karnataka Except during the 13th FC period. Similarly while taking the central tax share as proportion of NSDP Andhra Pradesh followed by Karnataka, Tamil Nadu and Kerala, except during 10th FC in case of Karnataka. In this respect the hypothesis is accepted.

Table 3: Average Proportion of Revenue Receipts, Revenue Expenditure and Central Transfers in NSDP at Current Prices (2011-12 base year)

Years	Andhra Pradesh			Karnataka			Kerala			Tamil Nadu		
	RR	RE	CT	RR	RE	CT	RR	RE	CT	RR	RE	CT
1995-00 (10th FC)	22.78	25.76	8.30	11.10	11.88	2.89	11.62	14.06	3.27	12.29	14.05	3.13
2001-05 (11th FC)	24.76	27.96	7.74	12.50	13.55	3.28	11.64	15.41	3.05	13.42	15.14	3.13
2006-10 (12th FC)	28.67	24.48	9.26	13.74	12.76	3.88	12.22	14.34	3.48	14.30	13.75	3.78
2010-15 (13th FC)	28.06	50.54	8.67	13.56	47.05	3.68	12.92	52.51	3.15	13.79	43.05	3.37

Note: RR = Revenue receipts, RE = Revenue Expenditure, CT = Central Transfers.
Conversion of Base year for 2011-12 NSDP at current prices carried out by author.
Source: State Finances - A study of Budgets, RBI Publication, various issues.
Handbook of Statistics on Indian Economy 2016-17, RBI publication.

Table 4 gives the details of Non-Plan Grants and share in Central Taxes as proportion of revenue receipts, revenue expenditure and NSDP (at 2011-12 prices). It reveals that Andhra Pradesh has highest share in revenue receipts, revenue expenditure and NSDP. When considered the other three states Andhra Pradesh followed by Kerala (except during 13th Finance Commission period), Karnataka and Tamil Nadu. While coming to revenue expenditure Andhra Pradesh followed by Karnataka (except during 10th Finance Commission period) Tamil Nadu and then Kerala. In NSDP in case of Andhra Pradesh it is more than six per cent where as in all other three states fluctuated between two and three percentage points.

Table 4: Average Proportion of Non- Plan Grants and Share in Central Taxes Together in Revenue Receipts, Revenue Expenditure and NSDP at Current Prices (2011-12 base year)

Years	Andhra Pradesh			Karnataka			Kerala			Tamil Nadu		
	RR	RE	NSDP	RR	RE	NSDP	RR	RE	NSDP	RR	RE	NSDP
1995-00 (10th FC)	27.37	24.22	6.22	18.63	17.44	2.07	21.35	17.78	2.48	18.65	16.39	2.29
2001-05 (11th FC)	20.84	18.47	5.16	18.12	16.60	2.25	19.31	14.62	2.25	16.57	14.75	2.23
2006-10 (12th FC)	23.00	32.85	6.59	20.61	22.16	2.83	21.99	18.73	2.69	19.91	20.78	2.85
2010-15 (13th FC)	22.42	21.86	6.29	18.95	19.66	2.57	17.61	14.68	2.27	17.97	17.70	2.48

Note: RR = Revenue receipts, RE = Revenue Expenditure, NSDP = Net State Domestic Product.
Source: State Finances - A study of Budgets, RBI Publication, various issues.

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Handbook of Statistics on Indian Economy 2016-17, RBI publication.

7. Conclusions

The above analysis clearly shows that among the four southern states Andhra Pradesh is dependency on central transfers to the highest extent (45 per cent) during 12th Finance Commission period). Being a developed state among southern states Kerala also depending on Central transfers to the extent of 20 per cent in its revenue expenditure. This reveals the important role of central transfers in state finances of Indian States. It also gives the picture of Vertical and horizontal imbalances among the Southern States. Hence it is pertinent to suggest that all states as well as centre should search for alternative revenue sources to meet their revenue expenditure needs. Recent tax reform in case of Sales tax i.e. GST may help to overcome the resource crunch in the near future. It is necessary to create awareness about implementation and working of GST among all classes by both State and Central governments as it involves degitalisation to the greater extent. This may be an obstacle to those who cannot use computer and internet properly as they need to depend on salaried person for maintaining records online and uploading and down loading all economic transactions by any business unit.

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