International Journal of Multidisciplinary Research and Development
Online ISSN: 2349-4182, Print ISSN: 2349-5979; Impact Factor: RJIF 5.72
Received: 26-11-2019; Accepted: 28-12-2019
www.allsubjectjournal.com
Volume 7; Issue 1; January 2020; Page No. 180-184

Finance commissions and horizontal devolution in India: an analysis of major states by income categories

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Abstract
The study attempts to sketch the devolution of resources from the Centre through Finance Commissions to the fifteen major States of India. Expenditure for developmental processes of the States are mainly met from States' own revenue and from the share of the States in the divisible pool. Devolution from the Centre plays a major role in materialising the developmental needs of the States and is a major determinant of the overall development of States. Allocation of these funds are in accordance with the criteria employed by the Finance Commissions and the criteria itself has changed over the years. This can have impact on states, and this impact need not be uniform across the States. Hence, component wise devolution over the 11th, 12th and 13th Finance Commissions and the role of federal transfers in bridging the development gap and in enhancing equity among the states is examined here. Attempt is made in this regard to analyze the devolution to the States by categorising of the States into High Income (HI), Middle Income (MI) and Low Income (LI) on the basis of their per capita income.

Keywords: Finance Commission, Horizontal Devolution, Central Tax, Grants in aid.

Introduction

In a federal form of government, devolution of funds mainly aims at the overall development of the country and its components, viz, the States**.** It ensures the allocation of funds from the Centre to the States or from one level of government to the other. Federal system with multi-layers is designed to bring about inter government transfers. Apart from inter-governmental transfers it is envisaged to redistribute funds between richer and poorer states over the long run and thereby, to enhance equity among the states. Hence, vertical and horizontal equalisation has become an indispensable aspect of federal form of government and the States are clamouring and raising their voices, requesting the Centre to increase their respective shares in the funds devolved. Often some States argue that the funds allotted to them are not sufficient and they express their dissatisfaction in it. In this context, it seems relevant to examine the criteria employed for transfers through Finance Commission's and the role of federal transfers in bridging the development gap and in enhancing equity among the states. Here an attempt is made in this regard to examine the devolution to the States by categorising the states into High Income (HI), Middle Income (MI) and Low Income (LI) on the basis of their per capita income.

Objectives of the Study

- To study the component wise devolution of resources in the 11th, 12th and 13th Finance Commissions.
- To analyse the component wise devolution of funds from the Centre to different category of States.

Methodology of the study

This study analyses the trend in devolution of funds through Finance Commissions from the Centre to the States. The study considers horizontal devolution of resources and covers the period 2000-2013, which forms the period of Eleventh, Twelfth and Thirteenth Finance Commissions. This study is purely based on secondary data. Annual Publications of Reserve Bank of India: Handbook of Statistics on State Government Finances-2010, Finance Commission Reports (Eleventh, Twelfth and Thirteenth) and State Finances: A Study of Budgets are the main sources ofdata. The study examines the overall trend in transfers and analyses the transfers from Centre to the States by its main components, viz, share in central taxes, and grants-in-aid. The study probes into the horizontal imbalances in the transfer of funds. To analyse the Horizontal devolution, the study used the classification of fifteen states in India on the basis of their Per Capita Income, viz, High Income, Middle Income and Low Income states. It also used ANOVA and student's t test along with the descriptive statistics to examine whether there is significant difference in the transfers from the centre to the different Income category states, viz, High Income (HI), Middle Income (MI) and Low Income (LI).

Devolution of Resources: An Analysis of Horizontal Devolution

The Finance Commission is a constitutional body which is formulated under Article 280 of the constitution of India. The commission is constituted every five years by the President of India to review the state of finances of the Union and the States and suggest measures for maintaining a stable and sustainable fiscal environment in the country. The Finance Commission's recommendation plays a major role in the devolution policies. The policies are enacted from the recommendations made by the commission before its execution of that commission. Finance Commission act as a statutory body in the transfer mechanism is an exclusive feature of Indian federalism. There are various channels working in the transfer mechanism and among these, the Finance Commission is playing a major role in devolution of resources from the Centre to the States. The vertical and horizontal devolution is always a matter of discussion in the area of federal finance. In this context the Finance Commission is trying to reduce the inequality in its transfers. Hence, it seems important to observe the devolution of resources from the Centre to the States through Finance Commission for justifying whether Finance Commissions really contribute to horizontal equality or not. The study concentrated in the devolution to the states by its various components.

Table 1: Criteria for Devolution of Funds in Eleventh, Twelfth and Thirteenth Finance Commissions

Finance Commission Criteria for Devolution			
Criteria	**11th Finance Commission**	**12th Finance Commission**	**13th Finance Commission**
Population(1971)	10	25	25
Income Distance	62.5	50	-
Fiscal Capacity Distance	-	10	47.5
Area	7.5	-	10
Tax Effort	5	7.5	-
Infrastructure Index	7.5	-	-
Fiscal Discipline	7.5	7.5	17.5
Forest Cover	-	-	-
Total	100	100	100

Source: Finance Commission Report (Eleventh, Twelfth and Thirteenth)

Eleventh Finance Commission
The Eleventh Finance Commission has increased their overall devolution of funds.It gave much importance to the social sector development of the states like education, health and infrastructure and has recommended for increase in the government expenditure on it. An amount of Rs.4972.63 crores is recommended for the States towards the upgradation of standards in non-developmental and social sectors and special problem grants for the period 2000-05 is also made in the eleventh finance commission.The commission also continued the Calamity Relief Fund with the ratio of 75:25 by the Centre and State. The main focus of the Eleventh Finance Commission was to the development of the social sector. Some states are recommended to use the infrastructure index as one of the criteria for devolution before the Eleventh Finance Commission period for their own benefits because they had a good infrastructure compared to others. States like Karnataka, Madhya Pradesh, Maharashtra, Orissa, Rajasthan and Tamil Nadu have recommended the use of index of infrastructure. And then it became one among the criteria used in it.

Twelfth Finance Commission
The Twelfth Finance Commission made recommendation to reduce the Fiscal deficit of Centre as well as the State. The total tax devolution was increased by 1.5 per cent in the Twelfth Finance Commission period. Grants to local bodies given to the States for panchayati raj institutions and local urban bodies for the period of 2005–09 was Rs 200 billion and Rs 50 billion respectively. The Calamity Relief Fund sharing using the previous finance commission pattern with the size of fund was Rs 213.33 billion for the period of 2005–10 and this was much higher than the Eleventh Finance Commission.The Twelfth Finance Commission also focused to educate the States by giving more funds as grants for improving the educational facilities along with the infrastructural improvements.

Thirteenth Finance Commission
For achieving fiscal equity, the Thirteenth Finance Commission allows high weightage to income distance or fiscal capacity index. The Thirteenth Finance Commission had recommended reduction in the number of Centrally Sponsored Schemes (CSS) and to restore the power of formula based plan transfers. In so far fiscal consolidation is concerned, it hoped that the revenue deficit of the Centre needs to be progressively reduced and eliminated latest by 2014-15. While addressing environmental concerns, this Finance Commission had proposed an amount of Rs. 5000 crores as forest grant, an incentive grant of Rs. 5000 crores for grid-connected. It had recommended a 32 per cent share to states in net proceeds of shareable central taxes in each of the financial years covered under the recommendation of the Commission. Grants-in-aid for local bodies amounting to 2.5 per cent of the central pool of taxes is madein the Thirteenth Finance Commission
In essence, these three Finance Commissions aimed to increase the net proceeds of central taxes. Each one was giving special attention to the developmental as well as non-developmental needs of the states. The educational and infrastructural wellness is a necessary objective of these three Finance Commissions. Through this, the States can improve their GDP as well as it’s a way to development.

Devolution of Resources among the States: A Component wise Analysis
1. **Devolution of Resources among the States: An Analysis of Income wise Classification of States**

States are classified into High Income (HI) states, Middle Income (MI) states and Low Income (LI) states on the basis of their Per Capita Income in 2005. Here, States are classified as rich or poor or developed or developing on the basis of their income. So the transfer of resources from the Centre to the States should differ, if Finance Commissions stand for horizontal equality. For understanding this, allocation of resources among the States is analyzed. Per Capita Income is the base and this classification is used for the study to know that whether there is significant difference in transfers between the HI, MI and LI states. It can be analysed by using the following table - 2

Table 2: Average Transfer of Resources to States by Income Category over the Years (Amount in crores)

Year	Average Grants-in-aid			Average Share in Central Tax		
	HI	MI	LI	HI	MI	LI
2000-01	920	1812	1872	1100	3030	5764
2001-02	854	2070	1870	1026	2892	5058
2002-03	1160	1792	1984	1032	3290	5428

2003-04	1078	2258	2128	1368	3840	6394
2004-05	1182	2208	2930	1498	4590	7506
2005-06	2002	3672	3442	2204	5070	9028
2006-07	3036	3916	4902	2726	6472	11516
2007-08	2982	5132	5938	3404	8160	14528
2008-09	3886	5872	7220	3592	8610	15326
2009-10	4110	6224	8448	3696	8862	15772
2010-11	4306	6722	9408	4806	11350	21240
2011-12 (RE)	6378	9288	12980	5666	13272	25302
2012-13 (BE)	7224	12412	14210	6636	15832	29090

***Source*:** Computed from Handbook of Statistics on State Government Finances-2010 and State Finances: A Study of Budgets.

HI: High Income States, MI: Middle Income States and LI: Low Income States

Table – 2 gives the average value of transfers to the States of each income category. The table shows the amounts in crores to the high income, middle income and low income states as share in grants and share in central tax. From Table – 2, it is clear that the beneficent group in the case of grants in aid is Low Income States. Middle Income States are getting a higher amount than the High Income states. It means the middle income states play a medium role. The High Income states are getting the lowest amount in the case of grants. At the same time it is the same as in the case of share in central taxes. The High Income states are getting very low amount as share in central taxes and Low Income states are getting a high amount, when compared to the High Income and Middle Income states. In this case, it is important to check the whole difference among them and also the group wise difference among these three states. We can analyse the two sources of transfer of resources from the Centre to the States through Finance commission separately. It can be more clearly described by using ANOVA test for HI, MI and LI States for share in central tax and grants. Then the group wise comparison can be explained by using the t test. Firstly, the study analyse the share in central tax ie, share in divisible pool for the three income categories of States.

1.1 A Comparison of the Distribution of Share in Central Tax among High, Middle and Low Income States

Share in central tax is the major source of revenue to the states. Share in central tax is determined by various criteria followed by the various Finance Commissions. It is calculated from the total tax collected by the central government which is divided the among the States on the basis of the weightage in the prescribed criteria followed by them. When considering each group separately the actual amount of their share to each group is increasing over the thirteen year period. While comparing the three categories of States, the Low Income States are enjoying more taxes than the High Income and Middle Income States. All States are getting agood amount as their share in the devolution as central tax but the share of each will vary as per their weightage in the criteria followed by the Finance Commission. The tax revenue is distributed as per the criteria's recommended by the respective Finance Commission for the respective period to each State. Each Finance Commission has changed their criteria. The study tries to check whether there is any change in the allocation of share in central tax among these three income groups of States. Table-3 shows the Income wise classification of states and their respective shares in the tax devolution and grants-in-aid.

Table 3: Average Share in Central Tax and Grants-in-Aid of HI, MI and LI States in India (Amount in crores)

States	Average Share in Central Tax from 2000 to 2013	Average Grants from 2000 to 2013
Goa	349.4	190
Gujarat	4413.9	3667.7
Haryana	1434.5	1936.2
Maharashtra	6911.2	7380.8
Punjab	1799.8	1870.8
Andhra Pradesh	9878	6720.8
Karnataka	6128.2	4949.2
Kerala	3554.6	2140
Tamil Nadu	7067.3	4389.2
West Bengal	10020.3	6176.9
Bihar	15262.7	5255.4
Madhya Pradesh	9518.2	4308.4
Orissa	6700	4509.2
Rajasthan	7775.9	9634.6
Uttar Pradesh	26652.3	63129.2
Total	117466.3	126258.4

Data source: Computed from Handbook of Statistics on State Government Finances-2010 and State Finances: A Study of Budgets.

Here, for the analysis, codes are given to different category of states as LI=1, MI=2 and HI=3. The actual data of share in central taxes are taken for the study. ANOVA model is run by using this data for analysing whether there is any statistically significant difference in the allotment of share in central tax to the three categories of states.

a. Comparison of Unequal Variances of LI – MI States in their Share in Central Tax

Two sample t test with unequal variances of LI and MI States in share in central tax describes that there is no significant difference between LI and MI States in the allocation of share in central tax. There is difference in the allocation of share in central tax between LI and MI, but the difference is not statistically significant. The LI States and MI States getting the devolution in the form of taxes are almost the same, which implies that the criteria gives almost equal weight to the LI and MI states in the statutory transfers. The LI States and MI States are getting share in central tax without any significant statistical differences among them.

b. Comparison of Unequal Variances of HI – MI States in Share in Central Tax

The result shows that there is significant difference between HI and MI States in the allocation of share in central tax and the difference is statistically significant. The HI states are getting lower share in the tax devolution which is very lesser than the share in central tax to the MI states. The Finance commission's criteria give much attention to the developing states and their needs and the priorities to the HI States are very low. The criteria give vital role to the development of the relatively backward regions and the laggards and this can be the reason for the HI states getting low amount than the others, because their rank is much lower than the MI and LI states. By considering the Fiscal capacity distance, population (1971), area and infrastructure, the developing states get its benefit through the high preference to them. So it can be said that the criteria used by the Finance commission give much priority to the states with reference to their income level or with reference to their developmental needs.

c. Comparison of Unequal Variances of HI – LI States in Share in Central Tax

This comparison shows that there is significant difference in the allocation of share in central tax between HI and LI states. It is clear that always there exist a wide disparity in the allocation of share in central tax among the HI and LI states. It noticed that the disparity is in favour to the LI states. That is, the Finance Commissions allocates larger amount of share in central tax to the LI States than the HI and MI States. It is described in the earlier section that the Finance commission criteria give a larger weight to the factors that favour or contribute more to the development of the LI States. The basis of Finance Commission devolution is purely its criteria recommended by respective Finance Commissions. The States with the characters of under development get a larger amount as transfers from the Finance Commission. Finance Commission transfers are trying to bring horizontal equity to give more to the poor and less to the rich. That means HI States and LI States are getting share in central tax with statistically significant differences between them. It means there is horizontal equalisation in the policy in transfers by the Finance commissions in the case of HI, MI and LI States.

1.2 Analysis of Distribution of funds as Grants in aid among High, Middle and Low Income States

Grants-in-aid are important source of revenue to the States from the Central government. Grants are distributed among the states for meeting their developmental purposes. All states are enjoying the benefit from grants. In this study the States are categorised as HI, MI and LI as per their per capita income. The study tries to check whether there is any significant difference in the allocation of Grants among these three categories of states. Table – 2 shows that there is a difference in the allocation of grants among the HI, MI and LI States. This explains that there is difference in the allotment of grant in aid to these three categories of states. In this context, it is worth checking whether the result is statistically significant or not. For describing this difference the study used one way ANOVA. In this analysis thirteen year average of grants to each state in the respective category are considered.

Analysis of the Table – 2 shows that the mean grants in aid to LI states is higher than the HI and MI states. HI states are having the lowest mean and LI states are having the highest Mean. At the same time HI states having the high standard deviation and MI states are characterised by low standard deviation. The variation in grants in aid between LI states and HI are very low. Analysis done on the basis of Table - 2 explains that there is difference in the allotment of grant in aid to the three categories of states by considering their mean, but there is no significant difference in the allocation of grants in aid by considering the standard deviation of the States. On the basis of the descriptive statistics for understanding the difference among these three, it is important to check whether the result is statistically significant or not. For tracing this difference, if any, we are using one way ANOVA. In this analysis thirteen year average grants to each state in respective category are considered.

a. Comparison of Unequal Variances of LI – MI States in Grants in Aid

The result of group wise comparison reveals that there is no significant difference in the allocation of grants in aid between LI and MI states. That means LI states and MI states are getting grants without any statistical difference in allocation between them. The grants are provided on the basis of predetermined criteria by the finance commission and that reduces the disparity among them even in the allotment of funds. Grants are provided by considering the nature of State's means and by considering their special needs. Some States always face natural calamities and they are getting more amounts of grants from the Centre as the way to overcome it and this is another type of grant provided by the Centre for helping them. Grants are given to support the states to overcome the natural calamities named as grants for natural calamities. More than this, the Centre also provides institutionalised grants for education, health, irrigation, transport etc. Considering the developmental needs of the state irrespective of their category, the Finance Commission provides Statutory Grants on the basis of certain criteria. The LI states are always in need of more grants because they are vulnerable to the problems of natural calamities, spreading diseases, and also have special purpose needs. So LI states are in need of more grants, but they are not the one and only section needs more grants. All the states have same consideration in the allocation of grants in aid, but the LI states enjoy slightly preferential treatment. While comparing the LI States with MI States, there is only a slight consideration to the LI State, but it is not statistically significant. It gets special treatment when comparing the LI States with HI States because the disparity between them is much larger when compared with MI States, the disparity is not one of considerable magnitude. So it can be concluded that there is no statistically significant difference in the allocation of grants in aid between the LI States and the MI States.

b. Comparison of Unequal Variances of HI – MI States in Grants in Aid

Analysis on the allocation of grants to the HI and MI States shows that there are no significant statistical differences in the allocation of grants. The special needs of HI and MI states are almost same. The Grants in aid is used to overcome the problems faced by the States and cover the needs of States that are not satisfied by the devolution through the share in central tax. The own tax effort of HI and MI States are much higher than the LI States. The own tax revenue of such States are relatively high and they are able to address their developmental needs. So we can say that grants in aid to HI and MI are almost same and the difference is not statistically significant.

c. Comparison of Unequal Variances of HI – LI States in Grants in Aid

The result seems that there is significant difference between HI and LI states in the allocation of grants from the Centre to the States through Finance Commission. The LI States are always in need of more grants because they are always in the path of development so they need more money for meeting their needs for development. The devolution through share in central tax is purely based on the criteria and statutory grants are also based on some criteria employed by the Finance Commission. So grants-in-aid is a way to get more amounts by its weightage to makeup the special needs of the states. The analysis shows that there is statistically significant difference in grants in aid among the HI States and LI States. The results of t test shows that there is difference in the allocation of grants among HI-LI States, but there is no statistically significant difference in the allocation of resources among HI-MI combination and MI-LI States pair. Here HI States are enjoying low grants while LI states are enjoying high grants. So it can be interpreted that there is statistically significant difference in devolution while comparing States with two distant categories of income and, the statistically significant disparity is absent when comparing two nearest income categories of States in the case of statutory grants. So all states are getting grants as per their weightage in the criteria followed by the Finance Commission.

Thus, funds devolved through the Eleventh, Twelfth and Thirteenth Finance Commission shows an increasing trend, both in Central Tax and Grants-in-aid, showing an increase in the absolute amount transferred to the States. Thus, transfers from the centre to the states have increased, over the thirteen year period, viz, 2000-01 to 2012-13. Component – wise devolution of funds shows that there is an increasing trend in Share in Central Tax and Grants-in-aid over the thirteen year period. It shows that the rate of increase in Central Tax is much higher than rate of increase in Grants-in-aid. In absolute terms, the transfers as Share in Central taxes and Grants-in-aid are showing an increasing trend over the years to all the States. Share in Central Tax is primarily based on the Finance Commission criteria used for the devolution of funds. By considering the horizontal devolution of resources through the Finance Commission to the fifteen States show a different trend. In the case of income – wise classification of States, viz, High Income, Middle Income and Low Income States, the result shows a significant difference in the allocation of Share in Central Tax as well as grants-in-aid. The analysis reveals that the Low Income states gets more when compared with the other two categories.

The significant difference observed among the High Income, Middle Income and Low Income states were tested so as to explore the disparity in Share in Central Tax and grants-in-aid among the three income group of states. The result of the analysis clearly shows that there is significant difference in the allocation of Central Taxes between the pairs High Income – Low Income and High Income – Middle Income states. The analysis of the grants-in-aid as the transfers shows that there is significant difference between the three categories of states, viz, high, middle and low income states. However, the pair wise comparison of Grants-in-aid and the income – wise classification of states shows a significant difference between High Income – Low Income category of states. The significant difference in the share in central tax and grants-in-aid are shows that the finance commission is on the right path of horizontal equalisation in the case of High Income, Middle Income and Low Income state. So it allotted more share as tax and grants to the Low Income states than the other two.

Conclusion

The study concludes by observing that the Finance commission is devolving funds to the States purely based on the criteria's of the respective Finance commissions for their respective periods. These criteria gives due attention to the status of States as on the basis of their income capacity. This is reflected in the devolution as share in Central taxes and Grants-in-aid and these are the best ways to feed States and to uplift them. The Finance commission is bringing an equalising impact in the overall devolution through share in central tax and grants-in-aid. From the analysis of devolution as share in Central taxes, the study observed that the disparity between HI and LI is very high and there is a relatively low disparity among the HI and MI states, and that the disparity among the MI and LI States is absent. Thus, it is seen that horizontal equality is an important concern of all the Finance Commissions under consideration and the study concludes by observing that the Finance Commission transfers are in the right path towards horizontal equalisation and the criteria employed forms the basis for devolution.

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