# Implications of Finance Commission's Transfers to Low Income States: A Study of Bihar

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# Objectives of Finance Commission Transfers

- Primary functions
  - Correct for vertical and horizontal inequalities
  - Correct for fiscal and cost disabilities
  - Give specific purpose transfers to correct for benefit spillover
- Other functions
  - Any other issues in the interest of sound finances at all levels of governments
- Over the years along with the primary function many other issues are being referred to the successive Finance Commissions and this has implications for transfers and fiscal autonomy of states

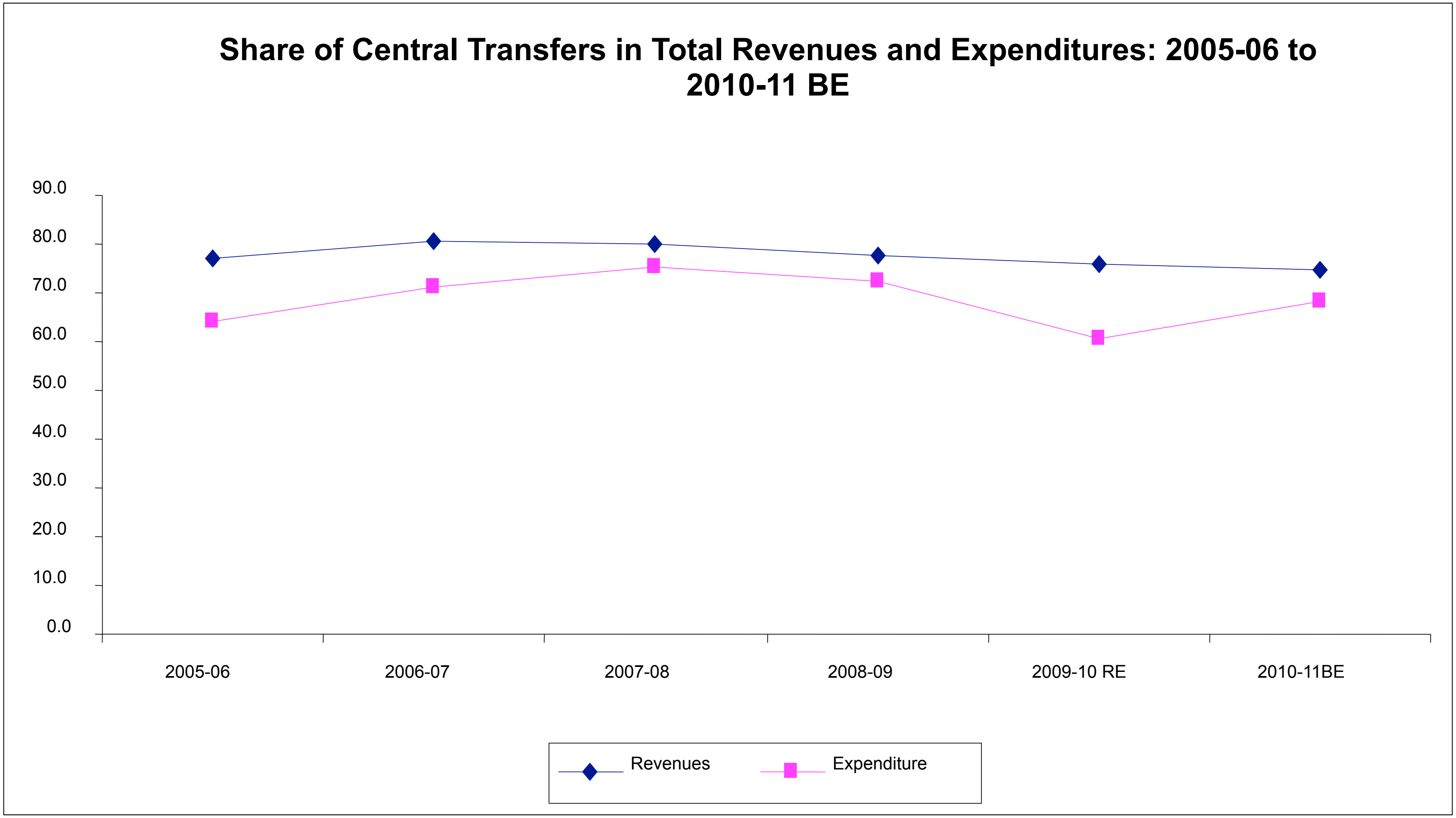
# What was Thirteenth Finance Commission’s mandate?

- Apart from primary task, the Commission was asked to give its recommendations on the following:
  - » A revised fiscal restructuring plan to correct for the recession induced fiscal expansion at federal and state level
  - » Implications of the proposed GST to be introduced
  - » Improving output and outcome of government expenditure
  - » Suggest measure for protecting environment and to tackle climate change
  - » Grants to local bodies to promote decentralisation

# Commission's Recommendations

- Enhanced vertical sharing to states
- Unusually large number of state and sector specific grants
- A revised road map for fiscal consolidation with state specific fiscal adjustment path specified
- A design of GST and a compensation package
- Adherence to the FC proposed design of GST would make the states eligible to claim compensation in the event of revenue loss due to the introduction of GST otherwise not

# Bihar’s Dependence on FC transfers



## Table 1: Tax Devolution

| | TFC | TwFC | EFC |
|---|---|---|---|
| Bihar | 10.917 | 11.028 | 14.597 |
| Low Income States | 53.618 | 53.788 | 53.762 |
| Middle Income States | 25.839 | 26.842 | 29.189 |
| High Income States | 10.943 | 11.199 | 9.75 |
| SC States | 9.6 | 8.171 | 7.299 |
| NSC States | 90.4 | 91.829 | 92.701 |
| Total | 100 | 100 | 100 |

Source: Report of the 11th, 12th and 13th Finance Commission's Reports

# The Horizontal Transfers and devolution of 13th FC

- The horizontal distribution formula of the TFC comprises of four different indicators:
    - fiscal capacity distance (47.5 percent);
    - area (10 percent);
    - population (25 percent); and
    - index of fiscal discipline (17.5 percent)
- Fiscal capacity distance and index of fiscal discipline in the same formula give confusing signals to the states
- What would have been Bihar's position if the index of fiscal discipline was dropped and the corresponding weights were assigned to fiscal capacity distance?

## Table 2: Horizontal Distribution Formula: Alternatives and Outcome

| | States | FC-XIII shares | No fiscal discipline criteria | 13FC shares |
|---|---|---|---|---|
| 1 | Andhra Pradesh | 6.937 | 6.627 | -0.310 |
| 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 |
| 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 |
| 20 | Orissa | 4.779 | 4.876 | 0.097 |
| 21 | Punjab | 1.389 | 0.990 | -0.399 |
| 22 | Rajasthan | 5.853 | 6.045 | 0.192 |
| 24 | Tamil Nadu | 4.969 | 4.130 | -0.839 |
| 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** |

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

**Table 1: Tax devolution and Grants to Bihar as per the recommendations of Thirteenth Finance Commission**
***(Rs. Crore)***

| | | Bihar | Total |
|---|---|---|---|
| 1. | Share in central taxes and duties | 158341.2 | 1448096.0 |
| 2. | *Grants-in-aid (2010-15)* | | |
| i. | Post devolution NPRD | 0.0 | 51800.0 |
| ii. | Performance incentive | 0.0 | 1500.0 |
| iii. | Local bodies | 5682.1 | 87519.0 |
| iv. | Disaster relief (including capacity building) | 1411.2 | 26373.0 |
| v. | Elementary education | 4018.0 | 24068.0 |
| 3. | *Improving outcomes* | | |
| i. | Improvement in justice delivery | 385.0 | 5000.0 |
| ii. | Incentive for issuing UIDs | 369.2 | 2989.0 |
| iii. | District innovation fund | 38.0 | 616.0 |
| iv. | Improvement of statistical systems at state and district level | 38.0 | 616.0 |
| v. | Employee and pension data-base | 10.0 | 225.0 |
| 4. | *Environment related grants* | | |
| i. | Forests | 38.4 | 5000.0 |
| ii. | Water sector management | 304.0 | 5000.0 |
| 5. | *Maintenance of roads and bridges* | 464.0 | 19930.0 |
| 6. | *State specific* | 1845.0 | 27945.0 |
| 7. | Total grants in aid (sum of row 2 to 6) | 14602.8 | 258581.0 |
| 8. | Total transfers (total of row 1 + row 7) | 172044.1 | 1706676.0 |

**Source:** Report of the Thirteenth Finance Commission, table 12.7.

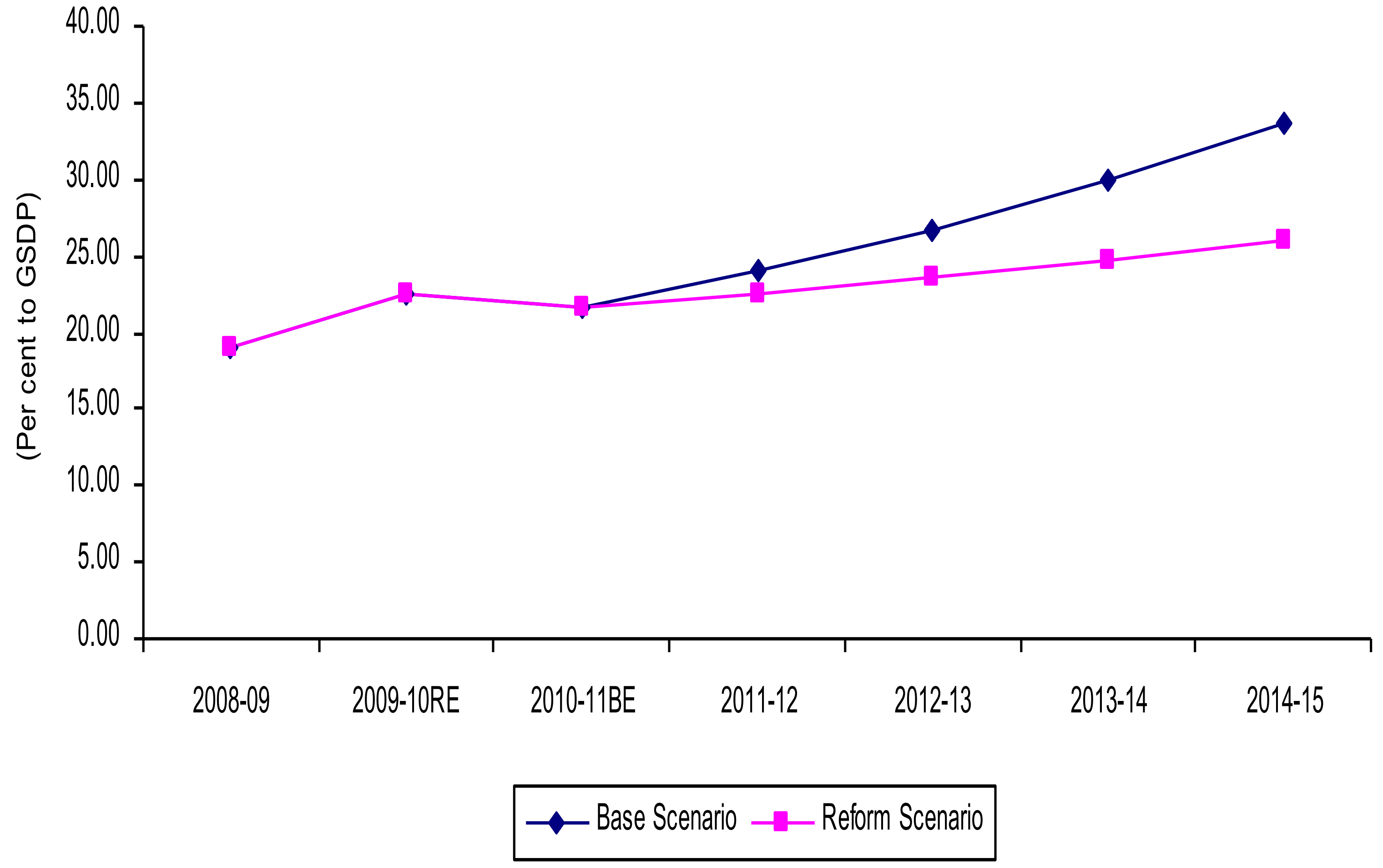
**Table 3: Base Scenario: Business as Usual Fiscal Adjustment Path**
**(As a percent to GSDP)**

| | 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 | 25.09 | 25.97 | 27.00 | 28.17 |
| General services | 7.98 | 9.46 | 9.18 | 9.51 | 9.76 | 10.09 | 10.51 |
| interest payment | 2.85 | 2.80 | 2.68 | 2.71 | 2.64 | 2.64 | 2.72 |
| 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 | 10.74 | 10.89 | 11.05 | 11.21 |
| 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 | 32.66 | 34.66 | 37.01 | 39.75 |
| **Revenue deficit** | -3.39 | -0.12 | -3.90 | -4.04 | -4.34 | -4.65 | -4.97 |
| **Fiscal deficit** | 1.90 | 6.57 | 2.73 | 3.53 | 4.35 | 5.37 | 6.62 |
| **Outstanding debt** | 35.63 | 38.15 | 36.45 | 35.50 | 35.49 | 36.49 | 38.63 |

**Table 4: Reform Scenario: Fiscal Adjustment Path Compliant with TFC Recommendations**
**(As a percent 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 |

**Figure 2: Development Expenditure Path: Alternative Scenarios**



## Table 5: Equalization of Per-capita Development Spending of Bihar with All State Average

| | | | |
|---|---|---|---|
| **Per capita Development Spending: All States (in Rs.)** | | | |
| | 2004-05 | 2005-06 RE | 2006-07 BE |
| **Development Expenditure** | 2514.03 | 3277.78 | 3357.34 |
| Social Services | 1315.43 | 1623.58 | 1772.53 |
| Economic Services | 1198.60 | 1654.20 | 1584.81 |
| **Per capita Development Spending: Bihar (in Rs.)** | | | |
| **Development Expenditure** | 903.78 | 1448.31 | 1763.45 |
| Social Services | 552.55 | 851.82 | 953.06 |
| Economic Services | 351.23 | 596.49 | 810.39 |
| **The Gap in Per Capita Spending (in Rs.)** | | | |
| **Development Expenditure** | 1610.25 | 1829.47 | 1593.88 |
| Social Services | 762.88 | 771.77 | 819.47 |
| Economic Services | 847.37 | 1057.71 | 774.41 |
| **Total Spending with equalization (In Rs Lakhs)** | | | |
| **Development Expenditure** | 2244122 | 2974654 | 3095734 |
| Social Services | 1174202 | 1473436 | 1634416 |
| Economic Services | 1069919 | 1501218 | 1461318 |
| **The Aggregate Gap (In Rs. Lakhs)** | | | |
| **Development Expenditure** | 1437371 | 1660283 | 1469689 |
| Social Services | 680975 | 700394 | 755618 |
| Economic Services | 756395 | 959889 | 714071 |
| **Gap as a per cent to GSDP** | | | |
| **Development Expenditure** | 22.89 | 23.38 | 20.07 |
| Social Services | 10.84 | 9.86 | 10.32 |
| Economic Services | 12.05 | 13.51 | 9.75 |

# Conditional Specific Purpose  Grants

- The paper discusses only three
  - » State Specific Grants linked to revised road map for fiscal consolidation
  - » For elementary education
  - » For local bodies

# For Elementary Education

- Condition
  - The nominal growth of the elementary education expenditure at the state level should be at least 8 per cent to be able to be eligible to get the grants for elementary education
- What is the actual growth of elementary education expenditure in Bihar?
  - Bihar's trend growth rate of expenditure on elementary education has been 16.48 percent during 2001-02 to 2007-08. If we take recent years, the expenditure on elementary education in Bihar has grown at the rate of 24.14 percent during 2005-06 to 2008-09.
- Implications
  - Due to the rigid fiscal correction targets, it is quite possible for a state to bring down the expenditure on elementary education and still be able to get the state specific grants and grants for elementary education as per the recommendation of the FC.
  - This condition does not help alter expenditure distribution towards education rather gives scope for reduction.

# Education Expenditure Grants and Equalisation

- In nominal terms, the grant for elementary education proposed by TFC is much higher than what was proposed by the Twelfth Finance Commission.

- The Twelfth Finance Commission grant for education for Bihar was 2728.76 crore. The complete equalization requirement as per the Twelfth Finance Commission norm worked out to be 18191.73 crore for Bihar for its award period.

- Thus the grant that has been provided by the TFC is inadequate to bring in education expenditure equalization as per the Twelfth Finance Commission norms and it is only 22 percent of the complete equalization requirement as per the Twelfth Finance Commission norm that too in nominal terms.

- It is also important to note that the TFC has pegged the grant for elementary education based on Sarva Sikhsha Abhiyan (SSA) norms and recommended a grant of 15 percent of the estimated expenditure of each State provided by Ministry of Human Resource Development on SSA.

- The rationale given by the Commission is that this grant will augment State resources and provided adequate fiscal space to implement the Right to Education Act and also would help the States to provide for the anticipated increase in the share of States contribution for SSA by the terminal year of 11th Plan to 50 percent.
- This is ad hoc and arbitrary. Instead of depending on the SSA norms and justifying it for the purpose of enhancement of States contribution for SSA, the Commission should have revised its own norms for complete equalization and given grants required for States.

# Grants to Local Bodies

- The Commission has recognized “that larger fiscal transfers to the local bodies to encourage speedier implementation of the 73rd and 74th Constitutional Amendments regarding the transfer of functions and functionaries in consonance with the subsidiarity principle” is a meaningful approach towards enhancing the cause of decentralization.

- The most important recommendation of the TFC is its decision to link grants to local governments to a share of the divisible pool of the union tax revenue. This accounted for 87,519 crore which is more than three times higher than Rs. 25,000 crore recommended by the 12th FC.

# The conditionality

- The grant recommended by the TFC has two components:
- The basic component and the performance-based component.
    - » The basic grant is equivalent to 1.5 percent of previous year's divisible tax revenue. All the States will have access to this grant for all the five years.
    - » The performance grant effective from fiscal year 2011-12 will be 0.5 percent for 2011-12 and 1 percent thereafter, upto 2014-15. The availability of the performance grant is subject to 9 points conditionality

# Conclusions

- Although the Finance Commission transfers have increased the share of tax devolution to the States from 30.5 to 32 per cent, the share of Bihar in total horizontal distribution at 10.917 per cent is lower than what was recommended by the Twelfth Finance Commission.

- The study observed that Bihar's share of devolution has been declining consistently over the award period of the recent Finance Commissions creating serious fiscal strain on State finances.

- The revised road map for fiscal consolidation proposed by the Finance Commission though attainable for the State of Bihar, it will have to be with a fiscal contraction especially through reduction in discretionary development spending which can further accentuate the already existing large social and physical infrastructure bottlenecks in the State.

- The Commission's approach towards GST implementation is a model which is far away from what is being discussed in the empowered committee of State Finance Ministers and there is less likelihood that the proposed model will be accepted by the States. The revenue neutral rate estimated in this paper shows that if Bihar has to protect its current level of revenue, the rate of GST will have to be higher than what is proposed by the GST taskforce of the TFC.

- With regard to the specific purpose grants, especially for education, the analysis reveals that it is way below the complete equalization requirement even with respect to the norms prescribed by the Twelfth Finance Commission.

- However, substantial increase in the in the devolution to the local bodies by the TFC and the suggested reforms for decentralization if carried forward by the State can actually strengthen the local-self governments in Bihar.