15TH FINANCE COMMISSION

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FORUM
OF FREE ENTERPRISE

"Free Enterprise was born with man and shall survive as long as man survives".

- A. D. Shroff
Founder-President
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SHAILESH KAPADIA

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Shailesh qualified as a Chartered Accountant in 1974 after completing his Articles with M/s Dalal & Shah and M/s G.M. Kapadia & Co., Chartered Accountants, Mumbai. Shailesh had done his schooling at Scindia School, Gwalior and he graduated in Commerce from the Sydenham College of Commerce & Economics, Mumbai, in 1970.

Shailesh enjoyed the confidence of clients, colleagues and friends. He had a charming personality and was able to achieve almost every task allotted to him. In his short but dynamic professional career, spanning over fourteen years, Shailesh held important positions in various professional and public institutions.

Shailesh's leadership qualities came to the fore when he was the President of the Bombay Chartered Accountants' Society in the year 1982-83. During his tenure he successfully organized the Third Regional Conference at Mumbai.

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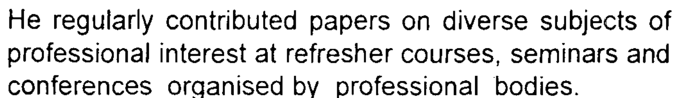

He regularly contributed papers on diverse subjects of professional interest at refresher courses, seminars and conferences organised by professional bodies.

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Editorial Introduction

The evolution of federal financial structure over the last about seven decades is truly a fascinating feature of the Indian economy. It is a chronicle of how the fiscal balance between the Union and States on the one hand, and amongst the States on the other hand, can be harmoniously constructed in a large and diverse country as India. Doubtless, this highly complex and challenging task has been made possible thanks to the sanctity ascribed to Article 280 of the Indian Constitution. Under this Article, the President of India appoints the Finance Commission [FC] every five years with specific Terms of Reference [ToR]. Alongside, the FC often takes into cognizance so much of socio-economic and fiscal changes, which do transpire during this period.

Thus, every FC after making an elaborate evaluation of economic and fiscal position of Union and States, in relation to their assigned constitutional functions and responsibilities as well as the ToR, has been offering its comprehensive report containing, among other things, the crucial recommendations on vertical [between the Union and States] and horizontal [amongst the States] devolution of revenues. Although the Constitution does not make FC's recommendations binding on the Union Government, it has virtually become a convention to abide by them, especially when it comes to sharing

of revenues. This practice has given considerable sense of fiscal comfort and confidence to the States.

So far fourteen FCs have performed their assigned tasks, and each one of them has made notable contribution, bringing about progressive changes in India's federal financial structure. What, however, was the most striking so far and has invited widespread comments – both appreciative as well as critical – was the 14th FC's recommendation bringing about far-reaching shift with regard to vertical distribution by prescribing that the States' share in the net proceeds of Union tax revenues be 42 per cent. This marked an unprecedented huge jump from 32% recommended by the 13th FC. This surely was based on the rationale of granting greater fiscal autonomy to the States, who were envisaged to be playing much greater role in India's development process going forward.

We are now in the midst of the 15th FC, which was constituted in November 2017. It has already become fully functional, and is slated to submit its recommendations by end October 2019. The implementation of its award would become effective for a period of five years from April 1, 2020. One of the significant terms of reference, namely, that "the Commission shall use the population data of 2011 while making its recommendations" has become politically controversial. Some key political spokespersons of the southern States have argued

this provision would result in lower resource allocation to them.

Be that as it may, the objective of this typical FORUM's publication is to present an interesting compilation of already published three separate articles on several crucial issues and challenges confronting the 15th FC authored by eminent experts. Thus, we have [a] Dr. C. Rangarajan and Dr. D. K. Srivastava reflecting on "Balancing Conflicting Claims"; [b] Dr. Indira Rajaraman dealing with "The Southern Alliance and the 15th Finance Commission; and [c] Dr. Abhay Pethe offering his views on "Why 15th FC ToR flaws need to be addressed urgently". We believe that our avid readers – be they politicians, policy makers, professionals, academicians, research scholars and students – would gain considerably from their objective analysis and valuable insights on many crucial aspects of ToR, and their relevance and implications in the deliberations and recommendations of the 15th FC.

It will be impertinent and audacious on our part to seek to summarize in this editorial introduction various incisive observations and suggestions coming from such erudite scholars. All of them have presented their thoughts with precision and lucidity, enabling us to appreciate and absorb the same with considerable ease. Nevertheless, we wish to highlight some of the most striking points from the FORUM's perspective:

- First, there is intellectual convergence on the controversial issue of ToR proposing the changeover from 1971 population census to 2011 census figures. All three papers converge on this point. Dr. Rajaraman stresses that "Today, it is time to bring on board the incremental population in states which failed (even without a perverse incentive) at population control." Specifically, Dr. Rangarajan and Dr. Srivastava point out that "using 1971 population data implies consciously using information that would be 50 years out of date by 2020-21.....". Like-wise, Dr. Pethe argues vehemently that 1971 population census is "an irrelevant and long-outdated..." and that "the current population is the best basis for working the 'need' of the States".
- Second, Dr. Rangarajan and Dr. Srivastava have made a case that "we are reaching a situation where the Constitution itself can be amended to fix the share that must go to States and leave Finance Commissions only with the task of horizontal allocation". We believe that this suggestion deserves to be deliberated by our fiscal and constitutional experts.
- Third, both the authors suggest that "the FC has to take a call on the degree of equalization that may be considered feasible. A balancing of criteria is needed. Most of India's future potential growth will be driven by the States

which can effectively utilize their demographic dividends, which will be facilitated by an adequate provision of education and health services in these States".

- Fourth, Dr. Indira Rajaraman articulates in her article the significance of GST in determining accurate measures of States' taxable capacity. It is pointed out that "with the goods and services tax [GST], we now have for the first time a closer approximation to the true relative taxable base in different states". She further argues "although the GST taxable base is not comprehensive, it provides a relative measure which is all that is needed to estimate the relative top-up needed". The other important point she makes is with respect to migration, on which she states, "There remains the problem of compensating for the strains imposed by temporary migrant flows on infrastructure capacity. Migrants head mainly for city nodes. Delhi is the biggest migrant magnet but, as a Union territory, gets excluded from the field of vision of finance commissions, which look only at flows from the Centre to states. Delhi's expenditure burdens are borne directly by the Central government. There may be a strong case for bringing back an earlier finance commission practice of a carve-out for Union territories from the divisible pool, appropriately ring-fenced to secure better

pollution control, water and sanitation." This is a striking observation made by her.

- Fifth, Dr. Pethe, among other things, has raised two very substantive issues: [a] by arguing that an increase in States' share to 42% "was wrong headed" and suggesting that it would be "prudent for the 15th FC to bring down the percentage to be devolved to the States from 42 percent to 36 percent"; and [b] by taking up the cause of cities and suggesting that "the lack of empowerment and governance of cities as well as the role of States in this is well known". He invites our attention to what the 13th FC had done by proposing "fund-flow from the FC to the local governments to the tune of 2.5 percent of the total funds to be devolved".

All in all, we expect that this compilation of three articles would serve a valuable role in creating awareness and educating the concerned people on one of the most vital aspects of public policy – of creating transparent, dynamic and harmonious federal financial structure in the spirit of competitive and cooperative federalism in India.

Sunil S. Bhandare
Editor

The Southern Alliance and the 15th Finance Commission

Dr. Indira Rajaraman*

State shares have to be firmly founded on accurate measures of relative state taxable capacity—which is now enabled by the goods and services tax.

On 10 April 2018, the finance ministers of three southern states and Puducherry (a Union territory) met at Thiruvananthapuram to protest the terms of reference (ToR) of the 15th Finance Commission (FC-15), which will prescribe state shares in statutory fiscal support from the Centre for the period 2020-25. It was not just a political meeting, because I was invited too, as, presumably, were other scholars. I could not attend unfortunately because of a competing commitment.

A follow-up meeting early this month is planned to finalize a formal protest to be lodged with the

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President of India, who appoints every Finance Commission. The principal concern centres on the direction in the ToR to use population figures from the 2011 census in place of the 1971 census in the formula for determining state shares.

To begin with, these are state shares of a divisible pool, which has risen from roughly 24% of the Centre's tax revenue at the start of reform in 1991, to a peak of 42% prescribed by FC-14 for the period 2015-20. The elliptical suggestion in the ToR that FC-15 might consider a reduction of this divisible pool has led to widespread state disaffection, and not just in the south. But let me now confine myself to shares within the aggregate, which is what the southern protest is mostly about (I should state that I played no part whatever in drawing up the ToR of FC-15).

Population has declined in importance in terms of its direct weight over the years, although it enters indirectly into other factors going into the formula. To prevent population size from becoming a perverse incentive for states to neglect population control, seven finance commissions over a span of 35 years were explicitly directed in their ToR to freeze population shares of states at the 1971 census levels. FC-14 was the first released from that constraint, to which it responded by taking a mix of shares of the 1971 and 2011 censuses.

Today, it is time to bring on board the incremental population in states which failed (even without a perverse incentive) at population control. Those extra people, those extra children, exist. State shares cannot be viewed as an entitlement, independent of the underlying basis. If southern states get lower shares owing to a lower relative population today, that is the formula. No anti-southern bias there.

Southern states' statutory shares fell starting in the mid-1980s from what had previously been a roughly stable one-quarter of the aggregate. The fall in shares became particularly sharp after the year 2000, to the present level of slightly under 18% prescribed by FC-14. More than 90% of the post-2000 drop happened before FC-14, while the 1971 census population freeze was on. The formula dropped weightage for contributions to revenue, introduced area (thus disadvantaging densely populated states) and gave more weightage to indicators of economic deprivation.

The statutory share from the Centre has to be viewed as a top-up to what states are able to generate from their own tax base. Finance commission flows aim to provide broadly similar access to publicly funded amenities over a landscape characterized by wide regional inequalities. A more prosperous state like Goa has higher per capita collections from its own tax base, and clearly needs less of a top-up

than a state like Bihar. At the same time, finance commissions cannot go by observed tax revenue, since the tax effort of states might (and does) vary. A common tax effort percentage is, therefore, applied to variations in state domestic product per capita, which is used to proxy differences across states in the taxable base.

With the goods and services tax (GST), we now have for the first time a closer approximation to the true relative taxable base in different states. This is despite the exclusion of petroleum products, electricity and liquor from the GST. Since the coverage of the GST tax base is uniform across states, and since the GST can be presumed to have imposed a uniform tax effort across states within its coverage (although this may be contested), state-wise collections give us a better handle on the relative taxable capacity of states than the domestic product proxy that has been used hitherto.

Compensation for differential fiscal capacity is what currently dominates the formula determining state shares, with a weightage of around 50% over the last four finance commissions. Is this a perverse growth incentive? Yes, if viewed that way. But what has to be remembered is that state growth is valued for itself, and will not be held back just because a statutory share is going to fall as a consequence.

So, the decline in southern state shares over the past several commissions until FC-14 largely

reflects faster economic growth. That should be cause for pride, not grievance.

A legitimate grievance of the southern states, however, is population migration to these states from the slower growing states of the north. In the Economic Survey (ES) for 2016-17, an excellent chapter estimated inter-state economic migration between the censuses of 2001 and 2011 at roughly 5.5 million per year. Of this, the annual flow to Kerala was slightly under half a million (Delhi and Maharashtra far eclipse the southern states in terms of their migratory pull). But any economic migration reflected in census figures will determine relative census population shares. No worries there.

What does not get captured in the census is migration of the temporary kind. For the post-census period after 2011, the ES innovatively used data on unreserved passenger traffic on the rail network for five years to get an estimate of nine million for annual nationwide inter-state economic migration on a net basis, which is to say it netted out return journeys between every pair of destinations. Thus, they capture what may be termed long-term accretions to the population of the destination state, and are in that sense similar to migration reflected in the census (except that they cover five years rather than 10).

Gross migration is not reported in the ES, but informal estimates suggest they could be three

times the estimated net figure (which means that of every 100 migrants, two-thirds are temporary and make the return journey, and one-third stay on and get into the net figure). These population inflows do impose a strain on water, sanitation and road networks in the destination state, and do not enter into census-based calculations of fiscal entitlements.

So yes, temporary migration is something FC-15 has to worry about providing for. But don't temporary migrants typically move towards some targeted work opportunity in a rapidly growing node? Wouldn't they be adding to state domestic product in the host state, and thereby to the taxable capacity of the destination state? Yes, and no. The work contribution of these migrants does indeed get reflected in the income originating in the host state, but if they remit all their income home, or carry most of it back with them, the income accruing to the host state, and thereby the consumption base on which state taxes are levied, will be less than the income originating.

This is where the new GST helps in estimating the relative taxable capacities of states. When the migrant returns home to Jharkhand, say, and makes GST-bearing purchases there (a bike, or cement for house renovation), the effect will show in the GST base of Jharkhand in a way that the state domestic product of Jharkhand would not (because the way

it is measured in India at the state level excludes remittance income and indirect taxes).

With GST offering a better measure of relative state taxable capacity than what we have had so far, the grievances of host states with high outward remittances, corresponding to labour in-migration, get partly taken care of.

Even if wages are remitted out entirely, some benefits of domestic migrant labour do get captured in the state where they work, in the form of higher profits for the employer (because migrants tend to hold down wages), and higher profit income will get reflected in the taxable base of the host state, in terms of higher purchases of GST-leviable goods and services, or of petrol and diesel, or of liquor, all of which are taxable by the state. To repeat, although the GST taxable base is not comprehensive, it provides a relative measure which is all that is needed to estimate the relative top-up needed.

Kerala may be a host state for domestic migration, but it has been an exporter of prized manpower to the rest of the world. As a major recipient of international remittances, the income accruing to Kerala far outpaces the income originating in the state. Since finance commissions have so far been compelled to use state domestic product as a measure of relative tax capacity, which excludes

remittance income, Kerala has on that account actually been getting a top-up higher than was due.

There remains the problem of compensating for the strains imposed by temporary migrant flows on infrastructure capacity. Migrants head mainly for city nodes. Delhi is the biggest migrant magnet but, as a Union territory, gets excluded from the field of vision of finance commissions, which look only at flows from the Centre to states. Delhi's expenditure burdens are borne directly by the Central government. There may be a strong case for bringing back an earlier finance commission practice of a carve-out for Union territories from the divisible pool, appropriately ring-fenced to secure better pollution control, water and sanitation.

Other issues raised by the southern alliance are not covered here for lack of space. I will only conclude by saying that a strong institutional tradition has been built up over the years by which finance commissions are entirely free to deal with their ToR as they choose.

Why 15th FC ToR flaws need to be addressed urgently

Dr. Abhay Pethe*

FINANCE COMMISSION

For several months now, the Terms of Reference (ToR) of the 15th Finance Commission (FC), which will cover a five-year period commencing 1st April 2020, has been at the centre of an economic debate in the country. The Finance Commission lays down the principles for giving out grant-in-aid to States and other local bodies and thereby seeks to ensure an equity in public service delivery across India. While a lot has been already written on the ToR by policy makers, politicians and academicians, this article briefly deals with a select few elements of ToR and how they could be tackled.

One of the striking changes in the ToR this time around is that the population is to be taken as

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per the Census 2011 rather than that of the 1971. That Census 1971 has been the basis for several FCs (last 10) and had the support of the National Development Council (NDC) is well known and so are the arguments favouring such an irrelevant and long-outdated statistical dataset as a foundational platform for such a critical exercise that will set the rules for revenue-sharing between the Centre and the States. It is a no brainer that the current population is the best basis, if population figures are to be considered to be the foundation for working out the 'need' of the States. At any rate for many other purposes (like using it for per capita distance calculation as well as the share computation of the Panchayati Raj Institutions (PRI) and Urban Local Bodies (ULB)), the earlier FCs, especially in recent times, have been using the latest available population figures.

Fear has been expressed that this change will lead to 'losses' for States that have delivered well in terms of population control and further that this will lead to a north-south divide. This argument is based on 'Business As Usual' scenario and a rather poor reckoning of the maturity and ability of the 15th FC members. Clearly, there are ways – reduction of weight to this criterion is an obvious one – in which the sudden jerky changes in State shares can be avoided on this count. In fact, the most important probable cause for the north-south divide is the fact that the FC this time has no representation from

the south, thereby the optics of the composition of the FC is not well managed.

As far as the vertical proportion (share between Centre and States) is concerned, an increase in the States' share to 42 percent was wrong headed. This was primarily a consequence of the misreading of the concept of cooperative federalism as well as assuming a certain amount of maturity of the State polity. In my judgement, the State bureaucrats and politicians both in terms of capacity and vision are rather more myopic as well as parochial when compared with their central counterparts. This implies that matters that concern environment as well as inter-generational issues are better handled by the central government. These are crucial concerns going forward which require considerable resources.

The logical fold-ins of many centrally-sponsored schemes (CSS) consequent to increasing the devolved proportion to the States and consequent squeezing of central budgetary support were not appreciated by the States. In fact, the 'illusion' of more flows led them – by all counts – to reduce their efforts to raise revenues, especially when perceived to be politically inconvenient. Without overestimating the capacity and vision at the Centre, one may hold that time is not ripe yet to completely give up a paternal attitude by the centre in the interest of the Union. It would, therefore,

be prudent for the 15th FC to bring down the percentage to be devolved to the States from 42 percent to 36 percent; allowing for the inertial momentum intrinsic in historical experience of a two percent increase per FC. Whilst perchance redundant, there is an implicit nudge in the 15th FC ToR in this direction.

The 15th FC has been asked to take a call on the continuation or otherwise of the revenue deficit grants. Given the adoption of the Fiscal Responsibility and Budget Management Act (FRBM) and Fiscal Responsibility Legislations (FRL), there ought to be no revenue deficits to contend with. Now, we are privy to the history of States finding clever ways of by-passing these. This is further compounded by the difficulty of estimating revenue deficits of the States (both because of capacity as well as an inherent complexity of the problem) that would pass the post-facto test of reasonability. Given all this and to avoid the danger of perverse incentive as well as a penalty to well-behaved States, the 15th FC should stop financing the States' revenue deficit per se and find some ingenious solution to do this if it's a constitutional requirement. Special issues of the States should be addressed on case-by-case basis to provide grants and relief to the States but not confined to – or indeed ignoring – revenue deficit considerations.

The matter of introducing incentive compatibility or addressing the issue of rewarding efficiency referred to in the ToR is perhaps redundant or may even be considered supercilious. The FC members clearly would have the sense and competence and should have the independence to do as they deem fit. But the wisdom of explicitly flagging it, especially after the rather stark experience (mostly negative) of the 14th FC, which, in its wisdom, gave a complete go by to the efficiency or the incentive compatibility criterion, is imprudent. Efficiency or the incentive compatibility ideally should be the cornerstone of all right thinking economists in case of any policy design. Therefore, the argument should have been for an ever larger weight for efficiency criterion, prescribed by the political feasibility, in the devolution formula. This would also help allay the fears (arising out of the population base matter referred to earlier) of the better performing States.

Related to the above, but important in its own right, is the matter of measurement of per-capita income-distance criterion. This essentially entails that richer states get less allocation under this criterion and relative to the poorer ones judged on the basis of average measure of States' income. Whilst the criterion is impeccable when it comes to logic, there are a couple things to consider. One, that the weight of over 50 percent should be significantly reduced and two, the distance should be measured from a disaggregated unit. This means that rather than

using the State-level per-capita income, district-level income should be used. The last argument is based on the concern that while some of the richer States are categorised in the top States and hence, get next to nothing on account of this criterion, they have major issues arising out of huge inter-district inequality. Intra-state regional inequality is indeed a concern of deprivation that surely warrants consideration.

Again, linked to this is the matter of regional imbalance in the States. Given that this is a politically-sensitive subject and one which has been dealt by the Centre via Parliament by providing Section 371(2) in the Constitution of India, it cannot be seen to be the State's responsibility alone. Indeed, the Centre should put the money where its mouth is. This may indirectly satisfy those asking for 'special' status. Further, since in the current scenario, there is no other conduit to pass the resources from the Centre to the States, one may argue that for the time being, the FC should be used as an instrumentality for this purpose.

As we know, 'the story of India has been considered to be story of her States'. This has been true for some time now, with intra-state issues incrementally assuming importance. Perhaps, time has come to add an addendum by saying that the story of India is now – and more so in the future – would be the story of her cities. The lack of empowerment and

governance of cities as well as the role of States in this is well known. The last few FCs have taken cognisance of this and have started a quasi-direct dialogue with the local governments. Whilst remaining within the constitutional provisions, the 13th FC had provided a via media of a formulaic and hence, a buoyant, fund-flow from the FC to the local governments to the tune of 2.5 percent of the total fund to be devolved. This should be continued with added strength, say doubling of the formula in percent terms, forgetting the aberration of the 14th FC which went back to absolute magnitudes. The overall local bodies devolution should also be divided in the proportion of 40:60 (Urban:Rural) which would be forward looking and not penalise the more urban States.

On the matter of GST, the reference to it in the ToR is both meaningless and wrong- headed. This is especially so since we have an established and well-functioning GST Council that could and should be called upon to do what has been mentioned in the ToR. In the same category of 'meaningless and wrong-headed' is also the reference to back-casting the normative projections (which in addition is oxymoronic) and finally the reference to 'populist measures' which is connotatively deficient and hence, or otherwise, denotatively empty.

Balancing Conflicting Claims

Dr. C. Rangarajan*
Dr. D.K. Srivastava**

The 15th Finance Commission has to take a call on the degree of equalisation that's feasible

In context of the Terms of Reference (ToR) of the 15th Finance Commission (FFC), certain key aspects relate to (a) the mandate for using the 2011 population; (b) 'whether revenue deficit grants' be given at all; (c) the impact of the goods and services tax (GST) on the finances of the Centre and States; (d) the reference to 'conditionalities' on State borrowing; and (e) providing performance incentives in respect of some contentious indicators.

Shift from 1971 to 2011

The southern States apprehend that they stand to lose under the so-called 'population criterion' if the

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2011 population replaces the use of 1971 figures. State populations change not only because of their differential population growth but also due to migration. Using 1971 population data implies consciously using information that would be 50 years out of date by 2020-21, the first year of the FFC's recommendation period. Population data used by the successive Finance Commissions in different criteria have served as a 'scaling' factor — that is, the larger the size of the population, the larger is the magnitude of fiscal transfer. In principle, fiscal transfer is determined in per capita terms and then scaled up to cater to the entire population living in the State. In deriving the per capita GSDP (Gross State Domestic Product), it is always calculated using current rather than dated population, as is done in the 'income distance' criterion. Scaling per capita transfer up only to an imaginary size of population such as the 1971 population for years beyond 1971 was always an artificial exercise. No other major federation uses such a practice. Major federations like Canada and Australia with well-established fiscal transfer principles use all relevant information that is up-to-date as much as possible.

Losses or gains depend on the relative weights attached to different criteria, and changes in other information including per capital GSDP. There is a case under the present circumstances to have a relook and lower the weights attached particularly

to the population and income-distance criteria. It is interesting to note that the weight attached to the population criterion has varied from 25% to 10% and that attached to the distance formula from 62.5% to 50% from the 10th to the 14th FCs.

The reference in the ToR regarding revenue deficit grants does not necessarily imply that grants given under Article 275(1) should be discontinued. This article enjoins the Finance Commission first to determine the 'principles' which should govern the grants-in-aid of the revenues of the State and then determine the 'sums' that are to be paid. Revenue deficit grants often did follow implicitly the gap-filling approach, even though moderated by application of some partial norms. This approach has been heavily criticised in the literature on fiscal transfers in India for the adverse incentives that it generates. In fact, there is a strong case to discontinue revenue deficit grants based on gap filling but continue to recommend grants under Article 275(1) based on more acceptable principles.

Horizontal allocations

Most major federations follow an equalisation approach to determine fiscal transfers that is consistent with the objectives of equity and efficiency. In fact, just preceding the reference to 'revenue deficit grants' under Clause 5 of the ToR, the FFC has been asked to be 'guided by the principles of equity, efficiency, and transparency'.

Under the principle of equalisation, transfers aim to 'equalise' fiscal capacities, enabling States to provide services at comparable standards provided they make comparable tax effort after taking into account cost and use disabilities. Equalisation grants are policy neutral and need not be sector-specific although the 11th and 12th Commissions used the equalisation principle partially to provide sector-specific grants. It is the application of the 'equity' principle that has resulted in relatively well-off States losing their share. It has no other connotation.

In this context, one notable group consists of the mineral-rich States: Jharkhand, Odisha, Chhattisgarh, Madhya Pradesh and Assam. These coal-rich States continue to carry a significant pollution load on behalf of the nation. They lost the opportunity of early industrialisation due the Centre's policy of freight equalisation whereby the transport of coal was subsidised, thereby neutralising their main location benefit. With freight equalisation, many thermal power plants were set up in the southern States, powering their industrial growth. Although freight equalisation is now discontinued, environmental constraints beset setting up of industries in these mineral-rich States.

The Finance Commission has the difficult task of resolving competing claims of different groups of States. This is best done by adhering to the most

appropriate principles, including that of policy neutrality. The Finance Commission, which is ideally expected to provide a symmetric treatment between the Centre and States, is not the appropriate platform for promoting Central policy priorities. References in the ToR to the Centre's flagship schemes, 'populist policies' of States and conditionalities on State borrowing imply an asymmetric view of the Centre vis-à-vis States. In fact, as far as State borrowings are concerned, after the recommendation of the 12th Finance Commission, major States do not borrow from the Centre. In any case, too long ToR should be avoided. Finance Commissions know better.

Devolution of taxes

The 14th Finance Commission raised the proportion of sharable taxes to states to 42%. It was at pains to point out that the increase was largely meant to 'enhance the share of unconditional transfers to the States'. In deciding on the share, it is necessary to take into account not only the constitutional responsibilities but also the perceptions of the people who look to the Central government for remedies to all issues. It started with economic planning. Every economic issue is now laid at the door of the Centre itself. Perhaps, we are reaching a situation where the Constitution itself can be amended to fix the share that must go to States and leave Finance Commissions only with the task

of horizontal allocation. Even as the share going to States gets increased, there is need to include 'contribution to Central taxes', suitably measured, also as a criterion in horizontal distribution as some of the taxes are vested in the Centre only on grounds of efficiency and economy. It is here that the relatively advanced States have a valid grouse.

Fiscal transfers in India have long been characterised by two major inefficiencies: the use of dated population figures and a 'gap-filling' approach. Implementing a comprehensive equalisation approach would overcome these deficiencies. This requires estimating States' fiscal capacities reflecting their tax bases. In the case of the GST, consumption rather than income would be a better tax base. This should be supplemented by the tax-bases of the non-GST taxes. To assess the expenditure needs, cost and use disabilities should be incorporated. This should capture higher health expenditures for some States like Kerala where the population is ageing. For the mineral-rich States, the cost of their environmental load should be incorporated. For the hilly States, remoteness would be a cost-related disability.

Full equalisation in India implies considerable redistribution due to the large populations of the low fiscal capacity States (see Rangarajan and Srivastava, 'Reforming India's Fiscal Transfer System', Economic and Political Weekly, 7th June,

2008, for a detailed discussion). The FFC has to take a call on the degree of equalisation that may be considered feasible. A balancing of criteria is needed. Most of India's future potential growth will be driven by the States which can effectively utilise their demographic dividends, which will be facilitated by an adequate provision of education and health services in these States. This would facilitate an accelerated growth of their fiscal capacities requiring relatively less redistribution for achieving greater equalisation over time.

The views expressed in this booklet are not necessarily those of the Forum of Free Enterprise.

Terms of Reference

1. Terms of Reference and the matters that shall be taken into consideration by the Fifteenth Finance Commission in making the recommendations are as under:

   (i) The distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under Chapter I, Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds;

   (ii) The principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States by way of grants-in-aid of their revenues under Article 275 of the Constitution for purposes other than those specified in the provisos to clause (1) of that article; and

   (iii) The measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.

2. The Commission shall review the current status of the finance, deficit, debt levels, cash balances and fiscal discipline efforts of the Union and the

States, and recommend a fiscal consolidation roadmap for sound fiscal management, taking into account the responsibility of the Central Government and State Governments to adhere to appropriate levels of general and consolidated government debt and deficit levels, while fostering higher inclusive growth in the country, guided by the principles of equity, efficiency and transparency. The Commission may also examine whether revenue deficit grants be provided at all.

3. While making its recommendations, the Commission shall have regard, among other considerations, to:

    (i) The resources of the Central Government and the State Governments for the five years commencing on 1st April 2020 on the basis of the levels of tax and the non-tax revenues likely to be reached by 2024-25. In the context of both tax and non-tax revenues, the Commission will also take into consideration their potential and fiscal capacity;

    (ii) The demand on the resources of the Central Government particularly on account of defence, internal security, infrastructure, railways, climate change, commitments towards administration of UTs without

legislature, and other committed expenditure and liabilities;

(iii) The demand on the resources of the State Governments, particularly on account of financing socioeconomic development and critical infrastructure, assets maintenance expenditure, balanced regional development and impact of the debt and liabilities of their public utilities;

(iv) The impact on the fiscal situation of the Union Government of substantially enhanced tax devolution to States following recommendations of the 14th Finance Commission, coupled with the continuing imperative of the national development programme including New India – 2022;

(v) The impact of the GST, including payment of compensation for possible loss of revenues for 5 years, and abolition of a number of cesses, earmarking thereof for compensation and other structural reforms programme, on the finances of Centre and States; and

(vi) The conditions that GoI may impose on the States while providing consent under Article 293(3) of the Constitution.

4. The Commission may consider proposing measurable performance-based incentives for

States, at the appropriate level of government, in following areas:

(i) Efforts made by the States in expansion and deepening of tax net under GST;

(ii) Efforts and Progress made in moving towards replacement rate of population growth;

(iii) Achievements in implementation of flagship schemes of Government of India, disaster resilient infrastructure, sustainable development goals, and quality of expenditure;

(iv) Progress made in increasing capital expenditure, eliminating losses of power sector, and improving the quality of such expenditure in generating future income streams;

(v) Progress made in increasing tax/non-tax revenues, promoting savings by adoption of Direct Benefit Transfers and Public Finance Management System, promoting digital economy and removing layers between the government and the beneficiaries;

(vi) Progress made in promoting ease of doing business by effecting related policy and regulatory changes and promoting labour intensive growth;

(vii) Provision of grants in aid to local bodies for basic services, including quality human resources, and implementation of performance grant system in improving delivery of services;

(viii) Control or lack of it in incurring expenditure on populist measures; and

(ix) Progress made in sanitation, solid waste management and bringing in behavioural change to end open defecation.

5. The Commission shall use the population data of 2011 while making its recommendations.

6. The Commission may review the present arrangements on financing Disaster Management initiatives, with reference to the funds constituted under the Disaster Management Act, 2005 (53 of 2005), and make appropriate recommendations thereon.

7. The Commission shall indicate the basis on which it has arrived at its findings and make available the State wise estimates of receipts and expenditure.

8. The Commission shall make its report available by 30th October, 2019, covering a period of five years commencing 1st April, 2020.

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- Eugene Black
Former President,
World Bank

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