FIFTEENTH FINANCE COMMISSION: IS IT JUST A SOUTH VERSUS NORTH DEBATE?

EXPERT VIEW

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The Fifteenth Finance Commission's terms of reference (ToR) have evoked a sharp response from southern states. The ToR mandates the Commission to use 2011 population for tax sharing and devolution of resources instead of 1971 population as was the practice in the past. Between 1971 and 2011, except Telangana, population shares of four southern states in total declined from 22.01% to 18.16%. Thus, other things remaining the same, use of 2011 population for sharing resources means a decline in the flow of resources to these states.

However, there is a need to widen this debate beyond southern states. Between 1971 and 2011, population share has declined in 10 states other than the four southern states. These are Assam, Goa, Himachal Pradesh, Odisha, Punjab and West Bengal. Thus, use of 2011 population would also affect economically less prosperous states like Assam, Odisha and West Bengal.

It is also premature to assume that states with a decline in population will receive lower transfers. It would depend on how the Fifteenth Finance Commission views this and suggests mechanisms to ensure fairness, stability and predictability of transfers. The fundamental question here is not about state-specific gain or loss due to the use of 2011 population, but the approach of the Finance Commission in dealing with changes arising due to the ToR. In the past, tax-sharing formula was a combination of factors reflecting equity, need and efficiency. The ultimate outcome would depend on how the Commission treats each of these factors in horizontal allocation of resources.

Population being a neutral indicator of need has been used by all 14 finance commissions. In the context of 2011 population, what the Fourteenth Finance Commission did is significant. Though 1971 population received 17.5% weightage in the tax-sharing formula of the Commission, it also gave 10% weightage to 2011 population to reflect demographic change. The effect of this change was not a corresponding loss of tax share of all the 10 states that had experienced a decline in population share between 1971 and 2011. Thus, it is too early to conclude about the outcome of the use of 2011 population on resource sharing.

However, there is a fundamental question about the use of population for resource sharing. Any finance commission is required to assess fiscal needs of states for tax sharing and grants. Whether assessment of fiscal need requires use of population is the first question. If one assumes it does, should the Commission be asked to use a particular reference population? Binding Commission's work to a particular reference population is arbitrary and unfair to all the stakeholders including the Commission.

The Fifteenth Finance Commission has been asked to propose measureable performance-based incentives for efforts and progress made by states in moving towards replacement rate of population growth. To address this, the Commission may need to make distinction between incentive and reward. Analytically, incentive is something in the absence of which things would not have happened the way it actually happened. In that context, establishing the link between use of 1971 population as an incentive for the success of family planning programme (FPP) in states is hard to establish. The issue of fertility transition is complex and depends on a host of factors. Attributing success of FPP to the incentive design emanated due to use of 1971 population for resource sharing is incorrect. Secondly, when it comes to reward, it should always be ex-post performance. Since decline in population in 10 states is real and its adverse impact on resource transfers is real, designing an appropriate grant mechanism to reward these states should be done by the Union government. Is there a need to wait for a Finance Commission recommended incentive structure for that?

The policy on resource sharing needs to make a distinction between tax sharing and grants

Finally, the policy on resource sharing needs to make a distinction between tax sharing and grants. Tax sharing is to correct the vertical and horizontal imbalances arising due to constitutional assignment of tax powers and expenditure responsibilities between the Union and states. Also, as per the Article 270 of the Indian Constitution, tax share recommended by the Finance Commission does not form part of the consolidated fund of the Union government, implying this is not a component of Union budget. This distinction should not be ignored in any policy debate on transfers to states. This also implies incentive or reward should be done through a grant mechanism instead of horizontal tax sharing. Probably it is time to change the term tax devolution to national tax sharing to clear ambiguities!

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