

mintessay

The Finance Commission and the Thiruvananthapuram conclave

States should indeed raise their legitimate concerns. However, they will hopefully do so in a spirit of cooperative federalism

SUDIPTO MUNDLE

is emeritus professor at the National Institute of Public Finance and Policy and was a member of the Fourteenth Finance Commission.

The Finance Commission is one of the key institutions of our federal system. Unfortunately, the terms of reference (ToR) of the recently appointed 15th Finance Commission (FC) have become exceptionally controversial. The Kerala government convened a conclave of southern state finance ministers in Thiruvananthapuram on 10 April to discuss six broad issues arising out of these ToR. This article discusses each of these issues based on some preliminary remarks about preserving the spirit of cooperative federalism and the foundational principle of equity that has guided the awards of all FCs.

The conclave was convened because the southern state governments felt they have some shared features and interests, and they should therefore consider a collective stance on such issues. But a question arises whether such common interests are exclusive to the southern states or are they shared by a larger group of states. If it is the latter, and this is indeed the case as demonstrated below, then the projection of the southern states as an exclusive group would be at odds with the concept of cooperative federalism. Fortunately there seems to have been some re-thinking. When the group meets again, more states with shared interests are likely to be invited, regardless of geography or other considerations.

There is a further question. If "shared interests" are limited only to the particular issues affecting a sub-group of states, then who will address wider issues that affect the entire federation of states? Why cede that policy space to other states not in the sub-group or, more importantly, the Union government? Why score a self-goal? A sub-group of state governments coalescing around shared interests should certainly coordinate their stance on these issues. But it is in their interest to also collectively address issues of national policy.

There is also the foundational question of inter-state equity. The FCs are mandated to determine the allocation of the shareable pool of tax revenue among the Union and states and grants-in-aid to the states from the consolidated fund of India. The principle for determining such allocations was clearly laid out by the 1st FC itself, namely, that the allocations should enable the provision of a comparable level of basic services across all states. This fundamental principle of equity has been applied by all subsequent FCs, though interpreted in different ways.

The remarks that follow on specific issues are based on the foregoing observations. The first issue the conclave flagged is the specification of the 2011 census as the reference population. The huge controversy around this issue is quite unwarranted. For enabling the provision of a comparable level of basic services across all states, the population size of each state is clearly an important determinant of its need. The relevant population is of course the present population, not the size of population that existed 40 or 50 years ago. Hence the 2011 population data,

the latest available census data, has been specified as the reference population. This is clearly preferable to the 1971 population that had been specified, for instance, in the ToR for the 14th FC. The 1971 population had been made the reference population earlier because it is used for electoral purposes of delimitation. Changing that reference year would change the existing balance of constituencies. However, that is a separate political issue that should not be mixed up with FC awards that have to be based on different considerations.

Shifting the population base from 1971 to 2011 reduces the population share of altogether 10 states, southern as well as northern and eastern. These states can justifiably claim that their success in reducing their population growth rates should be recognized. In fact, there is an explicit provision for this in the 15th FC's ToR 7(ii). The concerned states should make a strong case for giving adequate weight to this item instead of questioning the use of 2011 population.

The second issue raised at the conclave is the revenue deficit (RD) grant. ToR 5 of the 15th FC states that "The Commission may also consider whether RD grants should be provided at all". This is extremely odd and in conflict with the mandate of the FC. All FCs have been giving RD grants. Why is that? FCs compare the expenditure needs of states with their available resources, both being based on explicit criteria. If there is a gap between the estimated expenditure needs of a state and the revenue resources available to it after factoring in its own revenue-raising capacity and revenue share from devolution, the FC provides an additional RD grant to fill the gap. The manner of estimating and filling the gap has varied from FC to FC. However, in line with the principle of equity, all FCs have provided a RD grant to fill the gap. To do so would be in conflict with the principle of equity followed by all past FCs and should be strongly contested.

Bibek Debroy, chairman of the prime minister's economic advisory council, has been critical of the 14th FC for relying only on the formula-driven devolution of the shareable pool and scrapping all grants-in-aid except for local bodies and disaster management (*The Indian Express*, 11 April). It is surprising that a diligent scholar like Debroy missed the fact that the 14th FC did give a RD grant for those states that had a post-devolution gap as per its assessment. Moreover, the assessment itself was based on criteria very similar to that which Debroy recommends, namely, enabling the provision of a comparable level of basic services to citizens across all states.

The third concern flagged by the conclave is fiscal consolidation. The 15th FC will hopefully follow the global best practice being pursued in many advanced countries and emerging market economies for counter-cyclical fiscal policy, namely setting the structural fiscal deficit as the target deficit level. This is the equilibrium level of deficit consistent with maintaining a sustainable level of public debt. This fiscal rule would



HINDUSTAN TIMES

For a comparable level of basic services across states, the population size of each state is clearly an important determinant of its need

serve as an automatic stabilizer, with the actual fiscal deficit ratio being higher (lower) than the structural deficit when growth is too low (high), thereby stabilizing the economy.

Since the target deficit is the combined deficit (Union and states), the 15th FC will also have to specify how this total deficit is to be apportioned between the Union government and the different states. Maintaining macroeconomic stability is the constitutional responsibility of the Union government, for which it must have adequate policy flexibility. However, the deficit apportioned to the states vitally affects their fiscal space and hence their capacity to deliver a minimum level of public services. Therefore, while recognizing the primary role of the Union government, the states should also have a role in determining the apportionment of the total fiscal deficit. It is an illustration of a national policy space where state governments should claim their role. The goods and services tax (GST) council, chaired by the Union finance minister, is an excellent example of how cooperative federalism can be applied for other macroeconomic policies where the Union government has primary responsibility but the states also have a vital stake.

The fourth issue flagged by the conclave is performance-based incentive grants. The 15th FC has been encouraged to use this approach and prepare measurable indicators for the same (ToR 7).

However, the items cited for measuring performance have little to do with the provision of public services by state governments. They mostly relate to flagship programmes and other favourite schemes of the Union government. These are being supported by central or centrally-sponsored schemes (CSS) of the Union government. Thus, in addition to the high priority it attaches to its own schemes, and the incentives for states already built into the CSS, the Union government now seeks to leverage FC grants to induce state governments to also focus on these programmes rather than their own priorities. This is an unhealthy trend quite contrary to the spirit of federalism and should be strongly discouraged.

The fifth concern raised at the conclave is why the 15th FC is asked to assess the impact of GST when the GST council is there. This concern is unwarranted. Certainly the GST comes under the jurisdiction of the GST council. However, in reviewing and assessing the revenue flow from indirect taxes, the 15th FC will have to assess the revenue impact of GST. Without this, the 15th FC cannot assess the flow of indirect tax revenue, a core task for the FC to prepare its recommendations. Furthermore, the states have been guaranteed compensation for any loss from GST, estimated as per agreed formula for the next five years. So they have little to worry about on this account.

The sixth and final concern raised at the conclave is about the Union government imposing conditions for approving state borrowing. The Union government has been explicitly empowered to approve or disapprove a state's borrowing programme against conditions imposed by it under Article 293 if there are any outstanding loans or guarantees of the Union government to a state. The states no longer borrow from the Union and all such outstanding debt will be paid off from around 2025. However, external loans are still provided to the states through the Union government and against sovereign guarantees provided by the Centre. Hence the state governments will have to continue to seek approval of the Union government, subject to conditions it imposes, for their borrowing programme. This is a constitutional requirement.

To conclude, some of the concerns flagged at the Thiruvananthapuram Conclave regarding the ToR of the 15th FC are unwarranted, while others are legitimate. The states should indeed raise these legitimate concerns. However, they will hopefully do so in a spirit of cooperative federalism and keeping in view both the national interest as well as the overarching principle of equity among the states.

Comments are welcome at views@livemint.com