Finance commission road map

PUBLIC INTEREST

RATHIN ROY

This year, the Fifteenth Finance Commission (FC) will be constituted. Article 280 of the Constitution mandates the commission to decide how taxes that form part of the "divisible pool" are to be distributed a) between the Centre and the states, and b) between the states. The divisible pool consists of the bulk of taxes collected in India i.e., income taxes, the goods and services tax (GST) and, customs duty.

As economic advisor to the Thirteenth Finance Commission, I was able to closely view the deliberations on these matters. The vertical devolution between the Centre and the states is necessarily determined iteratively, because if the Centre's needs were to be determined first, then the share of the states would be a residual, and vice-versa. Successive FCs deemed fit to marginally increase the share of the states, until the Fourteenth FC, which increased the states' share by a whopping 10 per cent, to 42 per cent of the divisible pool. But at the present juncture, GST implementation guarantees compensation to the states out of the Centre's resources; further, cesses on indirect taxes have been abolished. This effectively boosts the collective share of the states. At the same time, the Centre has reduced its transfers to the states, a process accelerated by the end of plan grants. In considering the vertical devolution these will be the major factors that will impact the next iteration.

In view of the Centre's constrained fiscal position, especially on account of its commitments to reduce the revenue deficit to manageable levels, it would be important for the Fifteenth FC to take a realistic view of the need for adequate financing to meet the centre's commitments on defence, internal security and the legacy of high interest payments on accumulated debt. The Centre would do well to engage frankly and realistically with the FC, rather than continue with the historic tradition of presenting unrealistic and inflated numbers as an initial bargaining position. In the case of the states, the Fifteenth FC will have to grapple with increasing disparity between states that have benefitted from private investment, and those that have not. Migration from poor to rich states has its political and social limits and intergovernmental finance must do its part in redressing this negative externality that has been a feature of our growth process for more than 25 years.

The FRBM Committee report has, in effect, imposed an additional core responsibility. While fixing the aggregate debt-GDP ratio of the states at 21 per cent, it has asked the Fifteenth FC to decide limits for individual states. Debt-GSDP ratios vary widely across states, so this will not be easy. However, this is an opportunity for the commission to take a holistic view of state finances, since the horizontal devolution will now specify the totality of resources available to states, from both the divisible pool, and allowable borrowing. The commission could even think of a common formula for both these devolutions, which will make fiscal discipline endogenous to state finances.

Article 280 empowers the commission to consider any other matter referred to it in the interests of sound finance. Financing for disaster management will continue to be a concern. I think that the implications of UDAY on state finances is an important matter for consideration, as is the question of how both levels of government could deliver a coherent financing strategy to achieve the SDGs and implement Climate change commitments. Here, grants-in-aid will play an important incentivising role, but the commission could also propose collaborative financing arrangements, in the spirit of cooperative federalism.

Population continues to be a conundrum. Finance commissions have used the 1971 population as a factor in determining the horizontal distribution. The case for using 1971 population, is now no longer credible 50 years down the line. But if the 2011 census is taken, southern and western states will be severely disadvantaged. Should other credible measures be used instead of population?

Finally, I have two "design" aspirations. Annual budgeting is inefficient, reduces credibility, and allows unhealthy discretionary power to the fiscal authorities, leading to poor fiscal execution and waste. Several FCs have recommended that a medium term fiscal framework be implemented, but efforts to date have been gestural and ineffective. The Fifteenth FC should recommend concrete, time-bound measures to implement an operational, mutually consistent, medium term fiscal framework at both levels of government, using appropriate incentives to make this happen.

The second is to reflect on the size of the Indian state — a fundamental fiscal question which has not been asked for almost 60 years. Collectively, the central and state governments tax approximately 17 per cent, and borrow 6-7 per cent, of GDP, which means the size of the state is 24 per cent of GDP. For the services we aspire to receive, is this too large, too small, or just enough? The answer impacts many public service decisions. For example, if everyone agrees that we need to spend, say, 2 per cent of GDP more on education, then we could argue that tax-GDP ratios should be raised by 2 per cent to fund this. But, this would imply a 2 per cent increase in the size of the state. Is this desirable? If so, what are the limits to such an increase, if the desire is also to spend more on defence, health etc.? Consensus on the size of the state is the only guarantee of effective fiscal prudence. As a constitutional body, it is important that the Fifteenth FC weigh in on this fundamental fiscal question.

The writer is director, NIPFP, and was Economic Advisor to the Thirteenth Finance Commission