Sixteenth Finance Commission and ‘beyond the GDP’ paradigm

The analytical framework of the 16th Finance Commission will be 'beyond GDP', by integrating human development variables. Will it also apply a 'gender lens' in the inter-governmental fiscal transfer framework within the terms of reference?

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The Finance Commission has a major role in holding our country together.

The 16th Finance Commission is expected to be constituted this month, and its terms of reference (ToR) will be in the public domain soon.

Prima facie, inter-governmental fiscal transfers (IGFTs) are expected to offset fiscal disabilities across jurisdictions, with 'economic convergence' as one of the predominant objectives.

However, over the years, the mandate of finance commissions has widened, and climate change commitments have become integrated within the ToR.

In the contemporary debates of 'continuity versus change' in policy spaces, the ToR of the **16th Finance Commission** is, in all probability, expected to be a continuity rather than a radical change. Economists debate the magnitude and criteria of IGFTs. It is always a concern if a new finance commission goes the efficiency route or the equity route. In determining the scientific formula for tax devolution, population is considered a 'neutral indicator' and has a lot of weightage.

However, the recourse to the latest available population figures to devise a tax transfer formula has created contention among states which have controlled population over time.

These states have demanded an adjustment mechanism to take care of this plausible loss. In the realm of cooperative federalism, this bargaining, especially by south Indian states, for addressing their concerns related to using population as a predominant criterion for tax transfers can be considered a powerful nudging experiment in fiscal federalism.

The states have kept the pressure high, and the finance commission has devised an adjustment mechanism to avoid plausible losses in tax transfers to population-controlled states by incorporating a demographic transition variable.

Income Versus Population Criterion

Designing a tax transfer formula predominantly on the basis of population can create regional disparities, and the finance commission has, over the years, given more weightage to the income criterion.

This is based on equity principles as well. Institutions, especially fiscal federal institutions like the Finance Commission, have a major role in holding our country together.

The process of poor states 'catching up' with rich states can happen when economic convergence is given significance. However, empirical evidence suggests that India has a long way to go to attain economic convergence, given the wide deviation in per-capita income between the rich and poor states.

The distance of the per-capita income of a state from the richest state has also created dissatisfaction among states that have maintained a robust economic growth path.

In the unconditional tax transfer formula for related transfers, the discretion of the policymakers is minimised. However, the choice of variables and weights in a tax formula can create unintentional discretion in finance commission transfers.

Going Beyond Economic Growth
Economists have flagged the need to go beyond the income and population criteria in the finance commission's transfers. 'Beyond economic growth' has developed as a strong paradigm across macroeconomic policy-making bodies to integrate 'Leave No One Behind' concerns.

The analytical framework of the 16th Finance Commission will be 'beyond GDP', by integrating human development variables. Will it also apply a 'gender lens' in the IGFT framework within ToR?

If this happens, the Indian Finance Commission will lead the way towards 'beyond GDP' and it is indeed apt to do so as a post-pandemic fiscal strategy. To translate these IGFT innovations into reality, economists have to start thinking about the variables that can go into the tax transfer formula to capture the 'beyond GDP' dimension.

The Human Development Index (HDI) is a composite index, giving weightage to education, health, and income, and constructed annually. However, policymakers prefer the tax transfer to be simple and practical. This might give a preference for simple indicators of human development over using a composite index (HDI) in the tax formula. This revolution in integrating human development with a gender lens is expected.

Just like India was the first country to design an IGFT incorporating climate change variables (design for ecological fiscal transfers) by the 14th FC, we need to wait to understand if the 16th FC will do trendsetting related to human development by integrating a gender lens.

Flypaper Effects

Economists have also debated the issue related to flypaper effects—money sticks where it hits—regarding the impact of IGFT on raising its own revenue. Economists have warned of the inverse relationship between tax transfers and tax effort. The **15th Finance Commission** has incorporated tax effort into the scientific formula, though the weightage given was relatively lower. As elections are round the corner, to incentivise electoral consent, it is highly likely that the government will design a few conditional grants in addition to tax-based unconditional transfers through the finance commission.

Climate Change Commitments

It is highly likely that the ToR of the 16th Finance Commission will retain the climate change commitments in the tax transfer formula against the backdrop of COP28 and our commitments for 'just transition'. However, will the commission integrate air quality-related variables along with forest cover? These are the new dimensions expected in the design of IGFTs related to climate risks and uncertainties. If these dimensions are incorporated, will it be through formula-based transfers or conditional specific-purpose transfers?

Personal Characteristics And Composition Of The Commission

Globally, there are two models for the composition of such IGFT-related commissions: political and technical. If the commission is constituted with more political members than technical professionals, there is a high chance that the scientific elements of tax transfer design go haywire. However, unlike in many countries, Indian finance commissions are composed of technocrats, and their recommendations have been 'conclusive' and accepted for implementation.

The political composition of finance commissions can make recommendations 'inconclusive ' and it will affect the fiscal federal architecture of our country. Do the personal characteristics of the chairman and members of the finance commissions affect tax transfer design?

India looks forward to her 16th Finance Commission eagerly to understand both the magnitude—if they go beyond 41 percent of the divisible tax pool to devolve to states—and the design of tax transfer criteria and weightage.

Though IGFT to the third tier constitutes relatively less significance in finance commissions, the decisions on the conditional or unconditional grants designed for the third tier—both rural and urban local self-governments—have helped to reduce the ad hocism and arbitrariness in the fiscal transfers to the third tier.

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