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Balancing conflicting claims

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

In the 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 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 Using 1971 population data implies consciously using information that would be 50 years out of date by 2020-21, the first year of the FFC’s recommendation period.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.

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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.

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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, June 7, 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.

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