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Editorial
Rethinking devolution criteria for the Viksit Bharat

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Institutions play an essential role in development. Since the institutions need to coevolve with development, any institutional inertia for change could act as a drag on development. In India, one such most influential institution is the Finance Commission (FC), with its prime constitutional mandate to recommend how much of the Union's net tax revenue is to be devolved to the States (size of the divisible pool) and how it to be shared among the States (read as subnational entities). Their role assumed significance because of the congenital inequality in the distribution of revenue and expenditure responsibilities between the Union and the States. As observed by the 15th FC, States together are responsible for over 62 percent of the combined expenditure of the Union and the States whereas their entitlement is limited to only about 37 percent of the total revenue.

The Finance Commissions have accomplished their constitutional mandate of fiscal devolution in a highly commendable manner by being sensitive to the inequality at the vertical (between the Union and the States) and horizontal (between States) level and contributed much towards holding India together. Yet, there remains a crucial issue with the core criterion being adopted in the devolution of the divisible pool as it is not in sync with the structural changes in the economy and India's new vision of a Viksit Bharat (Developed India) by 2047.

In devolving the divisible pool the FCs have been guided by three critical criteria, which are need-based, equity-based, and efficiency-based. The indicators and weights assigned for each criterion changed over time. The 15th Finance Commission, for instance, considered tax and fiscal efforts (2.5%), forest and ecology (10%), demographic performance (12.5%), area

(15%), population (15%), and income distance (45%). The most important one is the income distance, capturing the difference in the per capita income of a State concerned from that of the State with the highest per capita income. Accordingly, the States with lower per-capita income received higher entitlement to the divisible pool, and their share declined as the per-capita income increased. The presumption is that the States with higher per capita income will have a higher tax capacity as measured by tax to GSDP ratio enabling them to mobilize the needed revenue for providing their citizens with basic minimum public goods.

However, studies by the Gulati Institute of Finance and Taxation (GIFT) and the National Institute of Public Finance and Policy (NIPFP) have shown a paradox of declining tax-to-GSDP ratio with rising per capita income across the Indian States. To illustrate, from the first half of the 1990s to the five years ending 2020, the own tax to GSDP ratio of high-income States declined from 8.8 percent to 6.1 percent, while that of low-income States increased from 5.9 percent to 6.2 percent. At the same time, given the devolution criteria, the share of the high-income states in the total divisible pool during the above period declined from 21.14 % to 15.4%. Thus, the higher-income states are faced with a double whammy; higher per capita income drives their own tax to GSDP downwards and it also causes a reduction of their share in the divisible pool. This being the reality, there are obvious limits to the use of per-capita income as a proxy for fiscal capacity.

The paradox of the negative relationship between per-capita income and own tax to GSDP ratio could be attributed to the structural change in the economy of the State concerned along with the division of taxing powers between the Union and the States. The growth of the Indian economy after the economic reforms is contributed mainly by the services sector. The relative contribution of the service sector to GSDP and their growth varies across the States. From 1990-94 to 2016-20, the share of services in GSDP increased by 25 percent in Karnataka, 19 percent in Kerala, and 17.3 percent in Haryana. Concomitantly, Karnataka experienced the highest decline (2.9%) in own tax to GSDP ratio followed by Kerala (2.8%) and Haryana (1.7%). Similarly, Madhya Pradesh and Orissa showed the lowest increase in the share of services, 1.1 percent and 3 percent, and their own tax to GSDP ratio increased by 1 percent and 1.7 percent respectively.

While the service sector emerged as the growth engine of certain states, the right to levy service tax since 1994 has been vested with the Union Government, depriving the State Governments of their potential tax revenue from the growing service sector. Further, the predominance of the informal sector in services also stood in the way of their contribution to the tax revenue. While the growing informal service sector added to the GSDP of states, their tax contribution remains limited. The introduction of GST could not resolve the issue because significant services like health and education are exempted from GST. In Kerala, the service sector which contributes 64 percent of GSDP accounts for only 17% of total GST collection. The output orientation of the state also does matter. Experts have argued that since exports are not subjected to taxation, the States deriving higher per capita GSDP from exports are losers of tax revenue. Hence, the states that derive higher per capita income from services and exports face a double whammy; they are confronted with a declining tax base and a reduced share in the divisible pool.

Apart from the structural changes in the economy of the States concerned, their output orientation also influences the tax base of the subnational economies. Experts have argued that since exports are not subject to taxation, the States that derive their higher per capita GSDP from exports are bound to be losers of tax revenue. Thus viewed, States driven by export-oriented manufacturing and services like software lose heavily on their tax base and tax effort as seen in the case of Karnataka and Tamil Nadu.

The adoption of per-capita income as a prime devolution criterion when the service sector-driven structural change and exports emerged as the growth engine of the economy has acted as a double whammy for the high-income States. Their share in the divisible pool was cut because of their higher per capita income while their own tax effort declined as their growth was led by services and exports for which they were not entitled to tax. The persistence of the primacy of income distance as a devolution criterion suggests that the FC could be more sensitive to the changing character of the Indian economy and its new aspirations. Hence, in a context wherein the county is more aspirational than ever before, there is a need for a paradigm shift in the approach of the Finance Commission. This should involve a strategy of walking on two legs; while handholding the laggards, the performers shall not be penalised. The 16th Finance Commission may consider reducing the weight of income distance criteria with a corresponding increase in the weight of the need-based criteria. Alternatively, it could consider an adjusted per-capita GSDP weighed by the sectors of GSDP for which taxes are levied and the State's contribution to the country's exports.

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