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Editorial
The 16 Finance Commission, States and Development Challenges

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The union Government has recently released some important details regarding the Terms of Reference (ToR) for the 16th Finance Commission, although the Chairperson and members are yet to be appointed. Since the states' own revenue (tax and non-tax) accounts for only about 67% of their revenue receipts, the recommendations of the Commission, to be implemented from 1April 2026 for 5 years, will be having crucial bearing on the fiscal health of States. As per the available information, the ToRs, unlike in the case of 15 Finance Commission, where in it was expected to review a recommendation made by its predecessor (14 the Finance Commission), are well within the constitutional framework. Having unequivocally set the constitutional context, the 16 Finance Commission could make its recommendations in consultation with the states by duly considering the contextual aspects.

Vertical devolution

When the first Finance Commission was appointed in 1951, only the income tax and the excise on a few commodities were shared with the states. From the 10th Finance Commission onwards, all the taxes of the union became a part of the shareable pool. In the event of the abolition of the planning commission, 14th Finance Commission raised the share of states from 32 percent to 42 percent which was reduced to 41 percent by the 15 Finance Commission when the state of Jammu And Kashmir ceased to exist. Thus viewed the successive Finance Commissions have been successful not only in enhancing the size of the divisible pool but also the share of states therein. Yet, there are reasons to believe that there is a long way to go in this regard.

It is generally been perceived that the vertical inequality between the Union and the states needs to be reduced. Evidently, the states are destined to shoulder much of the developmental responsibilities and therefore expenditure. But their revenue entitlements are at a much lower level. The 15th Finance Commission observed that while the states together account for over 62% of the national expenditure their share in revenue is only about 37% which is apparently at the root of the fiscal stress of states. Secondly, it appears that while the Finance Commissions have been allocating more resources to the States, the Union has been reducing

allocation by adopting a strategy of mobilising revenue through imposing cess and surcharges. The share of cess and surcharges, which are not shared with the states, recorded more than three -fold increase during the past 12 years from about 5.2 percent in 2009-10 to 17.1 percent in 2022-23. Even after discounting for the GST compensation cess, about four percent, the increase has not been insignificant. As a result, the effective share of States in the gross tax revenue of the union government is only about 30% as compared to about 35% during 2015-16 to 2019-20. It is true that the cess and surcharges collected by the union are not given away to any foreign countries. Yet, if past trend continues the institution of Finance Commission itself could become redundant as there would be nothing much left with to devolve to the states. Hence, for reducing vertical inequality, the Finance Commission could consider setting a limit to the share of cess and surcharges to five percent (2009-10) level. If it exceeds the stipulated level, the finance commission may compensate the states by a corresponding rise in the share of states in the divisible pool. This is broadly in sync with the observation made by Rangarajan and Srivastava.

There are a number of issues relating to vertical equality on which further reflection is needed. For example, the ex-ante projection of the revenue entitlements to the states by the Finance Commission for five years, very often than not, puts the states (and also the Union) in difficulty. This has nothing to do with the competence of the Finance Commission. But because, making precise projections for five years in the present open and uncertain world is almost an impossible task, to say the least. For example, the 14th Finance Commission projected that the total taxable revenue available from the central pool for Kerala would be of the order of Rs 25869 crore for the year 2019-20. But due to factors beyond the control of the Finance Commission the actual amount received has been only Rs 16401 crore (only 63.4%), as reported by Adith S Karthik and Christabell in this issue of Kerala Economy. Needless to say, states that made plans and programmes keeping faith on finance commission numbers are undoubtedly doomed to frustration. This takes us to the observations already made by scholars of eminence like Dr Govinda Rao who highlighted the perils of Finance Commissions being a transient body and made the case for a permanent body. Going beyond such specifics, evidently, there is an imperative reflect on the extent to which the institution of Finance Commission co-evolved in sync with the significant changes in our approach to development strategy as manifested in policy changes pertaining to all aspects of the economy on the one hand and their multifaceted outcomes on the other.

Horizontal devolution

The pundits of public finance are of the view that Finance Commissions shall not be burdened with the responsibility of resolving all the developmental problems of the States and the union. Their mandate shall be limited to the devolution of financial resources. While this view is to be respected, for different reasons, the Finance Commission cannot afford to be oblivious of the ultimate goal wherein development is at the centre stage. Given the

context in which India is emerging as the fastest growing economy in the world with a projected GDP growth of over 7% in 2022-23 and aspiring to be the third largest by 2029 and a developed economy by 2047, the Finance Commission, while taking decisions, has to be cognizant of national aspirations while being sensitive to the fact that India grows and develops if and only if the states grow and develop. Hence, while addressing the horizontal equity the Finance Commission, in the national interest, needs to aware of perils of penalising performing states.

Ensuring horizontal equity could not be more challenging in a highly diversified country like India. Some get penalised as others fail to deliver. While one needs to be sympathetic to the plight of people in less developed States, the policy of only carrots for the sustained poor performance and sticks for those performing better may be considered anti-development. Share of Kerala in the divisible pool has declined steadily from 3.9% in the 10th FC to 1.9% in the 15th FC as a “reward” for being top among Indian in HDI, SDG among others. Any inquiry into the current fiscal crisis of Kerala would lead first to the door steps of this ‘horizontal inequality’ Better performing states have their own sets of problems; the issue of aging and ensuring sustainability for example. Since these issues are yet to receive the attention of the Finance Commission that they receive, the 16 Finance commission may have to adopt a strategy of walking on two legs; while being considerate to those lagging behind, there has to be adequate provision for rewarding performance.

In a study for the NITI by Govinda Rao has shown that while the general-purpose transfers are regressive, the specific purpose transfers do the opposite. A recent and detailed NIPFP study by A N Jha, Yash Jaluka and Pinaki Chakraborty on Centrally Sponsored Schemes (CSS) reinforced the earlier conclusion with respect to specific purpose transfers and highlighted numerous issues with respect to the one size fits all based CSSs which the Finance Commission cannot afford to overlook.

The issue of borrowing and debt is yet another issue in the realm of FRBM Act, which has a highly credible intention of economic stability. However, it is high time to explore why this has landed the whole country in a highly undesirable situation of chasing an ever-moving target. Neither the union nor the states are able to adhere to it by being responsive to the needs of people. Questions are also asked as to how could the union instruct the states to keep the fiscal target within 3% when that of the union is as high as 6.4% in 2022-23 (BE). No country has progressed without investment and the poor countries with low saving invariably depend on borrowings. Hence the mechanical exercise of bringing down the debt-GDP ratio to 60% (40% for the union and 20% for the states) presumably based on the advice from the spoke persons of the Global North for whom the debt GDP ratio is as high as 240%, could be detrimental for the development. There could also be serious doubt about relevance of the indicators (same for all states in a county like ours) selected under FRBM Act. In this context, a case could be made for a Fiscal Responsibility and Borrowing Utilization Act

(FRBU) in place of FRBM Act. From a development perspective, let the borrowing be conditional on the annual flow of returns to repay the interest and value of the asset created, for repaying the capital. Let's be preventive instead of being curative. It is imperative that the 16 FC carefully examines the deficit in the sense and sensitiveness of the FRBM Act, as it stands today, to say the least.

It is by now evident that although high hopes have been pegged to GST, due to exogenous and Endogenous factors, there has been a slip between the cup and the lip. The finance Commission needs to note that GST in India became a reality only because states sacrificed about 52.8% of their tax revenue whereas the Centre surrendered only about 47%. When it came to the final division of GST between states and the Center, despite different committees made the case for higher share for the States, it was equally (50-50) shared. The states, apparently, agreed to this "unequal distribution" as they were assured of 14% growth in their GST revenue for the five years. While most politicians, presumably, have their timeframe limited to five years, from the perspective of any economy the time frame cannot be limited to five years. Hence, considering the surrender that the states have made, so long as there is GST there should be GST compensation, indeed by pre-empting the plausible free rider problem. Alternatively, the present sharing of GST should be revisited to ensure that the states receive a higher share than the Union.

India's cooperative federalism, as it stands today, is conceived in terms of cooperation between the Union and the states. The literature on fiscal federalism is abound with instances wherein programs successfully developed at the state level have provided models for subsequent federal programs. In India also, there are important cases where innovation and experimentation at state/ local level have led to new policy measures with national application. Hence the case for fostering a new cooperative federalism which compliments the existing vertical federalism with horizontal federalism by incentivizing joint investment, joint issuance of debt by states among others such that the burden of the Union could also be reduced.

There are many more issues and much to be deliberated up on. The situation was not different in the case of earlier Finance Commissions. Evidently, all of them have done their job diligently and their recommendations have been accepted by the government. The 16 Finance Commission cannot be different.

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