THE NEXT FINANCE COMMISSION WILL HAVE A TOUGH TASK

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‘Faultlines across States have in fact deepened in recent years along political, economic and fiscal dimensions’ | Photo Credit: Getty Images/iStockphoto

The government will appoint a Finance Commission in the next few months to determine how much of the Centre’s tax revenue should be given away to States (the vertical share) and how to distribute that among States (the horizontal sharing formula).

In the pre-reform period, the Finance Commission recommendations were not that critical because the Centre had other ways to compensate States, or indeed to play favourites, through plan financing and public sector undertaking (PSU) investments. Post-reforms, fresh PSU investments have thinned out and the Planning Commission was abolished in 2014 with the result that the Finance Commission remains virtually the sole architect of India’s fiscal federalism. Its responsibility and influence are, therefore, much larger.

Currently, the Centre gives away 41% of its tax pool to the States. For sure, States will demand that this proportion be raised, but I do not see much room for stretching this further given the Centre’s expenditure needs and the constraints on its borrowing limit. Therefore, much of the debate will centre on the horizontal distribution formula.

When the previous Finance Commission was appointed in 2017, its terms of reference became quite contentious because it was asked to take into account the 2011 population figures in determining the expenditure needs of a State. This was a departure from the standard practice until then of mandating Finance Commissions to use the 1971 population numbers so as not to give a perverse incentive to States to neglect family planning with an eye on a higher share of devolution. States which had done well in stabilising population growth rates, typically the southern States, protested against this change in the base year, calling it a ‘penalty for good performance’.

A similar conflict arises with regard to revenue deficit grants that the Finance Commission awards to States which remain in deficit on the current account even after tax devolution. In theory, revenue deficit grants have a neat rationale — that every State in a country should be able to provide a minimum level of service to its residents even if it involves an element of cross-subsidisation. The worry is that this too has become a perverse incentive. Why bother raising revenues on your own when the Finance Commission will compensate you?

Historically, Finance Commissions have struggled to determine how much a State's deficit is due to its fiscal incapacity and how much is due to fiscal irresponsibility. They have tried to tweak the distribution formula to support deficit States without penalising responsible States, a mathematically impossible task since you cannot give more to a State without giving less to another. The net result is that every horizontal distribution formula has been criticised as being inefficient or unfair or both.

These faultlines across States have in fact deepened in recent years along political, economic and fiscal dimensions. When the Bharatiya Janata Party (BJP) lost the Karnataka election last month, many political commentators read that as a north-south divide, with the BJP being confined to the northern States while the Opposition parties rule the southern States. Similarly, many headline numbers suggest that the southern States of the country are doing better in terms of infrastructure, private investment, social indicators and the rule of law, which has put them on a virtuous cycle of growth and prosperity and widened the north-south gap.

The bottom-line though is that it is in the very nature of horizontal distribution that richer States compensate poorer States. How to ensure that this happens without deepening the divide will challenge the government in defining the terms of reference of the Finance Commission, and of the Finance Commission itself in delivering on those terms of reference.

The terms of reference of the Finance Commission enjoin it to take into account the expenditure needs and revenue earning capacity of the Centre and States. I believe the forthcoming Finance Commission should use this leverage to focus on two issues in particular.

The first is the egregious practice by the Centre of increasingly resorting to a levy of cesses and surcharges rather than raising taxes. A white paper released by the Tamil Nadu government a couple of years ago pointed out that the proportion of cesses and surcharges in the Centre's total tax revenue had nearly doubled from 10.4% in 2011-12 to 20.2% in 2019-20.

There is a perverse incentive in operation here. The straightforward option for raising revenues is to raise taxes, but if the Centre does that, it has to part with 41 paise to States. On the other hand, if it raises the additional rupee by way of a surcharge, it gets to keep all of it. When the Constitution was amended in the year 2000 giving States a share in the Centre's total tax pool, the implicit understanding was that the Centre will resort only sparingly to cesses and surcharges, and not as a matter of routine as has become the practice. As a result of this breach of understanding, States have felt cheated out of their legitimate share of national tax revenue. The next Finance Commission should lay down guidelines for when cesses and surcharges might be levied, and also suggest a formula to cap the amount that can be raised.

The second issue of focus for the Finance Commission should be government spending on what has come to be called freebies. All political parties are guilty on this count, some more than others, but trying to apportion blame will be a wrong start.

In a poor country, where millions of households struggle for basic human needs, it sounds cruel to argue against safety-nets for the poor. But it is precisely because India is a poor country, that we need to be more circumspect about freebies.

In theory, the restraints imposed by the Fiscal Responsibility and Budget Management (FRBM) Act should have acted as a check on such populist spending, but governments have found ingenious ways of raising debt without it appearing in the budget books. It is not easy to unambiguously define a freebie, and any check on this will be contested as infringing on the sovereignty of elected governments. Nevertheless, the next Finance Commission should bite the bullet in the interest of long-term fiscal sustainability and lay down guidelines on the spending on freebies.

After the BJP lost the Karnataka election, the Prime Minister said that the guarantees offered by the Congress in Karnataka were impossible to implement, and if taken forward, ‘the country and the State concerned will become bankrupt.’ Strong words indeed. In the State Assembly elections to be held later this year, the Prime Minister should walk the talk and invest his political capital to show that the promise of good governance can trump the lure of freebies.

That will embolden the Finance Commission to formalise a mechanism for a restraint on freebies.

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finance (general) / taxes and duties / Bharatiya Janata Party / Karnataka Assembly Elections 2023 / Tamil Nadu / politics / Indian National Congress / Prime Minister Narendra Modi

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