

Fund and Freedom

The Statesman

June 24, 2018

Much has been written about the Central Government changing the terms of reference (ToR) of the Fifteenth Finance Commission (FCXV) by asking it to reckon 2011 population instead of 1971 population all earlier Commission's had used as the reference point for determining the devolution of Central resources to the states. Southern states are resentful as they stand to lose most from this, having more or less stabilised their populations - even West Bengal and Odisha will lose significantly. All these states have already achieved a total fertility rate below the replacement rate of 2.1, while the states which could not achieve this so far - UP, Bihar, Rajasthan, MP etc. – stand to gain most from this change. Reckoning 1971 population would have rewarded the states that were able to control their populations since then. But there is much more than population in the ToR of the FCXV that raises serious concern about the Centre-State federal relations.

Finance Commissions' recommendations broadly follow three principles- equity, equalisation and efficiency. While the equity principle is reflected in parameters like population and area of a state, the equalisation principle is reflected in parameters related to distance of per capita income or fiscal capacity of a state from the highest one so that disadvantaged states with low income or capacity get more funds than the prosperous states. The efficiency criteria is reflected in parameters like tax effort, fiscal discipline etc. All Finance Commissions have broadly followed the above principles even while using different parameters, except that the 14th Finance Commission (FC14) did not use any efficiency criteria; for the first time, it also assigned a 10% weightage to the 2011 population to take into account the inter-state migration since 1971, while giving the latter only 17.5% weightage. Both the 12th and 13th Finance Commissions had given population 25% weightage. Besides population, FC14 had given 50% weightage to income distance, 15% to area and 7.5% to the forest cover in a state.

The ToR of FCXV are indeed significantly different from those of all earlier Commissions and militates against the principle of cooperative federalism the NDA government seems so keen to uphold; they tend to nudge the states towards following the Centre's priorities. There are issues that trespass the autonomy not only of the states but of the Finance Commission itself.

Finance Commissions are set up under Article 280 of the Constitution from which they derive their authority. While article 280(3) defines their primary terms of reference regarding distribution of the net proceeds from the divisible pool and the principles governing grants-in aid as well as measures for augmenting the resources of local bodies, proviso 280(3)(d) allows the Centre to refer any other matter to the Commission "in the interest of sound finance". It is under this provision that the Centre has been giving elaborate guidelines and directives to the Commission, but the directives given to the FCXV raise serious questions about their Constitutional validity.

Firstly, Article 280(4) of the constitution gives the Commission absolute independence to "determine their procedure" and exercise "such powers in the performance of their functions as Parliament may by law confer on them". Providing a wide-ranging set of guidelines in the ToR of FCXV is tantamount to prejudice the thinking of the Commission – this fundamentally militates against the Constitutional independence of the Finance Commissions which are under no obligation to follow such guidelines. Some of the elements in Clauses 3 and 4 of the ToR of FCXV includes areas beyond the Constitutional

authority and mandate of the Commission, like asking it to propose “measurable performance-based incentives for States” in respect of “progress made in moving towards replacement rate of population growth”, “achievements in implementation of flagship schemes” of Govt. of India, “progress made in promoting ease of doing business”, “progress made in sanitation, solid waste management and bringing in behavioural change to end open defecation”, “expansion and deepening of tax-net under GST”, or “control or lack of it in incurring expenditure on populist measures”. These are larger issues of public financial management, to decide which the Commission neither has the authority nor the requisite expertise, and for which bodies of elected representatives may be the appropriate fora.

For example, regarding control of expenditure on populist measures, populism is not something practiced only the States, the Centre also equally indulges in populism for its own ends. Besides, what constitutes populism is not for the Finance commission to decide - a better mechanism would be through a consensus between the Centre and the states. The term “populism” itself is open to differing interpretations and changing perceptions. The mid-day meal programme considered populist after its introduction by the Tamil Nadu government now covers the entire country. Many consider MNREGA as an exercise in pure populism. The huge amounts earmarked for recapitalization of public sector banks to address their NPAs can be considered populist since the NPA problem has its root in dismal loan management. It is ironical that while there is no bar on the Centre to spend colossal amounts on such transfers, only the state governments are being asked to control their “populist” expenditure.

Secondly, Article 275(1) of the Constitution provides that grants in aid of revenues shall be given to those states which are “in need of assistance” and different sums may be provided to different states. ToR of FCXV excludes any reference to the words “in need of assistance”, extending the scope of such grants to states that may not actually be in need of assistance in terms of their revenues but to incentivize those states which have implemented Central schemes more effectively than the others. Thus progressive and advanced states which in FCXV’s opinion need to be incentivized for implementing the Central schemes and programmes more effectively can get such grants. This again is outside the Constitutional mandate of the Finance Commission.

Thirdly, the Commission’s methodology and recommendations should be equitable and symmetrical between the Union and the states and uniformly applicable to both. They must not benefit the Centre at the cost of the States. This is where the Tor is found lacking, for GST has already taken away most of the taxing power of the States. Is it not the responsibility of the Centre too to broaden and deepen the base of GST, to increase tax and non-tax revenues, target carefully the huge volume of subsidies or improve the ease of doing businesses? State and Centre share equal responsibilities in all these, but the Tor requires the Commission only to consider their impact on the States’ finances. Besides, how can FCXV be conceivably expected to entertain objectives such as population control, public expenditure management, spreading awareness about sanitation, or use the instrument of tax devolution and grants to achieve these ends?

Fourthly, Clause 3 (iv) of the ToR mandates the FCXV to consider the impact on the fiscal situation of the Union Government of substantially enhanced tax devolution to States following recommendations of FC14, coupled with the continuing imperative of the national development programme including “New India 2022”. These provisions not only violate the Constitutional provisions regarding federal financial relations, they clearly encroach upon the autonomy of the states. Reference to the FC14 seem to imply that it has been far too generous in increasing tax devolution and the Central government needs more resources for its New India -2022 which the FCXV must provide. We need to

remember that resources of the nation must be distributed between the Union and the States for undertaking the tasks assigned to them as defined in the Seventh Schedule and not to provide comfort to the Centre to spend money on its own special schemes. New India 2022 is a composite programme that reflects the vision of the Union government rather than the needs and priorities of the state governments. Its components like clean India, poverty-free India, corruption-free India, terrorism-free India, communalism-free India or casteism-free India are rather aspirational, without any specific measurable and quantifiable outcomes. Linking these long-term visions to financial devolution which is a Constitutional mechanism goes against all accepted norms of federal financial relations.

While the Centre has the primary responsibility of macroeconomic stabilization and redistribution, the States have the predominant responsibility of providing social and physical infrastructures, besides ensuring law and order and delivery of public goods and services. The approach of the Commission should be symmetrical between the Centre and States. It would be inappropriate to prescribe a system of incentives and penalty based on measurable parameters only for the States while inoculating the Centre from such treatment.