The Statesman

Opinion

3rd March 2015

Will Federalism at Work Let Populism Thrive

Govind Bhattacharjee

The just released recommendations of the Fourteenth Finance Commission's will have far reaching consequences for the states of the Indian Union, with 42 percent of the central divisible pool of resources now going to them, as compared to the existing 32 percent provided by the Thirteenth Finance Commission. In terms of resources now available to the states, it is indeed a quantum jump from the recommendations of all previous Finance Commissions which increased the states' share only in low incremental steps.

Divisible pool initially used to comprise only income tax and part of central excise duties. Successive commissions increased the states' share of these taxes. The Eleventh Finance Commission (2000-05) expanded the divisible pool substantially by including in it the net proceeds from all taxes covered under article 270 (income tax, corporation tax, central excise duty, customs duty, service tax and wealth tax) and making 29.5% of this pool sharable with the states. The next two commissions increased this share to 30.5% and 32% respectively. Cess and surcharges are excluded from the divisible pool which are entirely appropriated by the Centre; this remains a sore point with all states. Apart from devolution of taxes, Finance Commissions also recommend grants-in-aid of revenues of states under article 275.

The taxes are divided among the states on the principles of equity and efficiency, effectively transferring resources from the rich to the poor states on the basis of a formula that factors in population and area of a state, inter-state disparities in income and their fiscal and financial fiscal performance. From the sixth commission onwards, Governments have restricted the Finance Commissions to recommend only non-plan grants, plan part being made the prerogative of the now defunct Planning Commission. Plan transfers in most part depended on the discretion of the Central government; only a part was formula based that progressively went on shrinking with the proliferation of centrally sponsored schemes. These discretionary transfers have now been reduced after the replacement of the Planning Commission by Niti Aayog, an expert body without any power of resource allocation.

But the landscape of federal financial relations between Union and states have really started changing since the recommendations of the Twelfth Finance Commission; before that, the Finance Commission recommendations were by and large accounting recommendations, a little more here, a little less there. These failed to address the perennial financial problems of the states which had revenue resources that fell far short of their revenue expenditure, let

alone capital investment requirements, for which they had to borrow heavily. This led to swelling debt burden of each state and the nominal debt reliefs given by the successive Finance Commissions could hardly mitigate the crushing burden of their debt. Unable to manage this on the strength of their own resources, the states had to borrow from the centre just to be able to repay their debt instalments and interest; many states couldn't even manage that as servicing of their existing debt exceeded their fresh borrowings. The successive Central Pay Commissions, especially from the Fifth Pay Commission (1996-2006) onwards, increased the salaries of Central government employees forcing the states also to give matching rises to the salaries of their own employees without having matching resources, this compounded their financial problems even more. After the sixth Pay Commission recommendations (2006-16), the situations went absolutely beyond the control of most states and they started sinking in debt deeper and deeper.

Meanwhile the market rate of interest was going down, but Article 293 of the Constitution did not allow the states to borrow from the market without the Centre's permission if they were indebted to the Centre, which they were. Centre continued to charge higher interest rates which further worsened their indebtedness, making them fall into the viscous debt trap one by one, heading for sure disaster. It was in these circumstances that the Twelfth Finance Commission was constituted. They diagnosed the problem correctly but departing from the incremental accounting approach of the previous Commissions, came up with an outstanding out-of-box solution, forcing the states to control their unproductive expenditure by enacting FRBMA (Fiscal Responsibility and Budget Management Act), which bound themselves to contain their fiscal deficits within 3 percent of state income (GDSP) and in return, freeing them from the obligations of borrowing from the Centre. They rewarded states that could generate surpluses in their revenue accounts by giving them a matching relief on their debt burden and more. As a result, most states, except a few indigent ones, could pull themselves out of their debt traps by generating revenue surpluses. These surpluses financed their capital expenditure, curtailing borrowing to that extent. Their debt burden thus reduced as a consequence and their finances improved. The Thirteenth Finance Commission further reinforced the states' improved financial position and increased their share of divisible pool to 32 percent. Even West Bengal and Sikkim which had hitherto refused to enact the FRBMAs were now forced to enact these legislations so as to avail the benefits that could no longer be ignored for the sake of populism.

But the recommendations of the Fourteenth Finance Commission go far ahead – they have the potential to redefine and redraw the contours of federal finance in India by giving much more fiscal space to states to identify their own priorities and to spend thereon, instead of making them depend on an all-powerful centre to dole out resources through plan funds as per its own discretion, and in the process, jeopardising the process of growth and development of the country as a whole.

Centralised planning was a negation of the spirit of true federalism. Spirit of federalism is asserted when Centre and states are seen as equal partners in development, and not the former as a giver and latters as recipients of common resources, as it has been until now. National interest must be supreme in any arrangement of federal transfer of resources, but the aberration of the badly implemented centrally sponsored schemes, often designed with dubious logic, has so far hideously defeated this objective. The number of these schemes has now reduced from 347 during the ninth plan to only 66 now, but these are still far too many. Hopefully, Fourteenth Finance Commission's far-reaching recommendations will now force the Centre to consider scrapping some of these anachronisms and give the states the authority to spend the taxpayers' money more judiciously, according to the right priorities and careful targeting so as to eliminate wastes, leakages and corruption.

The recommendations will have the effect of increasing the net flow of funds to the states by extra Rs 2.21 lakh crore during 2015-16 alone – the biggest ever jump in the state' share so far. During the award period of the Commission (2015-20), tax share to states will exceed Rs 44 lakh crore. In addition, 11 states with deficits in their revenue account will get grants amounting to Rs 1.95 lakh crore during the period. Local bodies stand to gain significantly, with Rs 2 lakh crore earmarked for Gram Panchayats and Rs 87000 crore for our almost dysfunctional municipalities - resources enough for transforming them, if used judiciously. The aggregate level of transfer of Central resources – plan and non-plan combined - is estimated go up only by about 2% over the award period, but most of it will now be based on formula rather than on discretion and not tied to plan schemes of questionable usefulness. The Commission's methodology has been robust and estimates conservative, avoiding a high growth scenario in respect of taxes and GDP, which increases the credibility of their recommendations. By including forest cover as a new environmental factor and by giving weightage to inter-state migration since 1971 in population, it has taken into account the changing realities of the time.

For transfers outside the Finance Commission, it has recommended setting up of a new institutional mechanism 'consistent with the overarching objective of strengthening cooperative federalism', by limiting discretion, improving design and giving adequate flexibility to the States. By recommending to exclude the States from the operations of NSSF which was forced upon them, it has given them more liberty to manage their debt. It has also urged the Centre to follow the true spirit of fiscal responsibility by dispensing the concept of 'Effective Revenue Deficit', ingeniously invented by it to circumvent the 3% limit on fiscal deficit. All these recommendations are likely to bring in transparency and accountability in the public finances of union as well as states, heralding a spirit of federalism this country has not seen so far.

There is of course a danger lurking which the Commission ought to have considered and pre-empted. The mistakes that the Congress governments at the Centre had made by resorting to unbridled populism at the cost of the nation's growth are now much more likely to be

repeated with the increased resources available to the states. They are already in evidence in Delhi where the newly elected government has announced sops that will cost the exchequer about Rs 1700 crore annually. They may be fulfilling their election promises, and Delhi, a Union Territory, may not be under Finance Commission's jurisdiction, but such trends are irresponsible and dangerous. They are likely to be repeated by many states, especially those going to polls within a few months, like Bihar, West Bengal and UP. The potential of subverting economic gains for populist purposes assumes serious proportions when political parties enter into opportunistic alliances forsaking all semblance of principles with an astonishing brazenness and when looters masquerading as leaders are in positions to drive governance in states, our politico-economic arrangements needs serious introspection. These states will now find the increased resources as a welcome bonanza to spend on ever more populism, squandering resources through unconstrained sops and doles in an election or pre-election year. A forward looking Commission ought to have provided safeguards against these pitfalls.