

Charting the path for the Sixteenth Finance Commission

The Sixteenth Finance Commission is due to be set up shortly. Many critical changes have taken place since the constitution of the Fifteenth Finance Commission in November 2017 that includes COVID-19 and the subsequent geopolitical challenges. The combined government debt-GDP ratio had also shot up close to 90% at the end of 2020-21. Many States show large fiscal imbalances too.

The vertical and horizontal dimensions

The Fourteenth Finance Commission had raised the share of States in the divisible pool of central taxes to 42% from 32%. This was revised to 41% when the number of States in India was reduced to 28. However, the Centre could manage the situation because of the withdrawal of Planning Commission grants as the Planning Commission was abolished. There may not be a strong case for recommending any further increase in the States' share of central taxes in view of the Centre's large fiscal imbalances. Alongside, a re-examination of the role of non-shareable cesses and surcharges is required.

During 2020-21 to 2023-24 (BE), the effective share of States in the Centre's gross tax revenues (GTR) averaged close to 31%, which was significantly lower than the corresponding share of nearly 35% during 2015-16 to 2019-20. This was due to the inordinate increase in the share of cesses and surcharges to 18.5% of the Centre's GTR during 2020-21 to 2023-24 (BE) from 12.8% during 2015-16 to 2019-20. This heavy reliance on cesses and surcharges requires scrutiny by the Sixteenth Finance Commission. One option is to freeze the share of cesses and surcharges to some base number.

In the period under the Thirteenth Finance Commission, this share was just 9.6%. Perhaps, a 10% upper limit of the share of cesses and surcharges as a percentage of Centre's GTR may be recommended. To make it biting, the share of States must be increased if the proportion crosses 10%. Thus, there will be one proportion, say 42%, if cesses and surcharges exceed 10%, and another share of 41% if they are 10% or below. The formula may be nuanced by the Sixteenth Finance Commission with the help of the latest data. An issue of concern in recent years has been the poor performance of the Goods and Services Tax (GST) and the consequent decline in total



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Correcting excessive cesses, freezing the weight for income distance criterion, and sharper monitoring of fiscal deficit are the areas that need attention

divisible pool. Fortunately, this is not an issue now. GST collections have maintained good buoyancy in the last two years. GST still needs restructuring to make it a good and simple tax.

The share of individual States in the Centre's divisible pool of taxes is determined by a set of indicators that includes population, per capita income, area, and incentive-related factors such as forest cover and demographic change. In the case of per capita income, it is the distance of a State's per capita income from a benchmark, usually kept at the average per capita income of the top three States that is used as a determining factor. This distance criterion implies relatively larger shares for relatively lower income States. At present, it has the highest weight of 45% – it had an even higher weight previously. Many of the richer States have argued for a lowering of the weight given to this criterion.

However, due attention needs to be paid to the needs of the lower income States. These States are expected to provide a relatively larger share of 'demographic dividend' to India in future provided attention is paid to the educational and health needs of their populations. It may be useful to freeze the weight to distance criterion at the current level or even reduce it to 40%, but some upward adjustment in the resources transferred to the poorer States may be done through grants.

In fact, equalisation of the provision of education and health services should be prioritised in the overall scheme of resource transfers. Instead of using a large number of tax devolution criteria, the transfer of resources to individual States may be guided by the equalisation principle using a limited number of criteria such as population, area and distance, supplemented by a suitable scheme of grants. The equalisation principle is consistent with both equity and efficiency. It is used in federations such as Canada and Australia. The basic consideration of reflecting needs, costs of providing services, and equity considerations can all be reflected through these three criteria, provided there is more fine-tuning.

Recommendations

The debt-GDP ratio for the combined account of central and State governments had peaked at 89.8% in 2020-21, of which the Centre's debt-GDP ratio excluding any on-lending to the States

amounted to 58.7%, and that of States was 31%. While these numbers have begun coming down, these are still considerably above the corresponding Fiscal Responsibility and Budget Management (FRBM) norms of 40% and 20%, as in the 2018 amendment. In 2020-21, the Centre's fiscal deficit had shot up to 9.2% of GDP and that of States to 4.1%. In view of the large departures of the debt and fiscal deficit to GDP ratios from their corresponding norms and the reduction of the States' debt-GDP target to 20%, the 2018 amendment to the Centre's FRBM needs to be re-examined. This was also recommended by the Fifteenth Finance Commission.

The Twelfth Finance Commission had recommended a target of 28% consistent with an underlying nominal GDP growth of 12%. It is also clear that the adjustment needed for the central government is larger than that for State governments. At the same time, a few State governments appear to have relatively larger debt and fiscal deficit numbers relative to their GDPs. In this context, two concerns appear: these relate to the proliferation of subsidies and the re-introduction of the old pension scheme in States without a clear identification of the sources of financing and the resultant fiscal burdens. Often, such subsidies are sought to be financed by raising the fiscal deficit.

Reforms worth pursuing

One innovation which may be relevant in this context is to set up a loan council, as recommended by the Twelfth Finance Commission. This independent body should oversee the loan magnitudes and profiles of the central and State governments. The Sixteenth Finance Commission should examine the subject of non-merit subsidies in detail. However, exclusion of 'unjustified' subsidies while determining grants may cause the Finance Commission to be caught in political crossfire.

At the same time, one cannot afford to be relaxed with respect to subsidies and fiscal deficit. The Finance Commission should be strict about States maintaining fiscal deficit within limits. It should provide carrots to States maintaining fiscal deficit (for example including fiscal performance as a criterion in horizontal distribution) and sticks for those that exceed fiscal deficit limits (by suitably acting on the extent of borrowing allowed).