15th Finance Commission: The Balancing Act

What is the issue?

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- The union government recently constituted the 15th Finance Commission (FC) to take review the financial distribution between states and the centre.
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- As the terms of reference given to the FC have already created a controversy, it will have to take a prudent call on the degree of equalisation that's feasible.
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What are the Terms of Reference (ToR) given to the 15th FC?

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- Finance Commission is constituted by the president every 5 years (or earlier) to take stock of distribution of proceeds from the central tax pool to states.
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- The commission studies the fiscal situation of governments and makes its recommendations, which are only advisory in nature.
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- ToR is a list of issues highlighted by the union government for the FC to consider on a priority basis in its brainstorming exercise.
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- The key aspects of the ToR given to the 15th finance commission are
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- The mandate for using the 2011 population
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- The possible elimination of "Revenue Deficit Grants"
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- Impact of the GST on the finances of the Centre and States
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- Conditionality needed on State borrowing
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- Providing performance incentives to states on certain indicators
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- Going back to 32% formula from the current 42% devolution to states
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Why is the proposal to update to 2011 census data worrying some states?

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- Distribution of tax proceeds to states is decided based on multiple factors and population of the state is one major factor.
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- In order to promote family planning programs, it was decided in the 1970s to freeze the 1971 census as the bench mark for future the reference of FCs.
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- Notably, this was done to eliminate the benefit of an expanding population to reflect upon the financial proceeds a state receives from the centre.
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- Over the years population control mechanisms haven't been uniform throughout the country with some states doing much better than the rest.
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- As southern states performed particularly well in population control, they now content that a shift to the 1971 census would affect their finances.
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- Contrarily, some argue that we need to move to current figures instead of making our policies based on 50 year old archaic date (1971 census).
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- Notably, major federations like Australia and Canada almost always use the latest information available for devolving funds to its provinces.
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- "Fiscal Capacity Distance" (FCD) is the "difference of a state's per capita income from that of the state with the highest per capita income".
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- FCD is another criterion for distributing proceeds, and here too, for calculating the per capita income, the 1971 census is used.
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What are the other parameters in devolution of funds?

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- Losses or gains for states depend on the relative weights attached to different criteria, and changes in other information including per capital GSDP.
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- As some states have raided concerns, there is now a case to have a relook and lower the weights attached to the population and fiscal-distance criteria.
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- Notably, weight attached to the population has varied from 25% to 10% and that attached to the distance from 62.5% to 50% from the 10th to the 14th FCs.
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- **Grants -** Revenue Deficit Grants are given to states that weren't able to meet their fiscal deficit targets and have strained balance sheets.
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- This has been under criticism for adversely affecting budgetary prudence as it provides leeway for incentivising states to spend recklessly.
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- The government has hence rightly asked for considering its abolition, but this won't have any impact on the other grants for serving better purposes.
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- Notably, Article 275(1) urges the Finance Commission to determine the principles that govern the grants-in-aid to be provided by centre to the states.
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- **Equalisation -** Most federations follow an equalisation approach to determine fiscal transfers, for ensuring better support for poorer regions.
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- Such an approach is key to ensure that all states are financially capable of providing services at comparable standards.
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- Hence, if richer states are losing out a little, it's because they can sustain the same national standard with lesser share from the central pool.
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What is the case of the poorer mineral rich states?

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- Mineral rich States like “Jharkhand, Odisha, Chhattisgarh, Madhya Pradesh and Assam” are an interesting grouping.
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- These States carry a significant pollution load on behalf of the nation.
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- These states had the potential to become industrialised early on by virtue of their proximity to resources.
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- But they lost out due to the central government’s policy of freight equalisation whereby the transport of coal was subsidised.
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- Notably, freight equalisation was what led to many thermal power plants being set up in the southern States, which powered their industrial growth.
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- Hence, these regions do possess a legitimate right to access more funds from the central pool in order to overcome its backwardness.
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What are some technical concerns with ToRs given to the 15th FC?

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- The Finance Commission should remain policy neutral as it has to come out with recommendations that accommodate conflicting claims.
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- Hence, it is not the appropriate platform for promoting Central policy priorities – but some ToRs given to the 15th FC contravene this principle.
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- ToR’s points involving - Centre’s flagship schemes, ‘populist policies’ of States, and conditionality on State borrowing could’ve been avoided.
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- In any case, too long a list of ToRs, like the one given to the 15th FC, should’ve been avoided, as FCs deserves considerable independence in their approach.
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What are the other aspects that need pondering?

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- The contribution of proceeds from a particular state to the central tax kitty

needs to be accounted for in devolving funds.
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- Demographic aspects like aging populations in states like Kerala and Tamil Nadu need to taken into account as this could mean more health costs.
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- Environmentally affected mineral belt and geographically constrained states (ex: hilly and forested states) also need special consideration in allocations.
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Source: The Hindu

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