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Research Paper Economics



Role of Finance Commision in Fiscal Transfers in India

* Prof. P. Dhiraviyam

* Asst. Prof. in Economics, Govt. Arts College, Attur Tk, Salem Dt, Tamil Nadu

ABSTRACT

In the context of the ongoing work of the Thirteenth Finance Commission, this paper examines the record of the recent Finance Commissions, with a view to suggesting how best the present Commission can and should assert itself and follow a new, independent approach. The paper argues that the Thirteenth Finance Commission has got to find its own track if it does not want to remain as a pale shadow of its constitutional self. It should ignore those terms of reference which are not mandated by the Constitution as well as those which have become obsolete with the onset of recession in the economy. If it has to gain acceptance of the States, it has got to follow an equidistant attitude towards the Centre and the States. The paper argues for substantially stepping up the resource flows from the Centre to the States in view of the severe fiscal crisis of the latter and consequent inability to meet their expenditure responsibilities bestowed on them by the Constitution. The paper finds that one of the terms of reference of the Commission setting the objective of balancing the revenue account of States and the Union government and generating surpluses for capital investment has become outdated with the onset of recession in the economy. The recession calls for abandoning fiscal conservatism and embarking on increased public expenditure to build physical and social overheads as also to provide social protection to the victims of recession. The paper recommends that the grants to States must be made unconditional and free from interference. Key Words: Finance Commission, Centre, States, Fiscal Transfers, Statutory Transfers. This is a revised version of the paper presented at the Conference on "Towards Progressive Fiscal Policy in India", organized by the Centre for Budget and Governance Accountability, New Delhi on December 9, 2008.

Regaining the Constitutional Identity of the Finance Commission:
A Daunting Task for the Thirteenth Commission

States in India have been plagued by recurrent and severe fiscal crisis from the middle of the eighties. Mismanagement of the finances by the State governments is the reason for the crisis, most often highlighted during the current discussions on the issue. The role of the Central government, pivotal under the existing Centre-State financial relationship, is seldom mentioned as a possible reason, though it has been well established that Indian federal state is only a semi federal one and the existing constitutional allocation of financial powers between the Centre and the States is heavily skewed in favour of the former. It is well established that the Indian Constitution places considerable constraints on the States' capacity for resource mobilisation while saddling them with enormous expenditure responsibilies. The Constitution of India, however, envisaged a rather unique fiscal transfer mechanism to transfer adequate funds from the Central government to the States, taking into account the disproportion between the financial powers and expenditure responsibilities of the two tiers of the government.

Role of Finance Commission

The provision for a Finance Commission to be appointed by the President every five years or earlier under Article 280 of the Constitution is the only difference between the Government of India Act, 1935 and the Indian Constitution with regard to the distribution of financial powers between the Central and the State governments. The Commission is visualized as a semi judicial body and is entrusted with the twin responsibilities of apportioning Central Government revenues between the Centre and the States on the one hand and among the individual States on the other. But, over the years, the impartial arbitrator's role of the FCs is being undermined by the Central Government in a number of ways. The turf of this constitutional body had been encroached upon to a large extent, by the Planning Commission, an extra constitutional body and the Union Ministries during the plan era. The fault for allowing this encroachment lies partly with the successive Finance Commissions which abdicated their constitutional responsibilities and limited their role, on their own, in tune with the wishes of the Central government. In the context of the ongoing work of the Thirteenth Finance Commission (FC13), this paper examines the record of the recent Finance Commissions with the objective of suggesting how best the present FC can and should assert itself unlike its recent predecessors and follow a new independent approach.

TORs: Fetters on the FC

Binding the Commissions by larger and larger number of terms of reference (TOR) is a measure increasingly adopted by the Central Government which undermines the umpiring role of the FCs. The TORs are framed without consulting the states. It is as though the rules of the game are written by one of the teams in its favour when the game is about to be started. As late as August 2008, a new TOR was added to the Thirteenth Commission. These TORs are unnecessary as the Constitution itself has defined the TOR of the FCs. This body is to determine the allocation of Central revenues to be transferred to the States by way of sharing Central tax revenue and providing grants to the States "in need of assistance". Of course, the President can refer any other matter "in the interests of sound finance" under Article 280. In addition to the constitutional impropriety, TORs are objectionable as they are loaded heavily in favour of the Central government. The TORs give a detailed road map on how and in which direction the FCs should proceed, thus limiting the freedom and flexibility of this constitutional body.

The Thirteenth FC has been saddled with six TORs. The third TOR has ten sub TORs which include "the need to manage ecology, environment and climate change consistent with sustainable development!". No doubt, ecology, environment, climate change and sustainable development are all important. But the only doubt is how this TOR fits in with "the interest of sound finance" envisaged in the Constitution. Another sub clause asks the FC to assess the impact of the proposed implementation of Goods and Services tax with effect from 1st April 2010, including its impact on the country's foreign trade!.

This TOR also does not come strictly under the purview of the FC. In fact, one can argue that the FCs should take into account the revenue loss of VAT suffered by exporting states due to Central government's insistence that the State cannot tax commodity exports not only at the point of exports but also at the penultimate stage of sale. Many of the TORs reflect the economic philosophy of the Central Government which need not necessarily be subscribed to by many states ruled by different political parties. Already some of the TORs (eg: TOR 2, TOR 3.4) have become obsolete in view of the recession creeping into the Indian economy. No doubt, the FCs are not duty bound to be tied by TORs. But no recent FCs, constituted as they are, were prepared to assert its independence from the TORs. Some of them were only too willing to be the cheer leaders for the agenda of the Central Government.

Though funds through any channel, whether it is through Finance Commission or the Planning Commission or through the different Union ministries are welcome to the States starved of funds, they prefer funds coming through the Finance Commission channel. There are two main reasons for this. Firstly, the States consider the funds coming by way of Statutory transfers as their constitutional right as the Finance Commission unlike the Planning Commission is a constitutional body. Secondly, the funds through the Finance Commission are intended to be transferred to the States unconditionally for the use by the States according to their own priorities. Funds from the FC are to be received automatically and should be free from interference from the Central government. As will be seen later, these intentions of the Constitution makers are gradually being negated by the recent Finance Commissions by making their transfers more and more conditional, linking them even to state-specific purposes and binding them to particular schemes.

The Context of the Thirteenth Finance Commission

The Thirteenth Finance Commission's working may be seen in the context of

(1) the deteriorating fiscal position of the states
(2) the logic of the Central government's own reforms agenda and
(3) the onset of recession in the economy.

The poor fiscal position of the State is too well established for any elaboration. But the implications of the Central government's economic reform agenda call for some elaboration. The reforms envisage the Governments to reduce their role in economic activities and concentrate on providing social and community services like education, health care, social security, food security etc.. Under the constitutional dispensation, almost all these services come largely under the States' or Concurrent jurisdiction. This suggests the need for increasing substantially the share of States in Centre's revenue. But what has been done by the recent FCs in this direction is at best only marginal. The FC13 is deliberating at a time when the grip of recession on the economy is getting tighter. In the present times, some of the TORs on fiscal discipline have become outdated. They stand in the way of governments both at the Centre and States providing fiscal stimulus to the economy by running deficits in their budgets. In recessionary times, the role of the State governments becomes all the more critical as they have to shoulder the responsibility of providing unemployment relief, food security and other welfare measures for the victims of economic slow down.

Some Issues in Vertical Transfer

The Twelfth Finance Commission (TFC) had stepped up the States' share in total Central taxes only marginally, to 30.5 per cent from the 29.5 per cent fixed by the Tenth and the Eleventh Finance Commissions. This is despite the strong plea made by all the States unanimously to raise their share substantially. What is more, the stipulated 30.5 per cent is not that of

gross tax revenue but that of revenue after excluding Cesses and Surcharges and after deducting the cost of collection.

Consequently, despite fixing the share of States in total Central Taxes at 29.5 per cent by the Tenth and Eleventh Finance Commissions, the limit was touched only in one year (1997-98) during the entire ten-year period covered by their awards. The gap between the actual ratios and the stipulated ratio has been widening during the award of the TFC as may be seen from Table 1. The exclusion of Cesses and Surcharges from the shareable pool of Central taxes and the increasing resort to these measures by the Central government are the major reasons for this shortfall. During the five-year period ended 1999-2000, Cesses and Surcharges accounted for nearly 3 per cent of the gross tax revenue. In the next two years, their share was 2.7 per cent.

According to the TFC's estimate, the share of Cesses and Surcharges were expected to go up steeply to about 12 per cent during their award period. The FC13 should take some measures to arrest the increasing tendency of the Central government to keep a good portion of Central tax revenue out of the reach of the State government. Alternatively, the cesses and surcharges should also be made part of the divisible pool. The TFC like its predecessor had suggested capping of the overall revenue transfers to States from the Centre's gross revenue. It fixed the States' share to 38 per cent, an increase of just half a per cent from the share stipulated by the Eleventh Finance Commission. There is no need for fixing the maximum for Central revenue transfers as there is no corresponding minimum fixed for such transfers. Secondly, the ceiling of 38 per cent proposed by the TFC was much lower than the actual States' share during the first five years of the nineties covered by the Ninth Finance Commission's Award. Thirdly, the States' share rarely reached the ceiling of 37.5 per cent during the years since 1995-96. In 2005-06 and 2006-07, the State's share exceeded the stipulated limit of 38 percent. But this was on account of the proliferation of Centrally Sponsored Schemes(CSSs), not the most preferred means of transfers to the States.

Use of Excess Funds with the Centre

Leaving too much funds with the Central Government beyond meeting its expenditure responsibilities in its own subjects and may be to a limited extent in the Concurrent List can lead to proliferation of Central plan and Centrally Sponsored Schemes. The number and variety of CSSs in the State and Concurrent subjects are increasing. Only some of the traditional CSSs now go through the State Budget. The number of CSSs bypassing the State Budget altogether and reaching the para-state agencies and local bodies directly is increasing. It is estimated that the total outlay of all these varieties of CSSs in 2005-06 represented 38 percent of the Gross Budgetary Support (GBS) for Plan, 49.4 percent of the GBS for Central Plan, 165 percent of the total GBS for State Plans and 403 percent of the Normal Central Assistance (NCA) to states (Garg, 2006). The Governments seem to have lost count of the schemes. The estimates of the number of schemes range between 155 (Expert Group of the Planning Commission, 2006) to 190 (Garg, 2006). The annual plan document of Kerala lists 200 CSSs against which funds are shown as anticipated from the Central Government.

(1) Based on Annexure VII.3, Twelfth Finance Commission Report, p.409.
(2) Based on Annexure V.2, Twelfth Finance Commission Report, p.381.
(3) CSES Working Paper 20 4

The present tendency of the Planning Commission is to bypass the Gadgil Formula route for financing State Plans. Instead, more and more funds are now routed to the States by way of CSSs. The grant component of central assistance to states UTs plan in the Gross Budgetary Support(GBS) of the Eleventh Plan has decreased from what has been realized in the Tenth Plan (from 26.4 percent to 22.8 percent). On the other hand, the allocation of CSSs has increased from

1.4 percent of GDP during the Tenth Plan to 2.35 percent of the GDP in the Eleventh Plan. The projected Central assistance to the States/UTs for the Eleventh Plan under various schemes is Rs.324851 crores. Of this, normal plan assistance for all States is just Rs.111053 crores. CSSs constitute Rs.213798 crores, i.e., 65.8 percent of the total.(Isac and Chakraborty, 2008)

The Finance Commission which is enjoined "to improve the quality of public expenditure to obtain better outputs and outcomes" must assess the productivity of these schemes especially after the end of each plan period when the Central funds cease to come. In addition to the issues of efficiency of CSSs, the FC must also look into the equity and autonomy dimensions of the ever expanding CSSs. In addition to CSSs routed through the State Governments and other bodies, the Central government, flush with funds is entering the State and the Concurrent subjects through its own institutions. There has been instances of cash rich Central Government taking over many of the institutions developed by the State from its own funds, avowedly to make them centres of excellence.

The recent attempts to take over the Cochin University of Science and Technology and the Bengal Engineering and Science University and to convert them into IIESTs are examples of Central Government taking over some of the institutions of the States, made first to starve for funds due to in adequate transfers by both the Finance and Planning Commissions. There are numerous other proposals now on the anvil to start heavily funded educational institutions in the Central sector while the State institutions are getting debilitated due to paucity of funds with the State Government. A classic case is the proposal of the Central government for starting sixteen Central Universities, fourteen "World Class" Universities, eight IITs and five IISERs. There is also the proposal to start universities in every district which does not have a university at present.

Shortfall in Centres's Revenue Collection: Implications for the States The Finance Commissions had been wielding a big stick for disciplining the States by limiting the volume of grants barely enough to meet their deficits in non-plan revenue account, determined normatively by them. But no such stick is used in the case of the Central government. All FCs had failed to discipline the Centre by linking the States' minimum share to the Central revenue determined normatively by the Commission for the next five years and not to what is actually collected by the Centre. This is evident from Table 2, which shows the revenue normatively estimated by the Eleventh Finance Commission and the actual revenue collected by the Centre. There was considerable shortfall in actual revenue mobilization by the Centre from what was envisaged by the Finance Commission in its normative estimates.
The States lost heavily as a result of this laxity of the Central government which upset the finances of the States very badly. There seems to be a welcome reversal of the trend during the award period of the TFC. The FC should take note of how the magnanimity of the Central Government in granting tax concession for the corporate is at the expense of the states. The Union Finance Minister had confessed that his "endeavour to increase the effective rate of corporate tax paid by the corporations are not entirely successful because of the demand for continuing exemptions or for introducing new exemptions"(The Hindu, April 4, 2008). According to the statement of revenue forgone, tabled along with the Budget documents of 2007-08, the provisional tax expenditure in 2005-06 was estimated to be Rs.2,06,700 crore. For CSES Working Paper 2006-07, the estimate is still higher at Rs.2,35,191 crore. Some studies have shown that the effective corporate tax rate is only 20.6 percent as against the statutory tax rate of 33.66 percent.

Besides, the de facto tax rates are regressive in nature. While the smaller companies pay tax at the rate of 25.4 percent, the larger companies pay at the rate of 19 percent. For the public sector companies, the rates are more than for the large private sector companies. It may also be noted that the booming ITES and BPO industries pay at the rate of 7.36 percent only. Software development companies pay at a still lower tax rate of 6.38 percent. (V.Sridhar, 2008). Increasing Conditionalities of Debt Relief and Grants. In their debt relief recommendations, both the EFC and the TFC had violated the spirit of the Constitution by making debt relief conditional and linking it to fiscal reforms as conceived by the Centre.

The rescheduling of loans was subject to the enactment of the Fiscal Responsibility Act. The quantum of write off was linked to the amount by which revenue deficit is reduced during the award period. Going by the track record of most of the States in containing revenue deficit despite accepting the Medium Term Fiscal Reform Programme, it is quite unlikely that many states will be able to gain substantially from the debt relief schemes of the TFC. It may be noted that states had been able to avail of only two yearly installments of the Incentive Fund constituted as per the recommendations of the Eleventh Finance Commission.

The increasing conditionality of statutory transfers is becoming evident in the way the grants were provided by the TFC. TFC had raised the share of grants in total transfers to 19 per cent from 13.5 per cent under the Eleventh Finance Commission and 9 per cent under the award of the Tenth Finance Commission. Of the grants, the normatively determined unconditional deficit grants formed only 40 per cent. More than a quarter of the grants were made for meeting specific purposes, most of them conditional and some of them very discretionary. Grants were extended for meeting specific purposes like health, education, maintenance of roads and bridges, maintenance of public buildings, maintenance of forests and heritage conservation. The Commission should have realized that there are a number of CSSs operating already in all these areas. This leads to duplication, overlapping and conflict of jurisdiction. All the criticisms against CSSs are equally valid for FC sponsored schemes. Besides, not all grants had a strong equitable bias.(Table 3)

In some cases, as in the case of grants for meeting State specific needs, the Commission's discretion bordered on arbitrariness or mere caprice or whims. Sometimes, TFC went overboard and went into minor details regarding how the schemes financed by the grants should be utilised. Take this sample-

"In the case of the urban local bodies we have already stressed the importance of public-private partnership to enhance the service delivery in respect of solid waste management. The Municipalities should concentrate on collection, segregation and transportation of solid waste. The State governments may require the Municipalities…to prepare a comprehensive scheme including composting and waste to energy programmes to be undertaken in the private sector for appropriate funding from the grants-in-aid recommended by us. Grants-in-aid shall, however be available to support the cost of collection, segregation and transportation only, as the activities to be taken up by the private sector should be commercially viable once the Municipality is able to discharge its role effectively."

The largesses of the TFC can be seen in the sanctioning of a zoological park in one State and a botanical garden in another. In fact, TFC went to the extent of providing for multigym complexes and sports complexes at Taluk headquarters in Karnataka, by no means a fiscally disabled State. Such schemes involve capital expenditure. In these matters, the TFC was making provision for new schemes, which normally find a place under the State plans.(See Annexure)

As noted earlier, according to the spirit of Article 275 of the Constitution, the Statutory grants through the Finance Commissions should be mostly automatic and unconditional. No doubt, it was envisaged that in exceptional cases, the grants could be directed to broad but well-defined purposes. But

the TFC had distorted the spirit of this constitutional scheme and allotted more than one-third of the grants on conditional basis. The TFC had imposed its own priorities on the States. Besides, many 'one size fits all' schemes applicable to all parts of the country, which do not take the local specificities, distort the States' priorities. Perhaps, the Commission could have learnt from the pre-1969 experience of linking Central plan financing to Centrally designed individual schemes. This practice of linking plan finance to individual plan schemes was replaced by the Gadgil formula only because of its complexity, cumbersomeness, red-tapeism, inefficiency and arbitrariness. The FC13 must steer clear of the past approach of the FCs in tying up statutory transfers to specific purposes and schemes.

Finance Commission Awards and the State Plans

As noted earlier, the FC13 had been enjoined by the Central Government that it should have regard to the "demands on the resources of the Central Government, in particular on account of the projected Gross Budgetary Support(GBS) to the Central and the State plan……". But FC13, instead of providing funds to the Central Government for GBS to state plans can provide such support directly as its own, by providing adequate non-plan surpluses giving larger tax shares and grants. Of course, the distribution of surpluses to States. It is the policy of the Finance Commission with regard to tax sharing and grants that largely determines the surpluses in the non-plan account. But the FCs leave little or no surplus in the non plan account of many states after devolution and gap grants and they start with an initial handicap with regard to balance on current revenue, the nucleus for plan financing for the states(Table 4).

For the States as a whole the actual surpluses were less than the FC estimates except in the case of the Sixth FC. During the Seventh and the Eighth FCs, the shortfalls from the FC estimates of surpluses were quite large. From the Ninth FC onwards, the FC surpluses actually turned out to be deficits. This implies that the States as a whole started with negative balance of current revenues to finance their plans.

The distribution of non-plan surpluses among states after devolution and grants shows a regressive trend. For instance, the per capita non-plan revenue surplus of Assam, Bihar, Orissa, Rajasthan, Uttar Pradesh and Madhya Pradesh under the award of the TFC was much less than that of Haryana, Karnataka, Gujarat, Tamil Nadu, Maharashtra and Andhra Pradesh.(Table 5) Thus, the relatively backward States face a major handicap with respect to their plan financing as a result of the TFC's award.

Centre for Scio-economic and Environmental Studies (CSES) is an independent, non-profit, non-governmental organization for promoting policy and action-oriented research, and consultancy services. It was established in 1996 by a group of academics, scientists, technologists, management experts and social activists. The legal status of the Centre is that of a society registered under the Travancore-Cochin Charitable, Scientific and literary Societies Act 1955. The Centre has got FCRA registration from the Government of India. CSES positions itself as a non-partisan Think Tank. It seeks to fill a critical gap between the academic world on the one hand and policy makers, opinion shapers and the public on the other. It has already carved out a niche for itself by identifying areas of research, relevant to both policy makers and social action groups, which were not getting due attention from other academic and research institutions. While deciding its research priorities, CSES takes into account the present and the future role of the particular sector(s) issues in development. The Centre has been multidisciplinary in its orientation. The present focus of the Centre has been on development issues relating to Kerala.

Conclusion

If the Thirteenth Finance Commission does not want to remain as a pale shadow of its constitutional self, it has got to assert itself and follow its own track. It should not go by the beaten track of its predecessors. It should also ignore those terms of CSES Working reference which are not mandated by the Constitution. If it has to gain the acceptance of the States, it has to follow an equidistant attitude towards the Centre and the States.

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