AIDE MEMOIRE to the 13TH FINANCE COMMISSION on DEVOLUTION OF FUNDS

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Preamble:

The 13th Finance Commission is in session. As it enters the home stretch as rapidly moves towards completing its work of giving the award, it is imperative that it keeps in mind a few things at this crucial juncture. The present note sets out some of these issues dealing with the horizontal and vertical equity as well as grant principles when it comes to local bodies. Any discussion about the Indian economy has to firmly keep in mind the parametric environment that defines the Indian economy and its immediate future.

The parametric environment is defined – in the first instance – by the onset of the process of liberalization, privatization and globalization (or LPG for short) in the context of Indian macro-economy. At second remove but perhaps more important is the fact of a fractured polity. This is reflected in coalitional governments, emergence of regional parties and agendas as well as emergence of strong regional leaders within the national parties. The recent growth story has yielded many good fruits to the Indian economy despite its unmistakable exclusionary sub-plot. The latter is decidedly a good thing (not withstanding the current slowdown) and policies to ensure growth with inclusion assume centrality in any and all endeavors.

The Core:

One of the core duties of the Central Finance Commission to be traditionally found in the terms of reference is by application of the Article 280(3) of the Constitution is to make recommendations for the distribution of the net proceeds of shareable taxes between the Center and the States and between States of the respective shares[1]. In public

[1] The relevant part of the ToR of the 13th FC reads: The Commission shall make recommendations as to the following matters, namely:- (i) the distribution between the Union and the States of the net proceeds of

finance literature, dealing with fiscal federalism these are called vertical and horizontal distributions respectively. Despite 12 Central Finance Commissions having deliberated and given awards, these issues are as yet not ***completely*** settled.

It is a well known fact in Federal Finance literature that whereas the Central government has greater access to tax resources, the State governments have to face greater burden of delivery of public goods. This creates an imbalance referred to as vertical imbalance. Admittedly, it is quite difficult to precisely estimate the 'rational' quantum of resources that need to be devolved so that the states may perform their duties properly. We have however tried – a little later – to suggest a variable that may serve as a basis for such an estimate. Whilst historically there has been a consistent demand from the states for greater devolution share of the Central taxes, successive Finance Commission have used their own discretion in determination of the share. While much the same is likely to continue, there are some important specific features of the current parametric environment with respect to policy making frame that we will touch upon briefly. The fiscal position of the States is much better this time around as compared to the earlier time when 12th FC was in session (this is despite the temporary blip due to the current slow down).

The exercise of working out the overall share to be devolved is akin to solving a problem of constrained optimization. The constraints bite both ways and the unfortunate tendency is to give in to the omnipresent '*force of gravity or inertia*'. Here we mention only two pertinent issues. India has been seen as one with federal set up but essentially a Union with a strong centripetal bias. As already mentioned, in the recent past however, the political space in India has been characterized by fractured polity. It would not be incorrect to say that the days of coalitional governments (at all levels) are here to stay for at least some time in the immediate future. The rise of regional parties as well as regional leaders have given a fillip to regional (State level) aspirations. All this is reflected by the fact that more and more ground has to be yielded to the States in the recent past. Hence, more than ever before, political feasibility in a fractured and heterogeneous domain will present a biting reality. The second point has to do with the fact that for the first time, the

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taxes which are to be, or may be, divided between them under Chapter I Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds;

Finance Commission has been asked to have regard (among other things) to the demands on resources of the Central Government vide section 3 (ii) of the ToR[2]. While welcome in itself, this, even when *normatively* estimated, is going to put a downward pressure on devolution-share thereby perhaps eroding the authority of the constitutionally mandated Central Finance Commission. The Finance Commission will have to fight hard against this residual role and fight for territory. It will have to assert itself as a constitutional authority as against the Planning Commission which is the result of only a cabinet decision.

Vertical Distribution

As already noted, the fact of vertical imbalance is well documented in literature on fiscal federalism. Whilst there can be no two views on the universally evidenced general proposition that both the Revenue and well as Fiscal Deficits had to be reined in. We believe that the macro-caps as currently enunciated through the FRBMA does not go far enough and indeed comes in the way of good fiscal practice. Hence a more nuanced normative approach to redressing the problem of revenue deficits across States as well as fleshing out of micro-level bench marks is required. This provides one element of the basis for providing the rationale for *enhancing* the overall share to be devolved to a level of 40%. Thanks to FRBMA states' finance in terms of macro caps, the issue of RDs and GFDs are passé and the general position of State finances that confront this finance commission is much better than in the earlier case (as confronting the 12th FC). Indeed in case of many states the revenue deficit has turned to surplus (albeit marginally).Of course, the current meltdown and its impact on India as well as the impact of the 6th Pay Commission is temporarily going to throw the fiscal discipline to the dogs. In any case and without the temporary shocks, the malaise continues to be reflected in structural symptoms in yet another form. There are issues of debt stock and servicing thereof. Despite efforts at best practices, in expenditure control the borrowing is just enough to tide over the servicing and many a State continues to be categorized as a debt distressed

[2] The relevant part of the ToR of 13th FC reads: 3. In making its recommendations, the Commission shall have regard, among other considerations, to:- (ii) The demands on the resources of the Central Government, in particular, on account of projected Gross Budgetary Support to the Central and State Plan, expenditure on civil administration, defence, internal and border security, debt servicing and other committed expenditure and services.

State thereby shutting out avenues for borrowing for purposes of capital expenditure. This is akin to experiencing a debt trap and needs special attention from the 13th FC especially in the context of Section 2[3] in its ToR which requires it to suggest measures for stable and sustainable fiscal position of the States. Much has been achieved through the debt financing facility put in place by the 12th FC. However, the Central government in its treatment of NSSO debt takes illegitimate arbitrage profits. The mark up costs that it charges for management of these funds is reflective of inefficient process as well as unfairness not unlike a money lender of the worst kind. The FC must write off these debts over the term of its awards especially since these are not an important source of debt in the incremental sense.

As stated earlier, the fact that Revenue Deficits (RD) as well as Gross Fiscal Deficit (GFD) retard growth finds – as a first cut – almost universal acceptance. There is consensus on this even amongst those who believe that classification based on revenue-capital and planned non-planned' need to be seriously revisited and refined. Unfortunately this has the consequence that not much is left for spending on the crucial social sector, which has become a casualty. Illustratively, in Maharashtra for instance, the non-salary spending for education and health have remained stagnant in the recent past even in nominal terms. It is in this typical context that we request an enhancement of the overall devolution share from the current 30.5%.

For providing a basis for our request for enhancement we suggest that the 13th FC look at the Fiscal Space available with the States. In broadest sense, Fiscal Space can be defined as the availability of budgetary room that allows a Government to provide resources for a desired purpose without any prejudice to the sustainability of a Governments financial position. Thus, provision of fiscal space is nothing but providing comfort to the States for carrying out their core function that of providing public goods. Thus, while all effort at 'good practices' such as reprioritization, borrowing less than allowable limit and scrupulously keeping to the targets set by FRMB, the discretionary fiscal space (DFS) of the States has remained low in the recent past. In case of

[3] The Commission shall review the state of finances of the Union and the States, keeping in view, and in particular, the operation of the States' Debt Consolidation and Relief Facility 2005 – 2010 introduced by the Central Government on the basis of recommendations of the 12th FC, and suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth.

Maharashtra despite doing all it has been called upon to do, the DFS has significantly eroded in the recent past. It needs to be noted that this space argues for adequacy in provisioning of devolved funds which is an important element of *quality of expenditure* that the 13th FC has been asked to pay attention to vide section 3 (vii)[4] of its ToR. Here we have defined DFS as:

DFS = {Rev Exp – Interest – Admin – Wages and Salaries} / Rev Rec.

We have carried out an exercise of computing the space and what additional devolution in terms of share is needed to provide reasonable space for the resurgent States. *Our computations show that if the States have to be provided with 50% of DFS then the share to be devolved by Finance Commission has to go up to 50%. For a provision of around 45% of DFS the devolution share needs to go up to about 40%.* Our suggestion, therefore, in keeping with the fact that talk of much higher devolution percentage being in the air, is that the percentage to be devolved to the States should be enhanced to a level of 40%. In reaching its conclusion we would like the 13th FC to keep in mind the practice of the Central Government levying surcharges and keeping them outside the divisible pool. Also, we would urge the Commission to boldly discard the incremental approach (dictated by inertial force) and go for a big bang approach instead.

Before moving on to the matter of Horizontal distribution we would briefly touch on the matter of the practice of the Central government of levying surcharges outside the divisible pool. We would urge the Commission to take this into account before taking a call on the precise proportion to be devolved to the States. Also, given that one of the major sources of flows to the States is by way of Plan grants, the Commission has to keep in mind the additional fiscal stress that the States have to confront by way of maintenance of the assets so created and activities so undertaken. Whilst the untied or otherwise nature of such flows as well as the proportion of loan and grant components in these need to be reviewed by the Planning Commission, the Finance Commission has to pay some attention to these matters since 'committed liabilities' find an explicit mention in the terms of reference {See 3 (ix)}[5] of the Finance Commission this time around.

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[4] In making its recommendations, the Commission shall have regard, among other things to:- 3 (vii) The need to improve quality of public expenditure to obtain better outputs and outcomes;

[5] In making its recommendations, the Commission shall have regard, among other things to :- 3 (ix) The expenditure on non-salary component of maintenance and upkeep of capital assets and the non-wage

Thus, the peculiar circumstances in India federation arising out of diminishing discretionary fiscal space for the States, the treatment of debt by the Center and the exclusion of certain revenue sources from the divisible pool, not to mention the encroachment of the Planning Commission, implies a need for enhancing the proportion of the divisible pool to at least 40% (although the empowered State Finance Ministers are arguing for 50%!). This is required also on the basis of the current political scenario where the States are trying to emerge from the Central Shadow and assert their identities.

Horizontal Distribution

While in the following, the reference to Maharashtra is made repeatedly, it needs to be understood in the illustrative sense for the sake of concrete arguments, many of the arguments are carried at a more general level to similarly placed (well performing) States such as Karmataka and Gujarat. Maharashtra has been at the receiving end of the awards of the successive Central Commissions of recent vintages. In the earlier memoranda submitted we had shown how Maharashtra's share in divisible pool had steadily declined over the years. From a high of around 16% in the Income Tax by the 2nd FC it had declined to about 6% in the 10th FC. The case of excises was no different. The situation worsened in the 11FC following the 80th Constitution Amendment. The share then declined to a horrendously low share of 4.63%! The situation with the 12th FC was not much better with the share pegged around 5%. *It must be realized that such a precipitous decline has a serious disincentive effect with the perception that progressive States get a raw deal from the FCs and implicitly encourage laggards.*

Over the past all the commissions have debated the criteria that must go into the determination of horizontal distribution between the States. Whilst attempt to be fair has no doubt been at the core of the considerations, there has been a perceptible change in the criteria over time and successive finance Commissions, undoubtedly reflecting the changing ethos and macro-economic parametric environment and evolving concerns. While there is little reason to detain ourselves in tracing these changes over the years, we must mention that efficiency and incentive compatibility considerations have started

related expenditure on Plan schemes to be completed by March 31st 2010 and the norms on the basis of which specific amounts are recommended for maintenance of the capital assets and the manner of monitoring such expenditure;

making appearance at least from the 7th FC. *Given the current Indian economic ethos and her aspiration to emerge as a potent force in world order we believe that such considerations must be strengthened further. It naturally follows that this has to be reflected in the weighting scheme that the current Finance Commission adopts.*

There can be no two views on the merit of having a consensual and stable regimen in place when it comes to the laying down the variables and the corresponding weights that come to bear in horizontal distribution. After all, as we argued in our last memorandum, frequent and drastic changes only help to send out confusing signal to the States and are in no ones' interest. We would like to take steps in the direction of bringing just such a convergence. The change then will have to be reacted to only by refinements largely brought about by changing the weighting diagram. Of course for this the first condition is to have a base criterion firmed up, keeping in view the current economic ethos.

We find little reason to dwell on the past suggestions and the corresponding responses (outcomes) by the earlier finance commissions, even when some of the things there are particularly favorable to Maharashtra. For example, the collection criteria would be very well suited to the cause of Maharashtra and yet we recognize that it has been discarded since 9th Finance Commission and hence we shall say no more about it. All the relevant issues and discussions are very well documented in the past memoranda that we have submitted to the earlier Finance Commissions. We shall instead straight away briefly mention the criteria and weights applied in the 12th FC award and then go on to making our suggestions.

In its wisdom the 12th Finance Commission used the following criteria and weights:

No.	Criterion	Weight (%)
1.	Population	25.0
2.	Income Distance	50.0
3.	Area	10.0
4.	Tax Effort	7.5
5.	Fiscal Discipline	7.5

We must say that whereas at a fundamental level, we have no great dispute with the criteria chosen except to make two comments. One, whilst the element of equity is still overwhelmingly dominant and only about 15% are devoted to what could be categorized as efficiency consideration. As we have argued earlier, the present India economic scenario and ethos warrants greater weight be afforded to ‘efficiency criteria’. Secondly, we would suggest that the way two of the criteria viz., income distance and tax effort are incorporated is flawed and do not quite address the issues properly and hence do not serve the purposes for which they have been incorporated. We elaborate this in the relevant sections that follow. But first we very briefly dwell on a familiar theme of the peculiar regional skewness that we had dealt at length elsewhere. We of course are referring to exclusion of Mumbai while treating Maharashtra to avoid distortion.

It is a well known fact that Mumbai is a major growth driver of National importance. It is also a major resource center from the point of view of State as well as Central treasury. The fact is that it contributes over 26% of the State’s income. Of course even within Mumbai there are pockets of poverty and indeed the income is highly skewed. The per-capita income in Mumbai is more than three times the national average and removing Mumbai from Maharashtra causes a huge drop in the per-capita income of the State. It is of course true that distribution of income is never uniform and this is thus a problem likely to be faced elsewhere too. While logically correct this is not the case because of the peculiar importance in magnitude terms of Mumbai in the context of Maharashtra. No other metro anywhere in India plays as significant a role in its State. Thus Mumbai distorts the picture of Maharashtra’s GSDP in quite a unique manner. Thus, even while acknowledging extremely skewed distribution of income, removing it from relevant consideration may restore some semblance of reality and credibility to the figures representing Maharashtra’s GSDP. Let us now look at the criteria incorporated in the 12th Finance Commission and critiquing them we will move towards our submission, in this regard, to the 13th Finance Commission. The argument is that some element of dispersion has to be taken into account. There is also another (more general) element that the criterion if not refined properly will lead to encouraging laggards by rewarding inefficiency.

Population:

We continue to believe that problems of States with larger population are quite different from those faced by smaller States. The cost of basic public goods to be provided, depend on the size of the population (and not all of them are amenable to economies of scale). This is especially true if considerable proportion of its population is below poverty line. Mercifully, the 12th FC in contrast to the 11th FC did increase weight assigned to it to 25%. While endorsing the criterion, we would still request for a marginally increased weight to population to the extent of 30% with a modification (if data permits) of working out population pressure measure (based on some asset- base). Perhaps the last is overly ambitious as yet!

Income Distance:

This is a criterion with which we have serious issues. The way it is computed (the 12th FC has followed the same method as enunciated by the 11th FC). This method is fundamentally flawed and leads to a situation of 'winner's curse'. The implication of this for Maharashtra is in the nature of a double whammy. First because this is equity or need based criterion and Maharashtra is deemed (incorrectly) as a 'rich' State it loses out by definition. Secondly, the weight attributed to this criterion being very large the magnitude of impact is necessarily large. Maharashtra is a State with tremendously skewed regional pattern of income. If one were to compute the coefficient of variation of district level incomes for a State. The value for Maharashtra comes out to be 0.61 which is much greater than any other States (the value of 0.3 seems to be the median/mode. As noted earlier, whereas a few districts have per capita incomes which are multiples of national average, there are as many as 17 districts that are languishing below the national average. The citizens here are in serious need of public goods provisioning, especially in the social sector. However given that the flows from Finance Commissions have dramatically fallen especially on count of criterion under discussion, despite good practices and intent the State has not been able to do as much as it would want. This is because of the contraction in fiscal space that we referred to earlier and on latest count had fallen to 23% (and we have not factored in the impact of 6th Pay Commission!).

Here we suggest several ways to approach the problem. One suggestion could be to compute the distance from the single highest income and add to it the standard deviation of the State GSDPs. The important point of principle is that some dispersion disaggregated measure has to be looked at. This means that we look at either some disaggregated data (say at the district level) or consider some other poverty or backwardness or HDI related indicators.

The problem with the latter (gini-coefficient or backwardness index) is that reliable and consistent data across India is not available. Further, the actual implications of using these data (normalized in some form) in a formulaic manner are unclear (the fact that it will lead to cluttering and complicating the formula contravening the tenet of 'keeping it simple' is least of the issues). Most importantly, issues such as poverty and HDI and backwardness properly seen fall outside the purview of Finance Commission and are legitimately in the domain of Planning Commission to be tackled with CSS and such other planned schemes and strategies. ***Hence it would be proper to pursue the suggestion of using the district level data for the income-distance criterion***. Indeed a computation shows that the share under this criterion for Maharashtra is comparable to states like Rajasthan and Orissa. We mention this only to underline the extent of unfairness involved in the historical application of this criterion. Given that standard comparable and official data at district level is as yet unavailable, the other way to tackle this issue is to ***use the standard deviation (or an appropriate normalized measure of dispersion of the State's income (this could be derived from the consumption data from NSS rounds) and 'add' it within the distance criterion***. There is often the issue raised of the reliability of the point estimates of consumption (among other things) based on NSS type survey. While this is a point well taken, we believe that the confidence on the bands and distribution of the consumption pattern should be quite reliable (under the fairly general assumption of similarity of errors/ biases across States). The third or the final alternative would be to ***reduce the weight*** of this criterion in the formula.

Area:

As far as area is concerned we completely endorse this criterion. In the context of provision of public amenities/goods, apart from population pressure, area is of considerable importance. The difference is that whereas added population densities do sometimes allow for economies of scale to be reached (up to the point of congestion whence diseconomies kick in, in case of area larger areas do pose more than prorata problems of delivery). This leads us to believe that not only must this criterion be retained, but perhaps it ought to be retained with even a marginally greater weight of say 15% in the formula.

Tax Effort:

As far as the 'tax effort' criterion is concerned, our point is that whereas conceptually it is a proactive and an efficiency criterion, the way it is measured is incorrect. This is because it is computed as the ratio of tax revenue to GSDP. An increase in effort being seen as a desirable thing. This would be right **except for the fact that the increase in the GSDP does not reflect the taxable base for a state. We *need to measure (and reward) the effort of a state in terms of what is legitimately possible***. This is generic and is applicable to all the states, except for the fact that the state of Maharashtra is peculiar in the composition of its production structure. With a huge proportion coming from services, and with Industry and Agriculture along with related sector being squeezed in the proportionate sense, the incremental taxable capacity for the state does not rise as fast as the income. Thus, the contention here is that despite being a highly taxed state, Maharashtra does not get its due on this criterion. We thus urge the Commission to use this criterion (indeed with added weight) but after appropriately redefining it. We suggest that the appropriate ratios could be for example {Own-Tax Revenues/Revenue Expenditure} or (Own-Tax Revenues/(GSDP-Services Sector)}.

Fiscal Discipline: This is a criterion that has been continued by the 12th Finance Commission in the same form as was originally proposed by the 11th Finance Commission. We endorse this completely (indeed with an added weight) as an efficiency criterion. Of course with FRBMA targets being met some of the elements of this index will perhaps have to be revisited by entering into the micro-structure of State budgets. Of course this will have to be done with care (keeping in view the scale effects) so that greater sophistication than use of mere ratios (which were fine for broad macro-fiscal-variables) may be called for. Indeed, it may be worth while to do so by revisiting it in the context of the whole issue of debate in the arena of 'revenue/capital' and plan/non-plan re-conceptualization.

Decentralization

Post 73rd and 74th Constitutional Amendments the third tier of governments have attained constitutional legitimacy. It is well established in the context of real politick, to make them truly effective will require a constitutional amendment, by way of replacing 'may' to 'shall' to compel the States to devolve. It is also recognized that decentralization is a 'good practice' and it is in conformity with the tenets of both the enlightened self interest of the States as well as incentive compatibility. Econometric evidence suggests that those states that decentralize well have been benefited through higher tax buoyancies at local levels thus relieving fiscal stress on the State itself. It is time that decentralization is finally and truly 'invited in'. While the earlier attempt at creating a decentralization index may have come in for sharp criticism and hence discarded, there is nothing to stop us from creating a simple transparent index based on the 3Fs – functions, functionaries and funds – in decentralization literature. One could simply take the proportion of functions transferred in a state, the number of functionaries at the local levels as a proportion of State level employees and the size of the government (normalized per capita) at the local level. Short of constitutional amendment, this will be a smart and a concrete way to underscore the importance of 73rd and 74th constitutional amendments as practice in good governance. One way thus, to empower the process of 'decentralization' is to add it to the criteria for devolution with a significant weight.

Thus in sum we would suggest: Increase Fairness of the devolution. Create greater Discretionary Fiscal Space so that autonomy of the States is increased and they are able to provide/ deliver better public goods. Our suggestion tabulated (Criteria and Weights) below:

No.	Criterion	Weight (%)
1.	Population	30
2.a	Income Distance	12.5
2.b	Standard Deviation of State Income	12.5
3.	Area	15
4.	Tax Effort	10
5.	Fiscal Discipline	10
6.	Decentralization Index	10

Tailpiece

Apart from statutory devolution the way to strengthen decentralization is to increase the size of the local governments. While the capacity to absorb is a concern, it should not be used as an argument against augmenting the resources with PRIs and ULBs. The real empowerment will come with revenue handles rather than revenue assignments and full expenditure autonomy vested with the local bodies. But this is a larger agenda that will take a while and is not necessarily within the purview of the Finance Commission. Also, there is an argument of including the funds for the local bodies being given as a part of statutory devolution. This is worth serious consideration (along with the argument that the FC should – in the present circumstances – be directly talking to the local bodies, by passing the State government) however the legality of such steps need to be considered. At any rate the crux of the matter is that there has to be a multiple fold increase in the flows going to the third tier of government. In making such assignments, it is essential that the formulae should not be cluttered or complicated. The present situation (including the working of the State Finance Commissions, and the prevalent 'acts' that govern the functioning of local bodies) do not warrant revenue effort or such other criteria being used. The flows to local bodies should be focused on allowing the local bodies to operate and maintain the assets in some demarcated areas (such as water, roads and education). Rather than equalizing considerations, the equalization has to be worked out on the basis of **existing** assets. This has implications that backwardness or poverty indices will not work. The formula for working out the proportions to the States should be based on population (pressure), area to be serviced and O&M requirements.

In Conclusion

Keeping in view the current ethos that is suited to the macro management of the Indian economy, the 13th FC must suitably devise a formula that moves towards incentive compatibility. This is especially important in the context of the fractured polity. The points to keep in mind would be:

1. Devolve greater proportion to the States, given their mandate for provision of social sector public goods and the diminishing discretionary fiscal space.
2. Bring about changes in debt management by the Center
3. In computation of income-distance criterion keep the intra state variations in mind.
4. The variable tax effort whilst a laudable and impotant has to measured appropriately keeping in view the taxable capacity (potential) of the State.
5. Strengthen decentralization by adding a criterion to the statutory devolution formula as well as augmenting flows to the local bodies for O&M of specified existing assets.

Post Script:

Since this working paper is in the form of an essay there are no references. However, the interested reader may refer to some of the recent latest Vibhooti Shukla Working Paper Series. These reflect different aspects of the points mentioned here. The detailed arguments as well as references will also be available in these papers. This essay largely owes my experience of working with the memorandum committee of the government of Maharashtra as well as some of the work that I did for the 13th FC directly or indirectly. It started with the paper on Issues before the 13th FC and this essay represents – in a sense – the culmination. I will thus record my deep sense of appreciation for the discussions with Shri B. N. Makhija as well as Principal Secretaries of the GoM in particular Shri Sunil Soni and Shri Vidyadhar Kanade amongst others. I will also thank the FC members especially Dr. Vijay Kelkar for his encouragement. Needless to add the views and errors and inadequacies are mine.