The Report of the Thirteenth Finance Commission Conundrum in Conditionalities

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Working Paper No. 2010-76

December 2010

National Institute of Public Finance and Policy
New Delhi
http://www.nipfp.org.in

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Abstract

The 13th Finance Commission has forayed into a number of areas partly warranted by its terms of reference and partly due to the approach it adopted. The Commission, besides tax devolution, has recommended as many as 12 different types of grants with a plethora of conditionalities. A critical appraisal of the recommendations shows that the transfer system recommended by the Commissions suffers from the same limitations of inequity and perverse incentives as in the past.

The inability to offset the fiscal disabilities of the states leads to giving several grants. Even here, the approach is ad hoc. In particular, the grants recommended for individual states for their special needs is a classic example of ad hoc approach which is arbitrary and judgemental. The recommendations relating to the GST are the ones which have been resented most by the states and actually, this has taken the reform agenda backwards. The "all or nothing" types of conditions do not leave much room for a "grand bargain".

A major concern is with a plethora of conditionalities imposed by the Commission. Besides the conditions on GST compensations discussed above, there are several conditions stipulated for achieving fiscal consolidation and incentivising local bodies. There are questions on design, implementation, and monitoring of these conditions. These questions leave one suspect that the Commission lost an opportunity to reform the transfer system yet again.

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(Published in *Economic and Political Weekly*, November 27, 2010 Vol. XLV(48); 46-50.

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Conundrum in Conditionalities

Introduction

The report of the 13th Finance Commission, is perhaps more comprehensive than any other report in its analysis of fiscal developments in the country and recommendations on issues not only relevant to intergovernmental finance, but also a variety of issues relating to fiscal management by central and state governments. The matters dealt with include fiscal consolidation, disaster relief, design and implementation of goods and services tax (GST), local government reform, education, environmental protection, and specific problems affecting individual states. It has broken the past record by making as many as 12 different types of grants. There are 5 subcategories of grants for improving outcomes alone and two environment related grants. Thus, besides the usual tax devolution and grants given to fill non-plan budgetary gaps, grants have been recommended for disaster relief and local bodies, performance incentive grants for three special category states (Assam, Sikkim and Uttarakhand), grants for elementary education to states equivalent to 15 per cent of the *Sarva Shikha Abhiyan* (SSA) expenditures, grants to compensate the states for any loss of revenue arising from GST reform, grants for reduction in infant mortality rate, environment related grants for forest development, renewable energy and water sector management, incentive grants for improving outcomes in five different areas, separate grants for road maintenance, and state specific grants to meet their special needs. Thus, the scope of coverage by the Commission is much wider than the past. In the process, it has loaded the centre and even more, the states with a plethora of conditionalities to micro-manage their fiscal systems.

However, unlike the past, by and large, the reaction to the Report of the Commission has been muted. There is hardly any detailed analysis of the main recommendations either by the states or by independent researchers and that is really surprising. In part, this may be due to the fact that state finances are in a much better shape today than the time when either the 11th or 12th Finance Commissions submitted their reports. Of course, some states have expressed unhappiness with the way the detailed conditionalities have been prescribed. Even more, they were dissatisfied with the way the recommendations relating to the GST have been made. On the main recommendations relating to tax devolution and gap grants, however, there has not been much discussion.

The focus of this paper is to examine the approach of the Commission in regard to its ToR and analyse the recommendations relating to its main task, namely tax devolution and grants and analyse the conditionalities. Detailed analysis of other recommendations have not been gone into in this paper mainly because, many of the grants recommended are not warranted by the ToR *per se*, and there is no need to go into the merit or otherwise of these grants. The important point is that in recommending 12 different types of grants with a variety of conditionalities attached, the Commission simply fragmented the transfer system. *Section 2* analyses the general approach of the Commission in regard to the ToRs and summarises the major recommendations in regard to the revised roadmap for fiscal consolidation and the introduction of GST. This section also examines the recommendations in regard to the substantive Terms of Reference (ToRs) relating to tax devolution and grants-in-aid. In particular, it examines the new innovation of the Commission in bringing in the fiscal capacity distance factor in tax devolution in the place of per capita income. *Section 3* analyses the conditionalities and their usefulness and efficacy. The last section makes a few concluding remarks.

2. Approach of the Commission

In terms of total resources transferred, the Commission's recommendations are supposed to result in a marginal increase in the transfers. According to the Commission's estimates, the aggregate transfers (tax devolution and grants) recommended by the Commission works out to 32.2 per cent of total revenues of the central government or close to 4 per cent of the estimated GDP. The Commission's recommendations were guided by the desire to maintain the long-term stability in the relative shares of the centre and states in total revenues and therefore, it set the indicative target for transfers from all sources at 39.5 per cent which is marginally higher than 38 per cent set by the previous Commission. Thus, the overall transfers to the states are determined on the basis of the Commission's judgement that the relative shares of the centre and states in total revenues, and expenditures should remain stable and not on any objective consideration of their resources or requirements. The fact is the recommendations will neither result in the keeping the relative shares of the centre and states in total revenues and expenditures constant nor is there any economic rationale to state that such a goal is desirable. Furthermore, there is nothing that prevents the central government from introducing more centrally sponsored schemes involving sizeable expenditures and exceed the limit set. With the central government raking up huge revenues from sources like telecom auction of which the states do not get any share, the relative share of the states is likely to go down sharply. The goal itself is misconceived because, income elasticity of demand for different expenditures is different and generally, the expenditure requirements under the state list like education and healthcare are likely to increase at a much faster rate than defence and administration. Of course, in the Commission's defence, it must be stated that unlike the past Commissions, this Commission at least made their assumptions explicit.

(a) Tax Devolution and Gap Grants

The approach followed by the Commission to deal with the first two terms under *Article 280* relating to tax devolution under *Article 270* and fiscal disability grants under *Article 275* grants is not different from the past. The past Commissions were criticised for making recommendations not on the basis of estimated fiscal capacities and needs of the states, but based on the projections made on the base year actual revenues and non-plan revenue expenditures. Two basic shortcomings of the approach pointed out are, "the tyranny of the base year" and "fiscal dentistry". The Commission, like the past Commissions 'sanitises' the base year estimates and applies some norms and judgements to make projections on them rather than estimating fiscal capacities and needs of the states for determining the transfers. After making tax devolution based on certain independent factors (of course, related to capacity and need), the gap between non-plan revenue expenditures and post devolution revenues is determined and grants to states are given to fill this gap.

Thus, the overall transfer to the states with post devolution gaps is determined by the 'cavities' between projected non-plan revenue expenditures and states' post devolution revenue receipts. The perverse incentives arising from this approach is widely discussed in the literature and there is no need to dwell on this in detail (Rao and Singh, 2005; Rao, 2009). Interestingly, although the ToR do not make the distinction between plan and non-plan requirements and even as there is widespread recognition of the unscientific nature of the distinction and the distortions they create, the Commission chose to confine its basic recommendations to cover the gap between post-devolution revenues and non-plan revenue expenditures. Perhaps, it is too much to expect the Finance Commissions from deviating from the past.

On determining the proportion of tax devolution and grants too, the approach of the Finance Commissions generally has not been based on any objective considerations but on the basis of judgements and 13th Finance Commission is no exception. It has merely tinkered with the overall share of the states at the margin. The states' share in central taxes has been increased from 30.5 per cent (including the share of additional excise duties) to 32 per cent. The states can also levy sales tax/VAT on additional excise duty items. In addition, as mentioned above, 12 different types of grants were recommended.

On the distribution of the shares of the states *inter-se*, the Commission has assigned the same weights to population and area as the previous Commission. An important innovation of the Commission is in replacing the distance from the highest per capita income with the distance from the highest per capita fiscal capacity distance. Unlike the past Commissions, instead of estimating the entitlements based on the distance from the highest per capita income, the Commission takes the distance from the highest per capita 'fiscal capacity' and gives 47.5 per cent weights to the factor. The Commission has estimated the average tax-GSDP ratios separately for general category states and special category states for the period, 2004-07, and estimated 'per capita taxable capacity' for each state by multiplying the group's average ratio with the GSDP of the state. It has then estimated per capita taxable capacity for each state and the distance from the highest fiscal capacity is estimated. The distance multiplied by the population of the state divided by the summation of this variable for all the states gives the shares of individual states.

There are both conceptual and methodological problems with this approach. There are both conceptual and methodological problems with this approach and these are discussed in the next section. This also has significant implications for inter-state distribution of tax devolution and Finance Commission transfers in the case of the states with no post-devolution gaps. If the Commission thought that by taking fiscal capacity rather than per capita incomes, it has avoided the disincentives arising from the 'gap-filling' approach, it is sadly mistaken. The controlling total for basic transfers still continues to be the gaps between projected non-plan expenditures and own revenues of the states. Thus, from the viewpoint of both equity and incentives, the Commission's approach is not different from the past.

The Commission gives two reasons for taking this measure. The first is that the single average applied to GSDP for both general category and special category states does not actually capture the fiscal distance between the two groups because sectoral composition of GSDP varies between the two groups. The states with higher share of agricultural incomes, for example, are supposed to have lower taxable capacity. Second, the measure of GSDP is in factor cost and it does not include net income from outside the state. It then goes on to state that tax-GSDP ratio in general category states is much higher than in special category states. For these reasons separate averages for general and special category states have been taken as norms.

Unfortunately, the argument is not convincing. States' revenue collections accrue mainly from consumption taxes and there is nothing to show that sectoral composition should make any difference. Of course, it is difficult to levy taxes on consumption by unorganised sectors (including self consumption by producing households). Furthermore, the share of agricultural incomes in special category states is not more than the general category states. In fact, overwhelming proportion of income in special category states is from public administration and not agriculture. Of course, the tax -GSDP ratios in these states is low not because their taxable capacity is less but they simply do not put in comparable effort to raise tax revenues. As far as the second argument is concerned, it is true that GSDP as an indicator of fiscal capacity is flawed, but the Commission uses the same measure to estimate the tax-GSDP ratio which also excludes the net income from outside the state!

It is not the contention here that the special category states do not deserve a special treatment. Surely, the argument for differential treatment should come from cost disabilities in these states as the remoteness of the states and high transportation costs of goods, large proportion of forest area and difficult terrain significantly increases the unit cost of providing public services which, surely, should be taken account of. In any case, the reasons given in the report do not provide enough reason for substituting the per capita income difference with the so called 'fiscal capacity' distance measure.

On a closer look, adoption of the new measure is retrograde in some ways. The implicit assumption of the past Commissions in estimating the distance from the highest per capita income was that per capita income is the sole determinant of fiscal capacity. At higher levels of per capita incomes, the capacity is assumed to be disproportionately higher as indicated by the distance from the highest per capita income. The 13th Commission while taking average tax/GSDP ratio also assumes that per capita income is the sole determinant of taxable capacity and taking average for the group (general category and special category) assumes the relationship to be proportional. Of course, in order to make the distribution progressive, the Commission took the distance from the highest capacity in determining the relative shares of the states. Thus, conceptually there is superiority of the so called 'fiscal capacity' index over per capita income when you assume that the tax-GSDP ratios should be the average irrespective of the level of per capita income of the state (within each group). At the same time, this has significant implications for progressivity in the *inter-se* distribution of tax devolution to the states.

The fact of the matter is that tax-GSDP has a significant and positive relationship with per capita incomes in general category states and this cannot be entirely attributed to variations in tax efforts. There are logical reasons for expecting lower tax-GSDP ratios in states with lower per capita incomes. The main reason is that the states with lower per capita incomes have much higher proportion of unorganised sector transactions and non-market consumption and these can not be captured by any tax administration and, therefore, cannot constitute the potential tax base. Secondly, thus far, due to the levy of Central Sales Tax, the sales tax has been predominantly origin based which implies that the richer producing states could collect the taxes by exporting the burden to the consumers in poorer states. Taking the average tax – GSDP as the norm for determining taxable capacity surely tends to *bias* the distribution against the poorer states.

We have tried to estimate the relationship between tax-GSDP ratio and per capita incomes of the states and the result presented below shows a significant relationship between tax-GSDP ratios with per capita GSDP. The estimated log-linear regressions show that the coefficient of per capita income on tax-GSDP ratio is positive and significant, while the coefficient of non-agriculture GSDP is not significant. Thus, the sectoral composition of income does not seem to have a significant impact in determining the tax ratio whereas the states with higher per capita incomes have higher tax ratios.

$$\ln(T/Y) = \underset{(-1.0395)}{-2.4848} + \underset{(1.9914)}{0.2863^{*}} \ln(Y/P) + \underset{(0.5165)}{0.3595} \ln(Ynag/Y)$$

$R^2 = 0.4060$ F= 4.44

(Significant at 5 per cent level)

Where T = Tax revenue of the state, Y= GSDP of the state, P= Population of the state,

Ynag = per cent GSDP from non-agricultural sectors

Canada is one of the countries that employs the estimates of fiscal capacity for determining equalisation payments. They it identifies as many as 33 revenue sources of the provinces and estimates revenue capacity using the representative tax system approach. In this, after quantifying each of the revenue bases of the provinces, the average effective rate of each source is worked out. Applying the average effective rate on the actual revenue base yields the revenue capacity from the source. By summing up the potential for all the revenue sources, the total fiscal capacity of a province is arrived at. The provinces with lower than average revenue capacity are given equalisation payments to bring them up to the average level so that each province is enabled to provide comparable levels of public services at comparable tax rates. Interestingly, the provincial fiscal base also include revenues from oil and with sharp increase in oil prices, Alberta which has sizeable oil revenues distorted the estimates and even a relatively affluent province like Ontario would have become eligible to receive equalisation payments. Therefore, the formula was revised to include only half of revenues from oil in estimating revenue capacity.

Australia employs both fiscal capacity and needs in computing the 'relativities' of the states on the basis of which equalisation grants are given. Here again, the fiscal capacity is estimated using the representative tax system approach for each of the taxes levied by the provinces and this is added to arrive at the aggregate capacity. The Commonwealth Grants Commission compiles information on each of the taxes for individual provinces and makes the computations available to the states.

Unlike these countries, the fiscal capacity is only one of the factors used in the devolution formula and the overall transfers are determined by the projected gap between revenues and non-plan revenue expenditures. Nevertheless, the Commission could have done well to use a better measure of fiscal capacity rather than taking simply the average tax-GSDP ratio for the group as the norm.

Finally, like the previous two Commissions, the 13th Finance Commission uses fiscal discipline as one of the factors to determine the share of individual states in tax devolution and assign 7.5 per cent weight to this factor. This is measured as the improvement in the ratio of own revenues to revenue expenditures of the state divided by all state average ratio of own revenues to revenue expenditures. The simple point is if the previous Finance Commission's recommendations result in higher transfers to a state, its revenue expenditure would increase and ratio of own revenue to expenditure will decline. This would show the state as less disciplined!

A comparison of the relative shares of individual states in tax devolution (excluding the service tax shares) is shown in *Table 1*. In order to provide comparable estimates for the identical period, the 12th Finance Commission formula was applied to the data used by the 13th Finance Commission. It is seen that the biggest losers due to change in the devolution formula are the poorest states of Bihar, Uttar Pradesh and Madhya Pradesh.

(b) Grants-in-aid to States

Generally, equalising transfers are supposed to offset the fiscal disabilities of the states arising from lower revenue capacity and higher unit cost of providing public services. The objective is to enable the states to provide comparable levels of services at comparable tax rates. The approach of the 13th Finance Commission, like its predecessors, has not permitted it to adopt such an approach and the continuation of the gap-filling approach, as already pointed out has impacted on both equity and incentives. In fact, inability of the Commissions to offset relative fiscal disabilities of the states necessitated the Commission to recommend a large number of specific purpose grants. A more holistic approach to offset disabilities would have obviated the need for many of the specific purpose recommended.

This is not to say that there is no place for specific purpose transfers. Indeed, some specific purpose transfers are necessary to ensure minimum standards of services in respect of important services which are considered meritorious. However, many of the grants recommended by the Commission, particularly those given for specific requirements do not fall into this category. Giving grants to the states for their "special needs" for example, gives an appearance of being arbitrary and judgemental. I shall not be surprised if the states come up with a plethora of their special needs when the next Commission starts functioning.

One of the important features of the 13th Finance Commission's approach is giving as many as 12 different purposes. As mentioned earlier, grants are recommended for a variety of purposes. In the process, the Commission wanted to achieve besides its own core objectives, several objectives that should have required separate commissions on matters such as macroeconomic management, GST reform, expenditure reforms, and ecology and environment. It is certainly not to doubt the eminence of the people in the Commission or their capacity to deal with each of these issues, but simply that giving as many as 12 different types of grants has only resulted in fragmenting the already disjointed system of intergovernmental transfers and created a plethora of conditions to the centre and states.

Did the ToR require the Commission to make so many grants? Apart from tax devolution, grants and augmenting the consolidated fund of the states to supplement the resources of local bodies, the ToR simply requires the Commission to "….have regard, among other considerations…" to resources and expenditure commitments of the central government, resources of the state governments and the need to generate revenue surpluses for capital investment, tax efforts of central and state governments and the need for additional resource mobilisation, the *impact* of the proposed GST, need to improve the quality of expenditures to obtain better outputs and outcomes, the need to manage the ecology, environment, and climate change for sustainable development, the need to ensure commercial viability of irrigation and power projects, departmental undertakings and non-departmental enterprises through various means including the levy of user charges and measures to promote efficiency and the norms for the non-wage component for the maintenance and upkeep of capital assets and the non-wage related maintenance expenditure on plan schemes on the basis of which specific amounts are to be recommended. Except in the case of maintenance expenditures, the ToR does not require the Commission to recommend grants. Of course, there is nothing that prevents the Commission from recommending grants for various purposes, but as mentioned earlier, a holistic approach to determining the transfers would have obviated the need for fragmenting the transfer system and imposing so many conditions which will make monitoring them a daunting task.

Table 1 :Difference in the shares of Individual States between 12th and 13th Finance Commissions

	Shares of states in tax devolution (including service tax)			**Shares re-estimated using 12th FC formula for 13th FC data**		**Difference**
	12th FC	**13th FC**	**Difference**			
Andhra Pradesh	7.362	6.948	-0.414	7.089	6.937	-0.152
Bihar	11.037	10.934	-0.103	11.407	10.917	-0.490
Chhattisgarh	2.656	2.474	-0.182	2.520	2.470	-0.050
Goa	0.259	0.266	0.007	0.256	0.266	0.010
Gujarat	3.572	3.046	-0.526	2.960	3.041	0.081
Haryana	1.076	1.050	-0.026	1.015	1.048	0.033
Jharkhand	3.364	2.806	-0.557	2.851	2.802	-0.049
Karnataka	4.463	4.335	-0.128	4.470	4.328	-0.142
Kerala	2.667	2.345	-0.322	2.379	2.341	-0.038
Madhya Pradesh	6.717	7.131	0.415	7.360	7.120	-0.240
Maharastra	5.001	5.207	0.206	4.886	5.199	0.313
Orissa	5.165	4.787	-0.379	4.780	4.779	-0.001
Punjab	1.300	1.391	0.091	1.368	1.389	0.021
Rajasthan	5.614	5.862	0.249	5.973	5.853	-0.120
Tamil Nadu	5.309	4.977	-0.333	5.103	4.969	-0.134
Uttar Pradesh	19.280	19.708	0.428	20.211	19.677	-0.534
General. Cat. States	**84.842**	**83.267**	**-1.574**	**84.628**	**83.136**	**-1.492**
Arunachal Pradesh	0.288	0.328	0.040	0.297	0.328	0.031
Assam	3.238	3.634	0.396	3.126	3.628	0.502
Himachal Pradesh	0.522	0.782	0.260	0.487	0.781	0.294
Jammu & Kashmir	1.214	1.394	0.180	1.370	1.551	0.181
Manipur	0.362	0.452	0.089	0.398	0.451	0.053
Meghalaya	0.371	0.409	0.037	0.359	0.408	0.049
Mizoram	0.239	0.269	0.030	0.247	0.269	0.022
Nagaland	0.263	0.314	0.051	0.287	0.314	0.027
Sikkim	0.227	0.239	0.012	0.228	0.239	0.011

Table 1 :Difference in the shares of Individual States between 12th and 13th Finance Commissions (contd.)						
	Shares of states in tax devolution (including service tax)			**Shares re-estimated using 12th FC formula for 13th FC data**		**Difference**
	12th FC	**13th FC**	**Difference**			
Tripura	0.428	0.512	0.083	0.432	0.511	0.079
Uttaranchal	0.940	1.122	0.182	0.918	1.120	0.202
West Bengal	7.063	7.276	0.213	7.222	7.264	0.042
Special. Cat. States	**15.155**	**16.731**	**1.573**	**15.371**	**16.864**	**1.493**
Total	100.000	100.000	0.000	**100.000**	**100.000**	**0.000**

Note: Excludes the share of service tax.

(c) Approach to GST Reform

There is considerable unease on the treatment of ToR relating to GST. Note that the ToR requires the Commission to take into account the impact of the proposed implementation of GST and not work out the modalities to deal with the reform itself. Instead, the Commission went about detailing the outline of "the model GST" – with features such as minimum exemptions, a single rate of tax on all goods and services uniformly levied across states, zero-rating of exports, and ensuring destination based tax to ensure seamless trade across the country. It also recommended the "grand bargain" to be conducted between the centre and states' with six elements namely, the design of GST to evolve the model GST, operational modalities, binding agreement between the centre and states with contingencies for changing rates and procedures, implementation schedule, disincentives for non-compliance and the procedure to claim compensation. It recommended a compensation package of Rs. 50,000 crore, for any loss of revenue and if all elements of the grand bargain are not satisfied the compensation will not be payable.

Any desirable tax reform should minimise the cost of compliance as well as the distortion cost while not increasing the cost of collection (Bird and Zolt, 2004) and GST reform is expected to minimise all the three costs though, the claim made by the NCAER study that the levy will result in a gain in an estimated GDP increase in present value terms between Rs. 14.69 crore and Rs. 28.81 crore seems to be much too exaggerated. Although the detailed methodology of the study is not available even in the NCAER study report, the very fact that the study is based on 2003-04 input- output table indicates that the productivity gains since 2003-04 including those arising from the introduction of VAT replacing the cascading type sales tax has not been taken into account. In any case, with the type of shortcomings in the quality of data, to place faith in such estimates demands a leap of faith. This is not to state that the reform is not important. Surely, this will not be a "game changer" as the 13th Finance Commission believes. In fact, the introduction of VAT was a game changer and the GST reform should be seen as only the next step in the reform process.

The point is that tax reform is a process and not an event and if the design aspects are not negotiable in the "grand bargain", it is doubtful whether the reform can go further at all. Even more retrograde was the estimate of revenue neutral rates made by the GST task force. There are several problems with these estimates and to take four different estimates and taking an average shows that the task force itself does not have the conviction in any one of the methods (Rao and Chakraborty, 2010).

While everyone desires that the rate of tax should be low, to show highly underestimated rate as revenue neutral as the task force did force the states to adopt extreme positions. Not only that the revenue neutral rate estimated by the task force is way too below what the states think, but there are wide variations in the revenue neutral rates across states. Thus, even if the central government gives compensation for three years, if there is a permanent decline in the revenues, the states with high revenue neutral rates fear loss of revenue.

It is important to note that the consumption tax reform involving the central and state governments will have to make a compromise between tax uniformity and fiscal autonomy. While the aim should be to get the fundamentals of the reform right, compromise is unavoidable and the solution may have to settle at less than the best from the point of view of tax uniformity but allows some measure of fiscal autonomy. To state that the "GST grant compensates for the seeming limitation in fiscal autonomy by enhancing expenditure autonomy through compensation payments and additional formulaic transfers" (p. 71), is to misunderstand the concept of fiscal autonomy altogether. First, compensation is given against the loss of revenues and not a bribe for adopting the GST reform. Second, fiscal autonomy under fiscal decentralisation means manoeuvrability to change standards of public services by changing tax rates and not simply softening the budget constraint to spend more money.

Indeed, the ideal design should be the goal, but in many states the socio-political considerations may not allow them to adopt uniform minimum exemptions and a single uniform rate. In fact, even as economists recommended moving over to a single rate of VAT in Sweden recently, the government found it impossible to change over to a single rate. Everyone knows that equity is better served by better targeting expenditures and not by having high and multiple rates and yet, political perceptions are hard to change. Bird and Gendron (2007, p. 13) show that in European Union the standard rate of VAT varied from 15 to 25 per cent with a mean of 19.4 per cent and except for Denmark, every other European country has one or more rates in addition to the standard rates. It is not to argue that having multiple rates is desirable and surely, every effort should be made to minimise rate differentiation from the viewpoint of reducing the collection cost, compliance cost to the taxpayers and distortions in the economy. But these are political decisions and compromises are unavoidable. The Commission's approach of insisting on "all or nothing" rules out compromises altogether.

(d) Roadmap for Fiscal Consolidation

The revised road map for fiscal consolidation charted by the Commission is, in many ways, a continuation to the map laid down by the 12th Finance Commission. The fiscal deficit target is set to be consistent with the targeted debt to GDP ratio. The consolidated Debt to GDP ratio is targeted to decline from 78.8 per cent in 2009-10 to 67.8 per cent in 2014-15. In consistence with this, the fiscal deficit is supposed to be reduced from 9.5 per cent to 5.4 per cent during the period. The central government is required to reduce its outstanding debt to GDP ratio from 54.2 per cent in 2009-10 to 44.8 per cent in 2014-15 and its fiscal deficit target is to reduce it from 6.8 per cent to 3 per cent and revenue deficit from 4.8 per cent to a surplus of 0.5 per cent during the period.

Has the fiscal restructuring recommended by the 12th Finance Commission been an unqualified success? Surely, there was significant progress in compressing fiscal and revenue deficits at both central and state levels until 2008-09 when various fiscal developments in the year resulted in the deficits going out of control. I have argued elsewhere (Rao, 2009a) that the significant improvement in the fiscal situation in the country since 2003-04 was not due to legislated discipline but due mainly to sharp increase in the income tax revenues arising from the buoyancy of the economy and even more, introduction of tax information network (TIN). In fact, increase in revenues from income tax between 2003-04 and 2007-08 was almost three percentage points to GDP, although this helped the central government to achieve the revenue increase targets as set out by the FRBMA task force. At the same time, the task force had indicated the compression of revenue expenditures by two percentage points and the only component of revenue expenditure compressed was interest payments which declined because of debt swap and lower interest rates. In the case of the states, the improvement was caused by higher tax devolution arising from the buoyancy of central taxes, particularly the income taxes as well as larger central transfers to states. On the expenditure side, the rescheduling and writing off of states' debt by the 12th Finance Commission and lower interest rates reduced their interest payments. Of course, states' own tax revenues too increased as a share of GSDP due to the buoyancy of the economy and the associated increase in taxable consumption. At the same time, there was virtually no compression in non-interest expenditures.

Equally important point to note is that the sharp upsurge in the deficits in 2008-09 was mainly due to central government's decision to spend more on pay revision, increased subsidies, expansion in the scope of *National Rural Employment Guarantee Act* and introduction of loan waiver scheme and not due to the stimulus package given to meet the global economic crisis. This is not to say that these measures did not provide the stimulus. They certainly did, but along with the election related expenditures, its amount is very difficult to quantify. In fact, increased spending on these items even before the crisis helped in soft landing the economy. But the structural issues relating to the fiscal imbalances in the centre as well as in the states have not been addressed and the consolidation will have to start all over again. Indeed, the fiscal responsibility legislations did not inculcate the culture of fiscal austerity and the entire exercise was reduced to a routine.

The 13th Finance Commission has recommended the revised roadmap for fiscal consolidation and in order to impart effectiveness to the process, it has made a series of recommendations to make the FRBM process (i) transparent and comprehensive; (ii) sensitive to countercyclical changes; and (iii) institute a system to effectively monitor the compliance. The measures to make the system comprehensive and transparent include preparation of a more detailed medium term fiscal plan (MTFP) to put forward detailed estimates of revenues and expenditures and to make it a statement of "commitment" rather than merely one of "intent". It has recommended a number of micro measures such as putting forward the economic and functional classification of expenditures as a part of MTFP, preparing the detailed statement on central transfers to states, reporting compliance costs on the major tax proposals, presenting the revenue consequences of capital expenditures, fiscal fallout of PPPs, preparation of an inventory of vacant land and buildings valued at market prices by all departments and enterprises (*see*, *Table 2*). The Commission has recommended that the values of parameters underlying the projection of revenues and expenditures in the MTFP should be made explicit and the band within which the parameters can vary when there are exogenous shocks while remaining within the FRBM targets. It has also recommended that the nature of shocks warranting the relaxation of FRBM targets should be specified. The stimulus to the states should be in terms of larger devolution rather than increased borrowing limits and the centre should meet this additional cost. Most importantly, the Commission has recommended the setting up of a committee which will eventually transform into a fiscal council to conduct an annual independent public review and monitoring of the FRBM process. The Council should be an autonomous body reporting to the Ministry of Finance, which in turn should report to the Parliament on matters dealt with by the Council.

Many of the recommendations are important, but the question is whether the Commission has gone beyond its mandate to micro manage the process. In fact, some of the recommendations such as keeping the inventory of land and buildings are important to ensure the comprehensiveness of the budget but may not be feasible for the immediate implementation of the FRBM. For the present, it should be enough to make both the centre and states to get a comprehensive picture of their financial assets and liabilities including the list of guarantees given. Of course, requirements such as presenting compliance costs of various tax proposals have formidable data problems with the taxpayers unwilling to disclose the cost such as the amount of bribe paid to tax officials. The NIPFP study in 2002 by Arindam Das-Gupta had to rely on a small sample to make the estimates. Experience has also shown that FRBMA can be successful only when the government, not just the Finance Ministry has a strong will to embrace fiscal discipline. Mere passing of the FRBMA and presenting the detailed MTFP with all the details recommended does not translate the intent into commitment. Has the government not been presenting the documents on outcome budgeting and revenue foregone from various tax exemptions and concessions without much effect? Furthermore, without the involvement of the various spending departments in the preparation of MTFP, it will be impossible to ensure discipline from them. How much faith can we repose on the capacity of the committee which will evolve into a Fiscal Council to undertake independent review and monitoring of the process? Given that the Council will be appointed by the Finance Ministry and will report to it, how independent the review will be and how effective will the monitoring process be? In any case, without the Government's willingness, institutions can not ensure fiscal discipline and it remains to be seen, how far the Government will move in this direction.

3. Conditionalities for Central and State Governments

An important feature of the 13th Finance Commission's recommendations is a plethora of conditionalities imposed on both central and state governments. Ideally, the recommendations implementing the reforms should rely on the mechanism of incentives to enforce them and specific purpose transfer is the most important instrument used. When properly designed, these can be very effective, particularly in altering the spending priorities of the states to ensure minimum standards of services in respect of services with significant inter-state spillovers. In some cases incentives should be mixed with penalties in order to make the conditions effective.

Surely, there are economic reasons for giving conditional transfers and stipulating conditions is a part of providing incentives to ensure provision of normative minimum standards of the specified service. In designing the conditions and recommending implementation mechanisms, however, some important factors must be kept in mind. First, the incentives should be sufficiently sizeable and effective to make the parties comply with the conditions. Second, it is important to ensure that the conditions imposed are within the capacity of the parties to comply. Third, the conditions should be well designed. It is particularly important to target the conditions to ensure that the penalty for failure to comply will be on the non-compliant and not others. Furthermore, the targets should be realistic and when the issue involves negotiations and agreements between the centre and states on the one hand and among the states *inter-se* on the other, although it is desirable to set ideal targets, in the given environment of political economy, the conditions should be flexible enough to accommodate departures from the ideal.

As mentioned earlier, the 13th Finance Commission has recommended a plethora of conditions both to ensure minimum standards of expenditure and to incentivise central and state governments to undertake reforms. Indeed, both complying with and enforcing the various conditions is going to be a challenge and some states have questioned the conditionalities on the grounds of encroachment in their fiscal autonomy. There are also issues of enforcing conditions when these do not involve either 'carrots' or 'sticks'. In fact, the conditions imposed on the centre do not involve either incentive payments or penalty. Furthermore, there is an asymmetry in the enforcement of conditions. In the case of the states, the enforcement will be done by the central government whereas for the latter, it is both the player and the umpire. Therefore, it is often said that while the Finance Commissions can only bark at the centre, they can bite the states!

Apart from the large number of conditions, there are problems of design and implementation. First, unlike the case of 12th Finance Commission which recommended debt write-off and rescheduling linked to fiscal adjustment, the 13th Finance Commission's conditions to the states' fiscal consolidation does not entail any incentive payments except in the case of the states which did not pass fiscal responsibility legislation as required by the 12th Finance Commission. Of course, the central government will have the role of enforcing the conditions but can it withhold any portion of tax devolution or revenue gap grants for non-compliance? How can the conditions be enforced on the central government? Second, the revenue loss compensation grant recommended by the Commission stipulates that the states will have to comply with all the seven components of the "grand bargain". The design part of the condition requires the states to have the model GST which *inter alia* includes subsuming of a number of state taxes, exemptions to only unprocessed food items, public services, education and healthcare and service transactions between an employer and an employee. While the model GST is the goal and the reforms should work taking this as a target, it would be unrealistic to expect the states to adopt the model GST straight away. The Commission's recommendations do not consider adoption of any GST structure other than the model GST they have recommended. The objective of the recommendation is to incentivise the states to make the transition and it must be remembered that any reform, including tax reform is not an event but a process. We may have to do with less than the best, if necessary, and the recommendations do not allow for any solution other than what the Commission considers to be the best. This has been a setback for GST reform with the states taking varying positions and the central government has had to initiate the process again to take the reform forward.

The conditions relating to the local government reform cannot be effective. This is because, the grants are targeted to the local bodies but the conditions have to be met by the states. What is the incentive for the states to fulfil the conditions? Will the state governments be benevolent enough to undertake the stipulated conditions?

4. Concluding Remarks

The Report of the 13th Finance Commission submitted in December last year and placed in the Parliament in the budget session of the Parliament in February has not been subject to critical analysis and discussion. The central government has accepted the recommendations relating to transfers and its other recommendations have been accepted in principle. In general, the response to the Finance Commission report has been muted and there has hardly been any serious analysis or debate except those recommendations relating to the GST on which the states have expressed serious concerns. This paper makes a critical appraisal of the recommendations of the Commission, particularly those that relate to the basic task of the Commission.

The 13th Finance Commission, in its analysis and recommendations has dealt with a number of issues that have not been gone into by the previous Commissions. This is partly occasioned by the expanded terms of reference, but to a considerable extent this is due to the Commission's own approach. Besides tax devolution, the Commission has gone on to recommend as many as 12 different types of grants with a plethora of conditionalities. Indeed, the Commission has forayed much beyond the task of the Finance Commission.

The approach of the Commission in regard to the ToRs on tax devolution and grants is not different from the past. The only difference is the taking of per capita taxable capacity distance in the place of the per capita income distance as a criterion for tax devolution. Taking taxable capacity in the devolution formula does not take away the inequity and perverse incentives arising from the gap filling approach. Furthermore, taking average tax-GSDP ratio as a norm to determine taxable capacity does not recognise the fact that taxable capacity increases more than proportionately as per capita income increases.

The inability to offset the fiscal disabilities of the states leads to giving several grants. Even here, the approach is *ad hoc*. In particular, the grants recommended for individual states for their special needs is a classic example of the *ad hoc* approach which is arbitrary and judgemental. There is no need for such transfer once their fiscal disabilities are offset. The grants recommended for elementary education covers only 15 per cent of the *Sarva Shiksha Abhiyan* requirements of the states. The understanding is that the rest of the funds should come from the states' own resources. The previous Commission gave 10 per cent. The question is why 15 per cent and why not more or less?

The recommendations relating to the GST are the ones which have been resented most by the states and actually, this has taken the reform agenda backwards. The "all or nothing" types of conditions do not leave much room for a "grand bargain". It is not surprising that the states have taken different bargaining postures and have gone about increasing the general rate of VAT from 12.5 per cent to 13.5 per cent. In fact, the central government has virtually ignored these recommendations to continue the dialogue with the states and hopefully, all the parties will work towards a consensus to levy the GST in the near future and even if it is not the "model GST" recommended by the Commission, it will retain the basic features of a sound GST.

A major concern is the plethora of conditionalities imposed by the Commission. Besides the conditions on GST compensations discussed above, there are several conditions stipulated for achieving fiscal consolidation and incentivising local bodies. There are questions of design, implementation, and monitoring of these conditions. Not surprisingly, some states have raised the issue of autonomy. Can all the conditions stipulated be met? Some of them can be implemented only in the long term and it may not be possible for the centre as well as the states to implement within the period of recommendation of this Commission. How can the conditions be enforced when there are no incentives? How do we deal with the issue of conditions in respect of local body incentivisation where the conditions are for the state governments and if they do not fulfil them, local bodies will lose the grants? These questions leave one suspect that the Commission lost an opportunity to reform the transfer system yet again.

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Table 2: Conditionalities Recommended by the Finance Commission			
	Recommend-ations	**Conditions for Government of India**	**Conditions for states**
1	**Goods and Services Tax**	**Grand bargain to be concluded.**	**Grand bargain to be concluded.**
		Elements of the grand bargain are: Design of GST: Model GST. Operational modalities. Agreement between the centre and states with contingencies for changes. Disincentives for non-compliance. The implementation schedule. The procedure for claiming compensation. **GST model must be consistent with all the elements of the grand bargain**	Elements of the grand bargain are as outlined in column 2. **GST model must be consistent with all the elements of the grand bargain.** Compensation ceiling of Rs. 50000 crore to be given to states only when they comply with all the elements of the grand bargain. The amount will be reduced by Rs. 10000 crore for every year of delay. Unspent balance to be distributed to all the states according to devolution formula. If there is no consensus on implementation of GST and if it is in variance with the recommended GST, there will not be any compensation.
2.	**Fiscal Consolidation**	**Fiscal targets to be achieved** Central debt – GDP ratio to be brought down from 54.2 per cent in 2009-10 to per cent to 44.8 per cent in 2014-15. Fiscal deficit to be compressed from 6.8 per cent to 3 per cent and revenue deficit to be reduced from 4.8 per cent to a surplus of 0.5 per cent. Capital expenditure to be increased from 2.1 per cent to 4.5 per cent. Disinvestment revenue to be increased from 0. per cent to 1 per cent. FRBM rules to be changed to put a ceiling of 5 per cent of GDP for the stock of outstanding liabilities. **Making FRBM transparent** Annually adjusted medium term fiscal framework to set medium term targets	**Fiscal targets to be achieved** Debt – GDP ratio to be contained at 25 per cent by 2014-15 from 27 per cent in 2007-08. Long term and permanent target of zero revenue deficit. The states with zero revenue deficit and surpluses in 2007-08 should return to zero revenue deficit by 2011-12. They should have a fiscal deficit of not more than 3 per cent in 2011-12 and maintained thereafter. General category states with revenue deficits in 2007-08, Kerala, Punjab, and West Bengal should return to revenue deficit by 2014-15. These states are required to reduce their fiscal deficit to 3 per cent of

		consistent with achievement of FRBM to provide evidence based rationale for deviations in actual out-turns from the targets. **Reforms in the budgeting process** MTFP to be converted into a statement of commitment rather than merely one of intent. Annual MTFP statement to be converted into a more detailed rolling medium term fiscal plan (MTFP) containing three year forward estimates of revenues and expenditures along with a narrative explanation on how the estimates are generated. **Reform in the design and implementation of fiscal responsibility legislation**. Making FRBM process more comprehensive and transparent. Government should prepare a detailed economic and functional classification of expenditure budget as a part of MTFP from fiscal year 2011-12. All central transfers to states to be set out in an independent statement. Systemisation of tax-expenditure estimates with detailed basis of estimation reported. To report on the compliance cost of major tax proposals in the MTFP from 2013-14. All capital expenditure proposals included in the central budget should be accompanied by a statement of revenue consequences of capital expenditures for the lifetime of the proposed projects. This should be done from 2013-14. New policy initiatives that are known to involve future expenditure commitments should be reflected in the MTFP. It should also provide projections for transfers to states in the form of either plan assistance or centrally sponsored schemes. Contingent liabilities to be reported fully and adequate provisioning to be made. PPP documents should report on the details and quantities of financial obligations of public sector in PPP. These should be collated and stated in MTFP. Disinvestment receipts should not be put in the public account but in the consolidated fund. Administrative departments as well as departmental and non-departmental undertakings should prepare a complete inventory of vacant land and	GSDP by 2014-15. The five special category states,(Arunachal Pradesh, Assam, Himachal Pradesh, Meghalaya and Tripura) which had fiscal deficit of less than 3 per cent of GSDP should maintain their revenue balance and achieve the fiscal deficit of 3 per cent or less by 2011-12. To each of the remaining six special category states with more than 3 per cent of GDP during the three years 2005-08, the Commission gave a separate adjustment path to reach the fiscal deficit of 3 per cent of GSDP by 2014-15. **Monitoring and Compliance** The structure of MTFP should be more comprehensive giving details of significant items under revenue and expenditure projections. Independent review/monitoring should be instituted. Revenue consequences of capital projects, government liabilities from PPP and related arrangements, inventory of physical and financial assets and vacant public land and building should be done by the states. The states that have not availed the benefit of consolidation under DCRF, the benefit limited to consolidation and interest rate reduction to be extended subject to their enactment of the FRBM Act. Benefits of interest relief on NSSF and write off available to the states only if they bring about the necessary amendment/enactments of FRBM.

		buildings valued at market prices. Consolidated list should be placed in the Parliament along with the budget documents from fiscal year 2013-14. **Sensitivity to shocks to counter-cyclical changes** MTFP should make the values of parameters underlying revenue and expenditure projections. FRBMA should specify the nature of shocks that would require relaxation of targets. Rather than raising the borrowing limits of the states, when the shocks occur, the central government should assume the entire responsibility and pass on resources for spending to the states in the form of larger devolution. **Monitoring and Compliance** Independent review and monitoring of the implementation of FRBM process. Committee to be appointed for the purpose, which, over time, should evolve into a full-fledged Fiscal Council. The Council should be an independent body reporting to the Finance Ministry, which in turn should report to Parliament on matters dealt with by the Council.	
3.	**Local Bodies General basic grants Incentive framework for general performance grant**		**States will receive general performance grants only if the following nine conditions are satisfied** Supplement to the budget document for local bodies. states should require local bodies to maintain accounts. Besides the supplement, states should certify that the accounting systems as recommended have been introduced. States should put in place an audit system for all local bodies. C&AG should be given technical guidance and supervision over audit of al the local bodies in the state. Annual Technical Inspection report and Annual report of the Director of Local Fund Audit must be placed before the state legislature. State governments should put in place independent local body ombudsmen to look into complaints. State governments should put in place a system to electronically transfer the grants provided by the Finance Commission to local bodies

			to receive it within five days of their receipt from the central government. In places where there is no banking infrastructure, the state government should transfer funds through alternative channels so as to reach the local bodies within 10 days. State governments must prescribe through an Act the qualifications of persons eligible for appointment as Members of SFC consistent with *Article 243I (2*) of the Constitution. All local bodies should be fully enabled to levy property tax. State governments must put in place a state level Property Tax Board to assist all municipal bodies in the state an independent and a transparent procedure for assessing property tax. State governments must put in place standards for delivery of all essential services provided by local bodies. All municipal corporations with a population of more than 1 million (2001 Census) must put in place a fire hazard response and mitigation plan for their respective jurisdictions.
	Incentive framework for special area basic grant		**The state can draw down the special area performance grant only if it satisfied with the following conditions** States should indicate in a supplement to the budget, details of plan and non-plan transfers to local bodies under various heads. It should specify the agencies that will receive the special area basic and performance grant and conditions under which it is given and the procedure for auditing these expenditures. If they are not *panchayats*, they must maintain accounts consistent with the instruction in force. The accounts should be audited by C&AG and the audit report tabled wherever so mandated. Compliance will be demonstrated by the certificate from C&AG. At least district level officials and functionaries of these agencies must be brought under the ombudsmen. Compliance is demonstrated by passage of relevant legislation and

			its notification. Compliance on transfer of funds within the stipulated time would require self-certification by state governments with the description of the arrangements in place.