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The Sixteenth Finance Commission's Lamentable Abdication

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The 16th Finance Commission's narrow Terms of Reference acknowledged deep political-economic tensions between India's richer, less populous peninsula and poorer, more populous north. But its formula changes, abolition of revenue deficit grants, and central debt bias entrench existing imbalances.

The Terms of Reference for the Sixteenth Finance Commission were markedly different from those of its predecessors. It was brief, to the point of succinctness. It enjoined the Commission to determine the vertical (between the union and the states) and horizontal (between the states) division of the divisible pool of taxes, and to recommend grants to states, to local bodies, and for disaster management. The usual litany of additional responsibilities-looking at climate change, fiscal discipline, and public financial management-were done away with.

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This was done with good reason. Intergovernmental fiscal relations were to be reviewed at a juncture when political imperatives loomed larger than at any other time in the history of independent India. Demographic changes were fostering changes in the political balance of power, even as the economic balance of power had shifted significantly due to uneven development.

The principle of one person one vote had for long been held in abeyance. The composition of the Lok Sabha was determined by the state-wise distribution of population as measured by the 1971 census. The consistently increasing population of the poorer northern and eastern states relative to the southern and western states meant that the balance of electoral representation--and therefore political power-would shift significantly if delimitation were to occur based on the current population distribution. The failure to conduct the 2021 census had further clouded matters.

At the same time, the potentially less politically powerful southern and western states were now significantly richer and better developed than the northern and eastern states than they had been even in 1991. The southern states had per capita incomes well above the national average, comparable to Indonesia's per capita gross domestic product (GDP). Uttar Pradesh (UP) and Bihar in north India had per capita incomes lower than that of Nepal.

The peninsula (southern and western states) was more industrialised and more productive than the north and east. They have levels of human development comparable with the lower rung of developed countries, while these indicators for the northern and eastern states compare with those in nations such as Burkina Faso and Afghanistan.

More recently, the wave of Hindu nationalist ideology that brought the Bharatiya Janata Party (BJP) into political power in Delhi was backed by the support it garnered everywhere except in south India, which remained a redoubt of the Congress and regional political parties.

This means that India is confronting an existential tension between political and economic dynamics. This is also expressed in tensions on the fiscal stage. There are two dimensions to this.

First the union government has historically garnered the majority of resources from the divisible pool. It spends this on providing military and paramilitary security and on its regulatory functions. As the Indian economy grew, one would expect these expenses to fall as a proportion of GDP, thereby providing space for a greater devolution to the states to provide merit goods like health, education, water, sanitation, and urban and rural development. This has not happened.

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In the 1970s and 1980s the central government used significant chunks of resources to pay for growing a national public sector industrial complex, ranging from energy to transport to agricultural distribution and processing. Then it engaged in the implementation of national anti-poverty programmes on a scale.

In recent times, the bulk of its spending has been on transfers of various sorts, in what I call a move from a development to a compensatory state. The central government now competes with state governments to provide large-scale transfers to those who have failed to benefit from the post-1991 expansion in economic growth.

Thus, the central government spends heavily on employment guarantee (read unemployment compensation) programmes, food and fertiliser subsidies, and an array of pensions and handouts. Total expenditure on these is larger than the entire outlay on centrally sponsored health, education, housing, and water and sanitation programmes.

Central compensatory expenditures naturally flow in larger measure to the more populous and poorer regions of the country. So, the larger the vertical devolution to the centre, the smaller the share of resources raised in the richer and more prosperous regions that is spent back in those same regions.

The horizontal devolution is based on a formula. Until the Fifteenth Finance Commission, the population variable in this formula was calculated based on the 1971 population. This has now changed and the 2011 population is used.

In addition, for the past 30 years, the largest weight in the formula is accorded to "income distance"-the distance of the per capita income of a state from the average, meaning the poorer a state, the greater its devolution share. Thus, the horizontal devolution is significantly weighted in favour of the poorer, more populous states.

As the chief economist of the Thirteenth Finance Commission, I observed that no state contested this formula. Instead, richer states would point to pockets of deprivation in their geography and ask that these be recognised using state-specific grants. This has now begun to be severely contested.

The legitimacy of using the Finance Commission as the main instrument of progressive geographic redistribution has been questioned. Critics point to political bias, given that the ruling party in Delhi derives its power from the poorer states. They also note that inequality has only worsened over time, despite these progressive transfers.

Finally, the continued abeyance of delimitation-reflected in the use of 1971 population figures to calculate horizontal devolution-no longer holds ground. It means further transfer of resources from richer to poorer states, even as the poorer states, now numerically much larger than 35 years ago, consolidate their political power.

> Collectively, this means that the formula continues to disproportionately favour the poorer, more populous, northern and eastern states.

The Sixteenth Finance Commission has tried to address some of these issues. Space does not permit speaking of how it has done so in its argumentation-suffice to say for now that the exercise has been highly unsatisfactory with clumsy technocratic language being used to mask the real political question.

Despite the consistent increase in non-shareable cesses and surcharges, the Commission has chosen to continue to allow the central government to retain 59% of the divisible pool. Against a background where all states are being asked to shoulder an ever-increasing burden of expenditure on cost sharing schemes, including on health, education, sanitation, and employment guarantee, this is egregiously unequal. It of course reinforces the current pattern of central spending being disproportionately high in the less prosperous and more populous states.

The horizontal devolution introduces another metric-"contribution to GDP"-but this is more in the nature of gestural appeasement than any serious attempt to rectify the imbalance in the horizontal distribution This can be seen both in the formula and by posing a simple counterfactual.

The formula retains the inverse of per capita income as the largest weight determining the share of an individual state. It also moves to the latest available census to determine population weights. Collectively, this means that the formula continues to disproportionately favour the poorer, more populous, northern and eastern states.

It does introduce "contribution to GDP" as a new parameter, which would increase the share of the more prosperous peninsular states. But horizontal devolution is a zero-sum game. Where does this 10% come from?

Looking at Table 1, we see that the weight accorded to income distance (which favours the poorer states) has been reduced by 2.5% but the weight accorded to population as per the 2011 census (which favours the more populous states) has been increased by 2.5%. So, there is no net gain to the peninsular states on this score.

The "contribution to GDP" component entirely favours the southern states. So does demographic performance. But the weight of demographic performance has been reduced by 2.5%. A further 2.5% has been obtained by removing the tax effort component. Finally, the weight for area has been reduced by 5%.

This collectively has made room for the 10% weight accorded to contribution to GDP. It is therefore little wonder that all the southern states have seen only small or zero increases in their share of the divisible pool and poorer states like UP and Bihar with large populations continue to receive the largest chunk of resources.

Table 1: Differences in Weight of Criteria between the Fifteenth and Sixteenth Finance Commissions

Criteria	**15th FC (2021–26)**	**16th FC (2026–31)**
Income distance	45%	42.5%
Population (2011)	15%	17.5%
Demographic performance	12.5%	10%
Area	15%	10%
Forest	10%	10%
Tax and fiscal efforts	2.5%	-
Contribution to GDP	-	10%
Total	**100%**	**100%**

The abolition of all state-level grants has further reduced the fiscal resources going to the peninsular states. Kerala, for example, generates a significant proportion of its income through remittances. But this does not contribute to GDP or the tax base. Hence, Kerala was typically accorded a revenue deficit grant to partially correct for this.

This Commission has abolished revenue deficit grants. The Commission incorrectly reasons that these grants had a negative effect on fiscal discipline. If the Commission had bothered to read a bit of history, it would perhaps have understood that these grants, like grants to the northeast and to hilly regions, were given to partially alleviate structural features that inhibited a state's fiscal base.

> There is also an emergent political rupture between peninsular states and the centre, due to the impending parliamentary delimitation, which could, without remedy, translate demographic divergence into political hegemony.

Such structural limits become evident when forward revenue and expenditure forecasts are made for individual states. Every Commission has done this. This Commission has not bothered to do so (or if it has, has chosen not to reveal these forecasts). It instead cites a World Bank publication. But that publication (and none others cited) does not provide forecasts for revenue and expenditure, but only debt and debt sustainability forecasts. As a result, this Commission has not addressed the core fiscal concern of whether fiscal capacity measures up to fiscal need.

The obsession with debt that seems to possess this Commission is particularly egregious. It, unlike previous ones, was not asked to comment on debt sustainability or to make recommendations regarding a debt glide path for the centre and the states. Yet it has chosen to do so. And it has done so with a patent bias towards the central government, again allowing the centre an (un-monitorable) higher ceiling while limiting states to a one-size-fits-all 3%.

By limiting the focus of this Commission to vertical and horizontal devolution, the Terms of Reference acknowledged the political economy challenge to extant intergovernmental fiscal arrangements. This challenge is driven by the underlying tension between uneven demographic and economic development. It has been accompanied, over time, by a breakdown in institutional trust in the centre's even-handed treatment of different states (whether for valid or invalid reasons).

It has also been accompanied by brazen moves by the centre to reduce the access of the states to public resources, through increasing resort to cesses, a new practice of conditionality-based relaxation of borrowing limits, and constantly raising state contributions to centrally sponsored schemes. There is also an emergent political rupture between peninsular states and the centre, due to the impending parliamentary delimitation, which could, without remedy, translate demographic divergence into political hegemony.

In these circumstances, the Finance Commission had a historic duty to use the space afforded by the Terms of Reference to define and enunciate this existential challenge and propose pathways to address it. That it did not do so is a very regrettable abdication of responsibility.

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