Finance Commission’s dose of reality

The report of the Fifteenth Finance Commission is comprehensive and analytically rich. This is welcome at a time when there is little quality economic analysis emanating from the Government of India. The Commission has also accomplished a remarkable job, given the clumsy and normatively biased Terms of Reference (ToR) that it had to work with.

The analysis of the Central and state government finances is sound. The report also does a reasonable job of acknowledging the impact of the pandemic, and the prior structural growth slowdown, by projecting cautious recovery in nominal gross domestic product (GDP) growth to 11.5 per cent in FY26. It assumes only modest increases in revenue/GDP ratios. It optimistically accepts the government’s assertion of an increase in disinvestment proceeds in FY22 and FY23 but tempers this assessment going forward. This is wise. Going by the current track record, disinvestment receipts have consistently been off target. Given these modest projections, and the assumption that the fiscal deficit will fall to 4 per cent of GDP in FY26, it presents the arithmetic reality: A shrinking Central government whose spending falls, from 31.1 per cent of GDP in FY20, to 12.8 per cent in FY26.

My only quibble is with the historical analysis. It asserts that the Central government secured fiscal consolidation when, in fact, the data it presents shows that governments of all hues have consistently missed their fiscal deficit targets. It also fails to acknowledge explicitly that the fiscal stress on the state governments has been caused by central interventions, importantly UDAY, and the unacceptable and invidious resort to cesses.

The award itself is quite fair. It is a big relief that a weak Central government has not been allowed to pass on its fiscal stress to the states citing its expenditure needs — the vertical devolution is constant, and buttressed by grants. The horizontal devolution retains the primacy of the income distance criterion and has cleverly managed to balance the debate on whether states with lower fertility growth are being penalised — it proportionately incorporates fertility declines and population size in its criteria.

It is disappointing that this Commission does not only condone, but allows for, a continuation of the resort by the Central government to cesses. At the end of the Commission’s award period, cesses are projected to be close to 19 per cent of gross tax revenue compared to 15 per cent in 2019-20. Perhaps the Commission recognizes that it is powerless to end this unsavoury practice that deprives the states of their legitimate share in the divisible pool. It is disappointing that a constitutional body has been so timid on this score.

The Commission was presented with a ridiculously biased ToR, which enjoined it to incentivise states to be handmaidens of Central government economic policies and to develop “measurable performance indicators” to validate this. The approach that the Commission has taken is to recommend “performance-based” grants that, among other things, purportedly further the goal of “Atmanirbhar Bharat” “matribhushana” development, and the like. This gen- effects to GOI’s desire that public resources be used to align state governemnts with Central priorities. The practice of state specific “grace and favour” grants has also been reinstated. However, the total volume of all these grants annually is not sizeable, so this optical grandstanding in deference to the ToR has not been fiscally expensive.

The Commission has also written some innovative English responding to the ToR, asking it to consider “whether a separate mechanism for defence and internal security ought to be set up”. After elegant deliberation, the Commission recommends setting up a non-lapsable fund into which budgetary allocations and proceeds from sale of land and other assets owned by the Ministry of Defence are transferred. In effect, this partitions the Budget — imagine a situation where each ministry had such a Fund. This would render the budgetary exercise meaningless by making the consolidated fund irrelevant and curtailing fungibility. But this is purely optical—if the government wished to spend more on defence and internal security using these proceeds, it could do so without creating such a Fund.

The recommendations on fiscal consolidation are surprisingly brief, almost shy. There is no innovative thinking that captures the global discussion on reassessing the framework for fiscal responsibility and the increasing acceptance of the proposition that the accountant’s view of debt sustainability should be replaced by an assessment of what fiscal space is used for rather than how much. The report provides three alternative fiscal deficit scenarios, which allow for more borrowing, the slower the macroeconomic recovery compared to the Commissions’ medium-term assessment, and vice versa. This is a rather irresponsible exercise in humility. If the Commission’s macroeconomic estimates are feasible and achievable, then there is no logic for a range.

For the rest, the report claims honest. The Centre’s revenue expenditure will continue to be financed out of borrowing in large measure, there will be no improvement in revenue mobilisation even if GDP grows as forecast, and the government’s claims on disinvestment are taken sceptically given its track record. Given this story of continuing fiscal weakness going forward, with no ideas or strategies to reverse this, a higher medium-term fiscal deficit glide path is inevitable. And this is what the Commission has proposed.

The report reiterates good recommendations for reforming the fiscal architecture with wishful brevity, perhaps recognising the refusal of the government to undertake more than cosmetic changes in the Instrumentation of India’s fiscal architecture for the past 30 years. Years of ad hoc decision-making and the refusal to face up to glaring structural fiscal weakness has resulted in low executive and analytical capacity in India’s finance ministry, that continues to be administrative in its orientation. The Commission is to be commended for recognising this implicitly, and delivering a report that copes with this unfortunate state of affairs as best as possible.

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Views are personal
1. Political economy of Fiscal responsibility Business
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