CSES

ISSUE BRIEF

Terms of Reference of the Fifteenth Finance Commission: Implications for Kerala Is the Cooperative Federalism on the Back Foot?

K.K.George and K.K.Krishnakumar

APRIL 2018

Centre For Socio-economic and Environmental Studies (CSES)
Khadi Federation Building, NH Bypass, Padivattom, Koci-682024, Kerala, India
Tel: 91484 2805107, 2805108 Email: csesindia@gmail.com www.csesindia.org

Terms of Reference of the Fifteenth Finance Commission: Implications for Kerala
Is the Cooperative Federalism on the Back Foot?

K.K.George and K.K.Krishnakumar*

The provision for a Finance Commission (FC) to be appointed by the President every five years or earlier under Article 280 of the Constitution is the only difference between the Government of India Act, 1935 and the Indian Constitution with regard to the distribution of financial powers between the Central and the State governments. The Finance Commission, a semi judicial body, was conceived as an arbiter between the Central government and the State governments and to determine the share of Central revenues to be transferred to the States. This body also determines the inter-state allocation of these Central revenues to be transferred to the States. Sharing of Central tax revenue is the principal means of fiscal transfers from the Centre adopted by the Finance Commissions. The Commissions also determine the quantum of grants to the States "in need of assistance" under Article 275 of the Constitution. But, over the years, the impartial arbitrator's role of the Finance Commissions is increasingly being undermined by the Central Government in a number of ways. It is

* *K.K.George is Chairman, Centre for Socio-economic & Environmental Studies (CSES). K.K.Krishnakumar is a Fellow at CSES.*

more so in the case of both the composition and the Terms of Reference (ToR) of the Fifteenth Finance Commission (FC15).

The turf of this constitutional body had been encroached upon to a large extent by the Planning Commissions in the past and off late Niti Ayog, an extra constitutional body and the Union Ministries under the present dispensation. The fault for allowing this encroachment lies partly with the successive Finance Commissions which abdicated their constitutional responsibilities and limited their role, on their own, presumably in tune with the wishes of the Central government. This is particularly so in the case of the Fifteenth Finance Commission. There is no representative in FC15 who is familiar with the state finances. All of them except one are connected with the Central Government Bodies like the Niti Ayog. The one and the only academic in the Commission, Dr.Anoop Singh, Adjunct Professor, Georgetown University had only a tenuous relationship with the Indian Economy in the distant past. The Chairman is a senior bureaucrat turned politician.

The Terms of Reference (ToR) were framed very casually as there are two major lapses of which one was rectified afterwards. In the initial gazette notification dated November 27, 2017 of appointment of FC15 members, the Chairman Shri.N.K.Singh is designated as Member of Parliament. Actually he is a former Member of Rajya Sabha . Through an extraordinary corrigendum dated December 4, 2017 this error has been rectified. The next major lapse is with regard to the basis of assessment of resources of central and state governments. Usually the consideration of the FC in the assessment of resources of the Central Government is those likely to be achieved during the year prior to the five-year period for which reasonably accurate data may be available to the Commission. But as per the ToR of FC15, the FC would assess the resources based on the tax and non-tax revenues likely to be reached by 2024-25, without mentioning the base year on the basis which the forecasts are made. We only hope that this is only a printing mistake!

Potential Loss due the Change in Population Criteria

For the first time, unlike the ToRs of the previous FCs, one of the items of the ToR clearly mentions that "the Commission shall use the population data of 2011 while making its recommendations."[1] This clause in the ToR goes against the assurance given in the parliament with a view to encourage control on population, a national goal then and also now. This policy was also approved by the National Development Council (NDC) in its 33rd meeting in 1979 and reiterated in the National Population Policy in 2000. The fact that the period for

[1] The ToR of FC14 mentioned that "the Commission may also take into account the demographic changes that have taken place subsequent to 1971" and the FC14 addressed this by earmarking only 10% share of the divisible pool by using the 2011 population as a criterion for the horizontal sharing.

which the distribution of Lok Sabha seats among states was frozen (42nd Amendment to the Constitution) was extended to another 25 years in 2001 has also to be taken into consideration in this context.[2] This clause will be affecting Kerala which has the lowest growth rate in population between 1971 and 2011 (56.4 %) as against a growth rate of (120.8 %) for India. The amounts the states could have lost or gained over their presently allocated share if FC14 had used the 2011 population in its 17.5% population criterion are computed and given in the Table 1. The list of losers includes Special Category states like Assam and Himachal Pradesh and low income states like Odisha. The gainers include high income states like Haryana, Gujarat and Maharashtra.

Kerala will be the second highest looser on this account with Rs.7800 crores during the five year period. Another southern state, Tamil Nadu is the topper in the list with a loss of more than Rs.10000 crore. All southern states are losers. Major gainers are Uttar Pradesh, Rajasthan, Bihar and Madhya Pradesh.

[2] This problem of using 2011 population for fixing the representation of states in the Parliament was already foreseen by the political upheaval through the 42nd Amendment to the Constitution.

Table 1

Potential Losers and Gainers if 2011 population was taken instead of 1971 population in FC14 recommendation

Sl.No.	States	Population share in 1971	Population share in 2011	Difference in share	Amount of gain/loss if FC14 had adopted 2011 population (Rs.Crore)
Losers					
1	Tamil Nadu	7.586	6.061	-1.525	-10537
2	Kerala	3.931	2.806	-1.125	-7773
3	Andhra Pradesh*	5.098	4.149	-0.949	-6557
4	Odisha	4.041	3.526	-0.515	-3558
5	West Bengal	8.159	7.667	-0.492	-3399
6	Karnataka	5.395	5.132	-0.263	-1817
7	Punjab	2.495	2.33	-0.165	-1140
8	Assam	2.693	2.621	-0.072	-497
9	Himachal Pradesh	0.637	0.577	-0.06	-415
10	Goa	0.146	0.123	-0.023	-159
Gainers					
11	Uttar Pradesh	15.439	16.785	1.346	9300
12	Rajasthan	4.744	5.758	1.014	7006
13	Bihar	7.757	8.745	0.988	6826
14	Madhya Pradesh	5.527	6.101	0.574	3966
15	Haryana	1.848	2.13	0.282	1948
16	Jammu & Kashmir	0.85	1.1053	0.2553	1764
17	Gujarat	4.916	5.077	0.161	1112
18	Maharashtra	9.283	9.44	0.157	1085
19	Jharkhand	2.62	2.771	0.151	1043
20	Nagaland	0.095	0.166	0.071	491
21	Meghalaya	0.186	0.249	0.063	435
22	Mizoram	0.061	0.092	0.031	214
23	Arunachal Pradesh	0.086	0.116	0.03	207
24	Manipur	0.198	0.216	0.018	124
25	Uttarkhand	0.827	0.847	0.02	138
26	Tripura	0.287	0.3019	0.0149	103
27	Sikkim	0.039	0.051	0.012	83
28	Chhattisgarh	2.143	2.146	0.003	21

Source: Population shares are taken from Report of the FC14

* Andhra Pradesh and Telangana combined

The use of current population is already hitting Kerala and other states with low population growth indirectly. In their devolution formula, all recent FCs have been taking into account the relative position of States in per capita Gross State Domestic Product (GSDP), in one form or other to assess their fiscal capacity. The relative positions of states undergo substantial changes depending on which year's population is taken as a denominator while calculating the per capita GSDP. An inter-state comparison based on 2011 population shows that Kerala's position is the eighth highest. On the other hand, if per capita GSDP were to be based on 1971 population, Kerala's rank will be only the sixteenth from the top.

Management of Ecology, Environment and Climate change

The Thirteenth Finance Commission, for the first time, was asked to examine the needs of state to manage ecology, environment and climate change consistent with sustainable development. This has been continued in ToR of the 14th FC and they earmarked 7.5% of the tax share for this. The criterion used for horizontal sharing among the states was the share of each state in the forest area. Kerala has received 2.76% of the total share under this which has been computed to about Rs.8200 crore. This item is not shown as a separate one in the ToR of FC15 unlike in the last two FCs. Instead, climate change has been mentioned as one among the several items of demand of resources of only the Central Government omitting the key role played by the State Governments in their budgetary commitments in maintaining and regenerating the forest cover which is the major contributor of prevention of climate change to which the nation has committed under the Paris Accord (2015) in which India is also a signatory. By giving less importance by way of not giving a separate item in the ToR, the States including Kerala have reasons to be apprehensive about the financial allocation to States on this account. In that case Kerala will be losing a minimum of Rs.8200 crore.

Actually the Finance Commission has to consider the forest cover and biodiversity of the States as a public good, beneficial not only for the States but also for the country and the whole world. In addition to the financial costs in the form of revenue loss, the States are incurring huge opportunity costs in the form of loss of agricultural production particularly of food grains. In the case of Kerala, enormous pressures are being exerted on the successive governments of the State by an extremely land hungry population. (The density of population of the State is the third highest among the states in India. The average size of the operational holdings is just 0.22 ha as compared to 1.15 ha for the country. The size of the holdings in Kerala was the lowest.[3]) There are pressures exerted on the government for putting forest land for agricultural production particularly of food production. These

[3] Agricultural Census Division, Ministry of Agriculture, 2010-11.

pressures are difficult to withstand in a chronically food deficit State.

Keeping forest cover intact costs the State in a number of ways, both direct and indirect, both financial and economic. In purely financial terms, the State has been losing potential revenue from forests following the Forest Conservation Act 1980, Supreme Court decisions and the National Forest Policy 1988. Kerala has a strong case to get rewarded financially for managing ecology, environment and climate change for the benefit of the whole country and the world. It is only fair that the State is compensated adequately by the present Finance Commission for 1) revenue loss, 2) funds spent for maintenance of forests and 3) Compensation for acting as a net Carbon sequestration area of the country.

Comments on some other ToRs

Another item in the ToR (3 (iv)) is concerned only with fiscal situation of the Union Government (allegedly) of substantially enhanced tax devolution to States by the FC14 coupled with the continuing imperative of the National Development Programme including New India-2022. The New India Programme 2022 is only up to 2022 and the period of the FC15 covers from 2020 to 2025. Besides, each state has its own imperatives of their own state specific programmes which are not considered by the Fifteenth Finance Commission as per the ToR. Similar comments are applicable for item 4 (iii), "achievements in implementation of flagship schemes, disaster resilient infrastructure with sustainable development goals and quality of expenditure". Cooperative federalism as being projected by the present Government at the Centre cannot be implemented by the Centre alone. The States's participation in implementing these programmes requires the administrative as well as financial support of the Central Government.

Item 4(viii) is of the above mentioned genre. It speaks of the control or lack of it in incurring expenditure on populist measures of the states. The term 'populist measures' is too vague and attribute all populist measures solely with the state governments. It may be noted that some of the populist measures like mid-day meal scheme and old age pension scheme were first conceived and implemented by some of the State Governments were later adopted by the Central Government.

Importance of State Specific Needs

The ToR of the Fifteenth Finance Commission did not consider the large number and variety of special problems of the individual States. The special problems of Kerala are arising out of the much eulogized and unique Kerala Model of Development as also fast demographic transition. It is often acclaimed that some of Kerala's achievements are comparable to those of developed countries. But these successes have also brought in its wake some of the developed countries' problems. Unlike these countries, the State does not have the financial ability to tackle them all by itself due to the low level of income and other fiscal disabilities. Since these problems are unique to the State and off late to southern states, they have not received the national attention and priority that they deserve. While the national agencies like the Finance Commissions and the Niti Aayog are still grappling with first generation problems in education, health care, sanitation, housing, population control and social security in other parts of the country, Kerala is saddled with second-generation problems resulting from its very success in attaining higher levels of social development and demographic changes. Some of the second generation problems Kerala which require special attention by the Finance Commission includes ageing of the working age population, problems of increasing life expectancy (elongation of the old age and 'old old (above 75 years)', feminisation of old age etc.), increasing health care expenditure due to ageing, reduction in working wage due to the elongation of the student age, pressure due to large scale migration from other states as a consequence of early demographic transition etc.

Conclusion

The composition of the Fifteenth Finance Commission and its ToR do not inspire confidence among the states, particularly Kerala. It largely takes into account the concerns of the Union Government and current specific programmes of the Central Government which are more populist than the so called populist schemes of the State

Governments. Ancillary but unforeseen consequence of birth control measures implemented much earlier than most other states by Kerala and other southern states should not be penalised. Instead they should be given incentives for achieving population control and other social development initiatives much ahead of times.

The minimum potential loss for Kerala calculated based on the devolution of previous Finance Commission (FC14) according to the changes in the ToR of the Fifteenth Finance Commission is about Rs.16,000 crore. Even with a weightage of 17.5% for population, by using 2011 population in place of 1971 population, it was estimated that Kerala would have lost Rs.7,800 crore. Any increase in the weightage of this criterion and the increase in the income distance criterion will further increase the potential loss of the State. FC14 has given 7.5% weightage for providing tax share to states to manage ecology, environment and climate change consistent with sustainable development, which is given much less importance in the ToR of the FC15. Instead, climate change is included as in the domain of the Central Government ignoring the role of the State Governments. If the Fifteenth Finance Commission decides to undermine this criteria, Kerala will be losing another Rs.8,200 crore in this regard.