

The anatomy of equity

A considerable amount of heat has been generated around the terms of reference (TOR) of the 15th Finance Commission, such as the suggestion that 2011 population data be used. The heat needs to be supplemented with illumination from Constitutional provisions and the historical evolution of federal finance in India. Article 280 is about the Finance Commission. While Article 280(2)(a) is about the horizontal division of the divisible pool between Union and state governments and the vertical distribution of the aggregate state share between states, one cannot wilfully forget Article 280(2)(b). This states, it shall be the duty of the Finance Commission to make recommendations about “the principles which should govern the grants in aid of the revenues of the States out of the Consolidated Fund of India”.

Unlike Article 282 of the Constitution, there is no suggestion of this being discretionary. Paragraph 8.13 of the 14th Finance Commission’s report stated, “However, a compositional shift in transfers from grants to tax devolution is desirable”, and there was an entire chapter (Chapter 11) on grants in aid. Those paragraphs and that chapter suggest 14th Finance Commission took grants in aid to mean Article 282, such as centrally sponsored schemes (CSSs). Therefore, except for local bodies and disaster management, it scrapped grants in aid and presumed formulae (with appropriate weights) would take care of everything. If this proposition is correct, on both legal and Constitutional grounds, logic dictates preceding finance commissions, which recommended grants in aid of the non-CSS variety, must have erred. At that time, there were no howls of protest that everything must be formulae-driven.

Why harp on grants in aid? Because there is a history to the Constitution and an evolution through the Government of India Act of 1935 (Article 142 of this legislation mentioned grants in aid). Because in the history of that evolution, there is an emphasis on equity, not just on efficiency. To name three reports out of many, the Indian Financial Enquiry Report (Niemeyer Report, 1936), Krishnamachary Enquiry Committee Report (1948) and Committee on the Financial Provisions of Union Constitution (Sarkar Committee, 1948) all considered the problem. Even if one forgets about grants in aid, the issue is exceedingly simple. Every citizen of the country, wherever he/she resides, must be entitled to a minimum basket of goods and services. Typically, these are public goods and services, because they won’t be delivered by markets, and governments (in the plural) cannot abdicate the responsibility. A citizen cannot be penalised simply because he/she happens to be born in a relatively disadvantaged geographical area that lacks requisite physical and social infrastructure because of historical and other reasons. Every such public good or service is optimally delivered at a certain level of government, which is why I have used the word governments in the plural. The Seventh Schedule sets out these layers, Union, State and local body and this Seventh Schedule is also a part of that historical evolution.

Equity is inbuilt into any system of taxation, in every country in the world. As a citizen, I can’t say I pay more taxes and, therefore, I am entitled to better quality publicly-funded health facilities than a relatively poorer person who pays fewer taxes. (That’s the difference between a tax and a fee and private funding is completely different.) Let’s say there is an aspirational district from UP, which is disadvantaged in terms of access to physical and social infrastructure. Because Noida pays relatively more taxes, surely a Noida resident doesn’t have a valid argument against cross-subsidising that aspirational district. As it is with regions, so it is between states. A relatively more advanced state is supposed to contribute more in taxes so that a relatively more backward state is cross-subsidised. (One shouldn’t forget that a relatively more advanced state is better positioned to tap non-tax resources, including private capital.) Nor should the debate only be about Union-state fiscal devolution. More than half the divisible pool is distributed to states. Therefore, more than half the heat and light should be devoted to the TORs of state finance commissions and the extent to which states have implemented their recommendations.

Many (indeed most) public goods and services are delivered by local bodies and therefore the devolution debate also needs to focus on resources of local bodies. If we are questioning the historical evolution and edifice of devolution, let's also question the Seventh Schedule. If health is today squarely in the State List, should the Union government at all contribute for the betterment of health outcomes? If the answer is yes, because health is important, by the same token, should state governments not contribute for the sake of defence, which is equally important? I am citing these examples to illustrate there is a much broader debate. We can't harp on 2011 population and duck the broader issue.

As is obvious, there is always a trade-off between equity and efficiency. Within formulae-based transfers, that's the reason every Finance Commission has separate indicators, some seeking to capture "equity", others seeking to capture "efficiency". The 15th Finance Commission hasn't yet finalised these indicators or their weights. Once the aggregate state share has been fixed, depending on the indicators and their weights, some states gain relatively more than others. That's inevitable in any such process and has happened with every Finance Commission. Before finalising indicators and weights, every Finance Commission consults states and others. The Finance Commission is a constitutional body and possesses the constitutional right to do so. These protests and public pronouncements, and even writings, have an undesirable shade of pre-empting the 15th Finance Commission's right and even influencing it, using means other than the due process, which is the consultative one. We don't yet know what this Commission is going to do with the 2011 population figure. (For the record, contrary to popular perception, the 14th Finance Commission also used 2011 population numbers, in addition to 1971.) We don't yet know what the 15th Commission is going to do with the expression in the TOR, "Efforts and Progress made in moving towards replacement rate of population growth". In a strictly legal sense, nothing in the TOR, except the bit which is a reference to Article 280, should be binding.

If every citizen is going to be entitled to the same minimum basket of public goods and services, on the equity part, there must be an attempt to compute the cost of delivering these public goods and services per capita. That's not easy to do and one looks for surrogate indicators that are objectively measurable. Several Finance Commissions, including the 14th, used population and geographical area. In 1936, Otto Niemeyer thought the same. It would be fair to "fix the scale of distribution partly on residence and partly on population". Is one seriously disputing that cost is a function of population? If not, surely the current population is more relevant than 1971. "Some States have suggested that since public goods and services have to be provided to the entire population, the Census data on population should be used for the purpose of devolution." This is a quote from the 14th Commission's report. If one considers views of the states on 1971 and 2011, stated before 14th Finance Commission, it wasn't a simple North-South divide, as many people seem to think.

The bottom line is simple. Let the 15th Finance Commission do its job and let everyone, including states, make submissions to the commission. If we want to engage in a public debate, that shouldn't be about the TOR, but about the broader theme of public finance and devolution all the way down to local bodies, including revamp of the Seventh Schedule.

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