Chapter 13

Looking Ahead: Towards a New Architecture for Federal Finance

13.1 The Terms of Reference (ToR) of the Thirteenth Finance Commission reflect the emerging need for India to respond transformationally, rather than incrementally, to national and global imperatives that are causing fundamental changes to the national development agenda. In the context of federal finance this poses its own specific challenges which this Commission has sought to address in its recommendations using the instruments at its disposal. However, it must be recognised that the change process is not confined to the time horizon of the Commission's recommendations or, even, to the ambit of these recommendations. In this chapter we identify areas where complementary actions need to be taken in the medium and long term to secure for India a fiscal framework equipped to meet the challenges of the future and to enable India to make the most of its demographic dividend.

13.2 This Commission's deliberations have been conducted in a fiscal environment which has been dominated by the proposal to implement the Goods and Services Tax (GST). When implemented in the manner proposed by us, this reform measure will put India's indirect tax system at the forefront of international best practice. The review of the GST in Chapter 5 of this report has highlighted the significant benefits that the model GST, can provide to the Indian economy. It will reduce the vertical imbalance between the Centre and the states. It will foster a common market across the country and accelerate growth. It will reduce distortions by completely switching over to the destination principle. It will make the Indian manufacturing sector more competitive and boost exports. It will facilitate investment decisions being made on purely economic concerns and thus help lagging regions. It will be a landmark effort in cooperative fiscal federalism, with all stakeholders contributing to the national welfare by accepting its framework. Such a Model GST will be a cornerstone of the new architecture of federal finance.

13.3 The emergence of rural and urban local bodies as key players in bringing about a development transformation has been recognised by this Commission and supported by a number of measures that we have recommended. This process needs to be fostered. Local bodies must be increasingly empowered to fulfill their responsibilities, and we are of the view that this would, in the future, involve a fundamental rethink of the Constitutional arrangements regarding inter-governmental allocation as well as devolution of resources to the third tier. To this end, we would urge careful thinking about Constitutional changes that would allow the third tier to access resources directly from the divisible pool. The introduction of the GST also needs to keep the local bodies in mind in the future since, being a consumption based and incentive compatible tax, it is well suited for direct allocation to the third tier. Such sharing of GST with local bodies will help in eliminating distortionary taxes such as octroi.

13.4 The above, in turn, signals the need to rethink the basis of allocation of different revenue bases to different parts of the inter-governmental fiscal framework. An important example is the allocation of revenues arising from the 'fiscal commons'. These are national resources and should be at the collective disposal of the central and all state governments.

Important examples of these would be profit petroleum, profit gas and revenue shares from spectrum. There may be other natural resources which also fall in this category. Hitherto, these non-tax revenues were considered to be exclusively in the domain of the Centre. We are persuaded of the case to view these as being shareable between the Centre and the states collectively. To do this, it would be necessary to include these as a part of the divisible pool. This would require a consititutional amendment. This is an important issue involving, *inter alia,* the optimal utilisation of natural resources and, therefore, requires careful further consideration.

13.5 Further reforms will be necessary to enable future policy initiatives, including those taken by succeeding Finance Commissions, to be in consonance with contemporary policy imperatives. In the context of future Finance Commissions, an important example would be the updating of award parameters (such as the parameters for horizontal devolution and those entering grant formulae), within the time horizon of the award period and not just (as is the case upto the present) when the award recommendations are made. To do this, however, there would have to be major structural improvements in the timely, accurate and regular availability of the required data. This is also true of dimensions of fiscal policy design and implementation, other than those directly covered by this Commission. It is for this reason that we have devoted considerable thought and attention to incentivising improvement in data quality and availability, and have made specific provisions for the same in our grants. Areas of special importance include data pertaining to forest cover, district level data on social and economic indicators that would enable better understanding and specification of intra-state disparities, as well as data on domestic and cross-border remittances and inter-state trade. We also need better data on human development and Millenium Development Goals (MDG).

13.6 It is widely acknowledged that improving governance is at the heart of securing a transformation in the quality of public expenditure in India. This is true at every level of government and it is important that Finance Commissions play their part in incentivising changes in governance using the instruments at their disposal. At the present time, criteria for horizontal devolution and for deciding the distribution of specific purpose grants use largely static parameters, such as population and area, as well as parameters that are proxies for fiscal capacity, fiscal need and revenue effort. To introduce the governance dimension, it would be necessary to consider dynamic parameters such as those related to indicators of MDG progress. Use of such parameters would incentivise states to think about ways in which to improve governance and outcome based service delivery. However, the lack of reliable, universally understood and regularly produced data has not made it possible for the present Finance Commission to consider such indicators. We would urge that attempts be made to remedy these lacunae.

13.7 FC-XII emphasised the need for statistical agencies to design and implement a plan to produce more timely data on Gross State Domestic Product (GSDP). In Chapter 9, paras 9.85 and 9.86, we have been constrained to use the latest available estimates of GSDP which are for years less recent than we would have liked. This is an issue that requires most urgent attention in order to eliminate time lags in the availability of data and to bring to a close the cumbersome process of generating comparable GSDP data. There should, in our view, be no hesitation on the part of all agencies concerned, whether at the central, state or district level, to put aside any perceived questions of mandate or primacy and collectively agree to a blueprint and methodology for delivering comparable GSDP data on a regular and timely basis. It is equally important that the Central Statistical Organization (CSO) assume greater responsibility for producing GSDP at market prices, and for generating estimates of income accruing to states inclusive of net inward remittances. It is important to recognise that data is vital for the business process underpinning effective policy making, monitoring and devolution, and that the availability of quality data is a factor that will determine whether future policy making is able to rise to the challenges posed by a rapidly changing social and economic environment.

13.8 Environmental issues are increasingly becoming important in the construction of optimal inter-governmental fiscal arrangements. In this report, we have sought to highlight how actions taken by states to maintain and enhance the supply of environmental public goods and to foster positive environmental externalities have resulted in benefits for the nation as a whole. We have made a beginning, therefore in introducing an environmental dimension into inter governmental fiscal arrangements. We envisage that this dimension will grow in importance in the future as environmental sustainability becomes one of the centrepieces of development policy formulation and the role of incentives in securing such sustainability can be expected to commensurately increase over time. The multidimensional approach to environmental policy within public finance is thus the need of the hour, looking across different dimensions of environmental sustainability and, especially, those that directly affect the poor and vulnerable in their daily lives like soil quality, water, sanitation, pollution and bio-diversity. The environment is a shared legacy with future generations and it is of the first importance that inter-governmental fiscal arrangements protect and foster this legacy for their benefit.

13.9 FC-XII recommended the introduction of accrual based accounting systems. Recognising that this changeover would require considerable preparation and training, it also recommended the introduction of eight financial statements as a precursor to this changeover. These statements, to be appended to the finance accounts, were to provide details on financial obligations and expenditure not presently available in the accounts. The Government of India accepted the recommendation to introduce accrual based accounting and asked the Government Accounting Standards Advisory Board (GASAB) in the office of the Comptroller and Auditor General (C&AG) to recommend an operational framework and a detailed roadmap for its implementation. The Second Administrative Reforms Commission (SARC) in its Fourteenth Report appraised the issue of accrual accounting and recommended that a task force be set up to examine the costs and benefits to the system as well as its applicability in the case of appropriation accounts and finance accounts. The report also underlines the need for training and capacity building; ensuring alignment of the plan, budget and accounts; as well as putting in place a viable financial system of accounts. The Ministry of Finance, in its presentation to the Commission, urged that the changeover to accrual accounting be managed with care and circumspection, given that the process is resource and time intensive, and that its benefits have not been unambiguously proven by international experience. We are satisfied that the issue is receiving close attention from the relevant authorities, and that extant actions by the Central, State and Local Governments are facilitating a 'bubble up' approach to the transition.

13.10 We have recommended several measures to enhance institutional deepening in our report, such as the creation of a council of finance ministers, a fiscal council, a local body ombudsman, etc. This should not be seen in isolation; rather, these are part of the overall effort that needs to be made to improve the quality of public institutions to deliver a framework that is suited to the demands of India, emerging as an important contributor to the growth and stability of the global economy.

13.11 Our report raised several important issues regarding the classification of revenue and capital expenditures. In Para 9.25 of the report, we have made the point that no provision exists to define a grant for creation of assets as a 'capital grant', under existing administrative arrangements. We would urge some thinking on this issue in the medium term. This will also be necessary if disinvestment proceeds are to be deployed for capital investments at the state and local body levels. There are several examples, globally, of solutions to the problem of classification of grants used for capital expenditures. In some cases, grants to finance capital expenditure are classified as 'capital spending' by both the disbursing and the recipient entities. In some other cases, grants provided by one unit of government for capital spending by another unit are classified as 'capital receipts' by the recipient of the grant, but as 'revenue expenditure' in the accounts of the unit providing the grant.

13.12 The fiscal position of many states has undergone a transformation. The states today are, collectively, at the cutting edge of best practices in maintaining prudent and pro-development fiscal policies. For each state taken individually, there is much to learn in terms of best practice from this hugely positive collective experience. Important areas where such best practices can be emulated and implemented include timely and accurate reporting of public sector accounts, engagement with legislative oversight bodies such as Public Accounts Committees, initiatives to independently review and monitor compliance with Fiscal Responsibility Legislation (FRL), effective design of medium term fiscal frameworks and significant progress in the fiscal and operational empowerment of local bodies. Improving quality of public expenditure, which is important for all states, would require independent evaluation of major schemes and projects on a regular basis.

13.13 In the context of modernisation, a comprehensive overhaul of the institutional arrangements for fiscal policy design and formulation is a vital challenge. The principal responsibility for this is vested with the Ministry of Finance. At the central level, the MoF needs to focus more closely on its primary function, which is to deliver and implement a prudent fiscal policy in consonance with the needs of overall development policy making. This would require an acceleration of the measures to shift regulatory and administrative functions into specialised agencies which are distinct from the ministry. In this context, the Commission supports the move to create a National Debt Management Agency (NDMA). Also, in such an economy, MoF, as the main force behind the fiscal responsibility and budget management processes, has to calibrate and implement an increasingly sophisticated roadmap for future fiscal consolidation. This requires considerably enhanced policy formulation and analysis capabilities and a more horizontal and integrated approach to the task than has historically been the case. As India is now a trillion dollar-plus economy, these are requirements for effective implementation of regulation and improved administration.

13.14 The proposed Fiscal Council and Council of Finance Ministers would require such a restructured ministry to be able to do its work optimally and effectively. Further, the issue of disinvestment and public private partnerships will require greater analytical depth to decision making, to make the most of these high-potential policy windows and to maintain and enhance public accountability in these areas. The challenges of medium term fiscal and budget design will also require fundamental changes in the business process of budget and tax policy formulation.

13.15 Finally, and most important in the context of Finance Commissions, we recommend the creation of a new State Finances Division in the Ministry of Finance (MoF) which will have the analytical capabilities to provide policy advice on matters pertaining to inter-governmental fiscal arrangements and financial relations. This division will serve as a national think tank on inter-governmental fiscal matters, a service which, at this point, is only provided by the Reserve Bank of India. It will also be pro-active in monitoring the progress of state level fiscal reforms and implementation of forward looking recommendations of the Finance Commission in letter as well as in spirit.

13.16 We would also recommend the setting up of an ongoing research programme on issues of inter-governmental fiscal federalism in India that could provide inputs to the Ministry of Finance and also serve as a research resource for the work of future Finance Commissions. This research programme should be independently managed by reputed national institutions.

13.17 The Ministry of Finance that is to take charge of policy making in the twenty first century will thus need to be very different in shape and form from that presently in place. We would urge all parties to immediately initiate this important institutional deepening.

13.18 In Chapter 3, we looked at the challenges posed to fiscal federalism by the differential impact of the growth process on different segments of the population and different areas of the country. It is a matter of great potential concern that increases in disparities in growth should not lead to demonstrable differences in access to opportunities and public goods. This is not an issue which can be tackled using the limited instruments of inter-governmental public finance available to the Finance Commission. It is a wider policy issue on which we feel the institutions charged with designing the overall development policy framework of the country, particularly the Planning Commission, should reflect on and address. Fiscal interventions to correct against real and perceived disparities generated by the growth process can only address the symptoms and alleviate the consequences of not securing inclusive growth in all its multiple dimensions. Hence, we would wish to reiterate the importance of securing growth that is inclusive across all the multifarious dimensions that are pertinent in a large, vibrant and variegated country like India.