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Paul Smoke

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Intergovernmental, State and Local Finances

Introduction

The purpose of this note is to comment on the 13th Finance Commission's report with a particular focus on subnational finances. It is divided into three parts. The first part comments on the general approach of the Commission. The second part responds to specific questions raised in the Terms of Reference (ToR) for this note. The third part covers a few additional noteworthy issues that merit special comment.

I. General Approach of the Finance Commission

The 13th Finance Commission has carefully followed the requirements outlined in their ToR (Chapter 2), both the broad mandate regarding the determination of an appropriate vertical and horizontal fiscal balance in the intergovernmental system and a range of related matters affecting the more effective use of public resources for inclusive and sustainable development in India. The process they followed in collecting information, conducting their analyses, developing their recommendations, and preparing their report was extensive, well considered, and well documented.

As summarized in Chapter 2 and documented in its annex, the Commission held numerous and extensive consultations with and secured inputs from a broad based set of government representatives at all levels as well as a range of nongovernmental actors and experts, and they organized (often with other partners) a large number of workshops and seminars on specific priority topics. The Commission organized a number of working groups and task forces that included both Commission members and other experts relevant to specific priority issues. The Commission also reviewed a variety of research efforts (on India and beyond) independently conducted by other parties, conducted some of its own research, and commissioned a wide-ranging set of studies to inform their work.

In communicating their findings, the Commission made regular reference to the specific requirements outlined in their ToR and explained how they approached these requirements. In a number of areas they went beyond the ToR to comment on issues that they felt were of importance to their overall subject matter. The Commission also tried to

be clear and specific about how their approach compared to that of previous recent Finance Commissions and the basis on which they were making recommendations.

Several substantive policy matters covered by the 13th Finance Commission are particularly noteworthy. Throughout the report, there is considerable attention given to:

- The central goal of inclusivity, but in the context of the need to improve the efficiency of resource use; the Commission emphasizes its responsibility to address both equity and efficiency and stresses the feasibility of doing so;

- The pressing need to consider how to better promote both environmental sustainability (including attention to the challenges posed by climate change) and fiscal sustainability (including matters related to fiscal consolidation, subsidy policies, public debt and the commercial viability of public sector undertakings);

- The need for a range of institutional, managerial and governance reforms (often with some specificity about particular priorities); and

- The overarching importance of supporting appropriate capacity development and providing incentives for public sector innovation.

The Commission took great care to think about how to more effectively empower and support local bodies (Panchayati Raj Institutions and Urban Local Bodies) and to consider the role and performance of the state governments and State Finance Commissions in this regard.

The report of the 13th Finance Commission is forthright about the challenges involved in securing and standardizing the information required to conduct their analyses. Some of these relate to differences across states in fiscal needs and capacities, while others are related to how particular services are delivered and how data are kept. Even the estimates of Gross State Domestic Product (GSDP) are subject to debate, and much attention is given (Chapter 7) to the different approaches and results from the various methodologies used to estimate this key variable.

Despite the constraints, the Commission used available information and improvised as needed to ensure that the data are as relevant, complete and consistent across states as possible. The Commission also makes important concrete recommendations regarding how to improve and institutionalize the assembly, maintenance and use of the data required for good fiscal policy development, implementation and monitoring and evaluation in the future.

The 13th Finance Commission, like its predecessors, has had to make many difficult decisions in a challenging environment covering a great range of sometimes competing goals and interests. On balance they have done an exemplary job in navigating this complex landscape and elaborating and justifying their recommendations. There are, of course, various aspects of their analysis and recommendations that might have been

handled differently, and some issues might have received additional consideration. A number of these instances are discussed in the rest of this note.

II. Specific Issues on State Finances in the ToR for the Review

The ToR for preparing this note specifically asked about four state-level issues related to the work and recommendations of the 13th Finance Commission: the progressivity of devolution and horizontal equity; the approach being advised to pursue fiscal adjustment; the considerable use of state-specific grants-in-aid; and the prominent use of incentives to improve fiscal performance. Each of these is discussed in turn.

Progressivity of Devolution and Horizontal Equity

The progressivity of the devolution and addressing horizontal equity seem to have been carefully considered by the 13th Finance Commission. The overall situation is rather complicated with many diverse elements crowding and influencing the system, including Planning Commission and Finance Commission mandates, recommendations and funding channels, as well as the requirements and advice coming from other major actors, such as the Central Pay Commission and various sectoral ministries. This means that some aspects of equity promotion are beyond the specific control of the Finance Commission.

The Commission report makes it clear that such factors, along with the diversity and complexity of the states and the intergovernmental system and data problems, created nontrivial analytical challenges for understanding needs relative to capacity; nevertheless, the Commission generally uses procedures and measures and make recommendations that are consistent with a strong focus on promoting horizontal equity.

The Finance Commission can pursue interjurisdictional equity and help to offset specific state disadvantages through two types of transfer mechanisms, the horizontal sharing of some portion of Union tax revenues with the states and the provision of grants-in-aid to states and local bodies. Transfers formulated through the Finance Commissions have in recent years dominated the overall landscape of transfers from all sources, accounting for an average of 68 percent of the total. Within Finance Commission transfers, there has been a recent tendency to increase the share of grants-in-aid. According to the report of the current Commission, grants are seen as a more effective way of targeting cost disabilities and meeting distributive considerations than tax sharing.

Tax sharing is done through the assignment of a pool of shared Union resources and the development of an allocation formula to distribute it (Chapter 8). The pool has varied across the Finance Commissions in terms of both the sources included in it and the overall volume of resources recommended for sharing relative to total Union revenues. The formula has also differed across Finance Commissions in terms of the individual variables included in it and the specific weights assigned to them.

The 13th Finance Commission made modest changes from their immediate predecessor to the revenue sharing pool. They increased the state portion of shareable taxes from 30.5

to 32 percent and the overall share of central gross revenue receipts from 38 to 39.5 percent on the grounds that the buoyancy of central taxes has been higher than that of state taxes and that the central government has or will take actions (e.g. with respect to food security, social security and land compensation) that nontrivially increase the expenditure commitments of the states. The Commission also made some modifications to the revenue sharing formula (see below).

Grants-in-aid encompass a wide variety of programs that vary to some extent across Commissions (Chapter 12). These include the core non-plan revenue deficit grants (which offset state deficits incurred in funding non-plan expenditures after the effects of tax sharing have been taken into consideration) and a variety of other grants formulated to meet particular objectives. The 13th Tax Commission provided for non-plan revenue deficit grants as well as several sectoral grants (e.g. elementary education, maintenance of roads and bridges, etc.), various special purpose grants (e.g. environmental, disaster relief, etc.), several forms of performance incentive grants, and state-specific grants (based on ad hoc requests to the Finance Commission from the states).

These different types of grants are distributed according to various criteria and rules. Many of them are explicitly designed to have an equalizing effect across the states either with respect to overall financial position or a deficit in some aspect of state finances (including variations in needs and costs of particular services). The recommendations of the Commission on disaster relief (Chapter 11) also promote equity in the sense that they recognize differences in the degree to which states are prone to natural disasters and in the extent to which states have the capacity to respond effectively when disaster strikes.

In considering horizontal equity, the 13th Finance Commission attempts to measure the fiscal capacity differentials across the states for both the sharing of Union revenues (Chapter 8) and the allocation of non-plan revenue deficit grants (Chapter 12). The use of normative (as opposed to historical) fiscal measures in this process—a practice that was once lacking in India—has been pursued to varying degrees by the more recent Finance Commissions. The Finance Commissions were criticized for years by some senior Indian public finance analysts (e.g. based on research conducted by experts at the National Institute of Public Finance and Policy, notably Professor D.K. Srivastava) for following a "gap filling" approach to grant allocation based too heavily on past actual values of fiscal variables, thus potentially undermining incentives for better state fiscal performance. The growing use of norm-based assessments of fiscal needs and revenue capacity is clearly a welcome development and should be expected to help promote greater horizontal equity.

Recent empirical analysis of the overall redistributive effect of fiscal transfers recommended by several immediately previous Finance Commissions (as measured by the responsiveness of per capita fiscal transfers to changes in per capita gross state domestic product—GSDP) confirms the achievement of a degree of horizontal equity. Studies of individual grant programs are not readily available, but several of these grants have been clearly designed to target particular state disadvantages and are thus equity oriented in a more limited sense than with respect to overall GSDP. (Even richer states can of course have areas under their jurisdiction that are disadvantaged in some respects,

and the central government must decide if it is a national responsibility to target such disadvantages or if that should be left to intra-state redistribution policy).

Another relevant factor with respect to horizontal equity is that per capita fiscal transfers have under recent Finance Commissions been considerably higher for the special category states compared to the general category states. Not all of these special category states are among the poorest states, but their finances are collectively more volatile, and their tax to GSDP ratios (historical and projected using a normative approach) are on average considerably lower than those of general category states. In addition, the states that are expected to incur "post-devolution" (after central tax sharing) deficits as calculated under the normative approach of the 13th Finance Commission are all special category states, and their favorable treatment is a stated objective of national policy.

Although there is clearly an effort to promote horizontal equity by the 13th Finance Commission, a few caveats are in order. First, the 13th Finance Commission slightly modified the formula for the sharing of Union revenues compared to the one used by the 12th Finance Commission. They maintained a 25 percent weight on population (as a side note, it is not really made clear why the Finance Commissions continue to use population figures based on the 1971 Census, although this is a requirement in their ToR and not the decision of the Commission) and a 10 percent weight on area. The Commission modestly reduced the weight on the fiscal distance measure from 50 to 47.5 percent, assigning a 17.5 percent weight to fiscal discipline (which combined the tax effort and fiscal discipline variables used by the 12th Finance Commission at 7.5 percent each and added the 2.5 percent taken away from the weight on the fiscal distance measure).

Although these modifications represent a relatively modest change in the revenue sharing formula, they are noted here because the fiscal distance variable is the one most associated with redistribution. There is empirical evidence that the 11th Finance Commission, which placed the highest weight on this particular measure, achieved the greatest historical degree of horizontal equity (measure by the responsiveness of per capita fiscal transfers to changes in per capita GSDP) among all of the Finance Commissions for which this specific relationship has been studied.

Second, past critics of the Finance Commissions have noted that despite the progress in using norms to measure fiscal gaps, this practice has been more limited and ad hoc on the expenditure side, so that a definitive assessment is not possible. The full details of how norms were developed and applied are not provided in the Finance Commission report. There is some information in Chapter 7 about how expenditure estimates were developed for non-plan expenditures, particularly salaries, pensions, interest payments, etc., but service delivery expenditures (maintenance) were individually estimated only for a few specific sectors.

There is also treatment in Chapter 12 of how selected sectoral expenditure needs were determined for allocating a number of individual grant-in-aid programs, but there seems to have been reliance on policy parameters and data provided by a various other agencies and line ministries. The technical details of how they were determined is not provided,

although in some cases, such as the grant for elementary education, it is evident that there has been considerable experimentation with financing schemes and extensive study of effects and options. Thus, it seems likely that some needs are estimated with more solid empirical evidence than others.

On balance, there is clearly an attempt to use norms and to take into consideration the expenditure needs of disadvantaged states. At the same time, the many assumptions and complications used in developing some of these estimates (and in some cases the lack of detailed information provided) preclude a definitive independent evaluation of whether the present approach to expenditure needs estimation is substantially more normative than under previous Commissions and what this implies for redistributive impact.

Third, it is important to underscore the fact that the Finance Commission awards are not the only resources provided to states. Analysts of Indian public finance have long lamented the lack of harmonization between Finance Commission awards and the Five-Year Plan periods and programs, and in recent years there have been efforts to improve links between the two. Although the 13th Commission builds on recent efforts to better tie Finance Commission recommendations to Planning Commission recommendations, the overall equity effect of the multiple allocations is not documented, and it is not clear that the required information is readily available. The situation is further complicated by the fact that some resources are not being used as intended (e.g., the special category states have apparently been using Plan assistance to meet non-plan needs, a practice against which the 13th Finance Commission has taken a strong stand).

In summary, there is every indication that the 13th Finance Commission has made great efforts to promote horizontal equity and to deal with special needs of handicapped states. At the same time, a definitive assessment of the Commission's recommendations is hindered by the complexity of factors in play and important data limitations. A variety of other issues discussed below also have some implications for overall equity.

Fiscal Adjustment Prescription

The TOR ask about the adequacy of a 'one size fits all' fiscal adjustment prescription for the states. Depending on how uniformity is defined, it is debatable that "one size fits all" is an accurate characterization of the 13th Finance Commission approach. It is true that the Commission's fiscal consolidation recommendations (Chapter 9) push states towards the same fiscal deficit target goals, but the recommendations differentiate between the paths to be taken by general category states and special category states, and there is also some differentiation within each of the categories. In addition, embedded throughout many other policies and recommendations in the report on specific elements of the fiscal system—including types of transfers, borrowing channels and debt relief policies—are approaches that to differing degrees treat states asymmetrically based on state category and characteristics, with a focus on dealing with documented disadvantages.

The TOR ask if the 13th Finance Commission should have encouraged some states to spend more and catch up and whether states are being 'punished' for good behavior in the

past because the Commission chose as base a high-growth year in which some states were running a balanced current account because of limited capacity to spend. A number of the expenditure and fiscal transfer policies outlined in the report are aimed at encouraging some states to spend more in critical areas, but it is hard to determine from the information in the report whether the likely effects of such policies will be sufficient (e.g. if the incentives are properly designed and whether states will have the capacity to take advantage of them or try to circumvent them) and indeed even to judge what constitutes "sufficient" in this complex landscape. There is always an element of subjectivity in defining such policy goals and their relative priority in the larger picture.

The issue of whether the 13th Finance Commission has potentially biased some of its analysis and recommendations by choosing a high-growth year as the base year for its approach is also difficult to answer definitively. The recommendations on fiscal consolidation in fact use different bases for the general category and special category states, with fiscal year 2007-2008 as the base for the former, and the average of fiscal years 2005-06, 2006-07 and 2007-08 as the base for the latter (on the grounds that they are typically subject to more volatile fiscal parameters).

Although fiscal year 2007-08 was a year of relatively strong fiscal performance, in many states it seems to have been just one point in what was a generally upward trend (across the limited years for which data were provided in the report) that generally exceeded the projections of the 12th Finance Commission before it was abruptly interrupted by the global financial and economic crisis in 2008-09. Moreover, the fiscal performance of a number of the states (both general and special category) in 2007-08 was essentially flat or even declined from the previous year, indicating that the chosen base year was not uniformly a zenith fiscal performance year. Given these various considerations, the approach taken by the Commission on balance seems reasonable.

Regarding the issue of whether some of the states were running a fiscal surplus simply because of their limited capacity to spend, this is acknowledged to be the case and is not uncommon in other countries. The 13th Finance Commission, however, seems to credit the state surpluses substantially to the enactment and enforcement of robust state Fiscal Responsibility Legislation and increases in the state shares of national resources. On the other hand, a number of the direct policy recommendations of the 13th Finance Commission are intended to create specific incentives and build capacity for increased spending and improved fiscal performance, so they are clearly not ignoring the capacity problem. Again, whether these policies will be adopted and how well they will work remains to be seen.

In summary, the fiscal adjustment recommendations of the 13th Finance Commission seem to be generally well considered and reasonable based on available information. At the same time, there are some issues regarding the data on which the Commission based its recommendations as well as a number of uncertainties with respect to how future shifts in conditions may influence the implementation and effects of these recommendations. As the implementation of fiscal adjustment proceeds, careful and

regular monitoring would certainly be in order to see if modifications to the recommendations might be warranted.

State Specific Requests for Grants

Generally speaking, there may be grounds to be concerned about the extent to which the 13th Finance Commission has granted extensive and diverse specific requests of the various states for particular grants-in-aid (Chapter 12). On the one hand, the Commission visited every state and conducted broad based consultations with relevant stakeholders, including national ministries with concerns about particular types of institutional, capacity and expenditure gaps in specific states. Thus, it seems likely that the Commission's state-specific grants have been designed to meet genuinely expressed local needs and priorities that also coincide with certain priority national interests.

The variety of purposes for which the 13th Finance Commission has recommended specific grants is considerable, ranging from support of particular public services in specific areas to broader purposes, such as promoting local culture or local economic development. Some grants are targeted to facility construction, while others are for operation and maintenance. There are also institutional development grants, ranging from the support of capacity building programs to the establishment of new centers. The Commission justifies these awards as filling important local needs that might otherwise remain unfunded.

On the other hand, international best practice in intergovernmental fiscal relations is generally moving away from such project/program specific financing, focusing instead on the use of general purpose (unconditional) grants and selected conditional grants in priority sectors (sometimes allowing substantial subnational spending discretion within the parameters imposed by broad sector-specific conditions). Some of the countries that have undertaken high-profile decentralizations in recent years, such as Indonesia, the Philippines, South Africa and Uganda, have relied heavily on unconditional transfers, although the systems have been to some extent modified to reduce discretion in some of these countries since the original design.

The practice of a national level commission making ad hoc discretionary decisions about the funding of a broad and diverse range of subnational expenditures seems more consistent with the operations of a centralized deconcentrated system with paternalistic instincts and a desire to keep a portion of shared resources subject to central direction rather than the operations of a devolved federal system that is trying to increase genuine devolution and improve transparency and subnational governance/accountability. Making decisions about such a wide range of qualitatively different awards is necessarily a somewhat subjective and non-transparent exercise, and therefore subject to potentially arbitrary or manipulative allocation. And although state-specific grants do not account for a dominant portion of grants-in-aid, at nearly nine percent of the overall total, they are not trivial either.

Current international best practice in a devolved system would generally be to provide states with additional unconditional funding if more resources are deemed necessary to help fund priority expenditures that fall under their functional mandates. There would be no need for special provisions for such a mechanism in India since there is already a mechanism in place to share resources. At the same time, there may be important political and practical benefits to having a dedicated grant for special state needs. If resources intended to help states to meet special needs were simply folded into a large general-purpose transfer, they could end up being diverted by subnational authorities for any number of purposes. While such diversions may be consistent with subnational democratic decision-making in a devolved system, some potentially productive special needs projects that also meet national priorities and serve consequential political interests might end up being unfunded.

There are ways of crafting compromises between project/program specific grants and additional unconditional resources. For example, it would be possible to provide each state with a semi-conditional block of funding that is not tied to specific individual programs or projects, but which can only be used by a state to fund expenditures that meet certain transparent criteria. These could be based on targeting characteristics of some area of the state (e.g. predominance of marginalized populations, international border areas, sites of historical significance, etc.) or factors that affect the ability of states to meet service needs due to cost or capacity issues (e.g. water contamination or scarcity, lack of facilities or trained staff, etc.)

Of course, the Finance Commission did take some of these types of considerations into account in awarding state specific grants, but it appears to have done so in a rather informal way that seems not entirely consistent with the emphasis in the rest of the report on the methodical and objective use of data and the insistence on fostering transparency. This situation may just be a function of the common difficulties associated with changing the practices that the various parties involved are accustomed to. It might be useful to consider if and how in the future it might be possible to meet the types of needs targeted by the state-specific grants in a more systematic and objectively verifiable way that both targets specific priorities and makes the basis of the grants clearer to the beneficiaries. At the same time, there is always and everywhere an element of politics in allocating grants, so expectations about what could be done must obviously be politically feasible.

Incentive or Performance-Based Grants

The introduction or expansion of incentive or performance-based grants as part of the intergovernmental fiscal system has increased substantially around the world in recent years. Thus, 13th Finance Commission's recommended use of grants-in-aid to incentivize managerial reforms, spending in social sectors, and structural reforms (e.g. judicial reforms) is broadly consistent with some of the recent and prominent intergovernmental fiscal reforms being pursued in other countries around the world.

There has, however, been some controversy about the use of performance-based grants, in part because traditional fiscal federalism suggests that local political mechanisms

should be operating by responding—within the boundaries imposed by the legal parameters of devolved functions and resources—to the expressed preferences of their citizens with minimal central government interference. This approach is laudable in principle, but some analysts seem to forget that fiscal federalism also implicitly assumes that local political and institutional systems have sufficient capacity and are subject to appropriate incentives to identify and respond to these local preferences, and that local people are both willing and able to express their preferences. This of course is often not the case—problems of marginalized populations, limited capacity, weak governance, elite capture, corruption and the like are common around the world, and there is general agreement that the central government bears responsibility for helping to develop appropriate systems, capacities and incentives.

Another consideration is that the basic systems and operational procedures needed for good subnational government performance in many developing and/or newly decentralizing countries are new or still in the process of being developed. Performance (or perhaps more accurately compliance) grants have been used to encourage the development and institutionalization of basic systems and procedures (see below). In addition, certain devolved or partially devolved services in many countries meet important national objectives, such that the development and enforcement of performance standards (for inputs and/or outputs) is perfectly legitimate and widely practiced both by national (for state/regional) and state/regional (for local) governments even in some highly devolved countries, particularly when centrally raised resources are being provided. Collectively, these factors suggest that the use of performance-based grants has the potential to be productive under certain circumstances if they are properly designed and targeted, although securing required data and properly measuring performance could be very challenging.

Unfortunately, there are not well proven examples of how performance-based grants could be useful in India, at least not for the more urbanized or higher-capacity areas. Most experience with performance-based grants to date has been in countries where limited capacity exists and basic systems are being developed. In some cases these grants are rather limited in volume. Kenya, for example, faced an environment in which nontrivially empowered local governments were not performing well even in terms of complying with basic public financial management requirements, so the Ministry of Finance dedicated a small portion of national income taxes to the Local Authority Transfer Fund for allocation by an objective formula to local governments. In order to ensure that basic financial accounts were being kept, however, a substantial portion of these funds could be withheld if local governments did not meet certain reporting obligations.

In other countries that have adopted performance based grants, such as Uganda, the amount of funding was more significant and the conditions more elaborate. Local governments also receive formula based allocations, but they are not entitled to receive any funding if they do not meet certain minimum conditions, in which case they receive only a capacity building grant to help them become eligible in future years. For local governments that meet the minimum conditions, their allocation in a particular year is

adjusted on the basis of the extent to which they meet certain (mostly compliance rather than output related) performance criteria. If they meet these criteria, they receive their full formula-determined allocation. If they exceed the criteria, they receive a bonus allocation, and if they fall short of the criteria, part of their allocation is withheld.

Unfortunately, there is no track record of genuinely output-based performance grants, such that state or local governments are rewarded or penalized for meeting or not meeting service delivery or other output or outcome targets. Such a transfer system would be data intensive because it would require a baseline that allows reasonable performance targets above current levels to be set for local governments with very different starting points. In addition, changes in service delivery performance often take some time to realize, and in many cases great progress could not be expected over the course of just a year or two. Nevertheless, a number of countries, including Indonesia and the Philippines, are in the process of designing or experimenting with output related performance based grants, so there will be some evidence emerging in the coming years.

If India wishes to consider the further development of such schemes, there are many purposes to which subnational government incentives could be put by the central government, ranging from the more limited goal of facilitating the adoption and performance of very specific system and procedural reform programs to the broader goal of promoting national priority expenditure objectives and broader development policies. Some of the major targets in recent performance schemes include:

- *Adoption of System Reforms:* Basic performance incentive efforts sometimes target simple reform adoption, and many of these, particularly in less and least developed countries, focus mainly on the development of some limited aspect(s) of the basic intergovernmental fiscal, administrative and legal system and its operating procedures. Such technical reforms are generally seen as contributing to improved governance and accountability through more efficient and transparent public sector conduct. Some accountability reforms may go beyond the basic elements of the system by trying to facilitate more direct engagement with citizens, e.g. through the mandatory adoption of participatory approaches or other citizen consultation and feedback mechanisms (generally at the local rather than the state level), as in the case of Cambodia.

- *Fiscal, Economic and Social Performance Targets:* Beyond the adoption of basic system and process reforms, incentives in grant systems can be used to stimulate improved fiscal behavior/aggregate budget performance, more or better local government service delivery in any number of sectors for which subnational governments have responsibility, and enhanced own-source revenue generation. These targets can be framed and pursued in a variety of ways. Incentives can also be provided to facilitate behavior that is intended to support other priority public sector goals and policies beyond various aspects of fiscal performance. These can be broad and multi-faceted, such as poverty reduction, or more limited in scope, such as pollution control or other environmental friendly behavior.

- *Innovation:* Central governments can use performance incentives to encourage local governments to try new ways of doing business. Examples include the adoption of new types of efficiency enhancing technology, the use of public-private partnerships in service delivery, the pursuit of joint initiatives with other governments (inter-jurisdictional cooperation), or efforts that create linkages with community driven development (CDD) activities (which are often supported by nongovernmental or external actors quite separately from the support of subnational governments). These types of initiatives would be appropriate when there are proven benefits from pursuing such innovations, or when the national government wishes to create an environment conducive to experimentation with alternative mechanisms to see if such benefits materialize.

The 13th Finance Commission in fact has in different ways and to varying extents recommended the use of all of these kinds of performance-based grants (Chapter 12). They propose a number of grants that provide incentives for promoting the development of specific components of the subnational government system and its operation (e.g. developing and using biometric identification to improve the targeting of subsidies), attaining specific output targets (e.g., achievement of renewable energy capacity, protection of forests, reduction of infant mortality rates), improving overall fiscal performance (e.g., grants that reward three special category states that have made particular progress in fiscal performance), and for the creation or development of institutions intended to improve various aspects of performance (e.g. independent regulatory mechanisms in the water sector, institutional support for the improvement of justice delivery, training and capacity building programs, development of systems and funds that support innovation, etc.).

Many of the incentive schemes are targeted at important problems and needs, and they probably increase incentives for various types of desirable behavior. There are, however, a number of possible concerns. First, with respect to the identification and breadth of specific incentives, there are many different types of schemes being proposed. Such a large number of programs is potentially cumbersome to manage, and it is likely that they would be at least partly managed by different agencies that are not well coordinated. Under such circumstances, the net overall effect of the programs is likely to be uncertain, for example, with respect to broader equity goals.

Equally relevant is the question of why the Commission decided to include this particular set of incentives and not others. In fairness, of course, such performance incentive instruments could be used for an enormous variety of purposes—everything cannot occur at once and the Commission obviously had to start somewhere, and most likely the decision was in part pragmatic in the sense of selecting programs for which some data are available and the relevant national agency is willing. The Commission report does try to justify both normatively and pragmatically the importance of the specific incentive schemes they have recommended for adoption, although more substantially on their own individual terms rather than in the context of the broader set of objectives and programs that might have been considered or included.

Second, the direction of grants under the recommendations of this Finance Commission seems to reinforce a broader trend in Indian intergovernmental finance for the central government to get more heavily involved in influencing the ways that state governments use the national resources transferred to them. A substantial portion of Plan grants has apparently become more conditional in recent years, there has been a general increase in the use of Centrally Sponsored Schemes (CSS) and related state matching requirements, while formula based assistance has declined as a percentage of Plan grants. The 13th Finance Commission in fact expresses the opinion (Chapter 4) that there should be a reduction in the use of these CSS and an increase in the less conditional formula-based Plan transfers.

The total 13th Finance Commission grants are at about the same (slightly lower) percentage of total Finance Commission transfers as they were under the previous Commission, but the non-plan revenue deficit grants have dramatically declined from nearly 40 percent to just over 16 percent of total grants, the lowest figure ever for any Finance Commission. The Commission position justifies this shift away from non-plan revenue deficit grants primarily because of the generally improved fiscal position of the states (leaving aside the recent adjustments in response to global trends, which the Commission believes can be corrected and improved on over the applicable period of its recommendations).

At the same time, it is also clear that the Commission is trying to take seriously the mandate of their ToR to pay more attention to performance and service quality. This implies that at least to some extent, the 13th Finance Commission is less concerned about imposing additional central direction on the use of Finance Commission resources and more concerned with trying to improve the efficiency in how these resources are used and to ensure that these resources will lead to broader and better service delivery for the citizens of India.

Finally, the multiplicity of incentive schemes raises potential concerns about incentives faced by and absorptive capacity of the states and the central agencies that will have to monitor and enforce compliance with the incentives (which in weak institutional and/or politicized environments also opens the system to manipulation), as well as the overall trajectory of improvements in the use of appropriate systems and procedures. One of the challenges of such ambitious initiatives is of course the effort involved in making them happen on the ground.

The Commission at some level recognizes this challenge and makes recommendations to support the chances of success, including with respect to capacity development and the improvement and regularization of basic data systems. These are, however, extremely demanding types of reforms that require major behavioral changes and may be subject to unintended obstacles and consequences. How this will all work out very much remains to be seen.

Overall the increased emphasis of the 13th Finance Commission on adopting incentive schemes in an environment where there have been serious concerns raised about state

government performance is a noteworthy and positive development. It would, however, be important to carefully monitor how these schemes unfold and what types of effects they have so that their performance can be adequately assessed and adjustments can be made as necessary.

III. Additional Issues

A number of additional topics covered by the report of the 13th Finance Commission merit special mention. These include the specific attention give to local bodies, the recommendations regarding the Goods and Services Tax (GST), and the focus on the broader development of the intergovernmental fiscal system.

Attention to Local Bodies

The 13th Finance Commission has made great advances in the degree of consideration that they give to the local bodies (Chapter 10)—Panchayati Raj Institutions (PRI) and Urban Local Bodies (ULB). Since the 73rd and 74th amendments to the Constitution in 1993, the development of these bodies has received considerable attention but more limited action. The 10th Finance Commission made some recommendations on its own initiative (i.e. without a specific mandate) for supporting local bodies and the 11th and 12th Finance Commissions had responsibilities in their respective ToR and made a number of recommendations in this regard.

The amounts allocated by these previous Commissions had steadily increased, but they were not fully utilized and were subject to range of conditionalities that apparently affected performance. The less-than-anticipated results under these previous Finance Commissions have partly been attributed to the role of State Finance Commissions (SFCs) and state governments in defining, implementing and influencing local fiscal affairs in individual states. This process has been plagued by challenges and the results have varied considerably across states. The 11th and 12th Commissions made several recommendations for reforms on this front, including on improving the functioning and reporting of the SFCs.

The 13th Finance Commission received a considerable volume of input expressing concern about the ad hoc approach and limited attention of earlier Commissions to dealing with local bodies and the inadequate volume of resources provided to them relative to their needs. The Commission built its approach based on many factors—recommendations from the Planning Commission (and provisions in the 11th Plan document), the Second Administrative Reform Commission, and the National Commission to Review the Working of the Constitution, as well as information drawn from broad consultation with interested parties on all aspects of the functioning of local bodies. The vast majority of this input supports enhancing the role of local bodies, providing them with a larger share of (and more stable and buoyant) resources, and helping them to develop the systems, capacity and accountability (including public

consultation) mechanisms that they need to fulfill their constitutional mandates as the level of government closest to the citizens.

The specific recommendations of the Commission include the allocation of a percentage of the divisible pool of taxes over and above the state share through a local grant-in-aid program. In the first year of the period, this would be 1.5 percent for the general basic grant (with a portion dedicated to special areas), while performance grants would be phased in during subsequent years as local bodies meet certain requirements. The state shares are determined by a formula dominated by population but which also includes a number of other measures intended to capture needs, equity, and degree of devolution (intended as an incentive for the state governments to empower local bodies).

Under the system proposed by the 13th Finance Commission, states cannot receive the allocations for their constituent local bodies until they have met certain conditions. Although at first glance it may not seem right to deprive local bodies of resources because states are not performing as required, the conditions recommended by the Commission are designed to help ensure that resources will reach in fact reach local bodies in a timely manner and that they will be subject to appropriate management and oversight.

The funds allocated to the performance grants are also subject to conditions, but on local bodies. These conditions are, however, aimed at the adoption and development of good systems and processes rather than at controlling the expenditures of local bodies. In this regard, they are consistent with the use of performance-based grants in some other countries, such as those noted above, as compliance mechanisms that reward local governments for using officially defined planning, budgeting and financial management processes intended to improve capacity, accountability and fiscal responsibility without interfering with their autonomy to allocate resources for locally determined priorities.

Overall this approach to sharing revenue with local bodies makes sense. At the same time, it should be noted that although the amount being allocated through the transfers for the local bodies is considerably larger than it has been in the past and is at present, it is still rather modest by international standards (and relative to the recommendations provided to the Commission by the Ministry of Panchayati Raj and the Ministry of Urban Development, among others). The overall level of 1.5 percent of the divisible pool for local bodies is much smaller, for example, than the Philippines (40 percent of internal revenues), Indonesia (26 percent of domestic revenues), Uganda (24 percent of the national budget), Kenya (15 percent of domestic revenues) and even Cambodia (3 percent of domestic revenues). In each of these cases, the constitution or relevant legislation also allows for additional general revenue sharing or the dedication of additional resources for conditional transfers. It is, however, not straightforward to compare these or other countries directly to India. Some other resources do pass from Indian states to local governments, and in some of the other country examples provided, there are no state/regional governments (Kenya and Uganda) or state/regional governments receive some (relatively modest) share of the specified allocations (Philippines and Indonesia). Thus, a more elaborate analysis would be required to do a more useful comparison.

Without more detailed information on and analysis of exactly what local bodies do, how much their functions should cost, how states share other types of resources with local bodies, and how much local bodies should be able to raise from their own sources of revenue, however, it is difficult to meaningfully comment on the adequacy of the resources being provided. And of course in India there is considerable variation in state-local relations and available information across states, as discussed in the Commission report, so doing the required analysis in a comprehensive and robust manner is difficult.

Another consideration is that the practice of providing grants to local bodies through intermediate tiers of government is widely, although not uniformly, considered undesirable by intergovernmental finance specialists based both on normative grounds and on problematic international experience (such as the retention of funds targeted to local governments by state governments in some countries, including Nigeria and Mexico). A number of other prominent federal or multi-tiered systems, such as Brazil, the Philippines, Indonesia and South Africa, provide transfers directly from the central government to municipal governments. The current approach, however, is probably legally necessary in India at the present time given provisions of the Constitution and its relevant amendments. It may also be the case that in a country as large as India, it is not reasonable to expect the central government to effectively manage grants to local bodies, especially ones that require detailed knowledge of local needs and the monitoring of compliance with the requirements of performance-based grants.

Finally, the program details and requirements are rather expansive, and it remains to be seen whether the complexity of the recommended program will jeopardize its effective implementation. In particular, the oversight mechanisms required to manage this type of system are considerable, and this has posed challenges in other countries that have adopted a similar, even much simpler approach. The Commission recognizes this reality and outlines the key needs in this area, but they also note several times that similar recommendations for system development by previous Finance Commissions remain unimplemented. This of course begs the question of whether the recommendations of this Commission will be adopted.

Beyond their recommendations on transfers to local bodies, the 13th Finance Commission makes recommendations about other steps that need to be taken to genuinely empower local bodies. These include institutional consolidation (e.g. the dissolution of development authorities and the assumption of their functions by the appropriate local government body); the strengthening of local own source-revenues (in policy and administrative terms); and providing for adequate and appropriate access to local capital finance (including pooled financing arrangements), among others.

Throughout the chapter on local bodies, there is recognition of the need to build better systems and capacity, although the exact approach to this challenging demand is not given much attention. In many of the Commission's recommendations, there is an emphasis on the use of incentives, and the acknowledgement that better data are needed in order to be able to do this and monitor performance. Also of note, the Commission has

repeated the sensible calls of their predecessors for the State Finance Commissions to improve their operations and to standardize their reporting so that it is easier for the central government to better understand and compare what is going on in the various states.

In summary, the 13th Finance Commission has done an admirable job of outlining the needs and challenges involved in improving the performance of local bodies. This is a complex matter that was only one part of their substantial charge, so they were not able to deal with all of the pressing issues in great detail, and it is impossible to do justice to the issues in a short note of this nature. At the same time, it is important in closing this discussion to emphasize that much remains to be done to develop the local bodies.

Before long two decades will have passed since the passage of the constitutional amendments intended to strengthen local bodies in recognition of the critical role they should play in both democracy and development in India. Given the considerable discretion allowed to dissimilarly inclined state governments regarding how to empower and develop local bodies and the powerful role of the differentially performing State Finance Commissions, progress has been generally slow and uneven. The efforts of the 13th Finance Commission make a contribution in helping to improve on the status quo; however, if more significant and steadier progress is to be made on this front, concerted national action will be required.

Key issues in this regard include continuing to improve coordination of the Finance and Planning Commissions and other key national bodies that affect subnational government responsibilities and funding; further steps to encourage states and State Finance Commissions to further empower local bodies; and efforts to develop technical and governance capacity of local bodies to effectively and accountably respond to the needs of citizens. The challenges are great and the situation is complex, but it should be possible to advance on these fronts if the political incentives and will exist to do so.

Goods and Services Tax

The report of the 13th Finance Commission contains a chapter on the proposed Goods and Services Tax (GST). This could be a major development for state finances, in part because it is expected to subsume a number of existing taxes and thus lead to a consolidation of the overall tax system. It is not possible to know how at the moment how the adoption of the GST will affect the fiscal situation of the states since the details of the tax have not yet been determined. There are sure to be different impacts across states, and some states specifically expressed concern to the Commission about the possibility of suffering nontrivial losses when the GST is implemented.

On the other hand, the Commission has made a considerable effort to provide for a transition process and to develop the GST under an inclusive “Grand Bargain” agreement between the central government and the states that would help to ensure that the design and implementation of the tax would be generally considered fair. In addition, the Commission has recommended the development of a compensation scheme that would

offset the impact of the tax on adversely affected states (if they follow the terms they agree to in the Grand Bargain). Overall, it is hard to say from available information how the adoption of GST and compensation schemes associated with it will affect the states, but the basic reform is a positive development.

Broader Development of the Intergovernmental Fiscal System

The ToR of the 13th Finance Commission obviously require them to focus on how to share resources among levels of government in India. As indicated throughout this note, the Commission has done an exemplary job in this regard. But they have also usefully and insightfully brought attention to many other elements of the overall system that create challenges and present opportunities for the effective generation and use of public resources in the context of promoting growth, inclusivity and sustainability. These elements fall into several categories that encompass a variety of reforms (some of which have already been mentioned above).

First, there is a sharp focus on reforming certain fiscal policies that affect the finances of the states and their ability to meet their obligations. These include the development of a more sophisticated and flexible Medium Term Fiscal Plan, the adoption of major tax reforms (including GST and the new Direct Tax Code), the reconsideration and rationalization of subsidy policies, the promotion of capital expenditures for needed public investment, and the creation of appropriate incentives for good fiscal behavior by the states, among others.

Second, there are a number of important recommendations for institutional reforms, including improvement and enforcement of fiscal responsibility legislation, the reform of public sector undertakings, the development of stronger regulatory agencies in some sectors, the consolidation of certain agencies with overlapping functions and/or weak performance, and the operations of the State Finance Commissions, among others

Third, there is considerable concern with financial and other managerial reforms, including the adoption of a uniform coding system for subnational accounting, the reduction/elimination of funding channels that operate outside the budget framework, the statement of revenue consequences of capital expenditures, and the improvement of auditing, among others.

Fourth, there is much explicit recognition that the recommended reforms cannot be successful without having necessary information and capacity. Accordingly, there is a great deal of emphasis on creating or improving and institutionalizing mechanisms for data assembly and analysis and the development of capacity needed to implement the new systems and to improve monitoring and evaluation of processes and outcomes. Future Finance Commissions would greatly benefit from the adoption of such reforms.

Finally, in looking forward the 13th Finance Commission believes that Finance Commission recommendations should be modifiable as needed to respond to emerging information about performance and changing conditions. Thus, they would like to see

the flexibility to update revenue sharing and grant-in-aid parameters during the award period of a Commission and not just when the awards are made every five years. This would be a very positive development, although it would, as the Commission acknowledges, depend on creating and institutionalizing the more sophisticated type of data system envisioned by the Commission.