Data, Transparency and Innovation in Resource Allocation: The Experience of the Finance Commission of India and State Finance Commissions

Abstract: The Finance Commission of India is a constitutional innovation that has helped build and strengthen India’s federal structure. Its recommendations on allocation of financial resources between Union and State governments are generally accepted in their entirety by union governments irrespective of party in power. However, State Finance Commissions which are supposed to perform the same function vis a vis State and local bodies have been less than effective in the same respect. This paper will try to look at underlying issues arising out of the constitutional design of these institutions and what can be done to address their shortcomings. At the same time, thanks to the introduction of the Goods and Service Tax, there is availability of high volume data that can help the way in which tax resources can be most efficiently allocated to the parts of the country which need it the most. This paper briefly explores how this might be possible in the Indian context and what relevance it could hold for Nepal.

I. Introduction:

It is perhaps virtually impossible in any federal polity to ensure a completely fair and efficient division of taxing powers such that every unit, at every level is completely self-sufficient in all matters of revenue. There is therefore some imbalance in the way taxing powers are divided between the national and sub-national legislatures. The tighter national integration of an economy might make it more efficient to give greater taxing powers to the national government allowing them to mobilise more resources, more efficiently in national interest. This therefore brings up the need for a mechanism to ensure a fair and equitable mechanism for the devolution of funds from the national to sub-national governments. Such a mechanism can only be fair and efficient if it is not entirely subject to partisan politics and can inspire the confidence of the sub-national units in its competence and suitability for this task. Usually, this task is therefore entrusted to an expert body which is tasked with coming up with the the principles and specifics of such resource sharing.

In India, the constitutional body in charge of this exercise - namely the division of tax revenue between the Union and State Government - is done by the Finance Commission of India. The FCI is not a permanent body but is constituted once every five years and its recommendations on the division of Union and State financial resources are effective for a period of five years until the next FCI is set up. On occasion, as happened during the Covid-19 pandemic, an extension is granted. As on date, the sixteenth FCI is in the process of being set up and it is expected to start its work at the end of November.

While this is the mechanism at the Union level, there is provision for a similar body at the State level, called the State Finance Commission (SFC), which performs a similar function but in the context of the State government and local self government bodies. In rural areas of

India, such bodies are the Panchayati Raj Institutions (PRIs) and Urban Local Bodies (ULBs). The concept of a SFC was introduced into the Constitution as a result of the 73rd and 74th Amendments in 1992 to the Constitution which sought to strengthen the third tier of government.

In this paper I will examine the relative strengths and weaknesses of the FCI and the SFCs both in terms of constitutional design and their effectiveness as bodies. In the first part of the paper I will focus on the FCI on these aspects and in the second part of the paper, I will focus on the SFCs. In either case I will be outlining the constitutional provisions which govern their work, the historical record of the FCI and SFCs and what other academic studies have had to say about their success or failure. Since neither the FCI nor the SFCs are permanent bodies, they cannot be spoken of as institutions in the same way as say the Supreme Court of India or the Election Commission of India given the lack of continuity and identity. However, on their own terms, on whether they have been able to influence the sharing of resources between the respective levels of government, we can see that while the FCI has been a qualified success over the years, SFCs do not seem to have had the same impact. In this paper I will try to explore why by looking at the constitutional design of these institutions and the differences between the two.

I may add a caveat here that the organisation that I am currently a co-founder of, Vidhi Centre for Legal Policy, has submitted research papers to the Fourteenth and Fifteenth FCIs. I was personally involved with this work in the context of the Fourteenth FCI. However, all the views expressed in this paper are purely my own and should not be attributed to either Vidhi or any past FCI.

Finally, in keeping with the theme of the paper, I will conclude by looking at how the functioning of these institutions can be improved through the better use of data and what lessons it might hold for Nepal. I believe that FCI and SFCs should be studied together as it is easier to discern what makes one more successful than the other as an institution in charge of financial resource allocation. A comparative study of the two sets of institutions provides a good basis to unearth what makes such an institution gain credibility and what might get in the way of such institutions developing credibility.

II. Finance Commission of India:

While the Constitution of India did build on top of some quasi-federal structures that were put in place as a result of the Government of India Act, 1935, there were, nonetheless, unique features in independent India’s federal structure that were not found prior to independence. One of these is the FCI.

Under India’s federal system of government, both the Union and State governments have the power to levy and collect taxes though the subject matter of such taxes are obviously different. While state governments are permitted to keep the entirety of the tax revenue that they collect, the Union government is required to share a certain part of its tax revenue with the state government. Given the subject matters of Union tax - income tax, corporation tax, customs, excise duty, et al which are collected on a nation-wide basis, the pool of revenue that the Union can collect is much wider than the taxes states can collect. However, the Union Government is not required to share in any fees and non-tax revenues that it collects under any law. Somewhat controversially, neither is it required to share revenue collected as a "cess". This has meant that a lot of union revenue is now getting collected as cess and not being shared with the States

It is the constitutional responsibility of the FCI to divide the tax revenues of the Union Government between the Union and the State and between the States as well. The former is called vertical devolution and the latter, horizontal devolution. As of 2023, 41% of the Union Government's tax revenues are to be shared with the States as part of vertical devolution. For horizontal devolution on the other hand, an elaborate formula has been evolved over the years to determine how much each state will get. As per the 15th Finance Commission's report, this formula takes into account the relative wealth, the population, the area, demographic change, tax collection efficiency, among other metrics. These metrics are a reflection of the principles which the FCI tries to follow in its allocation of revenue between the states. In addition, the FCI also makes recommendations to the Union Government on grants that it ought to give states and other policy recommendations for better collection of revenue.

Though there is no constitutional requirement that the FCI's recommendations are binding on the Union government, successive Union Governments, irrespective of party in power have accepted the FCI's recommendations and accepted upon them, at least as far as revenue share is concerned. Going only by the text of the Constitution, the FCI is just a body to "advise" the President of India on the allocation of revenues but a convention has arisen that its recommendations have been treated as binding by successive Union Governments. In addition, it is perhaps a testament to the increasing state capacity at the State level and the strengthening of federal government in India that the share of the states, in terms of vertical devolution, has increased over the years.

Part of this success may also be attributed to the process that the FCI follows and the transparency with which it functions. The FCI, soon after constitution, usually consults with all the relevant government stakeholders, both at the Union and State levels. Of late, it has also interacted with the local self government bodies and their representatives, apart from reaching out to experts and the general public in order to prepare their reports. The reports themselves are made public and give complete calculations and breakdowns of how the FCI arrived at its conclusions about the horizontal and vertical devolution. The chart below shows the latest criteria used and the relative weightage given to each metric.

Has the FCI been a complete and unqualified success? Perhaps not and the persistence of the 3-3-3 problem in India might suggest that there is much more thinking that needs to be done in the context of fiscal transfers. The 3-3-3 problem briefly is that the three richest states of India (as measured by their per capita income) are three times richer than the three poorest states in India. Since this problem was first identified it has probably gotten further aggravated with the gap between the average resident of India's richer states getting only much richer than the average resident of India's poorer states. While most other countries see greater convergence in the incomes of people in different parts of the country as a result of greater economic integration between different parts of the country, it has been the opposite. While the causes are still being debated, nonetheless, as the institution responsible for intergovernmental transfers of funds with a view to ensuring equity, this is a problem that the FCI has not been able to adequately address.

In the next section I will examine the constitutional design and functioning of the SFCs

III. State Finance Commissions

SFCs were introduced to the Constitution of India as part of an attempt to strengthen grassroots democracy. The 73rd and 74th Amendments to the Constitution respectively introduced rural and urban local institutions of self-governance. Though the Constitution initially left the constitution and regulation of these bodies to the State governments, there was a need felt to lay down a constitutional structure that states would have to adhere to in the context of local self governance. The 73rd and 74th amendments to the Constitution therefore cover everything from the conduct of local body elections to the powers that may be devolved to such bodies to the reservation of seats for women, scheduled castes, scheduled tribes, and other backward classes.

SFCs were introduced thus as an attempt to replicate the FCI at a state level but this time with reference to devolution of tax revenues between the State government and the PRIs and ULBs. Two more or less identically worded articles, Articles 243-I and 243-Y provide for the functions of the SFC in the context of PRIs and ULBs respectively. The functions of the SFCs broadly are:

1. To distribute net proceeds of revenue between State and local self government
2. To identify which state taxes and other sources of revenue can be collected by local governments.
3. To govern grants in aid given out by the State Government to the local government.

However, the 73rd and 74th amendments do not directly replicate the relationship between Union and State, at the State and local self government level. For a start, unlike States, local governments do not have law making or tax levying powers vested by them under the Constitution. They are dependent entirely on the State Government vesting the same in them through appropriate legislation. Therefore, local self governments are entirely dependent on the State Government to fund them, either by giving them legal powers to collect taxes or distribute money through grants. they cannot independently pass legislation to levy and collect taxes. Normatively, the constitution and functioning of the SFCs should not be that much more different from the FCI - however, the reality indicates otherwise.

A recent study in 2016 by VN Alok and others on the functioning of the SFCs has revealed a large set of problems in the way in which they have been functioning. While some states such as Kerala and Tamil Nadu have done better than others in the functioning of the SFCs, the overall report card of SFCs is one of dysfunction and ineffectiveness. Alok's study considered the legal framework set up by various states for the functioning of SFCs, their actual functioning and whether their reports were being taken seriously or being acted upon by the State Governments.

A major problem identified by the Alok was the fact that not all states set up their SFCs in a regular five year cycle. As a result, while some states had, over the years, set up five SFCs regularly, some had set up four and three, while many had no set up an SFC at all. Even among those States which had set up SFCs, Alok notes that they are riddled with serious problems, some of which I shall detail below:

I. Lack of fiscal data at the state level

Even the best functioning SFCs, Alok notes, bemoan the lack of adequate data in order to make adequate recommendations as part of their terms of reference. This has meant that they had to seek and collate the data from the local bodies themselves, further hampering their work in submitting a timely report. This is not a problem restricted to any one state but one which affects almost all of them.

II. Inconsistent methodologies followed by different SFCs

Unlike the FCI which has been fairly consistent with the methodology it follows for the horizontal devolution of funds between the States, SFCs, have adopted dramatically different kinds of methodologies for ascertaining the revenue gap of local governments. This has meant that it is not always easy or even possible to verify and cross check the robustness of the recommendations of the report of the SFC.

III. Lack of capacity in terms of constitution of the SFCs

One other issue highlighted by Alok has been the lack of much thought being put into the composition of the SFCs. This is a problem at two levels: one, the qualifications of the persons who are required to be in an SFC and two, the tardiness in filling up the positions in the SFCs. There's clear preference in the State government for retired bureaucrats and judges to head and constitute the SFCs leaving little space for experts in public finance and fiscal policy. Further, whatever the prescription, thte SFCs are not fully staffed on time resulting in delays in their functioning and inability to submit reports on time to the government.

IV. Poor State Government response

Unlike the FCI whose recommendations on fiscal devolution are almost always fully accepted by the Union Government and implemented accordingly, State Governments have not developed such a convention or practice

V. Absence of synchronization between SFCs and FCi

Apart from the varying kinds of dysfunction SFCs find themselves in, many of them also face a local variation of the 3-3-3 problem.

Even at the state level, between districts, vast differences exist in the incomes. To take a few examples - in the State of Uttar Pradesh for instance, the richest district is Noida with a per capita GDP of INR 6.13L while the poorest district is Sant Kabir Nagar with a per capita GDP of INR 32k: a twentieth of the former. In Maharashtra, the richest district is Mumbai with a per capita GDP of INR 6.43L while the poorest is Washim with a per capita GDP of INR 1.70L: about a fourth of the former. Due to the huge concentration of economic activity in India's largest mega cities, even in the richer states, there are vast disparities between the richest and poorest districts. Districts which contain large, economically dynamic cities have per capita incomes several times higher than rural, tribal dominated or largely agricultural districts. This creates enormous wealth disparities within a state seriously affecting the ability of local self governments to raise revenue (even where they have been given such powers by the State) and provide services to residents living in those areas.

What is of note is that most SFCs, even thirty years after their setting up, have not been able to gain as much credibility as the FCI has. It is not a case of dysfunction being the exception, but rather the rule in the last few decades.

While constitutional design might explain some elements of the success of the FCI as opposed to the SFCs, there's also the element of state capacity which needs to be addressed. Whether it be finding the appropriate kinds of experts to staff the SFCs or having the adequate data to be able to inform their recommendations, SFCs are unable to carry out their functions with the same level of effectiveness and efficiency as the FCI.

This has also perhaps led to the State Governments not taking their recommendations as binding resulting a paradoxical chicken and egg situation - State governments don't invest in SFC capacity leading to a poor quality set of recommendations leading the State to believe that the institutions are not really worth the trouble and failing to invest further in their capacity.

That said, as Alok's report points out, there are good examples of states which have ensured that their SFCs have been effective and well functioning - namely, Tamil Nadu and Kerala. Specifically, the good practices of these states which are worth noting are the quick constitution of SFCs, their ability to complete their reports and the State making public the action taken on their recommendations.

IV. Conclusion:

The FCI’s smooth and relatively unproblematic functioning has not meant that it has addressed all problems in the transfer of revenues between Union and State. One contentious issue that has dogged the FCI’s recommendations has been the use of population data to determine the horizontal division of fiscal resources. South Indian states which have had a relatively low birth rate thanks to improvements in healthcare and female literacy rates have complained that this has disadvantaged them relative to north Indian states. This, they argue, has created “perverse incentives” for north Indian states to not “control” their population.

The share of south Indian states in the revenue pool has indeed fallen over the years - however, this might have more to do with their improved economic position as south Indian states are, on a GDP per capita basis, much richer than their northern counterparts. As we have seen above, given the relatively larger weightage given to per capita income, population growth may not have as much of an impact on the relative shares of States in horizontal devolution as southern states may claim.

However, this is not to deny that there is a problem with the data sources being used by the FCI in making its horizontal devolution. While state level GSDP per capita income would be a relevant data point, it is an estimation made by the states themselves it perhaps may not be the most accurate data set for this purpose. Likewise population statistics which are dependent on the conduct of periodic censuses. At the level of the SFCs, the absence of granularity in data makes their task even more difficult. While district level GSDP may be available, using several years old data from the census may be leading to mis-allocation of resources between PRIs and ULBs. Even assuming that the data sources are neutral and impartial, just the fact that they are unable to capture the fast moving social and economic changes taking place in India might be leading to the greater in effectiveness of the FCI and SFCs.

One unfortunate example of how the absence of granular, high frequency data might be affecting resource allocation has been the inadequate coverage of India’s free grains scheme which relies on the census data to be able to assess the number of beneficiaries. With the 2021 census having not been conducted and its conduct looking unlikely in the near future also, this has meant that the total number of beneficiaries has remained static over the year even though India’s population has increased over the years. In addition, while the coverage ratios for urban and rural populations are fixed, rural to urban migration not being taken into account has meant that a lot of beneficiaries have been removed from the system without being added in the urban places where they are located.

This is why perhaps the FCI and the SFCs need to diversify the sources of data. The emphasis should be on getting more accurate, high frequency and granular data. Two immediate data sources which, in the Indian context might be relevant to the exercise might be data from the collection of the Goods and Services Tax and the births and deaths registrar. GST vendors being required to file e-returns with one single portal, while a process that was filled with troubles and complications, also provides a good insight into economic activity across states and within states. Likewise, with the online registration of births and deaths becoming mandatory, it would be a valuable source of data to keep track of the changes in demography.

These are only the public sector sources of data and one could even imagine private sector sources of data - such as cell phone tower data, internet consumption data, et al being useful in devising better mechanisms for resource allocation between states and further down to local self government bodies. Of course exactly how such data should be used, what are the caveats necessary and where the data could be a completely different paper. However, the purpose of this is to highlight the potential advantages of expanding data sources.

The flip side of increasing the data sources is to ensure maximum transparency in the way in which the data is used and the conclusions drawn from it. This would require also the details on the data sources and the specific manner in which the data has been used to arrive at conclusions. While this will not pose too many problems for public datasets (apart from ensuring that there are no privacy breaches) private data sets may prove to be a challenge here. Apart from privacy concerns, the private sector may be unwilling to share commercially sensitive data or have the same made public unless rigorous protections are put in place for the data use.

What relevance does all of this have for the Nepal National Natural Resources and Fiscal Commission set up under the Constitution?

This is, as of 2023, still a new body that is trying to find its feet in the polity and establish its credibility as a constitutional institution. I have not been able to access the English versions of the NNRFCs reports but be that as it may, Nepal, like India also has to address wide variations in regional economic development. Such transfers are perhaps not just needed in the context of sub-national units but also local self government institutions.

To be able to undertake this task in the coming years, the NNRFC will need the kind of data that goes beyond just government datasets. While there is no problem with relying on GDP, census figures, et al, the NNRFC will need to seek out other data sources which will give it a clearer picture of the economic conditions in different parts of the country. However, this must equally be backed up with a robust process that ensures the participation of all key government stakeholders and experts. Finally, the imperative of transparency cannot be stressed enough. The NNRFC reports should not only contain the principles on the basis of which the devolution of resources has taken place but should also identify the data sources, where possible give detailed calculations and allow for independent experts to verify and reproduce the calculations. While there will necessarily be disagreements over the merits of the NNRFCs recommendations (as there are in India) the credibility of the NNRFCs recommendations should not be called into question for lack of transparency, consultation or use of robust data.

My suggestions here are only a broad course of action for the NNRFC and I cannot say for certain exactly what data sets are available and to what extent they are reliable in the context of Nepal. However, I would like to end by saying that as a relatively new constitutional institution, the NNRFC should look to learn from what has made the FCI a success, build on what has helped make it a credible body and avoid some of the pitfalls that have come the way of the SFCs in India. Some of these issues are also in the hands of the Central government in Nepal to address and it must be kept in mind that a federation is only as strong as the trust placed in the institutions responsible for making the federation work.

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