

Editorial

16 Finance Commission, States and Indian Development

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Presumably, persuaded by the Hon'ble Prime Minister's highly perceptive statement "India grows when States grow", State Governments are apparently demanding the 16 Finance commission to ensure that the share of each State in the divisible pool should be in accordance with their contribution to India's development. Since the country is committed to become a developed one by 2047, Finance Commission, having a say on about 50% of the revenue receipts of Indian states, could ignore their requests only at the risk of not being sensitive to Vision India 2047. The crucial issue is how to understand the contribution of a state to India's development. The prevailing perspective in terms of "a particular state contributing Rs100 to the Union gets only 10 paise in return", is a narrow accounting approach and not appropriate from a development perspective.

A New Perspective

Considering fiscal federalism as a system, development of the India, having a cooperative federalism with 28 States and 8 union territories, could be construed as contingent on the interactions between the key stakeholders therein. They are broadly; a). The Union Government 2). The Governments of the States and c) The people of the States.

Since the development of the States lead to the development of India the crucial question is what determines the development of states. This depends on the state level specialisation in the production of goods and services which is a joint determinant inter alia of its resources endowment along with the institutions, endogenous and exogenous, that govern the utilization of resources and the distribution of the returns. These in turn give rise to certain broad pattern of specialisation in terms of economic activities by the states. In terms of the

observed specialisation, the states could be divided into two; Type I States, which specialise in the production of goods which are, by their very nature, tradable, and Type II States that specialise on non-tradable. Here the issue of our concern is how the specialisation at the state level that prevails contribute to; a) development and welfare of the people of State concerned, b) fiscal health of the state government concerned c) development of other states, and finally, d) the fiscal health of the Union. Here we assume that the fiscal health of any stakeholder is in tandem with their development.

Type I States, by specialising in tradable (say physical capital like machinery or manufactures) which are taxable generate employment and income for the people of the State and thus contribute to the development and welfare of the people of state concerned. The fiscal position of such a State is strengthened because the tradable contribute directly to their tax revenue. Since they provide taxes to the Union such states work for its fiscal health and development of the Union. With the supply of goods (eg machinery) they also contribute to the development of other States. Thus the specialisation by the Type I States acts as catalyst in the development of all the Stakeholders with none getting adversely affected. The extent of contribution for each Stakeholder, however, is an empirical question.

Type II States specialise in Non-tradable, human capital for example. By their very nature they are not tradable and non-taxable. By being mobile they migrate to other countries and other states in the country. Those migrate abroad get opportunities for earning higher income, and thus contribute the family income and welfare of the people of the type II States. Since those migrate abroad make remittance in foreign exchange, they contribute the development of the Union by help keeping the Current Account Deficit (CAD) under control and the building of foreign exchange reserve. Human capital that migrates to other states, as they embody knowledge, contribute to the development of those states. But what about the State Governments of the of the Type II States? As already noted, unlike the physical capital, the production of human capital doesn't provide any direct tax revenue entitlement to the state government. Instead, it adds to their fiscal stress because much of the investment in education and health is made by borrowing and thus added to the revenue deficit and debt burden of the Type II states. The specialisation by type II states, while having adverse developmental impact on themselves, contribute to the development of all the other stakeholders.

Case Study of Kerala

Viewed from the above perspective Kerala is a type II State and Kerala model of development turns out to be a model of export oriented human capital production. A part of the human capital migrated to other countries and equal number of them migrated to other States. As per the Kerala Migration Survey by Gulati Institute of Finance and Taxation (2023) led by Prof. Irudaya Rajan 2.2 Million Keralites have migrated to 183 of out of 197 countries in the world and made remittance to India. It was observed that Kerala with 2.76% of India's population account for about 23% of the total remittances to India in 2023

As shown by scholars like K N Harilal & K J Joseph and Pulapre Balakrishnan the migration-led "resource movement effect" and the remittance-induced "spending effect" has had an adverse effect on the growth of tradable sectors in Kerala and thus contributed to the stagnation of Kerala Economy since the mid 1970s. Thus the remittance to the country came at a cost of stagnating productive sectors of the economy which is the price that Kerala paid for the remittances which helped building up of the foreign exchange reserve of the country.

While India's trade policy has the provision for different direct and indirect subsidies for export oriented sectors, Kerala's export oriented human capital sector did not receive any export subsidies from the Centre. Since it was entirely financed by the State Government, about 63% of Kerala's revenue receipts is on salary/ wages, pension and interest of which about 60% is towards salary for the teachers. In the absence of any direct tax contribution by the sector or subsidy from the Union such a strategy was instrumental in increasing the revenue deficit and the growing debt burden of the state.

Regarding the development of other states, it is estimated that over two million people from Kerala are working in other states of the country. Since knowledge is most important resource the knowledge embodied in the human capital contribute to the development of other states. Kerala model added to the fiscal stress of Kerala whereas it contributed to the development of all the other stakeholders of India's fiscal federal system.

Takeaways

Kerala turns out to be a true engine of Vision India 2047. There could be other engines in the country which are to be located such that the 16th Finance Commission could facilitate Vision India 2047. For facilitating informed recommendations regarding horizontal

devolution in sync with India's new vision, NITI Aayog may consider developing an Index of State-level Contribution to Indian Development (ISCID). At the same time the issue of equity cannot be ignored. The aspirational India demands a new strategy of walking on two legs - rewarding performers, while handholding the laggards.

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