THEIR VIEW

India's 16th Finance Commission faces some daunting challenges

It must contend with forecasting complexity, mitigate centralization conflicts and ensure local governments are well funded

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MINT

Deliberations of the 16th Finance Commission (FC) are now proceeding in earnest. The appointment of the full commission only by the end of January has left it with just 19 months until end October 2025 to complete its work and submit its recommendations, well short of the full two years or so that is usually available. Fortunately, its terms of reference have been limited to the core issues mandated by the Constitution. Unlike in the case of recent FCs, the 16th FC has not been loaded with a host of other issues under the "any other matters" clause [article 280 (3)(d)]. This gives it the opportunity to focus its deliberations on core issues without having to devote time to other issues. This is important because the commission will have to contend with some daunting challenges, a few of which are discussed here.

The first issue relates to projections of revenue, especially from taxes, for the central and state governments. Macroeconomic projections are always important inputs for economic policy decisions, but particularly so for the volume of tax devolution to the states. The FC-recommended devolution formula applied to the divisible pool of central taxes will determine the volume of tax devolution that will flow to the states. If the actual volume of central tax revenues (except cesses and surcharges) turns out be more than the projections, then the devolution flows will provide some fiscal elbow room for both the Centre and states. But if the tax revenues turn out to be less than the projections, it will lead to fiscal stress for the central government as well as all state governments. Hence, the reliability of tax revenue projections is critical and the method adopted for making projections needs to be robust. A series of repeated shocks impacting the time series data used for forecasting makes the task very challenging. The financial crisis of 2008 was followed by demonetization (2016), roll-out of the goods and services tax (2017), the covid pandemic (2020-21 and 2021-22) and finally the Ukraine and Gaza wars that have roiled international commodity markets. The 15th FC, which had to make its projections under conditions of extreme uncertainty in the middle of the covid pandemic, took the unusual step of examining the implications of three alternative growth paths. Though comparatively less now, the level of macroeconomic uncertainty is still high and projections for the 16th FC period are also likely to be subject to large error margins. Reliable forecasting of central and state revenues will thus be a very challenging exercise.

The second issue is finding a balance between the principle of subsidiarity and the compulsions of centralization. The subsidiarity principle holds that in federal governance systems, decisions are more efficient when the decision-making authority is as close as possible to the constituents affected by the decision, while higher levels of authority should hold a subsidiary role; i.e., the delegation of authority essentially moves from the lower level upwards only when the issue to be decided upon effects constituents beyond the jurisdiction of the lower-level authority (such as a state government). Examples of such externalities include national security and defence, and the maintenance of macroeconomic stability and nationwide infrastructure systems. There is also the question of equity in providing a comparable level of public services, or merit goods like subsidized food, to constituents in all states across a common national tax jurisdiction. The allocation of subjects under the Constitution's 7th schedule to the central list, states' list and concurrent list is broadly consistent with these competing compulsions of decentralization and centralization. However, it has been argued that the present subject allocation does not adequately take account of externalities and needs to be revisited. The 16th FC obviously cannot change the 7th schedule. But if it decides to address these issues even in its observations, it will need to tread very carefully. Any such re-allocation of subjects would be a very sensitive political issue when many states, especially those ruled by non-National Democratic Alliance (NDA) governments, have complained that the Centre is encroaching their constitutional space through the use of centrally-sponsored schemes.

QUICK READ

The 16th Finance Commission confronts some challenging issues in the shorter-than-usual tenure it has got. Making accurate forecasts after a series of economic shocks is the first.

The Commission will also have to balance centralization and subsidiarity needs while ensuring that local governments are well funded in accordance with sound principles of governance.

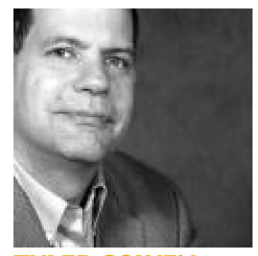
A third issue is ensuring adequate resources for the third tier of government. Local governments provide many of the key services that citizens need, like water supply and sanitation. Rapid urbanization has made this particularly urgent for urban local bodies. The Constitution referred to the importance of local governments but left it to state governments to determine what functions should be delegated to local governments. Subsequently, the 73rd and 74th Constitutional amendments elaborated on this in great detail, but again left it to state legislatures to decide what should be done. There is a direct conflict of interest here between state legislators and those elected to local bodies, which accounts for the continuing weakness of most local governments. FCs are mandated to recommend measures to augment the consolidated fund of state governments to supplement the resources of local governments based on the recommendations of state finance commissions. The last three FCs struggled with this mandate, but with limited success. Some states have failed to even appoint state finance commissions on time. Even when appointed, their recommendations are often ignored. The challenge is to design suitable incentives for state governments to induce them to effectively strengthen local governments.

These are the author's personal views.

MINT CURATOR

AI could drive up the neutral rate of interest in an economy

A great wave of AI-led investment could leave us short of savings



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The notion that lending rates fall over time has no basis in theory ISTOCKPHOTO

As improvements in artificial intelligence (AI) continue apace, so do questions about how AI will influence economies, asset prices and—the question of the moment—interest rates in America: Is AI more likely to make them go up or down?

You might think economists would have a simple handle on such a straightforward query, but the both macroeconomics and AI are complex. Nevertheless, I have a bold prediction: Real or inflation-adjusted rates will go up, and for a considerable period of time.

The conventional wisdom is that rates tend to fall as wealth and productivity rise in an economy. It is easy to see where this view comes from, as real rates of interest, especially in the US, have been generally falling for four decades. As for the theory, lending becomes safer over time, even as the wealth available for saving is higher.

So why might these mechanisms stop working?

My counter-intuitive prediction rests on two considerations. First, as a matter of practice, if there is a true AI boom, or the advent of artificial general intelligence (AGI), the demand for capital expenditures will be extremely high. Second, as a matter of theory, the productivity of capital is a major factor in shaping real interest rates. If capital productivity rises significantly due to AI, real interest rates ought to rise as well.

Think about capex in a world of AI. The scurry to produce more high-quality semiconductor chips will continue. Those investments are not easy or cheap. But the demand for investment will not stop there. The more that AI is integrated into lives and business plans, the higher will be the demand for computation. That will induce a significant expansion of energy infrastructure.

Again, those are not cheap investments. The American state of Northern Virginia, for example, is now facing a major dilemma along these lines, and not only because of AI. The region is home to major data centres, and now needs the equivalent of several large nuclear power plants to meet projected energy demands.

And that could be just the beginning of the rise in capex. AI is already driving some advances in the pace of scientific discovery, a trend that can be expected to continue. Imagine, for instance, if AI made water desalination cost-effective in many parts of the world. All of a sudden, there would be more demand to develop more parts of California, Arizona and Nevada. The US would build more real estate, using more energy in the process. Saudi Arabia, the UAE and many other places might do the same, boosting overall demand for investment yet higher.

Demand for space travel and satellite launches seems to be rising as well, partly because of AI. Software innovation has been driving a lot of progress on the hardware side. Less optimistically, AI-driven warfare and drone combat may rise in importance, as already is true in Ukraine and the Middle East right now. This is bad news that will nevertheless drive further investment.

If enough of these trends come together in a short enough period of time, then real interest rates can be expected to rise. Demand to borrow and invest will go up, although savings will probably not rise proportionately, at least not in the short run. As societies age, they are spending down their accumulated wealth.

If AGI is realized, it would be akin to the arrival of billions of potential workers into the global economy at roughly at the same time. That is a complicated scenario. But it is plausible that, over a relatively short period, it could boost investment by 5% or more of US GDP. There would also bet major investments to help human workers deal with the resulting adjustments and reallocations of their efforts.

In practical terms: Expect a boom in the moving-van sector, as well as an expansion of government programmes for worker assistance. These and other similar forces will place further upward pressure on real interest rates.

Macroeconomics is never simple, as I said. So all this should be considered more a guess than a prediction. Still, it makes sense to be prepared for a reversal of the long-run trend of falling real interest rates—at least for several decades, until AI-driven progress creates more wealth to replenish stocks of savings, lowering real rates once again.

In the meantime, be ready for change. Falling rates are not necessarily an iron law of economic history. Just as the Great Moderation was proved to be an illusion by the financial crisis of 2007-08, so may be the current 'great moderation'—of real interest rates—prove to be an intermittent phenomenon.

MY VIEW | PEN DRIVE

The world of Carnatic music needs to open up further

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Carnatic musician T.M. Krishna has been known as a disruptor for nearly a decade now, and this time, his decision to accept an award from the Madras Music Academy has both his supporters and detractors in a huff. His detractors remain firm in their view that Krishna is destroying their carefully walled-in world of cultural superiority; his supporters are unsure about why he is returning to the fold when he has travelled so far.

While this debate animates a minuscule section of society, the Carnatic music ecosystem of Chennai could serve as an example to explain why inclusion is petrifying to some: Lead performers, concert organizers and even critics and arts writers come largely from the same caste, their centuries of social capital working to keep them in that position, even allowing them to keep others out. Until about a decade ago, journalists with the "wrong surname" who were covering the arts beat in Chennai were at times stonewalled by gatekeepers of the insular world of Carnatic music. The profiling can be sophisticated or direct. As a cub reporter in Chennai years ago, I have been asked gently leading questions by both organizers and musicians about my background, or more direct ones about my caste location. In a few cases, they've chosen not to share stories about their art, experience and practice because I am not from the same caste or because I'd chosen not to answer. To be sure, these instances cannot compare with what performers from marginalized communities have said they face.

There may have been some easing of this bias against those who are merely observers of this world, as I was, but conscious exclusion remains and music and dance are tightly leashed. For practitioners who do not tick all the boxes, navigating the system can be near impossible. As recently as two years ago, an upper-caste writer published a review (which has since been edited) that questioned the merit of a show by a hereditary-caste performer because the dancer did not adhere to Brahminical notions of beauty, movement and symmetry. Late last year, another review on the same site hinted that a certain performer drew large audiences only on account of the individual's caste identity. This review was also edited and republished after there was an outcry on social media.

The Carnatic music world puts certain individuals, spaces and organizations on a pedestal and lays down their terms of engagement. True inclusion would require a ceding of power and an acknowledgement of one's own complicity in perpetuating inequality. It is far easier to invoke ideas of respect and tradition to retain the *status quo*.

Academia, politics, the corporate world and almost every other sphere of activity have been forced to confront caste, however imperfectly, and consider ways to work on inclusion, but the world of Carnatic music and Bharatanatyam seems to have shut itself off. The systemic alienation, erasure and snubbing of hereditary performing communities in an effort to create "pure" classical art forms has not been acknowledged. It often comes as a surprise to many that Sadir was appropriated and refashioned into Bharatanatyam. There are plenty of reliable and accessible sources for more information on this .

QUICK READ

Carnatic musician T.M. Krishna's decision to accept an award from the Madras Music Academy got traditionalists worked up as he's been an establishment critic and his fans for appearing co-opted.

While the award does signal a nearly 100-year-old institution's willingness to consider change, performers and voices from non-dominant social groups still seem largely marginalized.

Krishna has written and spoken about some of this injustice, looking within to question an unfair social ecosystem that sustains Carnatic music, the role of creativity in such a structured form of classical art, the role of the arts in democracy, and more. This time, though, he has chosen not to explain why he is accepting an award when so little has changed since he first decided in 2015 not to perform during the Margazhi season, the string of Carnatic music concerts held every winter, and spoke out against its insular ways. He has since performed with fisherfolk and Jogappa artistes and made choices and statements that have enraged traditionalists.

A few years ago, Sadir practitioner Swarnamalya Ganesh, who, like Krishna, has plenty of social and cultural capital, acknowledged the following in an opinion piece for *The News Minute* in the context of dance: "Of course, if the attempt is by a well-accepted artiste, the norm itself often shifts to accommodate it." This seems to be happening at the Music Academy now. Would a performer from another social bracket have been considered for this award by the institution under the same circumstances? Many performers, especially hereditary-caste performers, have been blacklisted for saying far less.

While the award does signal a nearly 100-year-old institution's willingness to consider change, performers from other castes and communities still seem too few and far between. This entire storm over Krishna, the Music Academy and purported protectors of tradition, therefore, remains an esoteric argument among privileged upper-caste performers and connoisseurs about who should be "allowed" to play in "their" performance spaces. Those who have been kept on the sidelines and those whose art forms have been appropriated remain on the margins of this conversation on inclusion.

The gap between intention and action remains a yawning one—and it will take more than signalling to bridge it.