सत्यमेव जयते

Finance Commission
Of India

Finance Commission

The Finance Commission is a constitutional body formed every five years to give suggestions on center-state financial relations.

(i) sharing of central taxes between center and states and within states.

(ii) distribution of central grants to states,

(iii) measures to improve the finances of states to supplement the resources of panchayats and municipalities, and

(iv) any other matter referred to it

The central taxes devolved to states are untied funds, and states can spend them according to their discretion.

Divisible pool of taxes consists of all taxes except cess and surcharge

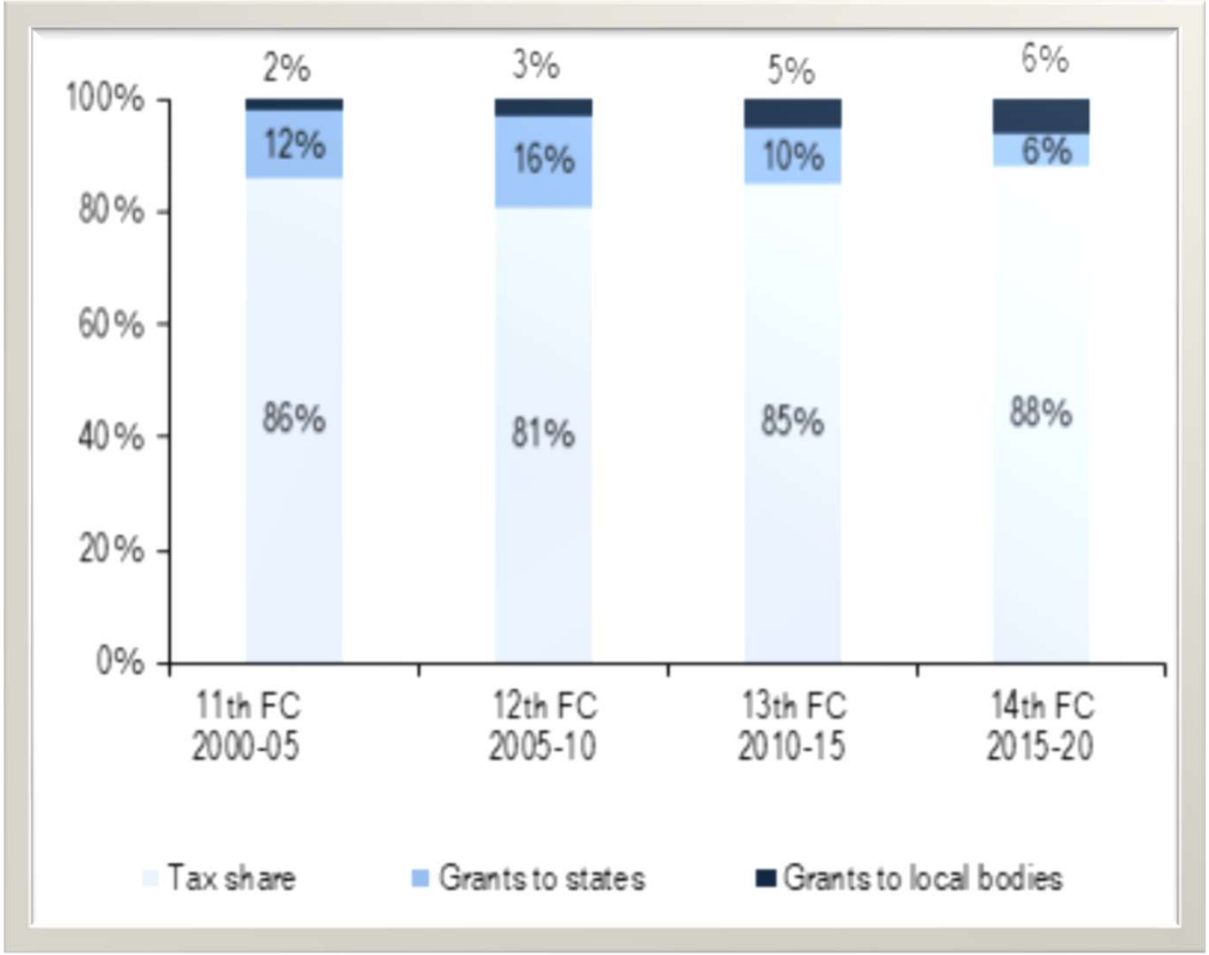
The central taxes devolved to states are untied funds, and states can spend them according to their discretion.

The center also provides grants to states and local bodies which must be used for specified purposes.

12th Finance Commission evaluated the fiscal position of states and offered relief to those that enacted FRBM laws

13th Finance Commission also incentivized states to increase forest cover by providing additional grants

The 13th and the 14th Finance Commissionassessed the impact of GST on the economy.



15th Finance Commission

- Constituted in November 2017
- (i) review the impact of the 14th Finance Commission recommendations on the fiscal position of the centre
- (ii) review the debt level of the centre and states, and recommend a roadmap
- (iii) study the impact of GST on the economy
- (iv) recommend performance-based incentives for states based on their efforts to control population, promote ease of doing business, and control expenditure on populist measures etc

Table 1: Some taxes levied by the centre, state and local bodies

Centre	States	Local Bodies
▪ Income Tax ▪ Corporation Tax ▪ Central GST ▪ Customs	▪ State GST ▪ Tax on Electricity ▪ Excise Duty on Alcohol ▪ Stamp Duty	▪ Tax on Land and Building ▪ Vehicle Tax ▪ Tolls ▪ Entertainment Tax

Table 2: Weight of criteria used by 11th to 14th Finance Commissions

Criteria	11th	12th	13th	14th
Income Distance	62.5	50.0		50.0
Population 1971	10.0	25.0	25.0	17.5
Population 2011				10.0
Index of Infrastructure	7.5			
Fiscal Discipline	7.5	7.5	17.5	
Tax Effort	5.0	7.5		
Fiscal Capacity Discipline			47.5	
Area	7.5	10.0	10.0	15.0
Forest Cover				7.5
Total	**100**	**100**	**100**	**100**

- 14th Finance Commission considerably increased the devolution of taxes from the centre to states from 32% to 42%.
- The Commission had recommended that tax devolution should be the primary source of transfer of funds to states.
- This would increase the flow of unconditional transfers and give states more flexibility in their spending.
- 14th Finance Commission recommeded grants-in-aid to be 12% of the central transfers to states
- Grants to states for three purposes: (i) disaster relief, (ii) local bodies, and (iii) revenue deficit.

Criteria used by Finance Commission

- **Population** is an indicator of the expenditure needs of a state. The 14th Finance Commission used the 2011 population data, in addition to the 1971 data. The 15th Finance Commission has been mandated to use data from the 2011 Census.
- **Area** is used as a criterion as a state with larger area has to incur additional administrative costs to deliver services.
- **Income distance** is the difference between the per capita income of a state with the average per capita income of all states. States with lower per capita income may be given a higher share to maintain equity among states.
- **Forest cover** indicates that states with large forest covers bear the cost of not having area available for other economic activities. Therefore, the rationale is that these states may be given a higher share.

Table 3: Share of states in central taxes as recommended by 14th Finance Commission

States	Share in taxes (%)	Population 1971 (%)	Population 2011 (%)	Area (%)	Forest cover (%)	Income distance (Rs crore)
Weight		**17.5**	**10**	**15**	**7.5**	**50**
Andhra Pradesh	4.3	5.1	4.1	4.1	3.4	73,979
Arunachal Pradesh	1.4	0.1	0.1	2.1	13.2	83,174
Assam	3.3	2.7	2.6	2.0	3.2	39,644
Bihar	9.7	7.8	8.7	2.4	0.9	24,584
Chhattisgarh	3.1	2.1	2.1	3.5	9.9	58,130
Goa	0.4	0.1	0.1	2.0	0.3	2,20,960
Gujarat	3.1	4.9	5.1	5.9	1.4	98,690
Haryana	1.1	1.8	2.1	2.0	0.1	1,16,179
Himachal Pradesh	0.7	0.6	0.6	2.0	2.4	1,06,285
Jammu & Kashmir	1.9	0.9	1.1	5.8	3.3	57,498
Jharkhand	3.1	2.6	2.8	2.1	3.1	44,028
Karnataka	4.7	5.4	5.1	5.0	5.6	76,781
Kerala	2.5	3.9	2.8	2.0	2.8	89,715
Madhya Pradesh	7.6	5.5	6.1	8.0	10.5	42,996
Maharashtra	5.5	9.3	9.4	8.0	7.5	1,03,091
Manipur	0.6	0.2	0.2	2.0	1.7	48,632
Meghalaya	0.6	0.2	0.2	2.0	2.6	65,762
Mizoram	0.5	0.1	0.1	2.0	1.5	73,549
Nagaland	0.5	0.1	0.2	2.0	1.5	62,472
Odisha	4.6	4.0	3.5	4.0	7.2	54,877
Punjab	1.6	2.5	2.3	2.0	0.2	92,055
Rajasthan	5.5	4.7	5.8	8.9	1.1	58,985
Sikkim	0.4	0.0	0.1	2.0	0.7	1,44,665
Tamil Nadu	4.0	7.6	6.1	3.4	3.3	98,327
Telangana	2.4	2.9	3.0	2.9	3.4	83,738
Tripura	0.6	0.3	0.3	2.0	1.2	55,524
Uttar Pradesh	18.0	15.4	16.8	6.3	1.6	33,815
Uttarakhand	1.1	0.8	0.8	2.0	4.8	95,971
West Bengal	7.3	8.2	7.7	2.3	1.8	58,323
All States	**100**	**100**	**100**	**100**	**100**	**64,290**

14th Finance Commission

- No specific mention of the treatment of gross budgetary support to the plan as a committed liability of the union government.
- The ToR also did not bind the FFC to look at only non-plan revenue expenditure of the states.
- Dispense with the distinction between plan and nonplan
- Considers both the 1971 population and 2011 population, while reluctantly giving higher weight to the 1971 population.

- A demonstrably symmetric view of the union finances, state finances and their fiscal relations was attempted
- An integrated view of revenue expenditure with no distinction between plan and non-plan, and a comprehensive view of revenue and capital expenditures, including public debt were attempted
- Special responsibilities of the union in macroeconomic management and its relationship with the global economy explicitly recognised
- Comprehensive view of the transfer from the union to the states, both within and outside the recommendations of the finance commission to address the fundamental issues relating to constitutional assignment, plans and CSS.
- The predominant role of the states, in particular, the state finance commissions, in empowering local bodies had to be recognized.
- FFC examined the issue of separate treatment of the special category states.

- Scope for improving the fiscal position of the union through increased disinvestment of shares in public enterprises, a rational dividend policy, sale proceeds from spectrum, a discriminatory capital infusion into the financial enterprises and the introduction of GST
- The fiscal position of states taken together has shown improvement both in terms of quantity and quality.
- The FFC recognized that the process of fiscal consolidation in the union should be accompanied by prudent fiscal expansion at the level of states.

- There has been a greater expansion in the fiscal activity of the union than of the states
- The transfers from the union to the states have increased substantially
- Within the transfers, discretionary components had increased in the review period, undermining the role of the finance commissions
- The focus on composition and the quality of aggregate transfers from the union to the states

- FFC considered the magnitudes, legitimacy and appropriateness of union transfers to states outside the mechanism of the finance commissions, keeping in view the Constitutional provisions.
- A major challenge in this regard was the enacted legal commitment and expenditures on ongoing schemes that fell under the Concurrent List and were being funded by both the union and the states.

FFC and Vertical Balance

- The approach to vertical devolution was governed by three factors:
- (a) the spirit of constitutional provisions
- (b) the concerns about the fiscal space expressed by the states and the union
- (c) the need for clarity on the respective functional and expenditure responsibilities of the union and states
- Tax devolution should be the primary route of transfer of resources to states since it is formula-based and conducive to fiscal federalism
- If it does not meet the needs of the specific states, they need to be supplemented by grants-in-aid on an assured basis and in a fair manner

FFC and Vertical Balance

- Recommended tax devolution of 42%
- Meets the twin objectives of increasing the flow of unconditional transfers to the states and yet leave appropriate fiscal space for the union to carry out its own functions and make specific-purpose transfers to the states
- The balance in fiscal space thus remains broadly the same in quantitative terms, but tilts in favour of states in qualitative terms through a compositional shift in favour of devolution and fiscal autonomy.

FFC and Horizontal Balance

- Weight of 17.5% to 1971 population and 10% weight to 2011 data
- Requirement of the Constitution is that public services should be provided to the entire population and needs should be assessed for the latest population
- Use of 1971 data to provide incentives to states to adopt family planning and not to penalize those states which have adopted family planning in the allocation of funds
- Weight of 7.5% to the forest cover to assess cost disabilities as restrictions imposed on the exploitation of valuable resources due to ecological resources, the concerned states are deprived of resources for development.

FFC and Horizontal Balance

- Weight of 15% to the area of states to account for admin costs
- To ensure that states with small areas do not suffer due to this, a minimum cap of 2% area was assigned to states with area below 2%
- FFC continued with the weights for revenue disability, but expressed it in terms of income distance as it is an easy to understand and transparent
- FFC did not consider the fiscal performance criterion in the tax devolution
- The practice of recommending state- or sector-specific grants-in-aid was eschewed by the FFC

Local Governments

- Recommendations are meant only to indicate measures to supplement the resources available to the states to support local bodies
- FC does not directly deal with local governments
- FC is required to recommend the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the state, based on the recommendations made by the state FC
- They are to be made based on the recommendations made by the finance commissions of the states
- But finance commissions do not exist in many states or their recommendations are not up-to-date
- FFC should not undermine or enhance the statutorily determined role and functions of local bodies

Local Governments

- The 14th FC has recommended Rs. 287,436 crore (US$48 billion approx.) for all local governments
- 14th FC recommended a grant-in aid for local governments that is equal to an estimated 3% of the divisible pool
- The 14th FC has continued with the 13th FC recommendation of making these grants available to local bodies in two parts – a basic grant and a performance grant, in a ratio of 90:10 for panchayati raj institutions and 80:20 for urban local government
- The basic grant is an unconditional grant, intended to be used by local bodies to deliver basic services

- Performance grant is meant to instil improved information on local finances and outcomes as well as focus on increasing own incomes of local governments
- The performance grant to urban local governments is to be given if they fulfil three conditions – have their accounts audited, improve own revenues, and publish service-level benchmarks
- The distribution of grants between the panchayats and between the municipalities left to the state governments based on the recommendations of the SFCs
- But a formula was suggested whereby the distribution was based on the 2011 population with a weight of 90% for population and 10% for area.
- No allocating was recommended for the scheduled areas (check 5th & 6th schedule of constitution)

Grants-in-Aid

- If the assessed expenditure need of a state exceeds the sum of revenue capacity and devolved taxes, then the state concerned will be eligible to receive a general-purpose grant-in-aid to fill the gap
- Grants-in-aid for state specificc projects or schemes not considered, as these are best identified, prioritized and financed by the respective states

Other Transfers

- The finance commission transfers comprised only 59% of the aggregate transfers of the union to the states, with the other transfers accounting for 41%
- The other transfers flow mainly as plan grants, and marginally as non-plan grants
- Plan grants can be divided into (a) central assistance (normal, additional, special and special plan); and (b) central schemes and CSSS which are conditional upon the implementation of specified schemes and programmes

Other Transfers

- Such transfers should be for supplementing the transfers recommended by the finance commission, and not supplanting or undermining them
- Duplication should be avoided
- Recommended for consideration the evolution of a new institutional arrangement for (i) identifying the sectors in the states that should be eligible for grants from the union, (ii) indicating criteria for interstate distribution (iii) helping design schemes with appropriate flexibility being given to the states regarding implementation (iv) identifying and providing area-specific grants

15th finance commission

- Major aspects of the ToR:
- The mandate for using the 2011 population
- The possible elimination of “Revenue Deficit Grants”
- Impact of the GST on the finances of the Centre and States
- Conditionality needed on State borrowing
- Providing performance incentives to states on certain indicators
- Going back to 32% formula from the current 42% devolution to states

15th finance commission

Table 1.1: Criteria and Weights Assigned for Horizontal Devolution

Criteria	Weight (%)
Population	15.0
Area	15.0
Forest and Ecology	10.0
Income Distance	45.0
Demographic Performance	12.5
Tax Effort	2.5
	100

How revenue has been divided?

- FC has considered ***the 2011 population along with forest cover, tax effort, area of the state, and "demographic performance"*** to arrive at the states' share in the divisible pool of taxes.
- In order to reward population control efforts by states, the Commission developed ***a criterion for demographic effort — which is essentially the ratio of the state's population in 1971 to its fertility rate in 2011 — with a weight of 12.5%.***
- The total area of states, area under forest cover, and "income distance" were also used by the FC to arrive at the tax-sharing formula.

Key recommendations:

- The Commission has reduced ***the vertical devolution*** — the share of tax revenues that the Centre shares with the states — from 42% to 41%.
- The Commission has said that it intends to set up ***an expert group to initiate a non-lapsable fund for defence expenditure.***
- ***Shares of the southern states, except Tamil Nadu, have fallen***
- Shares of states like Maharashtra, Himachal Pradesh and Punjab, along with Tamil Nadu, all of which have fertility rates below the replacement level, have increased slightly.
- On the other hand, Andhra Pradesh, Kerala, Karnataka, and West Bengal's shares have fallen, even though their fertility rates are also low.
- Incidentally, Karnataka, the biggest loser in this exercise, also had the highest tax-GSDP ratio in 2017-18, as per an RBI report on state finances.

Grants-in-aid

- In 2020-21, the following grants will be provided to states: (i) revenue deficit grants, (ii) grants to local bodies, and (iii) disaster management grants.
- The Commission has also proposed a framework for sector-specific and performance-based grants. State-specific grants will be provided in the final report.
- **Revenue deficit grants:** In 2020-21, 14 states are estimated to have an aggregate revenue deficit of Rs 74,340 crore post-devolution.
- **Special grants:** In case of three states, the sum of devolution and revenue deficit grants is estimated to decline in 2020-21 as compared to 2019-20. These states are Karnataka, Mizoram, and Telangana. The Commission has recommended special grants to these states aggregating to Rs 6,764 crore.

- **Sector-specific grants:** Grant of Rs 7,375 crore for nutrition in 2020-21. Sector-specific grants for the following sectors will be provided in the final report: (i) nutrition, (ii) health, (iii) pre-primary education, (iv) judiciary, (v) rural connectivity, (vi) railways, (vii) police training, and (viii) housing.

- **Performance-based grants**: Guidelines for performance-based grants include: (i) implementation of agricultural reforms, (ii) development of aspirational districts and blocks, (iii) power sector reforms, (iv) enhancing trade including exports, (v) incentives for education, and (vi) promotion of domestic and international tourism.

- **Grants to local bodies:** Rs 90,000 crore for 2020-21: 67.5% for rural local bodies and 32.5% for urban local bodies. This allocation is 4.31% of the divisible pool. The grants will be divided between states based on population and area in the ratio 90:10

- **Disaster risk management:** Recommended setting up National and State Disaster Management Funds (NDMF and SDMF) for the promotion of local-level mitigation activities. The cost-sharing pattern between centre and states is (i) 75:25 for all states, and (ii) 90:10 for north-eastern and Himalayan states.

Table 2: Grants for disaster risk management (In Rs crore)

Funding Windows	**National corpus**	**States' corpus**
Mitigation (20%)	2,478	5,797
Response (80%)	9,912	23,186
(i) Response and Relief (40%)	4,956	11,593
(ii) Recovery and Reconstruction (30%)	3,717	8,695
(iii) Capacity Building (10%)	1,239	2,998
Total	**12,390**	**28,983**

Table 4: Some of the grants-in-aid for FY 2020-21 (in Rs crore)

State	Revenue deficit grants	Grants to rural local bodies	State's share in grants for rural local bodies	Grants to urban local bodies	State's share in grants for urban local bodies
Andhra Pradesh	5,897	2,625	4.32	1264	4.32
Arunachal Pradesh	-	231	0.38	111	0.38
Assam	7,579	1,604	2.64	772	2.64
Bihar	-	5,018	8.26	2,416	8.26
Chhattisgarh	-	1,454	2.39	700	2.39
Goa	-	75	0.12	36	0.12
Gujarat	-	3,195	5.26	1538	5.26
Haryana	-	1,264	2.08	609	2.08
Himachal Pradesh	11,431	429	0.71	207	0.71
Jharkhand	-	1,689	2.78	813	2.78
Karnataka	-	3,217	5.29	1549	5.29
Kerala	15,323	1,628	2.68	784	2.68
Madhya Pradesh	-	3,984	6.56	1,918	6.56
Maharashtra	-	5,827	9.59	2,806	9.59
Manipur	2,824	177	0.29	85	0.29
Meghalaya	491	182	0.3	88	0.3
Mizoram	1,422	93	0.15	45	0.15
Nagaland	3,917	125	0.21	60	0.21
Odisha	-	2,258	3.72	1087	3.72
Punjab	7,659	1,388	2.29	668	2.29
Rajasthan	-	3,862	6.36	1,859	6.36
Sikkim	448	42	0.07	20	0.07
Tamil Nadu	4,025	3,607	5.94	1737	5.94
Telangana	-	1,847	3.04	889	3.04
Tripura	3,236	191	0.31	92	0.31
Uttar Pradesh	-	9,752	16.05	4,695	16.05
Uttarakhand	5,076	574	0.95	278	0.95
West Bengal	5,013	4,412	7.26	2,124	7.26
Total	**74,341**	**60,750**	**100**	**29,250**	**100**

Recommendations on fiscal roadmap

- **Fiscal deficit and debt levels:** Both central and state governments should focus on debt consolidation and comply with the fiscal deficit and debt levels as per their respective Fiscal Responsibility and Budget Management (FRBM) Acts

- **Off-budget borrowings:** Both the central and state governments should make full disclosure of extra-budgetary borrowings. The outstanding extra-budgetary liabilities should be clearly identified and eliminated in a time-bound manner.

- **Statutory framework for public financial management:** Expert group to draft legislation to provide for a statutory framework for sound public financial management system.
- **Tax capacity:** The Commission recommended: (i) broadening the tax base, (ii) streamlining tax rates, (iii) and increasing capacity and expertise of tax administration in all tiers of the government
- **GST implementation:** Continuing dependence of states on compensation from the central government (21 states out of 29 states in 2018-19) for making up for the shortfall in revenue is a concern. It suggested that the structural implications of GST for low consumption states need to be considered.

- **Financing of security-related expenditure:**
- ToR of the Commission required it to examine whether a separate funding mechanism for defence and internal security should be set up and if so, how it can be operationalised.
- Recommeded an expert group comprising representatives of the Ministries of Defence, Home Affairs, and Finance.
- Defence ministry proposed (i) setting up of a non-lapsable fund, (ii) levy of a cess, (iii) monetisation of surplus land and other assets, (iv) tax-free defence bonds, and (v) utilising proceeds of disinvestment of defence public sector undertakings.
- The expert group is expected to examine these proposals or alternative funding mechanisms.

Criticisms:

- The population parameter used by the Commission has been criticised by the governments of the southern states.
- The previous FC used both the 1971 and the 2011 populations to calculate the states' shares, giving greater weight to the 1971 population (17.5%) as compared to the 2011 population (10%).
- The use of 2011 population figures has resulted in states with larger populations like UP and Bihar getting larger shares, while smaller states with lower fertility rates have lost out.
- The combined population of the Bihar, Uttar Pradesh, Madhya Pradesh, Rajasthan and Jharkhand is 47.8 crore.
- This is over 39.48% of India's total population, and is spread over 32.4% of the country's area, as per the 2011 Census.
- On the other hand, the southern states of Tamil Nadu, Kerala, Karnataka and undivided Andhra Pradesh are home to only 20.75% of the population living in 19.34% of the area, with a 13.89% share of the taxes.
- This means that the terms decided by the Commission are loaded against the more progressive (and prosperous) southern states.