COMMENTARY ON INDIA'S ECONOMY AND SOCIETY SERIES

20

REPORT OF THE 15th FINANCE COMMISSION 2021-22 to 2025-26: WHAT IT MEANS FOR THE STATES

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Thiruvananthapuram

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REPORT OF THE 15th FINANCE COMMISSION 2021-22 to 2025-26 : WHAT IT MEANS FOR THE STATES

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ABSTRACT

The report of the 15th Finance Commission for the period 2021-22 to 2025-26 has brought back the conditionalities in disbursement of grants, especially in those to augment the Consolidated Fund of the States to strengthen the resource base of the Local Governments. The report, however, has not made recommendations which were apprehended by the States like review of revenue deficit grants Article 275 and reducing the share of the States in the divisible pool of taxes. The fact that vertical fiscal imbalances are worsening has been recognised. The rising share of surcharges and cesses continue to shrink the divisible pool of taxes. The new tax devolution criteria do not seem to have helped the low per capita income States as expected, while some other States have witnessed precipitous fall in their share. It is uncertain whether the sector and State specific grants will become a reality and this can constrain the States' capacity to spend in social and economic sectors.

Keywords: Finance Commission, Divisible Pool, Revenue Deficit Grants, Fiscal Consolidation

JEL Classification: H61, H62, H63, H70, H77

Report of the 15th Finance Commission - 2021-22 to 2025-26: What it means for the States

1. General Backdrop

The Report of the 15th Finance Commission (FC) has come out at a time when the consequences of the pandemic Covid-19 have resulted in a substantial rethinking on the role of the state in the economy, especially in social sectors like health. In the twilight years of what has been described as the 'Golden Age of Capitalism' (1945-1973), stagflation led to the rise of monetarist arguments and the view that the governments should govern least and leave most of the things to the private sector. The finance capital, which became the plenipotentiary steadfastly held the view that government borrowing has to be restrained as it would crowd out funds for the private sector. The rating agencies and their grading criteria attained a dominant role in determining the fiscal policy. The aim seemed to purge the last remnants of anything that was Keynesian and supporting demand-led growth with state intervention.

Even after the Global Financial Crisis of 2008, the disdain for a counter-cyclical fiscal policy persisted. As a consequence of all this, when the pandemic struck in 2019, the public health system could not cope with it. However, the grammar of fiscal rules sought to be imposed in the last few decades had to undergo a change. The deficit targets imposed by the fiscal responsibility legislations had to be dispensed with, at least temporarily.

As Domar (1944) had stated, there was need to stop worrying about debt and start thinking about growth. The walls of deficit targeting had to be at least temporarily broken to sustain lives and livelihoods. It is in this broad global backdrop that the 15th FC submitted its two reports. There have been cataclysmic changes in the global and national scenarios, which warranted a change in the approach from what was laid down in the Terms of Reference (ToR) and in the Report of the Fiscal Reform Budget Management (FRBM) Review Committee (2017). How far the change has been and what are the implications of the Report of the 15th FC (2021-22 to 2025-26) to the persisting vertical, horizontal inequities and federal principles are briefly analysed in this paper.

2. The ToR and the Apprehensions

When the ToR of the 15th FC were notified, strident dissent emerged among several States. This led to holding of conclaves and submission of a Memorandum by a group of State Finance Ministers to the President of India. The items in the ToR which kindled these reactions were:
:

1. The mandate to use population based on 2011 census in item 8 of the ToR was viewed as being contrary to the National Population Policy (1976) which stated that population based on 1971 Census should be the basis for delimitation of constituencies and for central assistance. The

mandate in ToR 8 not only curtailed the freedom of the FC while making recommendations, but also was a disincentive for the States, which had effectively implemented policies in health and other welfare sectors.

2. The item 5 of the ToR required the 15th FC to state whether Revenue Deficit grants under Article 275[1]should be given at all. These grants have been an important component for amelioration of vertical imbalances, which persisted even after devolution of taxes.
3. The inherent bias against the welfare programmes implemented by the States vis-à-vis those being implemented by the Centre.
4. The intention in ToR 7 to bring back sector specific grants, which had been stopped by the 14th FC. Sector specific grants curtail the degrees of freedom of democratically elected State governments to spend the money at their disposal.
5. The most unprecedented part of the ToR was that it sought to comment on the impact of the enhanced devolution recommended by the 14th FC.

These apprehensions were heightened by the additional ToR given towards the end of the original tenure of the 15th FC. This required the 15th FC to make recommendations on the need to create a non-lapsable fund for the capital expenditure in the defence sector. States felt that this will result in truncation of the divisible pool of taxes, which already is shrinking due to the rising share of surcharge and cesses, which are not shareable with the States.

3. *Vertical Imbalances- The Approach of the 15th FC*

Allaying many of the fears, the share of the States in the divisible pool of taxes has been fixed at 41 per cent of the Net Proceeds[2]. The 14th FC had recommended 42 per cent share. The 15th FC claims to have retained this and the reduction of 1 per cent is due to the State of Jammu and Kashmir becoming two Union Territories. The demand of the States like Kerala in the Memorandum submitted to the 15th FC was that the share of the States in the divisible pool of taxes shall be 50 per cent of the Net Proceeds[3]. This demand has not been acceded to by the 15th FC, but the argument that vertical imbalance is quite high in India has been elaborately discussed in the report.

"*However, India has a larger (and rising) vertical gap than most federations, reflecting the reality that many States have relied heavily on transfers from the Union rather than on own tax revenues to finance their expenditures. This reflects the large vertical imbalances stemming from the effective assignment of expenditure and revenue powers between the Union and the States. Typically, inefficiency in meeting the vertical gap (resulting in vertical imbalance) shows up in unfunded spending mandates, inadequate provision of public services (both at the sub-national level) or excessive sub-national government borrowing. Such imbalances are magnified*

[1] Article 275 provides for grants to be given to States in need in accordance with the recommendations of the Finance Commissions. It is not mentioned as Revenue Deficit grants in the Constitution.

[2] Net Proceeds, according to Article 279 of the Constitution is Gross Tax Revenues (GTR) of the Union less (Surcharges + Cesses) and cost of collection.

[3] The reason for demanding 50 per cent of the Net Proceeds is that to equalise the gap between States Own Tax+ Tax Devolution + Revenue Deficit grants and the GTR of the Centre, 50 per cent devolution is required.

during crises that drive a larger wedge between sub-national revenues and expenditure responsibilities, as we are seeing during the Covid crisis. In recent years, rising fiscal deficits in many States has been a key indicator of growing vertical imbalances, despite higher tax devolution from the Union, reflecting inadequate transfers to the States relative to their expenditure needs and revenue raising capacity." (paragraph 2.17)

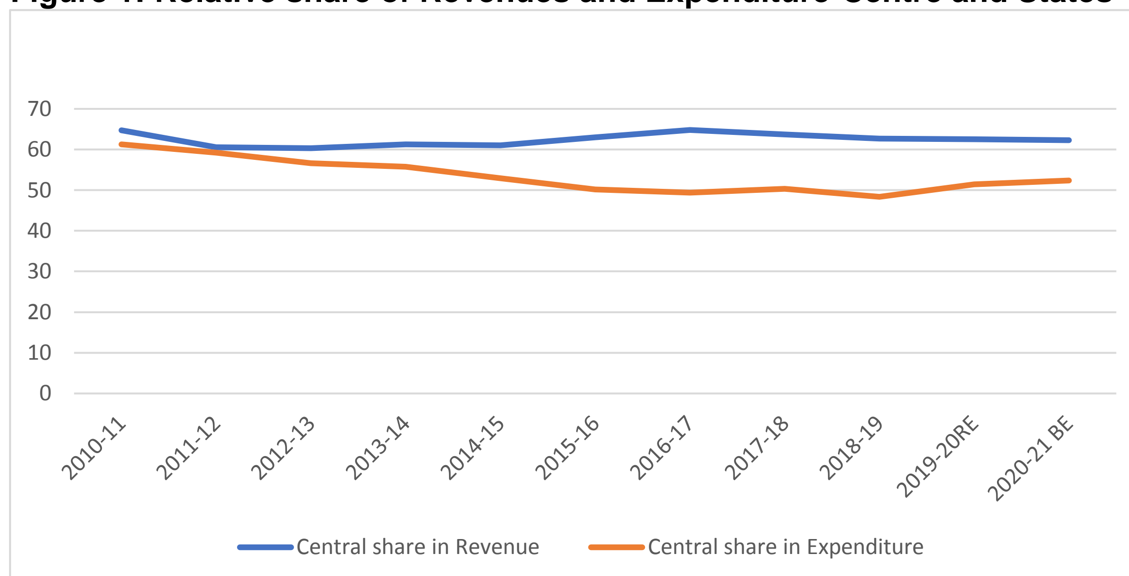
The degree of centralisation proxied by revenue and expenditure by the Centre (both prior to transfer to the States) is visible in the recent years (Table 1, Figure 1) ; implying worsening vertical fiscal imbalances.

Table 1: Relative share of Revenues and Expenditure-Centre and States

Year	Central share in Revenue	Central share in Expenditure
2010-11	64.7	61.3
2011-12	60.6	59.2
2012-13	60.3	56.6
2013-14	61.3	55.8
2014-15	61.0	52.9
2015-16	63.0	50.2
2016-17	64.8	49.4
2017-18	63.7	50.3
2018-19	62.7	48.4
2019-20RE	62.5	51.4
2020-21 BE	62.3	52.4

Source: Report of the 15th FC.

Figure 1: Relative share of Revenues and Expenditure-Centre and States



Source:Table1.

It is quite pertinent to note that when the share of taxes in the divisible pool went up, the share of surcharges and cesses in the Gross Tax Revenue (GTR) of the Union also rose. As surcharges and cesses are not shareable with the States according to Article 270 of the Constitution, this has effectively shrunk the divisible pool of taxes as can be seen from the declining share of the States in the GTR despite FCs recommending higher share of the Net Proceeds (Table 2).

Table 2: Surcharges and Cesses as % of Gross Tax Revenue

Year	Surcharge & Cess as % of GTR
2011-12	10.4
2012-13	11.7
2013-14	12.4
2014-15	13.5
2015-16	12.2
2016-17	13.5
2017-18	13.9 (10.6)
2018-19	19.9 (15.6)
2019-20 RE	20.2 (15.7)
2020-21 BE	19.9(15.3)

Source: Table 3.8, 15th FC Report. The figures in parentheses are excluding GST compensation cess.

In fact, the Centre has been reducing basic excise duty and making consistent increases in additional excise duty and road cess in the case of petroleum products as the latter are not shareable with the States. The rise in share of surcharges and cesses is evident during the last three years of the award period of the 14th FC, which had raised the share in divisible pool, to 42 per cent from 32 per cent. The share of States in the divisible pool of taxes as a percent of GTR has been continuously declining from 34.77 per cent in 2015-16 to 32.37 per cent in 2019-20. In 2020-21 Revised Estimates it is 29.4 per cent. As per 2021-22 Budget Estimates, it is 30.02 per cent.

In the face of this, it is to be taken note of that had the 15th FC reduced the States' share of taxes in the divisible pool and discontinued the revenue deficit grants under Article 275[4], the vertical fiscal imbalances would have exacerbated.

4. Conditionalities for Release of Grants to Local Governments

The 11th FC made release of a part of the post-devolution grants under Article 275 conditional on States achieving certain deficit targets. This came in for wide criticism and Amaresh Bagchi, a member of the Commission, wrote his dissent. The 15th FC has brought in a number of conditionalities for release of grants in the case of Local Governments (LGs).The web of conditionalities is alarming.

Grants to Local Governments, rural and urban are devolved as per the requirement under Article 280(3) (bb) and (c).

[4] Article 275 provides for grants to States in need of assistance and does not mention about revenue deficits.

“(*bb) the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats in the State on the basis of the recommendations made by the Finance Commission of the State:*
(c) the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State”

The 15th FC has recommended total grants to local bodies at Rs 4.36 lakh crore with Rs 2.4 lakh crore for rural local bodies, and Rs 1.2 lakh crore for urban local bodies, and Rs 70,051 crore for health grants through Local Governments.

These grants have been distributed on the criteria of population and area with 90 and 10 per cent weights respectively. There have been some limits for inter se distribution of grants among tires of local governments. But 60 per cent of the grants have been made conditional apart from three entry conditionalities. Unless the latter are satisfied, the State will not get grants under Article 280 (3) (bb) and (c). The entry conditionalities are:

1) constituting State Finance Commissions and implementing their recommendations by March 2024,
2) placing in public domain the audited accounts of the year prior to the previous year and provisional accounts of the previous year and
3) for urban local governments notification of floor rates for property tax in financial year 2021-22 and after that annual increase matching the three year average growth rate of Gross State Domestic Product.

Once these entry conditions are satisfied further conditionalities are imposed. 60 per cent of the grants are tied to water supply, sanitation and for urban local bodies solid waste management is also included; This implies that only 40 per cent of the grants can be spent according to local priorities.

First of all, State Finance Commissions should have been constituted and action should have been taken. One cannot find fault with this. The other conditions for availing of grants are publishing provisional accounts for the previous year and audited accounts for the year before online, for urban LGs, floor rate for property tax should be fixed and growth on a par with the five year average growth rate of GSDP should be ensured. All the conditionalities are to be cumulatively satisfied.

Once grants are disbursed, only 40 per cent of them are untied and the remaining 60 per cent can be utilised only in the specified sectors. Making 60 per cent of the grants tied, is an unrealistic constraint put on the process of democratic decentralisation and ignores the State wise specificities and needs. This is also counter to the subsidiarity principle which holds if the tier of government closest to the people can implement certain policies efficiently, such policies should be left to them.

5. Recommendations on Path for Fiscal Consolidation

The ToR of the 15th FC was notified when the recommendations of the committee to review the Fiscal Responsibility and Budget Management (FRBM) Act had caused considerable discontent among the States. The committee had recommended limiting general government borrowing to 60 per cent of the GDP (40 per cent for the Centre and 20 per cent for the States). The glide path of deficit targeting was fixed at 2.5 per cent and 1.7 per cent of GDP for Centre and States respectively.

Even in the pre-pandemic situation, this would have been a fiscal disaster for the States. The pandemic and its aftermath have resulted in a total change in scenario and the FRBM review committee's recommendations had become totally impracticable. The fiscal deficit glide path of the States for the next five years have been fixed at 4 per cent for 2021-22 and 2022-23, 3.5 per cent for 2023-24 and 2024-25 and 3 per cent for 2025-26. For 2021-22 an additional 0.5 per cent will be allowed, if power sector reforms are implemented.

The inequity in the approach is evident from the fiscal consolidation path for the Centre which is more liberal even while acknowledging the fact that revenue expenditure imbalance between the Centre and the States are rising. The range of fiscal deficit of the Union Government has been fixed at 6.5 (which is 9.5 as per revised estimates in the Union budget 2021),6.0,5.5,5.0 and 4.5 for the same period mentioned above. This not only would worsen the vertical inequity, which is already high, but also goes against principle that the basic economic responsibility for macro economic stabilisation is with the Centre (Musgrave1959).

6. Revenue Deficit Grants and Tax Devolution

As regards Revenue Deficit grants, the 15th FC has continued with the same (it has recommended Rs 2.94 lakh crore revenue deficit grants as against Rs 1.94 lakh crore by the 14th FC) and has used this as a mechanism to partly compensate the States which have lost much due to the change in devolution formula. But this is not a full substitute for the loss in share of the divisible pool taxes, as these grants taper off in later years. Hence, the losses from diminished tax share will continue.

The tax sharing formula has used population based on 2011 census as an explicit criterion and also for scaling the shares based on other criteria. The criterion Demographic Change which has 12.5 per cent weightage is a relief to the States, which have made demographic achievements and is the result of consistent demands made by these States. Only this has been scaled by population based on 1971 census. The income distance criterion has 45 per cent weightage in the 15th FC report as compared to 50 per cent in the 14th FC report. While computing per capita income for measuring income distance, current population enters as a denominator. As this is further scaled by 2011 population, States with better demographic indicators witnessed a further fall in their shares.

One pertinent point to be noted here is that FC transfers are less discretionary when compared to non-FC transfers and a rising share of FC transfers indicate better progressivity in central transfers. The share of FC transfers in total central transfers to the States has shown a declining trend during the six year period 2015-16 to

2020-21. Except 2020-2, the remaining five years are within the award period of the 14th FC. This clearly indicates that the degree of progressivity in Union transfers has come down.

Table 3: Share of FC transfers in total Union transfers

Year	Share of FC transfers in total Union transfers (%)
2015-16	72.3
2016-17	73.1
2017-18	68.8
2018-19	70.5
2019-20(RE)	62.5
2020-21 (BE)	64.6

Source: Table 3.19 of the 15th FC Report.

7. New Tax Sharing Formula - Losses and Gains

The new formula has resulted in substantial losses for Kerala and Karnataka and marginal losses for Tamil Nadu, Telangana, Odisha and Uttar Pradesh. The largest gainer is Maharashtra followed by Rajasthan, Gujarat and Bihar. The higher degree of progressivity[5] in the new formula is not that evident.

Table 4: Share in Divisible Pool 14th and 15th FCs

Name of State	Share in Divisible Pool (14th FC)	Share in Divisible Pool (15th FC)	Loss (-) / Gain (+)
Andhra Pradesh	4.31	4.047	-0.263
Arunachal Pradesh	1.38	1.757	0.377
Assam	3.31	3.128	-0.182
Bihar	9.67	10.058	0.388
Chhattisgarh	3.07	3.047	-0.023
Goa	0.38	0.386	0.006
Gujarat	3.1	3.478	0.378
Haryana	1.1	1.093	-0.007
Himachal Pradesh	0.71	0.83	0.12
Jharkhand	3.14	3.307	0.167
Karnataka	4.71	3.647	-1.063
Kerala	2.5	1.925	-0.575

[5]Progressivity implies lower per capita income States getting a greater share.

Madhya Pradesh	7.55	7.85	0.3
Maharashtra	5.52	6.317	0.797
Manipur	0.62	0.716	0.096
Meghalaya	0.64	0.767	0.127
Mizoram	0.45	0.5	0.05
Nagaland	0.5	0.569	0.069
Odisha	4.64	4.528	-0.112
Punjab	1.57	1.807	0.237
Rajasthan	5.5	6.026	0.526
Sikkim	0.36	0.388	0.028
Tamil Nadu	4.02	4.079	0.059
Telangana	2.43	2.102	-0.328
Tripura	0.64	0.708	0.068
Uttar Pradesh	17.95	17.939	-0.011
Uttarakhand	1.05	1.118	0.068
West Bengal	7.33	7.523	0.193

Source: Reports of the 14th and 15th FCs.

8. Sector Specific and State Specific Grants

Sector-specific grants: Sector-specific grants to States amounting to Rs 1.3 lakh crore has been recommended for eight sectors: (i) health, (ii) school education, (iii) higher education, (iv) implementation of agricultural reforms, (v) maintenance of PMGSY roads, (vi) judiciary, (vii) statistics, and (viii) aspirational districts and blocks. A portion of these grants will be performance-linked.

State-specific grants: The 15th FC has recommended state-specific grants of Rs 49,599 crore. These will be given in the areas of: (i) social needs, (ii) administrative governance and infrastructure, (iii) water and sanitation, (iv) preservation of culture and historical monuments, (v) high-cost physical infrastructure, and (vi) tourism. The Commission has also recommended a high-level committee at state-level to review and monitor utilisation of state-specific and sector-specific grants.

The question that is facing the States is whether they would get these and if they get it, whether they would get the amount recommended by the 15th FC. The Action Taken Report (ATR; presented in the Parliament by the Government of India states that with regard to Sector specific and State specific grants, due consideration will be given while formulating centrally sponsored schemes. It is also mentioned that other grants and tax devolution will also be factored in. In short, there is no specific commitment on these recommendations from the Government of India.

9. *Fiscal Consolidation- What do the Recommendations Imply?*

Much of the apprehensions of the States was on what approach would the 15th FC take on the fiscal consolidation path for the States. The road map in the FRBM review committee report (2017) was that overall fiscal deficit should be brought to 5 per cent from 6 per cent of the Gross Domestic Product (GDP) and the primary deficit of the States being higher, their fiscal deficit should be limited to 1.7 per cent of GDP. This was to achieve the general government debt target of 60 percent, with the Centre's debt at 40 per cent and that of States at 20 per cent. These targets had they been imposed in States, would have led to shrinkage of the fiscal space of the States to the point of bringing intervention in social and economic sectors to a standstill. The 15th FC has not recommended these targets. The important recommendations include taking into consideration extra budget borrowings. This needs to be disclosed. But are they part of government borrowings? Guarantees by governments are contingent liabilities but they cannot be treated as borrowings until they become payable through Annual Financial Statement. There needs to be clarity on this.

The 15th FC has in line with the previous 14th FC, suggested forming Fiscal Councils for assessing revenue and expenditure and report whether they are in accordance with the medium term fiscal targets. The 15th FC has suggested that the Fiscal Councils will be advisory in nature.

There is an important question. If a Fiscal Council formed by the Centre analyses and reports on States' finances on a continuing basis, will it be of an advisory nature or become the basis for giving conditional grants? It can as well become an extra legislative control on the States. There needs to be discussions on this aspect in a constitutional body like the inter-State Council. Presently, setting limits on borrowings rest separately with the Union and the States through Articles 292 and 293 respectively. Whether there will be one Fiscal Council or each State should have its own Fiscal Councils is to be decided. The latter will be in accordance with the constitutional provisions.

10. Concluding Remarks

In conclusion, it can be stated that the new web of conditionalities in grants, especially in grants to Local Governments under Article 280 (3) (bb) and (c) to augment the Consolidated Fund of the States for supplementing the resources for panchayats and municipalities does not augur well for a cooperative federal set up. The rise in share of surcharges and cesses is resulting in shrinking of divisible pool. The change in devolution criteria does not seem to have achieved a higher degree of progressivity. On the whole, the report is a step backward from that of the 14th FC.

On the positive side, it can be stated that the initiatives of the States, which came out against items in the ToR which were counter to the basic principles of federalism like review of revenue deficit grants under Article 275, reduction in share of divisible pool, have been successful. As regards the fiscal roadmap is considered, extra budgetary resource mobilisation is considered as something to be discouraged and more responsibility has been put on the States. The impact of Fiscal Council on federal relations needs to be discussed in detail between the Centre and the States.

The States which will face tapering of revenue deficit grants, stopping of GST compensation by 2022-23 and having to adhere to 3 per cent deficit target by 2025-26, will face fiscal constraints in the short run. The fiscal road map for the States has been made harder by imposing stiffer conditions than that for the Centre. Besides, the uncertainty regarding the State and Sector specific grants becoming a reality will hamstring the spending capacity of the States in the near future.

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