Fifteenth Finance commission

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Manifest pedagogy:

Finance commission and NITI Aayog are to be studied along with history of planning, in light of changes in development patterns, disaster management, environmental concerns and also growing regional inequality. Moreover, the cause and effect of policies put forth by the two are important for UPSC Prelims and Mains Examination

In news:

- 15th FC panel gets extension to examine defence funding mechanism

Placing it in syllabus:

Fiscal Federalism, Budgeting

Static dimensions:

- Finance commission (FC)
- Terms of reference (ToR) for 15th Finance commission
- FRBM Review

Current dimensions:

- Challenges before 15th FC
- Defence Funding Mechanism
- Regional Considerations

Content:

The Union Cabinet has approved expanding the terms of reference of the Fifteenth FC to address the funding requirements for defence and internal security as also extending its term to November 30, 2019. The Fifteenth FC was constituted by the President of India in November 2017 and was constituted to give recommendations for the five-year period starting April 1, 2020

Finance Commission:

- The First Finance Commission was established by the President of India in 1951 under **Article 280** of the Indian Constitution.
- Was formed to define the financial relations between the central government of India and the individual state governments.
- The Finance Commission (Miscellaneous Provisions) Act, 1951 additionally defines the terms of qualification, appointment and disqualification, the term, eligibility and powers of the Finance Commission.
- As per the Constitution, the Commission is appointed every five years and consists of a chairman and four other members.
- There have been fifteen commissions to date. The most recent was constituted in 2017 and is chaired by N. K.Singh, a former member of the Planning Commission

The Chairman of the finance commission is selected from people with experience of public affairs. The other four members are selected from people who:

- Are, or have been, or are qualified, as judges of the high court,
- Have knowledge of government finances or accounts, or
- Have had experience in administration and financial expertise; or
- Have special knowledge of economics

Every member will be in office for the time period as specified in the order of the President, but is eligible for reappointment provided he has, by means of a letter addressed to the president, resigned his office.

Terms of reference(ToR) of 15th FC:

- The ToR and the matters that shall be taken into consideration by the Fifteenth FC in making the recommendations are as under:

(i) The distribution between the Union and the States of the net proceeds of taxes and the allocation between the States of the respective shares of such proceeds;

(ii) The principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States by way of grants-in-aid of their revenues under Article 275 of the Constitution;

(iii) The measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State

- The Commission shall review the current status of the finance, deficit, debt levels, cash balances and fiscal discipline efforts of the Union and the States, and recommend a fiscal consolidation roadmap for sound fiscal management, fostering higher inclusive growth in the country, guided by the principles of equity, efficiency and transparency.
- The Commission may also examine whether revenue deficit grants be provided at all.

The terms referred for the consideration of the 15th FC have raised doubts over the cooperative spirit of the centre.

- Considering the use of 2011 census as the basis for resources allocation between states is the most serious issue (presently, 1971 census is being used).

- The proposal unleashes immense socio-political challenges because the census switchover would disadvantage states that performed better in controlling their population over the decades.
- Lower population growth is inherently linked to "lower fertility rates", which is a consequence of better education, health services and development.
- Hence, it is seemingly apparent that the states that have progressed faster are being penalised for their successes in developmental initiatives.
- Funds for southern states might get stifled as their family planning initiatives have almost stabilised their populations.
- Even West Bengal and North Eastern states have had considerable success in population control and might thereby see their share of allocations reduced.
- In contrast, some northern states continue to see a burgeoning trend in their population with little control, which might enhance fund allocations for them.
- This creates inter-state tensions, which is adding to the already existing cultural tensions between the northern and southern states.

Challenges before 15th FC:

Contending with the slowdown in the Indian economy is a major challenge. There is an upward trend in the fiscal deficits of states due to persistent off-budget spending. The inter-governmental transfer system has become overly complex with different sharing arrangements for different taxes. Spending autonomy of the states, combined with their ability to borrow, has obstructed efforts at consolidating public finances. There is little incentive for states to improve revenue performances.

The higher devolution under the 14th FC have seen marginal increases in social sector allocations. There are pressures to increase allocations to the centrally sponsored schemes (CSS) for higher expenditure on health and education.

On the horizontal balances, the 15th Finance Commission has the responsibility of equalising the widening gap between richer states and low-income states. These inequalities have resulted in widely differing social and capital expenditure between the states. A large part of the equalisation effort by the 15th Finance Commission would have to be through grants-in-aid rather than devolution.

The deteriorating public debt dynamics caused by the requirements of the power sector's restructuring would be a major area of concern. An alternative fiscal scenario would need to be considered to limit the on-budget fiscal deficits to 3 per cent by including the power sector. Then, a debt-to-GSDP ratio of 25 percent greatly limits the government's borrowing needs and has the potential to curtail social sector expenditure.

Other aspects to be taken into account by 15th FC:

Devolution – 15th Finance Commission has been asked to analyse the impact on the finances of the Union government due to enhanced devolution to states. This is an indication that the enhanced devolution of 42% (from 32%) might be reversed if the Union feels financially constrained.

Reversal will be counterproductive as the 2014 devolution did not lead to any change in the quantum of funds that reached the states. The only change was that the funds that were given away through central flagship schemes was trimmed and the money thus saved was transferred to the state kitty for facilitating unfettered spending as per state discretion.

Curbing Populism – The 15th commission has also been asked to examine ways to curb populist spending due to electoral calculations. Given the growing concerns over rising state deficits (especially in Bihar and Punjab), the concerns over excessive state spending are well taken.

But there is no clear definition of “populist” programmes or on who decides what is populaist and thereby the ambiguity is very open.

Pro-Business – Finding ways to encourage “Ease of Doing Business” has also been mandated from the 15th Finance commission. While competition among states for investment is welcome, a race among states to dismantle all regulation is undesirable. Better analysis of constraints to business is needed rather than merely removing regulatory checks that are key to sustain the business ecosystem.

Expansion of the Tax Net – The GST is a cooperative enterprise between the centre and the states. Expansion and deepening of tax base under the GST is the joint responsibility of both the centre and the states. It is possible that in some states, the tax base may have been extensively trawled. In some states, this may not be the case. States alone cannot be given full credit for good performance nor can they be held accountable for lethargy in widening this tax base.

Under the Goods and Services Tax (Compensation to States) Act, 2017, state governments are guaranteed a compounded annual growth rate of 14% over 2015–16 (base year). Any shortfall in their collections will be met by compensation grants from the union government to the extent of 100% of the operational loss for the next five years.

The centre recently amended the GST compensation act increasing the cess on some motor vehicles from 15% to 25%. Evidently, the GST Council anticipates demands for compensation from states to exceed original estimates. This 15th FC is being asked to incentivise states for good performance in GST, when the design of the compensation scheme promoted by the central government makes them indifferent to the success of the GST for the next five years.

Income distance criterion: Income distance has been used as a criterion for horizontal devolution over the last seven finance commissions. This parameter provides greater weightage to poorer states depending upon the distance of their per capita GSDP from that of a rich state (Haryana in the case of the 14th FC). Placing high importance on equity, the 14th FC provided a weightage of 50% to the income distance criterion.

If the 2011 population is used for computations, the five states of Uttar Pradesh, Bihar, Madhya Pradesh, West Bengal, and Rajasthan would have an aggregate weightage of 32.48% out of the 50% weight accorded to income distance to all the 29 states. The use of the 1971 population would have moderated the impact of this double whammy on the “non-poor” states.

FRBM Review Panel:

Debt to GDP ratio:The Committee suggested using debt as the primary target for fiscal policy. A debt to GDP ratio of 60% should be targeted with a 40% limit for the centre and 20% limit for the states. It noted that the majority of the countries that have adopted fiscal rules have targeted a debt to GDP ratio of 60%.The targeted debt to GDP ratio should be achieved by 2023.This ratio is expected to be around 70% in 2017.

Further, the government may be allowed to deviate from the specified targets upon the advice of the Fiscal Council in the following circumstances: (i) considerations of national security, war, national calamities and collapse of agriculture affecting output and incomes, (ii) structural reforms in the economy resulting in fiscal implications, or (iii) decline in real output growth of at least 3% below the average of the previous four quarters. These deviations cannot be more than 0.5% of GDP in a year.

Debt trajectory for individual states:The Committee recommended that the 15thFinance Commission should be asked to recommend the debt trajectory for individual states. This should be based on their track record of fiscal prudence and health

Defence fund transfer:

The Cabinet chaired by Prime Minister Narendra Modi has recently approved the proposed amendment to enable 15th FC to address serious concerns regarding the allocation of adequate, secure and non-lapsable funds for defence and internal security of India. Under the ToR of the Commission, it is proposed to ensure an assured allocation of resources towards defence and internal security imperatives.

The amendment provides, which the 15th FC shall also examine if a separate mechanism for funding of defence and internal security ought to be set up. However this attempt has been criticised as the Centre might occupy more fiscal space and the move would reduce the kitty that will be available for division between the Centre and states. Now the FC will submit its report to the government on November 30,2019 rather than October 31