Report of the 15th Finance Commission

February 11, 2020
Source: *PIB, Union Budget 2020-21 and PRS India*

The 15th Finance Commission (Chair: Mr N. K. Singh) submitted its report for FY 2020-21. The commission was required to submit two reports. The first report, consisting of recommendations for the financial year 2020-21, was tabled in Parliament on February 1, 2020. The final report with recommendations for the 2021-26 period will be submitted by October 30, 2020.

Key Recommendations

- **Decrease in the devolution of taxes to states:** The share of states in the centre's taxes is recommended to be **decreased from 42% during the 2015-20 period to 41% for 2020-21.** The 1% decrease is to provide for the newly formed union territories of Jammu and Kashmir, and Ladakh from the resources of the central government.
- **Criteria for devolution:** Criteria used by the Commission to determine each state's share in central taxes, and the weight assigned to each criterion;

- States with lower per capita income would be given a higher share to maintain equity among states.
- **Demographic performance:** The Terms of Reference (ToR) of the Commission required it to use the population data of 2011 while making recommendations. Accordingly, the Commission used only 2011 population data for its recommendations.
- **The Demographic Performance criterion** has been introduced to reward efforts made by states in

controlling their population. It will be computed by using the reciprocal of the **total fertility ratio of each state, scaled by 1971 population data.** States with a lower fertility ratio will be scored higher on this criterion. The total fertility ratio in a specific year is defined as the total number of children that would be born to each woman if she were to live to the end of her child-bearing years and give birth to children in alignment with the prevailing age-specific fertility rates.

- Forest and ecology: This criterion has been arrived at by **calculating the share of the dense forest of each state in the aggregate dense forest of all the states.**
- **Tax effort:** It has been **used to reward states with higher tax collection efficiency.** It has been computed as the ratio of the average per capita own tax revenue and the average per capita state GDP during the three-year period between 2014-15 and 2016-17.
- **Grants-in-aid:** In 2020-21, the following grants will be provided to states:
    1. Revenue deficit grants
    2. Grants to local bodies, and
    3. Disaster management grants.
- The Commission has also proposed a **framework for sectors specific and performance-based grants**.
- Revenue deficit grants: In 2020-21, 14 states are estimated to have an aggregate revenue deficit of Rs 74,340 crore post-devolution. The Commission recommended revenue deficit grants for these states
- **Special grants:** In the 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:** The Commission has recommended a

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: nutrition, health, pre-primary education, judiciary, rural connectivity, railways, police training, and housing.

- **Performance-based grants:** Guidelines for performance-based grants include:
    1. Implementation of agricultural reforms
    2. Development of aspirational districts and blocks
    3. Power sector reforms
    4. Enhancing trade including exports
    5. Incentives for education, and
    6. Promotion of domestic and international tourism.
- **Grants to local bodies:** The total grants to local bodies for 2020-21 has been fixed at Rs 90,000 crore, of which Rs 60,750 crore is recommended for rural local bodies (67.5%) and Rs 29,250 crore for urban local bodies (32.5%). 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.** The grants will be made available to all three tiers of Panchayat-village, block, and district.
- **Disaster risk management:** The Commission recommended setting up **National and State Disaster Management Funds (NDMF and SDMF)** for the promotion of local-level mitigation activities. The Commission has recommended retaining the existing cost-sharing patterns between the centre and states to fund the SDMF (new) and the SDRF (existing). 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. For 2020-21, State Disaster Risk Management Funds have been allocated Rs 28,983 crore, out of which the share of the union is Rs 22,184 crore. The National Disaster Risk Management Funds has been allocated Rs 12,390 crore.

Recommendations on the fiscal roadmap

- **Fiscal deficit and debt levels:** It recommended that **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:** The Commission observed that financing capital expenditure through off-budget borrowings detracts from compliance with the FRBM Act. It **recommended that both the central and state governments should make full disclosure of extrabudgetary borrowings.** The outstanding extra-budgetary liabilities should be clearly identified and eliminated in a time-bound manner.
- **The statutory framework for public financial management:** The Commission recommended **forming an expert group to draft legislation to provide for a statutory framework for sound public financial management system.** It observed that an overarching legal fiscal framework is required which will provide for budgeting, accounting, and audit standards to be followed at all levels of government.
- **Tax capacity:** The Commission noted that **tax revenue is far below the estimated tax capacity of the country**(around 17.5% of GDP in 2018-19 of centre & State). Further, India’s tax capacity has largely **remained unchanged since the early 1990s**. In contrast, tax revenue has been rising in other emerging markets. The Commission recommended:
    1. Broadening the tax base
    2. Streamlining tax rates, (iii) and
    3. Increasing capacity and expertise of tax administration in all tiers of the government.
- **Challenges in implementation of GST:** The Commission highlighted some challenges with the implementation of the Goods and Services Tax (GST). These include:

1. Large shortfall in collections as compared to original forecast
2. High volatility in collections
3. Accumulation of large integrated GST credit
4. Glitches in invoice and input tax matching, and
5. Delay in refunds.

- The 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.**

Other key recommendations are:

- **Financing of security-related expenditure:** The 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. In this regard, the C**ommission intends to constitute an expert group comprising representatives of the Ministries of Defence, Home Affairs, and Finance.** The Commission noted that the Ministry of Defence proposed following measures for this purpose:
  1. Setting up of a non-lapsable fund
  2. Levy of a cess
  3. Monetisation of surplus land and other assets
  4. Tax-free defence bonds, and
  5. Utilising proceeds of disinvestment of defence public sector undertakings.