

## **Report of the 15th Finance Commission for 2021-26**

### **Why in news?**

The 15th Finance Commission (FC), chaired by Mr. N. K. Singh, recently submitted its report with recommendations for 2021-26 period.

### **What is the FC tasked to?**

- The Finance Commission is a constitutional body formed by the President of India to give suggestions on centre-state financial relations.
- The 15<sup>th</sup> FC was required to submit two reports.
- The first report, consisting of recommendations for the financial year 2020-21, was tabled in Parliament in February 2020.
- The final report with recommendations for the 2021-26 period was tabled in Parliament on February 1, 2021.

### **Key recommendations in the report for 2021-26**

#### **SHARE OF STATES IN CENTRAL TAXES**

- The share of states in the central taxes for the 2021-26 period is recommended to be 41%, same as that for 2020-21.
- This is less than the 42% share recommended by the 14th Finance Commission for 2015-20 period.
- The adjustment of 1% is to provide for the newly formed UTs of Jammu and Kashmir, and Ladakh from the resources of the centre.

#### **CRITERIA FOR DEVOLUTION**

- The criteria for distribution of central taxes among states for 2021-26 period is same as that for 2020-21.
- However, the reference period for computing income distance and tax efforts are different.
  - 2015-18 for 2020-21 and 2016-19 for 2021-26
- Hence, the individual share of states may still change.
- The criteria used by the Commission to determine each state's share in central taxes, and the weight assigned is as follows:
  1. Income distance - 45%
  2. Population (2011) - 15%

3. Area - 15%
  4. Forest and Ecology - 10%
  5. Demographic performance - 12.5%
  6. Tax Effort - 2.5%
- **Income distance:** Income distance is the distance of a state's income from the state with the highest income.
  - Income of a state has been computed as average per capita GSDP during the three-year period between 2016-17 and 2018-19.
  - A state with lower per capita income will have a higher share to maintain equity among states.
  - **Demographic performance:** As per its Terms of Reference, the Commission used the population data of 2011 for its recommendations.
  - The demographic performance criterion has been used to reward efforts made by states in controlling their population.
  - States with a lower fertility ratio will be scored higher on this criterion.
  - **Forest and ecology:** This is arrived at by calculating the share of the dense forest of each state in the total dense forest of all the states.
  - **Tax and fiscal efforts:** This criterion has been used to reward states with higher tax collection efficiency.
  - It is measured as the ratio of the average per capita own tax revenue and the average per capita state GDP during the 3 years between 2016-17 and 2018-19.

## GRANTS

- Over the 2021-26 period, the following grants will be provided from the centre's resources:

### Revenue deficit grants

- 17 states will receive grants worth Rs 2.9 lakh crore to eliminate revenue deficit.

### Sector-specific grants

- Sector-specific grants of Rs 1.3 lakh crore will be given to states for eight sectors which are -
  - health, school education, higher education, implementation of agricultural reforms, maintenance of PMGSY roads, judiciary, statistics, and aspirational districts and blocks
- A portion of these grants will be performance-linked.

### State-specific grants

- The Commission recommended state-specific grants of Rs 49,599 crore.
- These will be given in the areas of:
  1. social needs
  2. administrative governance and infrastructure
  3. water and sanitation
  4. preservation of culture and historical monuments
  5. high-cost physical infrastructure
  6. tourism
- The Commission recommended a high-level committee at state-level to review and monitor utilisation of state-specific and sector-specific grants.

### **Grants to local bodies**

- The total grants to local bodies will be Rs 4.36 lakh crore (a portion of grants to be performance-linked) including:
  - i. Rs 2.4 lakh crore for rural local bodies
  - ii. Rs 1.2 lakh crore for urban local bodies
  - iii. Rs 70,051 crore for health grants through local governments
- The grants to local bodies will be made available to all three tiers of Panchayat - village, block, and district.
- The health grants will be provided for:
  - i. conversion of rural sub-centres and primary healthcare centres (PHCs) to health and wellness centres (HWCs)
  - ii. support for diagnostic infrastructure for primary healthcare activities
  - iii. support for urban HWCs, sub-centres, PHCs, and public health units at the block level
- Grants to local bodies (other than health grants) will be distributed among states based on population and area, with 90% and 10% weightage, respectively.
- The Commission has prescribed certain conditions for availing these grants (except health grants). The entry-level criteria include:
  - i. publishing provisional and audited accounts in the public domain
  - ii. fixation of minimum floor rates for property taxes by states and improvement in the collection of property taxes (an additional requirement after 2021-22 for urban bodies)
- No grants will be released to local bodies of a state after March 2024 if the state does not constitute State Finance Commission and act upon its recommendations by then.

### **Disaster risk management**

- The Commission recommended retaining the existing cost-sharing patterns between the centre and states for disaster management funds.
- The cost-sharing pattern between centre and states is:
  - i. 90:10 for north-eastern and Himalayan states
  - ii. 75:25 for all other states
- State disaster management funds will have a corpus of Rs 1.6 lakh crore (centre's share is Rs 1.2 lakh crore).

## **FISCAL ROADMAP**

### **Fiscal deficit and debt levels**

- The Commission suggested that the centre bring down fiscal deficit to 4% of GDP by 2025-26.
- For states, it recommended the fiscal deficit limit (as % of GSDP) of:
  - i. 4% in 2021-22
  - ii. 3.5% in 2022-23
  - iii. 3% during 2023-26
- A state may be unable to fully utilise the sanctioned borrowing limit as specified above during the first 4 years (2021-25).
  - In that case, it can avail the unutilised borrowing amount in subsequent years (within the 2021-26 period).
- Extra annual borrowing worth 0.5% of GSDP will be allowed to states during first four years (2021-25) upon undertaking power sector reforms including:
  - i. reduction in operational losses
  - ii. reduction in revenue gap
  - iii. reduction in payment of cash subsidy by adopting direct benefit transfer
  - iv. reduction in tariff subsidy as a percentage of revenue
- The Commission observed that the recommended path for fiscal deficit for the centre and states will result in a reduction of total liabilities of -
  - i. the centre from 62.9% of GDP in 2020-21 to 56.6% in 2025-26,
  - ii. the states on aggregate from 33.1% of GDP in 2020-21 to 32.5% by 2025-26
- It recommended forming a high-powered inter-governmental group to:
  - i. review the Fiscal Responsibility and Budget Management Act (FRBM)
  - ii. recommend a new FRBM framework for centre as well as states, and oversee its implementation

### **Revenue mobilisation**

- Income and asset-based taxation should be strengthened.
- The coverage of provisions related to tax deduction and collection at source (TDS/TCS) should be expanded.
  - This is to reduce excessive dependence on income tax on salaried incomes.
- Stamp duty and registration fees at the state level have large untapped potential.
- Computerised property records should be integrated with the registration of transactions, and the market value of properties should be captured.
- State governments should streamline the methodology of property valuation.

## **GST**

- The inverted duty structure between intermediate inputs and final outputs present in GST needs to be resolved.
  - Under the inverted duty structure, import duty on finished goods is low compared to the import duty on raw materials used in production.
  - Resultantly, domestic manufacturing becomes uncompetitive as against imported finished goods.
- Revenue neutrality of GST rate should be restored.
  - It has notably been compromised by multiple rate structure and several downward adjustments.
- Rate structure should be rationalised by merging the rates of 12% and 18%.
- States need to step up field efforts for expanding the GST base and for ensuring compliance.

## **Financial management practices**

- A comprehensive framework for public financial management should be developed.
- An independent Fiscal Council should be established with powers to assess records from the centre as well as states.
- The Council will only have an advisory role.
- A time-bound plan for phased adoption of standard-based accounting and financial reporting for both centre and states should be prepared.
  - This is even while eventual adoption of accrual-based accounting is being considered.
- The centre as well as states should not resort to off-budget financing or any other non-transparent means of financing for any expenditure.
  - A standardised framework for reporting of contingent liabilities should be devised.
- Both centre and states should strive to improve the accuracy and consistency of macroeconomic and fiscal forecasting.

- States should amend their fiscal responsibility legislation to ensure consistency with the centre's legislation, in particular, with the definition of debt.
- States should have more avenues for short-term borrowings other than the ways and means advances, and overdraft facility from the RBI.
- States may form an independent debt management cell to manage their borrowing programmes efficiently.

## **OTHER RECOMMENDATIONS**

### **Health**

- States should increase spending on health to more than 8% of their budget by 2022.
- Primary healthcare expenditure should be two-thirds of the total health expenditure by 2022.
- Centrally sponsored schemes (CSS) in health should be flexible enough to allow states to adapt and innovate.
- Focus of CSS in health should be shifted from inputs to outcome.
- All India Medical and Health Service should be established.

### **Funding of defence and internal security**

- A dedicated non-lapsable fund called the Modernisation Fund for Defence and Internal Security (MFDIS) will have to be constituted.
- This is to primarily bridge the gap between budgetary requirements and allocation for capital outlay in defence and internal security.
- The fund will have an estimated corpus of Rs 2.4 lakh crore over the five years (2021-26).
- Of this, Rs 1.5 lakh crore will be transferred from the Consolidated Fund of India.
- Rest of the amount will be generated from measures such as disinvestment of defence public sector enterprises, and monetisation of defence lands.

### **Centrally-sponsored schemes (CSS)**

- A threshold should be fixed for annual allocation to CSS below which the funding for a CSS should be stopped.
  - The objective is to phase out CSS which outlived its utility or has insignificant outlay.
- Third-party evaluation of all CSS should be completed within a stipulated timeframe.
- Funding pattern should be fixed upfront in a transparent manner and be kept stable.

**Source: PRS India**

