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 15th 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