15th Finance Commission

What is the Finance Commission?

The Finance Commission is **constituted by the President under article 280 of the Constitution,** mainly to give its recommendations on distribution of tax revenues between the Union and the States and amongst the States themselves.

Two distinctive features of the Commission's work involve **redressing the vertical imbalances between the taxation powers and expenditure responsibilities of the centre and the States respectively and equalization of all public services across the States.**

What are the functions of the Finance Commission?

It is the duty of the Commission to make recommendations to the President as to:

1. the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them and the allocation between the States of the respective shares of such proceeds;
2. the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India;
3. 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;
4. any other matter referred to the Commission by the President in the interests of sound finance.

The Commission determines its procedure and have such powers in the performance of their functions as Parliament may by law confer on them.

Who appoints the Finance Commission and what are the qualifications for Members?

The Finance Commission is appointed by the President under **Article 280 of the Constitution.**

As per the provisions contained in **the Finance Commission [Miscellaneous Provisions] Act, 1951 and The Finance Commission (Salaries & Allowances) Rules, 1951,** the Chairman of the Commission is selected from among persons who have had experience in public affairs, and the four other members are selected from among persons who:

1. are, or have been, or are qualified to be appointed as Judges of a High Court; or
2. have special knowledge of the finances and accounts of Government; or
3. have had wide experience in financial matters and in administration; or
4. have special knowledge of economics.

When was the first Commission Constituted and how many Commissions have been Constituted so far?

The First Finance Commission was constituted vide Presidential Order dated 22.11.1951 under the chairmanship of Shri K.C. Neogy on 6th April, 1952. Fifteenth Finance Commissions have been Constituted so far at intervals of every five years.

Why is there a need for a Finance Commission?

The Indian federal system allows for the division of power and responsibilities between the centre and states. Correspondingly, the taxation powers are also broadly divided between the centre and states. State legislatures may devolve some of their taxation powers to local bodies.

Recommendations of the 15th Finance Commission

How revenue has been divided?

1. FC has considered **the 2011 population along with forest cover, tax effort, area of the state, and "demographic performance"** to arrive at the states' share in the divisible pool of taxes.
2. In order to reward population control efforts by states, the Commission developed **a criterion for demographic effort — which is essentially the ratio of the state's population in 1971 to its fertility rate in 2011 — with a weight of 12.5%.**
3. The total area of states, area under forest cover, and "income distance" were also used by the FC to arrive at the tax-sharing formula.

Key recommendations:

1. The Commission has reduced **the vertical devolution** — the share of tax revenues that the Centre shares with the states — from 42% to 41%.
2. The Commission has said that it intends to set up **an expert group to initiate a non-lapsable fund for defence expenditure.**

State- wise distribution:

Shares of the southern states, except Tamil Nadu, have fallen — with **Karnataka losing the most.**

- Shares of states like Maharashtra, Himachal Pradesh and Punjab, along with Tamil Nadu, all of which have fertility rates below the replacement level, have increased slightly.
- On the other hand, Andhra Pradesh, Kerala, Karnataka, and West Bengal's shares have fallen, even though their fertility rates are also low.
- Incidentally, Karnataka, the biggest loser in this exercise, also had the highest tax-GSDP ratio in 2017-18, as per an RBI report on state finances.

Major Criticism

The population parameter used by the Commission has been criticised by the governments of the southern states.

1. The previous FC used both the 1971 and the 2011 populations to calculate the states' shares, giving greater weight to the 1971 population (17.5%) as compared to the 2011 population (10%).
2. The use of 2011 population figures has resulted in states with larger populations like UP and Bihar getting larger shares, while smaller states with lower fertility rates have lost out.
3. The combined population of the Bihar, Uttar Pradesh, Madhya Pradesh, Rajasthan and Jharkhand is 47.8 crore.
4. This is over 39.48% of India's total population, and is spread over 32.4% of the country's area, as per the 2011 Census.
5. On the other hand, the southern states of Tamil Nadu, Kerala, Karnataka and undivided Andhra Pradesh are home to only 20.75% of the population living in 19.34% of the area, with a 13.89% share of the taxes.
6. This means that the terms decided by the Commission are loaded against the more progressive (and prosperous) southern states.

Report Summary

Report of the 15th Finance Commission for FY 2020-21

- The Finance Commission is a constitutional body formed by the President of India to give suggestions on centre-state financial relations. The 15th Finance Commission (Chair: Mr N. K. Singh) 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 in the first report (2020-21 period) include:

- **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. The individual shares of states from the divisible pool of central taxes is provided in Table 3 in the annexure.

  Criteria for devolution

  Table 1 below shows the criteria used by the Commission to determine each state's share in central taxes, and the weight assigned to each criterion. We explain some of the indicators below.

Table 1: Criteria for devolution (2020-21)

Criteria	14th FC 2015-20	15th FC 2020-21
Income Distance	50.0	45.0
Population (1971)	17.5	-
Population (2011)	10.0	15.0
Area	15.0	15.0
Forest Cover	7.5	-
Forest and Ecology	-	10.0
Demographic Performance	-	12.5
Tax Effort	-	2.5
Total	**100**	**100**

Sources: Report for the year 2020-21, 15th Finance Commission; PRS.

- **Income distance:** Income distance is the distance of the state's income from the state with the highest income. The income of a state has been computed as average per capita GSDP during the three-year period between 2015-16 and 2017-18. 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 dense forest of each state in the aggregate dense forest of all the states.

- **Tax effort:** This criterion 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: (i) revenue deficit grants, (ii) grants to local bodies, and (iii) disaster management grants. The Commission has also proposed a framework for sector-specific and performance-based grants. State-specific grants will be provided in the final report.

- **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 (see Table 4 in the annexure).

- **Special grants:** In 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: (i) nutrition, (ii) health, (iii) pre-primary education, (iv) judiciary, (v) rural connectivity, (vi) railways, (vii) police training, and (viii) housing.

- **Performance-based grants**: Guidelines for performance-based grants include: (i) implementation of agricultural reforms, (ii) development of aspirational districts and blocks, (iii) power sector reforms, (iv) enhancing trade including exports, (v) incentives for education, and (vi) promotion of domestic and

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international tourism. The grant amount will be provided in the final report.

- **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. This is an increase over the grants for local bodies in 2019-20, which amounted to 3.54% of the divisible pool (Rs 87,352 crore). 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.

Table 2: Grants for disaster risk management (In Rs crore)

Funding Windows	National corpus	States' corpus
Mitigation (20%)	2,478	5,797
Response (80%)	9,912	23,186
(i) Response and Relief (40%)	4,956	11,593
(ii) Recovery and Reconstruction (30%)	3,717	8,695
(iii) Capacity Building (10%)	1,239	2,998
Total	**12,390**	**28,983**

Sources: Report for the year 2020-21, 15th Finance Commission; PRS.

Recommendations on fiscal roadmap

- **Fiscal deficit and debt levels:** The Commission noted that recommending a credible fiscal and debt trajectory roadmap remains problematic due to uncertainty around the economy. 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 extra-budgetary borrowings. The outstanding extra-budgetary liabilities should be clearly identified and eliminated in a time-bound manner.
- **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:** In 2018-19, the tax revenue of state governments and central government together stood at around 17.5% of GDP. The Commission noted that tax revenue is far below the estimated tax capacity of the country. 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: (i) broadening the tax base, (ii) streamlining tax rates, (iii) and increasing capacity and expertise of tax administration in all tiers of the government.
- **GST implementation:** The Commission highlighted some challenges with the implementation of the Goods and Services Tax (GST). These include: (i) large shortfall in collections as compared to original forecast, (ii) high volatility in collections, (iii) accumulation of large integrated GST credit, (iv) glitches in invoice and input tax matching, and (v) delay in refunds. The Commission observed that 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 recommendations

- **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 Commission 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: (i) setting up of a non-lapsable fund, (ii) levy of a cess, (iii) monetisation of surplus land and other assets, (iv) tax-free defence bonds, and (v) utilising proceeds of disinvestment of defence public sector undertakings. The expert group is expected to examine these proposals or alternative funding mechanisms.