Fiscal Federalism In India: Finance Commissions, NITI Aayog And GST

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- A Special Lecture by V.Srinivas IAS -

Abstract

The 14th Finance Commission award represented transformational reform in India's fiscal federalism, which resulted in State Governments receiving their highest ever devolution package. The additional fiscal space created by the 14th Finance Commission was to be utilized for the higher allocation to priority programs of States. India's Fiscal Federalism went through further changes with the constitution of NITI Aayog and GST Council. The Government has recently constituted the 15th Finance Commission. The paper deals with the impact of implementation of the recommendations of the 14th Finance Commission on the development programs of States, the Working of the GST council as a notable example of cooperative federalism and the impact of the the NITI Aayog. It also identifies the challenges before the 15th Finance Commission as an instrument for strengthening Fiscal Federalism in India.

Prof BalveerArora, Prof M.P.Singh, Distinguished Faculty of the Institute of Social Sciences, Distinguished Research Fellows at the Centre for Multilevel Federalism

I am delighted to be with you at the Centre for Multilevel Federalism. When Prof BalveerArora and Prof M.P.Singh invited me for an oration of Fiscal Federalism, I was immediately reminded of a recent paper titled "Union-State Relations and Reforms[3][4]" written by Dr. Y.Venugopal Reddy Chairman of the 14th Finance Commission. Dr. Reddy said

"The practice of fiscal federalism in India has been commendable over a long-term perspective in view of the severe challenges posed since independence. Greater role of states in the pursuit of decentralized development should not undermine the role the Union government has to play in macroeconomic stability."

Dr. Y.Venugopal Reddy said that 2015 represented a new era in India's Fiscal Federalism. The Finance Commission had recommended higher devolutions to the States and the Planning Commission was replaced by the NITI Aayog. Fiscal Federalism was taken to the next level with the constitution of the Goods and Services Tax Council. Post 1991 reforms, India lived in a period of rules based fiscal control and the Finance Commission was the instrumentality for promoting observance of the fiscal rules amongst States. That said, a scenario of shrinking fiscal space had emerged with a proliferation of Centrally Sponsored Schemes and inter-governmental transfers outside Finance Commission purview. In the constitutional context, fiscal federalism mandated that the borrowing program of State Governments had to be approved by the Union, there was a prohibition on external borrowings by a State. Subsequent to the 73rd and 74th amendment of the Constitution and insertion of clause (3) to Article 280, the Commissions started giving additional grants for local bodies as a measure to augment the consolidated funds of the States to supplement the resources of local bodies.

My years with Fiscal Federalism

My mind goes back to my initial years in service in 1995, to the implementation issues in the CSS scheme "National Watershed Development Program for Rainfed Areas". The scheme was implemented in Rajasthan on a 75:25. Despite submission of timely utilization certificates the releases from the Union to the State were often delayed. In 2008-09, I had the opportunity to implement another flagship CSS program "National Rural Health Mission", which was also implemented on 75:25 basis. The scheme was innovatively designed with central resources being transferred to the State Health Society outside the consolidated Fund of the State. The CSS had strong conceptual design, and innovative financing. Yet there existed anxious wait periods for central releases, despite an annual resource allocation. There were instances of smaller resource allocations or considerable delays in the actual releases.

In 1996, I was coopted into the Chief Minister's Office in Rajasthan, for a conclave of Opposition Chief Ministers seeking greater devolutions (approx. 33 percent) of central resources from the divisible pool. Chief Minister Rajasthan voiced concerns on the need for higher central transfers in a federal set-up to empower the States.

In 1999, as Deputy Secretary Finance (Expenditure and Taxation) in Rajasthan, I was coordinating with several State governments on the tax rates as the Nation transitioned from Sales Tax to the Value Added Tax mechanism. On the expenditure side, I held several Budget Finalization Committee Meetings for Non-Plan and Plan Expenditures. The thrust was always "let's cut non-plan expenditures to the bone, while the plan expenditures were allowed to surge". This was largely due to the preponderance of Centrally Sponsored Schemes, which enabled access to lager resource pool of the Union Government.

In 2002-03 and 2003-04, as Private Secretary to Finance Minister, I was in the official gallery to witness the deliberations in the LokSabha on the Fiscal Responsibility and Management Bill, the constitution of the 12th Finance Commission and had the opportunity to attend a number of deliberations of the Empowered Committee of State Finance Ministers. I was an active participant when terms of reference of the 12th Finance Commission, were drawn up by the Finance Minister, Dr. Vijay Kelkar, Advisor to Finance Minister and S.Narayan, the Economic Affairs Secretary. Most States faced high cost debts and were in urgent need for debt swap schemes. The thrust of the discussions was to instill a sense of fiscal responsibility into State governments. The Union introduced a debt swap scheme for States in 2002-03, which was aimed at reducing high cost debts of States.

In 2007, on my return from the IMF, as Planning Secretary Rajasthan, I attended the 53rd and 54th meetings of the National Development Council – for identifying a roadmap for improving Agricultural growth in the 10th Plan and then for approval of the 11th Five Year Plan. In formulating the State Plan for the year 2007-08 and the State budget for 2008-09, I had noticed that there were considerable rigidities in allocation of State Plan resources as there were significant resource commitments for a large number of centrally sponsored schemes. In the 11th Five Year Plan, CSS schemes were crowding out State Plan resources, often limiting resource allocations to infrastructure sector. This was what increasingly led to the clamor for restructuring of CSS schemes with greater flexibility.

To me, Fiscal Federalism is democracy at its functional best, the system adopts a bipartisan approach for common good. In most of the initiatives of the Ministry of Finance, the States went along with the Union. But there were several moments in the discussions in the run-up to the adoption of VAT, debt-swap schemes when there were sharp exchanges between the States and the Union on the roadmap adopted.

Constitutional Provisions

The Articles of the Indian Constitution relevant to Finance Commission are the following:

1. Article 268. Duties levied by the Union but collected and appropriated by the States
2. Article 269. Taxes levied and collected by the Union but assigned to States
3. Article 270. Taxes levied and distributed between the Union and the States
4. Article 271. Surcharge on certain duties and taxes for purposes of the Union
5. Article 275. Grants from the Union to certain States
6. Article 279. Calculation of 'Net Proceeds"
7. Article 280. Finance Commission
8. Article 281. Recommendations of the Finance Commission

Article 243, Article 243 A to Article 243 O deal with Panchayats and Article 243 P to Article 243 Z and Article 243 ZA to Article 243 ZG deal with Municipalities.

Dr M.GovindaRao[5] Member of the 14th Finance Commission says that

"Notwithstanding the weaknesses, it must be noted that the system of inter-governmental fiscal arrangements in India has served well for over 50 years. It has achieved significant equalization over the years, instituted a workable system of resolving the outstanding issues between the Centre and the States and amongst the States, and adjusted to the changing requirements. It has thus contributed to achieving a degree of cohesiveness in a large and diverse country."

The 14th Finance Commission

Dr. C.Rangarajan[6] the Chairman of the 12th Finance Commission said thus:

"The setting up of a Finance Commission every five years is a constitutional mandate. The fiscal relations in this country have evolved over time through political, institutional and functional changes within the ambit of the provisions of the Constitution. The Finance Commission has had an important role to play in this evolving structure because resource sharing based on constitutional division of functions and finances between Centre and the States is a critical element of fiscal federalism."

The terms of reference of the 14th Finance Commission as laid down in Article 280 of the Constitution were (a) proceeds of taxes to be divided between the Union and the States, usually referred to as vertical balances, (b) the allocation of distribution of taxes among States, usually referred to as the horizontal balance, (c) the principles which should govern the grant-in-aid to the States by the Finance Commission, which are over and above the devolution of taxes as per the formula; and (d) measures to augment the consolidated fund of a State to supplement the transfer of resources to Panchayats and Municipalities, based on recommendations of the respective State Finance Commissions, usually referred to as Finance Commission Grants to Local Bodies.

The 14th Finance Commission adopted an approach that could be beneficial for future Finance Commissions. The salient features of the approach was that they adhered to the letter and the spirit of the Constitution (balancing the Union and State's revenue powers with expenditure responsibilities listed in the 7th schedule of the Constitution), appreciated the problems raised by stakeholders, and attempted to address the troubling contemporary issues relevant to the Terms of Reference.

Dr. Y.Venugopal Reddy[7] says he was emboldened to look at the possibility to dispense with the distinction between plan and non-plan revenue expenditure based on a recommendation received from Dr.

C.Rangarajan in his capacity as Chairman of the High Level Committee on Efficient Management of Government Expenditures, but not acted upon by Government. The 14th Finance Commission made such a distinction redundant and irrelevant. In the process, it brought in a conceptual clarity in the transfer system in terms of general and specific purpose transfers, the former given on the basis of the recommendation by the Finance Commission and the latter given for central schemes, in the place of plan and non-plan distinction that prevailed in the past.

The 14th Finance Commission assessed State Finances as (a) For States with above average tax-GSDP ratio the assumed tax buoyancy was 1.05 implying a moderate increase and (b) for other States a higher buoyancy of 1.5 was assumed. The 14th Finance Commission assumed an increase in aggregate tax-GSDP ratio from 8.26 of GSDP to 9 percent in the terminal year. On the expenditure side, the 14th Finance Commission included the expenditure incurred on the centrally sponsored schemes in revenue expenditure. The expenditure was projected as 11.12 percent of GDP against 13.57 percent projected by the States.

The 14th Finance Commission recommended increasing the share of tax devolution to 42 percent of the divisible pool as against 32 percent recommended by the 13th Finance Commission. Dr. Y.Venugopal Reddy[8] says that

"There has been a compositional shift in transfers from grants from the Union to the States in favor of tax devolution, thus enhancing the share of unconditional transfers to the latter. The balance in fiscal space thus remains broadly the same in quantitative terms, but tilts in favor of States in qualitative terms through compositional shift in favor of devolution and hence fiscal autonomy."

The 14th Finance Commission did not adopt a fiscal performance criterion on the grounds that rules based fiscal regime under the Fiscal Responsibility Act was already in place and it was not necessary to introduce separate fiscal discipline indicator in the devolution formula.

The 14th Finance Commission adopted the 2011 population as a measure of demographic change in addition to the 1971 population (as required by the TOR) for formulating the horizontal balances. Further with regard to devolutions to Local Governments and Disaster Management not too many changes in policy framework for devolutions was prescribed from the earlier Finance Commissions. The devolutions to Local Governments would be in accordance with the recommendations of the State Finance Commissions.

With regard to "Grant in Aid" devolutions, the 14th Finance Commission deviated from the formula based devolutions of previous Finance Commissions and adopted four principles for such devolutions. The 14th Finance Commission argued that "apart from the merits and demerits of centrally sponsored schemes (CSS), the increase in their number as well as of Plan grants to States reveals the excess fiscal space available to the Union Government." The 14th Finance Commission recommended "we consider health, education, drinking water and sanitation as public services of national importance, having significant inter-state externalities. However in our view, the grants to these sectors should be carefully designed and implemented and an effective monitoring mechanism put in place with the involvement of the Union Government, State Governments and domain expertise. Therefore, we have desisted from recommending specific purpose grants and have suggested that a separate institutional arrangement be introduced for this purpose."

As regards Goods and Services Tax, the 14th Finance Commission did not indicate any fiscal incentives to the States to adopt such a tax. That said, the 14th Finance Commission recommended that outstanding issues of GST may be resolved by determination of (a) period of GST compensation, (b) legal status of the compensation fund and (c) universal application of the GST regime.

The 14th Finance Commission recommended a 3 percent fiscal deficit for the Union and States. Hoever, for the States having low debt to GSDP and interest payments to revenue ratio, an addition 25 basis of borrowing space was recommended. Further the 14th Finance Commission recommended that "Pricing of Public Utilities" can be improved by establishing independent regulators where they do not exist and empowering them adequately. On “Public Sector Enterprises” the 14th Finance Commission recommended that the Government evaluate the future of each public enterprise in the entire portfolio, and enhance the scope for borrowings by public enterprises instead of depending on government support of retained earnings.

The most far-reaching recommendation of the 14th Finance Commission was the increase in tax devolution from 32 percent to 42 percent enhancing the share of unconditional transfers to the States.

Impact on State Governments with specific reference to Rajasthan [9]

The 12th and 13th Finance Commissions had recommended an increase in the States’ share in the divisible pool of central taxes by 1.5 percent and 1 percent respectively. The 14th Finance Commission increased the States’ share by10 percentage points from a level of 32 percent to 42 percent by an increase in untied devolution grants and a corresponding reduction in the tied grants of central assistance to States. The NITI Aayog[10] examined the Social Sector Expenditure of States pre and post 14th Finance Commission and observed that barring Sikkim, Tripura and Uttarakhand, all other States were better off in terms of financial allocations in Financial Year 2014-15. The total central transfers to States in the financial years 2015-16 and 2014-15 increased by 21.19 percent. The social sector expenditures in the States increased by 1.73 percent and the expenditure on health and education as percentage of GSDP witnessed marginal positive increases.

In October 2015, the NITI Aayog received the report of the sub-group of Chief Ministers[11] on Rationalization of Centrally Sponsored Schemes recommended that the focus of CSS should be on schemes that comprise the National Development Agenda where the Centre and States will work together in the spirit of team India. Accordingly the CSS was proposed to be divided into Core and Optional Schemes – amongst the core schemes those for social protection and social inclusion form the Core of the Core and be the first charge on available funds for the National Development Agenda. The Centre’s financial pattern for Core Schemes was changed to 60:40 basis for “Other States” and for Optional Schemes to 50:50. The sub-group further said that 25 percent allocation in a Scheme should be flexi-fund to be sent in accordance with Ministry of Finance guidelines, and release of funds should be simplified, based on yearly authorization an actual releases on quarterly basis.

Rajasthan was amongst the States that had raised concerns at the burgeoning number of Centrally Sponsored Schemes at the National Development Council. At the 54th Meeting of the National Development Council on 19th December 2007, the Government of Rajasthan[12] took the following position:

“It appears that the ever-increasing size of CSSs will amount to completely taking away the flexibility of State Governments. Firstly, simply by reducing the moneys that might otherwise have been available to the States as untied central assistance, the States are made dependent as it were on the Centre. Secondly most CSSs/ ACAs/ SCAs require matching State Government share, thus further limiting States in the allocation of even their own limited resources.”

Analysis shows that in the case of Rajasthan there is an increase in central transfers. During 2015-16, the revenue receipts have increased by 9.81 percent over the previous year. Development expenditure as percentage of total expenditure increased to 80.9 percent in 2015-16 from 74.5 percent in the previous year. This increase in provides the State with flexibility in making priority sector allocations. The State has chosen to implement the UDAY scheme, which is aimed at recasting the Power Sector companies as the highest priority scheme.

Simultaneously allocations to social sector have shown sustained increases. The levels of total expenditures and the distribution of moneys amongst the priority sectors have shown trend increases. The CSS scheme devolution had be recast on a 60:40 basis entailing additional burden on the State. The higher devolutions have provided some additional fiscal space, but the State was carrying a significant debt burden and makes it difficult to adhere to the FRBM targets.

The State is pursuing the objective of zero revenue deficit; fiscal deficit not exceeding 3 percent of GSDP; interest payments to revenue receipt ratio not exceeding 10 percent and debt to GSDP ratio not exceeding 25 percent. To achieve these goals, considerable fiscal adjustment is required. In the current fiscal situation, the burden of fiscal adjustment would require additional central government support.

Rajasthan is amongst the first States to merge plan and non-plan distinction in the State Budget from 2017-18. Necessary requirements for creation of new budget heads were completed for finalization of budget estimates of 2017-18. There is only one distinction between revenue expenditure and capital expenditure, which is further sub-divided in the category of State and Central assistance.

NITI Aayog

The NITI Aayog, established in 2015, is one of Indian democracy's youngest institutions. It has been entrusted with the mandate of re-imagining the development agenda by dismantling old-style central planning. As the Indian economy rapidly integrated with the global economy contradictions arose between central planning and increasing private capital flows. The NITI Aayog was mandated to foster cooperative federalism, evolve a national consensus on developmental goals, redefine the reforms agenda, act as a platform for resolution of cross-sectoral issues between Center and State Governments, capacity building and to act as a Knowledge and Innovation hub. It represented a huge mandate for a nascent organization.

The NITI Aayog's precursor, the Planning Commission was established in March 1950 by a Government of India resolution with Prime Minister as Chairperson. The initial mandate was to establish heavy industries through public investment as a means for achieving rapid industrialization. The functions assigned to the Planning Commission were to assess and allocate plan resources, formulate plans and programs for area development, determine implementation methodology, identify resource constraints and appraise & adjust implementation.

The Planning Commission from 1950 to 2014 formulated twelve five year plans. The 1st and 2nd plans aimed at raising public resources for investments in public sector, the 3rd plan focused on increased emphasis on exports and the 4th Plan formulated at a difficult period of balance of payments crisis focused on agricultural development. The 5th Plan provided enhanced allocations for social sector spending. The 6th and 7th Plans were infrastructure plans focusing on raising plan resources for infrastructure spending. The 8th Plan formulated in the midst of economic reforms achieved 6.7 percent growth. The 9th Plan period witnessed a sharp decline in economic growth to 2.4 percent. The 10th and 11th Plans implemented in the 2004-2014 period witnessed economic growth trajectory of above 9 percent.

An internal evaluation in Government revealed that Planning Commission was witnessing policy fatigue necessitating structural changes in central planning process. The assessment identified that the collapse of public investment in the face of rising subsidies, huge demands on public resources from the Right to Education Act, the National Rural Employment Guarantee Act and a poorly targeted Public Distribution System. Further rigid labor laws were impeding progress, and there were difficulties in releasing land for public housing and other public projects. A new Institutional framework was needed.

As the Prime Minister announced the closure of the Planning Commission from the ramparts of Red Fort on August 15, 2014, the Economic and Political Weekly said that not many will shed tears for the demise of the Planning Commission[13]. The planning exercise that was followed hardly had any relevance for the market economy. It did very little to plan and implement public sector investments and its role in public–private partnerships was restrictive. The proliferation of Centrally Sponsored Schemes contributed to severe distortions in public spending.

The NITI Aayog has done enormous amount of work in a short period of 3 years. It started designing strategic policies, fostering cooperative federalism, provided knowledge and innovation support and undertook evaluation/ monitoring of major investments. The NITI Aayog formulated the Make in India Strategy for Electronics Industry, a Model Land Leasing Law, laid down a National Energy Policy, prepared a Roadmap for Revitalizing Agriculture, designed a Developmental Strategy for North East and Hilly areas and undertook an appraisal of the 12th Five Year Plan. Further the NITI Aayog recommended closure of sick PSUs, strategic disinvestment of other CPSUs and pushed for reforms in Medical Council of India and the University Grants Commission. The two-standout initiatives of the NITI Aayog were the model law on land leasing and the framework of priorities for disinvestment.

An over-arching theme of the NITI Aayog was the change in focus from central planning to cooperative federalism. The Prime Minister said that "Through the NITI Aayog, India will move away from the one size fits all approach and forge a better match between schemes and needs of States". The Governing Council of NITI Aayog met very often, 3 sub-groups of Chief Ministers were worked on centrally sponsored schemes (CSS), skill development and Swach Bharat. Based on their recommendations, the new CSS sharing system was notified and a transparent formula based allocation of resources was reached. The Swach Bharat cess was levied on all services. To promote skill development initiatives, the involvement of States in the PradhanMantriKaushalVikasYojana was ensured. The Atal Innovation Mission was launched to seed innovations to teach young minds new skills.

The NITI Aayog made serious efforts for Transforming India's developmental agenda. It sought proposals from all Central Ministries for Accelerated Growth and Inclusion Strategy, Employment Generation, Energy Conservation and Efficiency, Good Governance and Swach Bharat. In April 2017, the NITI Aayog Governing Council approved the 3 Year Action Plan agenda aimed at shifting the composition of expenditure by allocating a larger proportion of additional resources to high priority sectors, namely education, health, agriculture, rural development, defence, railways and roads. An agricultural transformation was envisaged with the objective of doubling farmer's income by 2022. This was to be achieved through a model land leasing law, reform of agriculture produce marketing committees, a legal framework for contract farming and policies to overcome distortions caused by the MSP scheme. Further the NITI Aayog, monitored the implementation of the Sustainable Developmental Goals.

It can be said that the NITI Aayog has undertaken path-breaking work in its first 3 years and the Nation can look forward to the Institution imparting a new dynamism to India's developmental process in the coming years.

The Goods and Services Tax

The Goods and Services Tax was introduced on July 1, 2017 following the passage of the 122ndConstitution Amendment Act 2016. The GST represents a very significant step in the field of indirect tax reforms in India, amalgamating a large number of Central and State taxes into a single tax, with the objective of mitigating cascading or double taxation in a major way and pave the way for a common national market. Under the Constitution, the Centre has power to levy tax on manufacture of goods while the States have the power to levy tax on sale of goods. In the case of inter-State sales, the Centre has power to levy a tax (the Central Sales Tax) but the tax is collected and retained entirely by the States. The Centre alone is empowered to levy service tax. The Centre also levies and collects taxes on import and export of goods as additional duties of customs (commonly known as CVD and SAD) in addition to basic customs duty. The GST is based on the principle of destination based consumption taxation as against the principle of origin-based taxation.

The Act of 2016 envisages constitution of Goods and Services Tax Council (GSTC) comprising of the Union Finance Minister, the Minister of State (Revenue) and the State Finance Ministers to recommend on the GST rate, exemption thresholds, taxes to be subsumed and other features. This mechanism seeks to ensure some degree of harmonization on different aspects of GST between the Centre and the States as well as across States. One half of the total number of members of the GSTC would form quorum in meetings of GSTC. The decisions in GSTC would be taken by a majority of not less than 3/4th of weighted votes cast. Centre and a minimum of 20 States would be required for majority because Centre would have 1/3rd weightage of the total votes cast and all the States together would have 2/3rd of weightage of the total votes cast.

The Goods and Services Tax Council has taken a number of important decisions in the past 2 years when it met 23 times. The GSTC decided that there would be 4 tax rates namely 5 percent, 12 percent, 18 percent and 28 percent. The tax rates for different goods and services have been finalized and notified. A cess over the peak rate of 28 percent on certain luxury and demerit goods has been imposed to compensate States for any revenue loss on account of implementation of GST. The GSTC also recommended enactment of 5 laws, the Central GST law, the Union Territories GST law, the Integrated GST law (to be levied on inter-State supply of Goods and Services), the State GST law and the GST compensation law. The CGST, SGST/UTGST and IGST would be levied at rates mutually agreed upon by the Centre and the States under the aegis of the GSTC. The GST would replace 7 Central Taxes namely Central Excise Duty, Additional Duties of Excise, Special Additional Duty of Customs, Service Tax and Cess and Surcharges; and 9 State Taxes namely State VAT, Central Sales Tax, Purchase Tax, Luxury Tax, Entry Tax, Entertainment Tax, State cesses and surcharges in relation to goods and services.

Once fully implemented, the GST will benefit in creation of a unified common national market for India, prevent cascading of taxes, harmonize laws, procedures and rates of tax, reduce the interface between the tax payer and tax administration and benefit a large segment of consumers with low tax rates.

Challenges before the 15th Finance Commission[14]

The composition of the 15th Finance Commission notified by Government on November 27, 2017, comprises of ShriN.K.Singh as Chairman with ShriShaktikanta Das and Dr. Anoop Singh as full time members and Dr. Ashok Lahiri and Dr. Ramesh Chand as part time members with ShriArvind Mehta as Secretary to the Commission.

Paras 4 and 5 of the Presidential Order dated November 27, 2017 are reproduced as below:

(4) The Commission shall make recommendations as to the following matters, namely:-

(i) The distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under Chapter I, Part XII of the Constitution and the allocation between the States of respective shares of such proceeds;

(ii) The principles which should govern the grans-in-aid of the revenues of the States out of the Consolidated Fund of India and sums to be paid to the States by way of grants-in-aid of their revenues under Article 275 of the Constitution for purposes other than those specified in the provisos to clause (1) of that article; and

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

(5) 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, taking into account the responsibility of the Central Government and State Governments to adhere to appropriate levels of general and consolidated government debt and deficit levels, while 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 gazette notification further states that the Commission shall have regard to (iv) the impact on the fiscal situation of the Union Government of substantially enhanced tax devolution to States following the recommendations of the 14th Finance Commission, coupled with the continuing imperative of the national development program including New India-2022 and (v) the impact of the GST, including payment of compensation for possible loss of revenues for 5 years and abolition of a number of cesses, earmarking thereof for compensation and other structural reforms program, on the finances of Centre and States.

The Commission has also been asked to consider proposing measurable performance based incentives for

States for expansion and deepening tax net under GST; progress made in population growth; achievements in flagship programs; progress made in increasing capital expenditure, eliminating power sector losses and improving quality of expenditure; progress made in in promoting ease of doing business; provision of grants to local bodies for basic services; progress in sanitation; and control in incurring expenditure on populist schemes.

The Commission shall use the population data of 2011 while making its recommendations.

The 15th Finance Commission will have to contend with the slowdown in the Indian economy. There is an upward trend in the fiscal deficits of States. The inter-governmental transfer system has become overly complex with different sharing arrangements for different taxes, spending autonomy of States combined with their ability to borrow has obstructed efforts at consolidating public finances, little incentives for States to improve revenue performances and revenue-sharing arrangements have led to pro-cyclical policies at State level. The high levels of intergovernmental transfers necessitate that States ensure that provincial tax enforcement and structural reforms are strengthened. The problem with persistent off-budget spending has proved a drag on the fiscal deficits of States.

The vertical balances to the States relative to Centre's gross revenue receipts have shown trend increases in every Finance Commission and it would not be possible to reduce the devolution without a corresponding increase in fiscal and revenue deficits of States. The higher devolutions under the 14th Finance Commission have seen marginal increases in social sector allocations. There are pressures to increase allocations to the CSS schemes for higher expenditures on Health and Education. The tax buoyancies have been affected by the transition to the GST and the GST compensation to States will continue till 2022. On the Horizontal balances, the 15th Finance Commission has the responsibility of equalizing the widening gap between richer States and low income States. The inequalities in fiscal capacities between States have resulted in widely differing social and capital expenditures between States. A large part of the equalization effort by the 15th Finance Commission would have to be through grant-in-aid rather than devolution.

The 14th Finance Commission recommendations ushered in a new era of fiscal federalism in India. Devolutions to States went up significantly from 32 percent to 42 percent. While most countries have found it difficult to finance federal transfers to provinces of about 30 percent, India has taken it to 42 percent. The Government followed up the historic devolutions under the 14th Finance Commission with the constitution of the NITI Aayog to promote cooperative federalism and the enacted the constitutional amendment to establish the Goods and Services Tax Council. These major progressive steps were backed by restructuring the centrally sponsored schemes allocation ratio from 75:25 to 50:50 to provide greater flexibility and ownership to States. States were mandated to pursue the objectives of zero revenue deficit, fiscal deficit not exceeding 3 percent of GSDP, interest payments to revenue receipt ratio not exceeding 10 percent and debt to GSDP ratio not exceeding 25 percent.

Despite these historic steps, there remain challenges. The Power sector resource requirements remain very high. In some States, fiscal deficit with Power sector allocations have climbed to around 9 percent. Deteriorating public debt dynamics caused by Power sector's restructuring requirements would be a major area of concern for the 15th Finance Commission. An alternate fiscal scenario would need to be considered to limit the on-budget fiscal deficits to 3 percent by including Power sector. A debt to GSDP ratio of 25 percent greatly limits the Government's borrowing needs and has the potential to curtail social sector expenditures. The NITI Aayog has pointed out that social sector expenditures have increased only marginally since the 14th Finance Commission despite an increase in total central transfers to States by 21.9 percent.

The 14th Finance Commission assessed State Finances as (a) For States with above average tax-GSDP ratio the assumed tax buoyancy was 1.05 implying a moderate increase and (b) for other States a higher buoyancy of 1.5 was assumed. The 14th Finance Commission assumed an increase in aggregate tax-GSDP ratio from 8.26 of GSDP to 9 percent in the terminal year. On the expenditure side, the 14th Finance

Commission included the expenditure incurred on the centrally sponsored schemes in revenue expenditure. The expenditure was projected as 11.12 percent of GDP against 13.57 percent projected by the States. For the 15th Finance Commission, GST will usher in higher tax buoyancy by bringing in a large number of new tax payers into the tax net. Higher tax collections under GST will provide the Union Government room for fiscal maneuver to finance the inter-governmental transfer system.

The 15th Finance Commission terms 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, taking into account the responsibility of the Central Government and State Governments. The Commission may also examine whether revenue deficit grants be provided at all. The best way forward would be to adhere to the letter and the spirit of the Constitution by balancing the Union and State's revenue powers with expenditure responsibilities listed in the 7th schedule of the Constitution, appreciate the problems raised by stakeholders, and attempt to address the contemporary issues relevant to the Terms of Reference.

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[2] This paper is dedicated in honor of Dr. Y. Venugopal Reddy Chairman of the 14th Finance Commission

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