14th Finance Commission

Chapter-14

Lecture-17-21

G.E. Public Finance, B. Com (H) 4th Sem

PART – B : ISSUES FROM INDIAN PUBLIC FINANCE

Introduction

- The Fourteenth Finance Commission (FC-XIV) was constituted by the President under Article 280 of the Constitution on 2 January 2013 to make recommendations for the period 201520. Dr. Y. V. Reddy was appointed the Chairman of the Commission. Ms. Sushama Nath, Dr. M. Govinda Rao and Dr. Sudipto Mundle were appointed full time Members. Prof. Abhijit Sen was appointed as a part-time Member. Shri Ajay Narayan Jha was appointed as Secretary to the Commission

Intro. Contd.

- The Finance Commission in India is constituted, usually, once in five years. It is a constitutional body created to address issues of vertical and horizontal imbalances of federal finances in India. The constitutional mandate of the Finance Commission is
- (a) to decide on the proportion of tax revenue to be shared with the States and
- (b) the principles which should govern the grants-in-aid to States. In addition to the core mandate, the Finance Commission is also entrusted with the responsibility to make recommendations on various policy issues, as and when they arise.
- The Finance Commission also tender advice to the President on any other matter referred to it in the interest of sound public finance. The Finance Commission is also required to recommend on 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. The recommendations made by the Finance Commission are advisory in nature and, hence, not binding on the Government. So far, 14 Finance Commissions have been constituted and the last one submitted its report to the Government in December 2014. Their recommendations are to cover a period from 2015-20.

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- The scope of the Finance Commission broadened over time as they were assigned several other issues on government finances, particularly those relating to augmentation of State Consolidation Funds to supplementing the resources of local bodies
- Vertical imbalances refer to the mismatch between the revenue raising capacity and expenditure needs of the Centre and the states. Horizontal imbalances exist because of the inability of some States to provide comparable services due to inadequate capacity to raise funds.
- Individual States in India also set up State Finance Commissions.

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- States being closer to people and more sensitive to the local needs have been assigned functional responsibilities involving expenditure disproportionate to their assigned sources of revenue resulting in vertical imbalances. Horizontal imbalances across States are on account of factors, which include historical backgrounds, differential endowment of resources, and capacity to raise resources. Unlike in most other federations, differences in the developmental levels in Indian States are very sharp. In an explicit recognition of vertical and horizontal imbalances, the Indian Constitution embodies the following enabling and mandatory provisions to address them through the transfer of resources from the Centre to the States.

Finance Commission

- Q.1. What is the Finance Commission?
- Ans. 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.

Finance Commission

- Q.2 What are the functions of the Finance Commission?
- Ans. It is the duty of the Commission to make recommendations to the President as to—

- 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;
- the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India;
- the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats in the State on the basis of the recommendations made by the Finance Commission of the State;
- the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State;
- 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.

Finance Commission

- Q.3. Who appoints the Finance Commission and what are the qualifications for Members?

- Ans. 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--
- (a) are, or have been, or are qualified to be appointed as Judges of a High Court; or
- (b) have special knowledge of the finances and accounts of Government; or
- (c) have had wide experience in financial matters and in administration; or
- (d) have special knowledge of economics

Finance Commission

- Q.4. How are the recommendations of Finance Commission implemented?
- Ans. The recommendations of the Finance Commission are implemented as under:-
- Those to be implemented by an order of the President:
- The recommendations relating to distribution of Union Taxes and Duties and Grants-in-aid fall in this category.
- Those to be implemented by executive orders:
- Other recommendations to be made by the Finance Commission, as per its Terms of Reference

Finance Commission

- Q.5. When was the first Commission Constituted and how many Commissions have been Constituted so far?
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- Ans. 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.

- Q.6. Is the Finance Commission unique to India?
- Ans. Most federal systems resolve the vertical and horizontal imbalances through mechanisms similar to the Finance Commission. For example Australia and Canada.

TERMS OF REFERENCE

- As indicated earlier, the three constitutionally mandated responsibilities of a Finance Commission are the distribution between the Union and the States of the net proceeds of shareable Central taxes, determining the grants to States which are in need of assistance and recommending measures to augment the Consolidated Fund of a State to supplement the resources of local bodies. These are mentioned as such in the Presidential Order constituting a Finance Commission. In addition to the substantive functions, any other matter can be referred to a Finance Commission in the interest of sound finance under Article 280 (3) (d) of the Constitution. It has become customary to mention certain considerations in the Presidential Order appointing a Commission, which the Commission may consider, among others, while making its recommendations. The Presidential Order listing out the main functions, additional matters and considerations constitutes the ToR of a Finance Commission. In fact, the First Finance Commission was not given any ToR. It proceeded with its work based on the substantive duties enumerated in the Constitution.

GRANTS-IN-AID

- Horizontal imbalances are addressed by the Finance Commission through the system of tax devolution and grants-in-aid, the former instrument used more predominantly. Under Article 275 of the Constitution, Finance Commissions are mandated to recommend the principles as well as the quantum of grants to those States which are in need of assistance and that different sums may be fixed for different States. Thus one of the pre-requisites for grants is the assessment of the needs of the States. The First Commission had laid down five broad principles for determining the eligibility of a State for grants. The first was that the Budget of a State was the starting point for examination of a need. The second was the efforts made by States to realize the potential and the third was that the grants should help in equalizing the standards of basic services across States. Fourthly, any special burden or obligations of national concern, though within the State's sphere, should also be taken into account. Fifthly, grants might be given to further any beneficent service of national interest to less advanced States. By and large, these principles have guided the grants recommended by all the Finance Commissions.
- Thus, over the years, there has been considerable extension in the scope of grants-in-aid. Now the Finance Commission grants cover in addition to meeting the non-plan revenue deficits, requirements of States on account of special problems, and partial equalisation of certain basic services. They even cover the capital expenditure needs of States in these sectors. As a result, the share of the gap grants in total grants had come down to about 40 per cent during the period covered by the Twelfth Finance Commission.

Fiscal Responsibility Budget Management (FRBM) Act

- An Act to provide for the responsibility of the Central Government to ensure intergenerational equity in fiscal management and long-term macro-economic stability by removing fiscal impediments in the effective conduct of monetary policy and prudential debt management consistent with fiscal sustainability through limits on the Central Government borrowings, debt and deficits, greater transparency in fiscal operations of the Central Government and conducting fiscal policy in a medium-term framework and for matters connected therewith or incidental thereto.

14th Finance Commission

- The Terms of Reference (ToR) of this Commission requires us to "review the state of the finances, deficit and debt levels of the Union and the States, keeping in view, in particular, the fiscal consolidation roadmap recommended by the Thirteenth Finance Commission, and suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth including suggestions to amend the Fiscal Responsibility and Budget Management Acts currently in force and while doing so, the Commission may consider the effect of the receipts and expenditure in the form of grants for creation of capital assets on the deficits; and the Commission shall also consider and recommend incentives and disincentives for States for observing the obligations laid down in the Fiscal Responsibility Budget Management Acts".

14th Contd.

- While recommending it also needs to consider
- (ii) the demands on the resources of the Central government, in particular, on account of the expenditure on civil administration, defence, internal and border security, debt servicing and other committed expenditure and liabilities.
- (iii) the resources of the State governments and demands on such resources under different heads, including the impact of debt levels on resource availability in debt stressed states, for the five years commencing on 1st April 2015, on the basis of levels of taxation and non-tax revenues likely to be reached during 2014-15.
- (iv) the objective of not only balancing the receipt and expenditure on revenue account of all the states and the Union, but also generating surpluses for capital investment."

14th contd.

- In short, the Commission has been tasked with evolving an approach, based on its review of Union and State finances, to create a fiscal environment that is sustainable and also promotes equitable growth. This would involve reviewing the functioning of the Fiscal Responsibility Budget Management Act, 2003 (FRBM Act) and suggesting amendments, if necessary, keeping in mind the effective revenue deficit (which takes into account the difference between revenue deficit and grants for creation of capital assets). The Commission is also expected to recommend incentives and disincentives for States to comply with the provisions of the FRBM Act. In making its recommendations, the Commission has to take into account resources of State Governments and the demands made on these resources, particularly how debt impacts the resources of debtstressed states.

Views of Previous Finance Commissions

- A review of the financial requirements of both the Union and State Governments, their indebtedness levels and long-term fiscal sustainability has been an important element of the analysis of successive Finance Commissions.
- The FC-XII recommended the Debt Consolidation and Relief Facility (DCRF),which involved the consolidation of Central loans (excluding loans given for Centrally sponsored schemes (CSS)/Central Plan schemes through ministries other than the Ministry of Finance) to the States contracted till March 2004 and outstanding on 31 March 2005 and rescheduling them for a fresh term of twenty years, resetting the interest rate to be charged on them at 7.5 per cent along with a debt write-off. An individual State could avail the DCRF only if it enacted a fiscal responsibility legislation prescribing specific annual deficit reduction targets in order to ultimately eliminate the revenue deficit by 2008-09 and reduce the fiscal deficit to 3 per cent of gross state domestic product (GSDP).

Views of Previous Finance Commissions contd.

- FC-XII recommended discontinuing the role of the Union Government in lending to the States, and the latter being allowed to approach the market directly. Recognising that some fiscally weak States would be unable to raise funds from the market, the FC-XII recommended that the Union could borrow in order to lend to such States, but the interest rates should remain aligned to the marginal cost of borrowing of the Union. External assistance was made a pass-through to States, with the Union acting as a financial intermediary. It also recommended that all States set up a Sinking Fund for the amortisation of all loans, including loans from banks and liabilities on account of the National Small Savings Fund (NSSF). For the discharge of the State's obligation on guarantees, the FC-XII recommended setting up guarantee redemption funds through earmarked guarantee fees.

Views of Previous Finance Commissions contd.

- The FC-XIII recommended a fiscal consolidation roadmap which would progressively reduce and eliminate the revenue deficit of the Union and yield a revenue surplus by 2014-15. It recommended that States with zero revenue deficits or revenue surplus in 2007-08 should maintain those levels while other States should eliminate the revenue deficit by 2014-15. The Commission also recommended a fiscal deficit target of 3 per cent of GSDP for all States, but with different target dates for general category states and special category states. A consolidated fiscal deficit target of 5.4 per cent of gross domestic product (GDP) was projected, of which the target for the Union was 3 per cent and that for all States 2.4 per cent. The FC-XIII set a combined debt-GDP target of 68 per cent2 for the Union and the States to be achieved by 2014-15. However, individually, the Union and States had terminal year debt-GDP targets of 44.8 per cent and 24.3 per cent, respectively.

Views of Previous Finance Commissions contd.

- The FC-XIII also recommended aligning the NSSF to the market and resetting interest rates on these loans to States contracted up to 2006-07 and outstanding at the end of 2009-10 at 9 per cent, subject to certain conditions. Conditional write-off was recommended for loans given by the Union to the States,which were outstanding at the end of 2009-10 and were administered by ministries and departments other than the Ministry of Finance.The benefit of the DCRF was extended to West Bengal and Sikkim,which had not availed the benefit earlier, on the condition that they enact the fiscal responsibility legislation.

Fiscal Consolidation:

The weak combined fiscal position of the Union and States at present, in our view, is primarily due to the large fiscal deficit of the Union Government. The fiscal consolidation path for the Union Government that the FC-XIII laid down envisaged a reduction in the debt-GDP ratio from 54.2 per cent in 2009-10 to 44.8 per cent of GDP, bringing the fiscal deficit down to 3 per cent and eliminating the revenue deficit, all by the end of 2014-15.However, the Union Government amended the FRBM Act in 2012. Under the revised roadmap, it is to achieve a revenue deficit target of not more than 2 per cent of GDP by 31 March 2015 and a fiscal deficit target of 3 per cent by 2017. The Union Government also introduced the concept of effective revenue deficit in 2012.

Thus, the approach of FC in fiscal consolidation spells out the need for equitable growth and improvements in the quality of fiscal adjustment, with scope for headroom, where appropriate, for States to take recourse to fresh borrowings to finance developmental expenditures. For making the fiscal rules operational for the States, FC have not proposed any conditionality in regard to adherence to the fiscal roadmap. We expect the Union Government to enforce the fiscal roadmap through the powers it has to approve any borrowing by the States during our award period under Article 293(3) of the Constitution.

Fiscal Rules

- For the Union Government, the ceiling on fiscal deficit will be 3 per cent of GDP from the year 2016-17 onwards up to the end of our award period. We expect that an improvement in the macroeconomic conditions and revival of growth as well as tax reforms (rationalisation of the tax structure on the direct taxes side and implementation of goods and services tax (GST) on the indirect taxes side) should enhance the total tax revenues of the Union Government, enabling it to eliminate the revenue deficit completely much earlier than 2019-20.
- The fiscal deficit targets and annual borrowing limits for the States during our award period are enunciated as follows: i. Fiscal deficit of all States will be anchored to an annual limit of 3 per cent of GSDP.The States will be eligible for flexibility of 0.25 per cent over and above this for any given year for which the borrowing limits are to be fixed if their debt-GSDP ratio is less than or equal to 25 per cent in the preceding year. ii. States will be further eligible for an additional borrowing limit of 0.25 per cent of GSDP in a given year for which the borrowing limits are to be fixed if the interest payments are less than or equal to 10 per cent of the revenue receipts in the preceding yeariii. The two options under these flexibility provisions can be availed of by a State either separately, if any of the above criteria is fulfilled, or simultaneously if both the above stated criteria are fulfilled. Thus, a State can have a maximum fiscal deficit-GSDP limit of 3.5 per cent in any given year.
- iv. The flexibility in availing the additional limit under either of the two options or both will be available to a State only if there is no revenue deficit in the year in which borrowing limits are to be fixed and the immediately preceding year.

Implicit Capital Outlay

- On the basis of the fiscal road map FC have drawn up, the capital outlay of the Union Government should increase from 1.6 per cent of GDP in 2015-16 to 2.9 per cent in 2019-20. If the Union Government eliminates the revenue deficit, the capital outlay in the terminal year of our projection should reach 3.8 per cent of GDP. Considering the aggregate revenue surplus of the states and assuming that the States would not have non-debt capital receipts, and adding the implicit capital outlay receipts of Union Government, the combined capital outlay should, at the minimum, be 7.5 per cent of GDP 2019-20.

National Small Savings Fund (NSSF)

- National Small Savings Fund (NSSF) was established in 1999 within the Public Account of India for pooling the money from different small saving schemes (SSSs). Collections from all small savings schemes are credited to the NSSF. Similarly, withdrawals under small savings schemes by the depositors are made out of this Fund. The money in the account is used by the centre and states to finance their fiscal deficit. The balance in the Fund is invested in Central and State Government Securities. Pattern of utilization of the fund among the centre and states is decided from time to time by the Government of India.
- States are asked to be taken away from the operation of NSSF and no burden shall be passed to the states.

Consolidated Sinking Fund

- Consolidated sinking fund was recommended by FC to set up to overcome their weak cash management

Fiscal Environment for Equitable Growth: A Shared Responsibility

- Recognising that the fiscal environment should be conducive to equitable growth, FC recommended that the Union and all the States should target improving the quality of fiscal management encompassing receipts and expenditures while adhering to the roadmap we have outlined.

- FC recommended that the Union Government should consider making an amendment to the FRBM Act to omit the definition of effective revenue deficit from 1 April 2015. It also recommended that the objective of balancing revenues and expenditure on the revenue account enunciated in the FRBM Acts should be pursued.
- FC also recommended the FRBM Act to be amended for establishment of a fiscal council. Further, the Union and State Governments may also amend their respective FRBM Acts to provide a statutory ceiling on the sanction of new capital works to an appropriate multiple of the annual budget provision.
- FC has also urged the Union Government to replace the existing FRBM Act with a Debt Ceiling and Fiscal Responsibility Legislation, specifically invoking Article 292 in its preamble. This could be an alternative to amending the existing FRBM Act as proposed by us. We urge the State Governments also to consider similar enactments under Article 293(1

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