**Finance commission**

***The Present Context***

The enactment of the Jammu and Kashmir Reorganisation Act, 2019, leading to the creation of two new Union Territories. The Commission needs to closely examine how best the needs of the Union Territory of Jammu and Kashmir can be addressed keeping in view all relevant factors.

The global scenario is unpredictable and experiencing a synchronised slowdown. After successive downward revisions, the International Monetary Fund (IMF) forecast global growth for 2019 at 3 per cent, which is the lowest since the global financial crisis of 2008-09, with further downside risk.

The United States-China trade war enhances the uncertainty and a volatile geo-political backdrop has implications for the behaviour of oil output and prices in the medium term. These contribute to the global uncertainty and slowdown. The IMF has observed that this synchronised slowdown will result in slower growth for 90 per cent of the world this year and that it will be more visible in some of the largest emerging markets such as India and Brazil.

Like many other countries, India too is going through a period of economic sluggishness. The growth in real gross domestic product (GDP) is expected to slow down from 7.2 per cent in 2017-18 to around 6 per cent estimated for 2019-20. The slowdown is driven by both external and domestic factors. While investment and exports have been slowing since 2011-12, the slowdown in consumption since early 2018, partly associated with a sharp decline in consumer confidence, is more worrying. Confidence, debt and risk aversion issues in the financial sector continue, imparting a downward bias to the short-term growth forecasts.

The Union Government and the Reserve Bank of India (RBI) have acted to address the slowdown through various measures such as making monetary policy more accommodative, a slew of structural measures to boost housing, exports and small and medium enterprises as well as with a sharp cut in corporate tax to make India a competitive investment destination. The Union Government expects all of these measures to start bearing results over the next few quarters. Weak revenue collections, driven by slowing activity as well as teething problems in implementing some of the newly introduced structural reforms, have elevated the fiscal risks.

With real economic growth at a seven-year low, combined with relatively low inflation, growth has been weak in nominal terms as well, leading to a weak tax base. Nominal GDP growth in the last reported quarter was a low 8 per cent. Not surprisingly, revenue collections have been sluggish. Significantly, the current slowdown in India also coincides with major structural reforms in the economy over the last five years – a new monetary policy framework; a bankruptcy code for resolution of stressed assets; demonetisation; introduction of GST in July 2017; a new corporate tax order; a series of other announcements by the Union Government to boost the housing sector and exports; plans to privatise a large set of public sector entities including oil companies; and introduction of direct tax reforms.

The short-term transitional difficulties in implementing these structural reforms can create a pessimistic view on the medium-term prospects of economic growth and revenue collections. For example, slow input tax refunds on GST collections have depressed growth for many small and medium enterprises (SMEs). Importantly, the economy is going through a unique process of formalisation and digitalisation – post demonetisation and introduction of GST. While this process would lead to enhanced productivity, higher wages and incomes in the medium term, it is creating significant challenges in the short term.

Recent announcements to expedite GST refunds should alleviate some of these bottlenecks. Similarly, some of the other announcements such as measures to boost the housing and exports sectors, credit guarantees for non-banking financial companies (NBFCs), expedited payments by public sector undertakings to SMEs, should all work to address the supply bottlenecks and raise aggregate demand.

The RBI has reduced interest rates sharply (by 135 basis points) during this easing cycle over a short period of eight months and has also taken steps to enhance the speed of transmission of its policies to the real economy. All these changes would require some time to filter through the economy, and may start to get reflected in the economic data over the next few quarters.

**Recommendations**

The FC was guided in its approach by the ToR, which is a departure from that of our predecessor and yet retains some broad themes of previous Finance Commissions by way of continuity.

* The ToR for Fifteenth FC clearly stipulates the use of population data of 2011 for the recommendations. As population is a major factor in the determination of the devolution formula, and it would also be used for scaling other criterion in order to address the parameters of equity and efficiency in the devolution process.
* Use the population data of 2011 created apprehensions that doing so would penalize those States that have achieved greater progress in reducing population growth since 1971. Fifteenth FC has attempted to dispel these doubts by introducing a new criterion of total fertility rate (TFR) as a measure of demographic performance.
* As issues relating to environment and climate change need to be given greater impetus and attention, the Fifteenth FC has continued to allocate higher weightage to forest and ecology.
* Fifteenth FC has decided to incentivise tax effort by including it as one of the criteria for horizontal devolution.
* Fifteenth FC has provided grants-in-aid for local bodies, disaster relief and for States with a post devolution revenue deficit. However no provision for State-specific grants have been made.
* Fifteenth FC has recommended revenue deficit grants and special grants, besides laying out the broad contours of the sectoral grants and performance-based incentives which would enable state governments to undertake the necessary preparatory work during 2020-21 to optimise the utilisation of resources in the remaining period of the award.
* Fifteenth FC has taken into account recent changes due to the re-organisation of the erstwhile State of Jammu and Kashmir. It has been estimated that the share of the erstwhile State of Jammu and Kashmir would have come to around 0.85 per cent of the divisible pool. Also there is a strong case for enhancing this to 1 per cent of the divisible pool to meet the security and other special needs of the Union Territories of Jammu and Kashmir and Ladakh. Since this enhancement has to be met from the Union's resources, it has recommend that the aggregate share of States may be reduced by 1 percentage point to 41 per cent of the divisible pool.
* **Criteria and Weights Assigned for Horizontal Devolution Criteria Weight (%)**
* Population-15%
* Area-15%
* Forest and Ecology-10%
* Income Distance-45%
* Demographic Performance-12.5
* Tax Effort-2.5
* Based upon the assessment of the post-devolution revenue surplus/deficit of the States for 2020-21, Fifteenth FC have estimated that fourteen States will need revenue deficit grants amounting to Rs. 74,340 crore. It has also provided special grants of Rs. 6,764 crore for three States in which the sum of tax devolution and revenue deficit grants is projected to decline in 2020-21 over 2019-20.
* Malnutrition of infants is a human capital issue that cannot wait to be addressed. Hence it has made an exception in the case of the nutrition sector by giving it a grant of Rs. 7,735 crore in 2020- 21 itself.
* Given the financial constraints in 2020-21, the FC has refrained from recommending any State-specific grants for the present year and has proposed to look into it later depending on available fiscal space.
* It has recommended an amount of Rs. 90,000 crore as grants to local bodies for 2020-21, which is 4.31 per cent of the estimated divisible pool in an effort to increase the share of local bodies’ grants for urban areas. Unlike the previous commission, Fifteenth FC has provided grants to all the three tiers of panchayats, as also to areas under the Fifth and Sixth Schedule of the Constitution and Cantonment Boards in urban areas. While 50 per cent grants to rural local bodies are untied, the remaining 50 per cent would be tied as grants for sanitation and water supply which are identified national priorities.
* For rural local bodies, no conditions have been prescribed for getting the grants in 2020-21. However, from 2021-22 onwards, the entry level conditions for rural local bodies getting these grants is the timely submission of audited accounts.
* In the case of urban local bodies, it has differentiated between cities by dividing them into two categories: (a) Million-Plus urban agglomerations/cities and (b) all other cities and towns with less than one million population. Larger cities will have a tendency to grow faster, and grants are provided to fifty Million-Plus cities on agglomeration basis, with special emphasis on meeting the challenges of poor air quality, ground water depletion and sanitation.
* For non-Million-Plus towns, 50 per cent of the funds are untied and the remaining 50 per cent tied, with an equal share for drinking water and sanitation. Though Fifteenth FC has not recommended any conditions for urban local bodies in 2020-21, it has recommended two entry level conditions in the subsequent years – notifying the floor or minimum rates of property tax to improve own revenues and timely submission of audited accounts.
* For determining state-wise allocations for disaster risk management, Fifteenth FC has recommended a new methodology which combines capacity (as reflected through past expenditure), risk exposure (area and population) and proneness to hazard and vulnerability (disaster risk index). The total amount recommended for the States is Rs. 28,983 crore in 2020-21, of which Rs. 22,184 crore is the Union share. In line with the provisions of the Disaster Management Act, 2005, it has recommend setting up of mitigation funds at both national and state levels in the form of a National Disaster Mitigation Fund (NDMF) and State Disaster Mitigation Funds (SDMF). It has also recommended additional funds for the National Disaster Response Fund (NDRF) since the levy of National Calamity Contingent Duty (NCCD) utilised to fund it has now largely been subsumed under the GST.