× The financial capacity of States is being weakened.

- Combined effect of
  1. Cutbacks in devolution
  2. Shrinking divisible pool
  3. Failure to pay full GST compensation
  4. Fall in Central Grants

↓

- States may experience a fall of 20-25% of their revenues this FY.

-(1) Cutbacks in Devolution

- Taxes raised by Centre
  ↓
  - FC recommends States' share
  - Before 2014 → devolution to States consistently more than the 13th FC's projections
  - 2014-15 → actual devolution less than FC's projection (-14%)
  - Subsequent devolutions → lesser and lesser
  - 2019-20 → -37% of the FC projection
- This is substantial reduction of fiscal resource of States
  ↳ ~₹7.97 lac crore less than what FC projected for 2014-15 to 2019-20

(2) Shrinking divisible pool

↳ Cesses & Surcharges levied by Centre
- Continuous increase from 9.3% to 15% of gross tax revenue of Centre
- These → are not shared with States
- Thus Central revenues increases
  ↳ even some taxes replaced with cesses and surcharges

↳ For 2019-20 alone, Centre expects ₹ 3.69 lac crore → won't go to the divisible pool.

(3) GST shortfall

↳ Shortfalls persistent
↳ i.e. why GST Compensation Cess was introduced
↓
GST cesses levied on luxury or sin goods on top of GST
↳ While GST Compensation will be provided only till 2021-22, but Cesses will continue
  ↳ increasing Centre's revenue.

↳ 2019-20 ⇒ Cess collected was ₹95K crore
This year → an exception
Following years → Centre will continue to collect more & more

↳ This Cess was enough to meet any contingency needs without burdening the Centre or State Govts.

↳ States proposal is that this year's GST shortfall should be paid in full to the States by Central borrowings
- ↳ These borrowings can be paid later using the GST Cess from years after 2022.

↳ Centre's stand is
- ↳ Total GST shortfall is ₹3 lac crore
- ↳ Centre will compensate only ₹1.8 lac crore
- ↳ Remaining ₹1.2 lac crore will be given as State Govt borrowings.
- ↳ Hence burdening the States

(4) Fall in Central Grants

↳ Central grants also likely to fall
↳ For Eg:
- Karnataka was allocated ₹ 31 K crore as annual grant
- Actual grants → only ₹ 17K crore

– Fall in revenue of States
↓
Now forced to resort to borrowing
↓
Repayments will burden State budgets for several years.
↓
Adverse consequences on per capita income, human resource development & poverty.

– Varied economic growth & income levels across States
↳ Confirm primacy of State Govts in economic sphere
↳ Livelihood, dev, welfare & security

Systematic weakening of States
↳ serves neither federalism nor national interest.

* Roadbumps ahead

- 15th FC report submitted to Prez
- To be tabled in Parliament
- Action taken report would reveal Govt's acceptance or rejection of recommendations
- 14th FC had
  - ↳ recommended higher share to States from 32 to 42% from divisible pool
  - ↳ But actual shares turned out to be far lower due to intro. of Cesses and surcharges to garner additional revenues solely for Union Govt.

- Issues -

(1) Recent standoff b/w Centre & State
  - ↳ on GST Compensation dues payment
  - ↳ Though 22 states agreed to Centre's proposal for borrowing by states, still future looks bleak.

(2) Southern States' worry
↳ use of 2011 population data, instead of 1971.
↳ penalize them for managing population growth better

(3) Last year, interim report by FC saying forecast is tough due to structural changes like GST, etc
↳ But this year, with even more uncertain times, the final report is out.

(4) Some unusual ideas like
- Creation of a non-lapsable fund for defence and security
- Incentivising States for performance on reforms considered desirable by Centre.

Still no recognition of the third tier

Primary task of the Union Finance Commission

- The Finance Commission is constituted by the President under Article 280 of the Constitution, mainly to give its recommendations on the distribution of tax revenues between the Union and the States and amongst the States themselves.
- After the passing of the 73rd and 74th Constitutional Amendments, the Finance Commission has allocated resources from the central divisive tax pool to local governments.

Recommendations of the Fifteenth Finance Commission

Higher vertical devolution

- The vertical devolution recommended to local governments is raised remarkably high. From a meagre share of 0.78% of the divisible pool with an absolute sum of ₹10,000 crore by the Eleventh Commission, the Fifteenth Finance Commission raised it to 4.23% with a reasonably estimated amount of ₹4,36,361 crore.
- Compared with the Fourteenth Finance Commission there is a 52% increase in the vertical share.

The 15th Finance Commission has recommended two types of grants - basic and tied

- Basic grants are untied and can be used by the local bodies for location-specific felt needs except for salary or other establishment expenditure.
- The tied grants can be used for the basic services of (a) sanitation and maintenance of open defecation free (ODF) status and (b) supply of drinking water, rainwater harvesting and water recycling.
- Previously the finance commissions like the 11th FC have tied specific items of expenditure to local grants and now the 15th FC has raised this share to 60% and linked them to drinking water, rainwater harvesting, sanitation and other national priorities in the spirit of cooperative federalism.
- However, it reduced the performance-based grant to just ₹8,000 crore — and that too for building new cities, leaving out the Panchayati Raj Institutions (PRIs) altogether.

Performance-Based Grants (PBGs)

13th FC

- (PBGs) link performance in pre-determined areas with access to and size of funding, applying clear and transparent allocation formulas.
- The performance-based grants which were introduced by the Thirteenth Finance Commission earmarked 35% of local grants.

14th FC

- The Fourteenth Finance Commission, however, cut the performance grant share to 10% for gram panchayats and 20% to municipalities with the conditionality that all local governments will have to show improvements in own source revenue.
- Municipalities are additionally required to publish service level benchmarks for basic services.

15th FC

- An important recommendation of the Fifteenth Finance Commission is the entry-level criterion to avail the union local grant (except health grant) by local governments which is performance-linked.

- For panchayats, the condition is online submission of annual accounts for the previous year and audited accounts for the year before.
- For urban local governments, two more conditions are specified: after 2021-22, fixation of the minimum floor for property tax rates by the relevant State followed by consistent improvement in the collection of property taxes in tandem with the State's own Gross State Domestic Product.

Entry-level criteria a significant movie

- The Eleventh to the Fourteenth finance commissions had recommended measures to standardize the accounting system and update the auditing of accounts, but there was limited progress.
- Therefore, the entry-level criteria of the Fifteenth Finance Commission are timely.

Will it bring substantial change in the system?

- The Eleventh Finance Commission published the fiscal data of all tiers of panchayats and municipalities in its report. But the data proved defective.

- The Twelfth Finance Commission did not publish any local fiscal data.
- The Thirteenth Finance Commission published data online and some researchers did use them.
- Unlike the previous commissions, the Fourteenth Finance Commission conducted a sample survey covering 15% gram panchayats, 30% block panchayats and all the district panchayats besides 30% municipalities, presumably to ensure quality in canvassing data. The results too were not published.

Concerns

- The Fifteenth Finance Commission nor the earlier finance commissions have examined how and where the financial reporting system has failed.
    - Without reliable data ensuring good governance would not be successful.
- The Fifteenth Finance Commission claims that it seeks to achieve the "desirable objective of evenly balancing the union and the states".
    - Recognition is not awarded to the third tier in this balancing act.

- Although the Fifteenth Finance Commission outlines nine guiding principles as the basis of its recommendation to local governments, there is no integrated approach (in contrast to the recommendations of the Thirteenth Finance Commission). It is forgotten that public finance is an integrated whole.
    - The Fifteenth Finance Commission though stresses the need to implement the equalisation principle, it is virtually silent when it comes to the local governments.
- Efficiency Compromised: In the criteria used by the Fifteenth Finance Commission for determining the distribution of grants to States for local governments, it employed population (2011 Census) 90% and area 10% weightage, the same criteria followed by the Fourteenth Finance Commission.
    - While this ensures continuity, equity and efficiency criteria are sidelined

* Towards a more federal structure

- After independence in 1947
  - ↳ many states like Travancore, Hyderabad, Jodhpur, Bhopal & Junagadh wanted their own separate countries.
  - ↳ so India opted to be a Union of states & not a federation.
  - ↳ because Central Govt has more authority & power in a Union Govt.
- Distribution of revenue
  - Income tax & corporate taxes ⇒ direct taxes
  - India
    - ↳ direct taxes go entirely to Centre.
    - ↳ Centre distributes 41% of its Gross tax revenues to States according to Finance Commission's (FC) recommendations
  - US
    - ↳ both the federal govt & the State govts collects taxes from individuals & corporations
    - ↳ Federal Govt further distributes 15% of its revenues.

- Concerns in distribution of revenue

- Usually, Centre does not meets it 41% target
- The intra-state distribution is based on some formula, yet there is inequity.
  - ↳ Some of the poorer states get up to 50% of their total revenue from Centre
  - ↳ while the national avg. is 26%.
  - ↳ Thus, the Centre gains more economic power over these poorer states
- Regional Disparity
  - ↳ Maharashtra, Delhi, Karnataka, TN & Gujarat Contribute 72% of tax revenue.
  - ↳ while UP contributes only 3.12% but gets over 17% of the revenue distributed by Centre.
  - ↳ Revenue distribution is based on complex considerations like poverty & population.
- Cross subsidy from south to north
  - ↳ For every ₹100 contributed, southern states get ~51% from Centre whereas Bihar gets back ~200%.

- Domination of north over south
  - happens despite the cross subsidy suffered by southern states
  - due to concentration of political power in North ⇒ more Lok Sabha seats
    ↳ Southern states already concerned that whether the 2026 revising of Lok sabha seats will further make them politically marginalised.
- Way forward
  - Centre's Cess on various items ~₹3.5 lac crore
    ↳ This revenue can be shared with states who are suffering due to cross-subsidy.
  - Greater economic power to states
    ↳ to collect taxes directly, in addition to the current ones like liquor, property, road & vehicles
    ↳ and make them less dependent on Centre.
    ↳ A period of transition to be given to poorer states
- India's unity needs to be preserved.
  ↳ A more federal structure is needed to focus on external threats instead of internal dissensions.