

Volume I

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LIST OF ABBREVIATIONS

A&E	Accounts and Entitlements
ACS	Average Cost of Supply
APTEL	Appellate Tribunal for Electricity
ARR	Average Revenue Realised
ASCI	Administrative Staff College of India
AsG	Accountants General
BMTPC	Building Materials and Technology Promotion Council
BRPSE	Board for Reconstruction of Public Sector Enterprises
C&AG	Comptroller and Auditor General
CERC	Central Electricity Regulatory Commission
CGA	Controller General of Accounts
CIP	Central Issue Price
CPI	Consumer Price Index
CPR	Centre for Policy Research
CPSE	Central Public Sector Enterprises
CPSMS	Central Plan Scheme Monitoring System
CRF	Calamity Relief Fund
CS	Central Sector
CSF	Consolidated Sinking Fund
CSO	Central Statistical Organization
CSS	Centrally Sponsored Schemes
DCRF	Debt Consolidation and Relief Facility
DDMA	District Disaster Management Authority
DDMF	District Disaster Mitigation Funds
DDRF	District Disaster Response Fund
DoT	Department of Telecommunication
DPE	Department of Public Enterprises
EAP	Externally Aided Projects
FCI	Food Corporation of India
GBS	Gross Budgetary Support
GDP	Gross Domestic Product
GRF	Guarantee Redemption Fund
GSSA	General and Social Sector Audit
GST	Goods And Services Tax
HDI	Human Development Index
HLEC	High Level Expert Committee
IFMIS	Integrated Financial Management Information System
IIFCL	India Infrastructure Finance Company Ltd.
IMF	International Monetary Fund
LMMHA Committee	Committee to review the List of Major and Minor Heads of Accounts of Union Committee and States

MGNREGA	Mahatma Gandhi National Rural Employment Guarantee Act
MIS	Management Information Systems
MPLADS	Member of Parliament Local Area Development Scheme
MSP	Minimum Support Price
MSS	Market Stabilisation Scheme
MTFP	Medium-Term Fiscal Policy
MYTs	Multi-Year Tariffs
NBS	Nutrient-Based Subsidy
NCCD	National Calamity Contingency Duty
NCCF	National Calamity Contingency Fund
NDC	National Development Council
NDMA	National Disaster Management Authority
NDMF	National Disaster Mitigation Fund
NDRF	National Disaster Response Fund
NEDC	National Economic and Development Council
NFCR	National Fund for Calamity Relief
NFSA	National Food Security Act
NHM	National Health Mission
NIF	National Investment Fund
NPDM	National Policy on Disaster Management
NPS	New Pension Scheme
NRDWP	National Rural Drinking Water Programme
NSDP	Net State Domestic Product
NSSF	National Small Savings Fund
OECD	Organisation for Economic Cooperation and Development
OPEC	Organisation of Petroleum Exporting Countries
PAT	Profit After Tax
PBIT	Profit Before Interest And Tax
PDS	Public Distribution System
PEFM	Public Expenditure and Financial Management
PEL	Production Exploration and License
PEM	Public Expenditure Management
PFMS	Public Fund Management System
PMES	Performance Monitoring and Evaluation Systems
PPP	Public Private Partnership
PSE	Public Sector Enterprise
RBI	Reserve Bank of India
RNR	Revenue Neutral Rate
RTA	Rail Tariff Authority
SDMA	State Disaster Management Authority
SDMF	State Disaster Mitigation Fund
SDRF	State Disaster Response Fund
SEBs	State Electricity Boards
SERCs	State Electricity Regulatory Commissions
SFC	State Finance Commission

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SRTUs	State Road Transport Undertakings
SSA	Sarva Shiksha Abhiyan
VAT	Value-added Tax
WMA	Ways and Means Advance
WRA	Water Regulatory Authority

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Chapter 1

Introduction

1.1 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 2015-20. 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 (Annex 1.1).

Terms of Reference

1.2 The Terms of Reference (ToR) of the Commission mandated the following:

“4. The Commission shall make recommendations as to the following matters:

- (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 the respective shares of such proceeds;
- (ii) the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States which are in need of assistance 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 the resources of the Panchayat 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 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 and Budget Management Acts.

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6. In making its recommendations, the Commission shall have regard, among other considerations, to:

- (i) the resources of the Central Government, for five years commencing on 1 April 2015, on the basis of levels of taxation and non-tax revenues likely to be reached during 2014-15;
- (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 the 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 1 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 receipts and expenditure on revenue account of all the States and the Union, but also generating surpluses for capital investment;
- (v) the taxation efforts of the Central Government and each State Government and the potential for additional resource mobilisation to improve the tax-Gross Domestic Product ratio in the case of the Union and tax-Gross State Domestic Product ratio in the case of the States;
- (vi) the level of subsidies that are required, having regard to the need for sustainable and inclusive growth, and equitable sharing of subsidies between the Central Government and State Governments;
- (vii) the expenditure on the non-salary component of maintenance and upkeep of capital assets and the non-wage related maintenance expenditure on plan schemes to be completed by 31 March, 2015 and the norms on the basis of which specific amounts are recommended for the maintenance of the capital assets and the manner of monitoring such expenditure;
- (viii) the need for insulating the pricing of public utility services like drinking water, irrigation, power and public transport from policy fluctuations through statutory provisions;
- (ix) the need for making the public sector enterprises competitive and market oriented; listing and disinvestment; and the relinquishing of non-priority enterprises;
- (x) the need to balance management of ecology, environment and climate change consistent with sustainable economic development; and
- (xi) the impact of the proposed Goods and Services Tax on the finances of Centre and States and the mechanism for compensation in case of any revenue loss.

7. In making its recommendations on various matters, the Commission shall generally take the base of population figures as of 1971 in all cases where population is a factor for determination of devolution of taxes and duties and grants-in-aid; however, the Commission may also take into account the demographic changes that have taken place subsequent to 1971.

8. The Commission may review the present Public Expenditure Management systems in place including the budgeting and accounting standards and practices; the existing system of classification of receipts and expenditure; linking outlays to outputs and outcomes; best practices within the country and internationally, and make appropriate recommendations thereon.

9. The Commission may review the present arrangements as regards financing of Disaster Management with reference to the funds constituted under the Disaster Management Act, 2005 (53 of 2005), and make appropriate recommendations thereon.

10. The Commission shall indicate the basis on which it has arrived at its findings and make available the State-wise estimates of receipts and expenditure.”

1.3 The following additional item was added to the ToR of the Commission vide President’s Order published under S.O. No. 1424(E) dated 2 June 2014 (Annex 1.2):

“Para 5 A. The Commission shall also take into account the resources available to the successor or reorganised States on reorganisation of the State of Andhra Pradesh in accordance with the Andhra Pradesh Reorganisation Act, 2014 (6 of 2014) and the Ministry of Home Affairs notification number S.O. 655 (E) dated 4 March, 2014 and make recommendations, for successor or reorganised States, on the matters under reference in this notification”.

1.4 The Commission was originally asked to make its report, covering a period of five years commencing on 1 April 2015, available by 31 October 2014. The Commission had completed all its State visits and consultations with all stakeholders, including most of Departments/Ministries of the Government of India by June 2014 and the process of finalisation of its recommendations had reached an advanced stage. The bifurcation of Andhra Pradesh and the additional ToR required the Commission to examine again various comparable estimates for financial projections. Subsequently, in view of the additional ToR notified, the President through his order, published under S.O. No. 2806(E) dated 31 October 2014, extended the tenure of the Commission to 31 December 2014 (Annex 1.3).

Administrative Arrangements

1.5 This Commission was confronted with several administrative difficulties in its initial stages, as had previous Commissions. Through the efforts of a small nucleus office, two temporary office spaces were arranged at Hotel Janpath and Jawahar Vyapar Bhavan, New Delhi, to enable the Commission to initiate its preliminary tasks from 1 February 2013 when the Chairman and Members assumed office. The regular office at Chatrapati Shivaji Bhavan, Qutab Institutional Area, New Delhi was made operational within 100 days due to the diligence and hard work put in by the small number of staff available in the early period.

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1.6 The process of appointing suitable staff was a time-consuming process. The entire system of recruitment through deputation required several levels of clearances. Most of the officers and staff joined by May 2013, when we moved out of temporary premises. In some instances, even after requisite permissions by the Ministry of Finance and other relevant agencies, officials were not released by the lending departments and ministries. The Government of India, however, allowed us to take qualified and suitable persons on contract to meet our requirements. We also got approval to restructure the composition of the staff by inducting more officers at the level of Director through a matching surrender of lower posts. We could, in the process, obtain the services of some very competent, qualified and industrious staff. The list of sanctioned posts and the officers and staff are in Annex 1.4 and 1.5 respectively.

1.7 In regard to the administrative arrangements, it was the experience of several previous Commissions that considerable time is lost in getting suitable office space and obtaining the services of willing and suitable staff. Our experience also was similar. The ToR of Finance Commissions in recent times have been very expansive. In particular, some of the ToR of this Commission were new, requiring considerable fresh thinking and original work. Further, the mandate gives a Finance Commission about twenty-four months, on an average, to submit its report. In our case, the time available was initially only twenty-two months. Though our Commission could initiate its work early enough, it would be an advantage for everybody in the future if the few initial months are not lost in putting together an office and requisite staff. **As the due date for constituting a new Finance Commission, as prescribed in the Constitution, is generally known well in advance, we would urge the Union Government to effectively resolve the location of office space and recruitment of staff well before the notification constituting the next Finance Commission. In our view, this could be achieved by suitably delegating and empowering the advance cell with the requisite mandate and relaxing the deputation rules for willing and suitable staff to join. Since the advance cell is usually headed by a very senior officer, the actions taken by it may be reviewed on an ex-post basis by the Finance Commission when appointed, rather than on ex-ante basis, as is being done at present. In this regard, Article 280 (4) of the Constitution, read with the Finance Commission (Miscellaneous Provisions) Act 1951 (Act No 33 of 1951), provides, in our view, adequate scope for the Union Government to reform the arrangements.**

Major Activities

1.8 The Commission was delegated the powers of a Department of the Union Government (Annex 1.6). It held its first meeting on 1 February 2013, after the Chairman and three Members had assumed charge. The fourth Member assumed office on 2 February 2013. The Rules of Procedure of the Commission (Annex 1.7) were approved in the first meeting so that it could commence its work. During the remaining part of its tenure, the Commission held 117 meetings on the dates indicated in Annex 1.8. The list of meetings excludes the meetings held with the State Government representatives at state capitals during the visits by the Commission and with the Accountants General of the States at New Delhi. A committee comprising of Members, Secretary and senior officers was set in place to guide work on the key issues before the Commission. It met regularly and initiated action on subjects requiring special study, identified

outside experts to carry out the research and regularly reviewed the progress of studies commissioned and in-house research work done by the staff. The inputs of the Committee were further reviewed at the level of the full Commission.

Collection of Information

1.9 The recommendations of Finance Commissions are based on economic and financial data collected from the Union and State Governments. The data gathered is supplemented by consultations with various stakeholders, experts, research studies commissioned and inputs from the public. Accordingly, on 1 February 2013, a public notice (Annex 1.9) was issued in all leading newspapers of India and on the website of the Commission, inviting views and comments from all interested individuals, knowledgeable persons, organisations and other sources on various issues related to the ToR of the Commission. The Chairman wrote to Union Ministers, Chief Ministers of States, the Deputy Chairman of the Planning Commission, Presidents of recognised national and state political parties, Governor of the Reserve Bank of India (RBI) and the Comptroller and Auditor General of India (C&AG), seeking their views on the ToR. The Secretary similarly wrote to all Chief Secretaries of the States and Secretaries in the Union Government.

1.10 The Finance Commission, being a temporary body, has to start afresh the task of collecting and compiling voluminous data on public finances from the Union and State Government every time it is constituted. The legacy data and files of the previous Commission do get transferred from the Finance Commission Cell in the Ministry of Finance. However, the data which the previous Commission used is of a period at least five years earlier and requires complete updating. All the State Governments and the concerned Ministries and Departments of the Union Government were, accordingly, requested to submit their memoranda, data on several items covering all items of revenues and expenditures, and topical notes on issues impacting the finances.

1.11 We decided to conduct regional workshops with the nodal officers of the State Governments in order to familiarise them with the data formats, statements and notes on specific topics required from them and to sensitise them on the time-lines. Four such workshops were held between February and April 2013 at Hyderabad, Ahmedabad, Kolkata and New Delhi. The feedback received revealed that the benefits from these workshops far exceeded the original intent. The workshops provided a very useful forum for exchange of ideas and experiences amongst State officials. For our officers too, it was a first-hand exposure to the ways in which State Governments approached the work of the Finance Commission and, in the process, several inconsistencies in the data formats got rectified. The real benefit of the exercise was in timely receipt of information, based on which visits to the States got facilitated. A list of participants of meetings with Nodal Officers is in Annex 1.10.

Consultations

1.12 In keeping with earlier practice, we had extensive consultations with State Governments, Ministries and Departments of the Union Government and other stakeholders and opinion makers. In our discussions, we consciously adopted a principle of listening to and absorbing all points of view. We sought clarifications and made enquiries with the sole purpose of better understanding the contextual situation in the light of our ToR.

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1.13 In order to obtain preliminary inputs on the ToR, the practice of structured interactions of the Commission with economists and economic administrators was widened to include experts from a range of other social sciences, apart from key policy makers. We also decided to have these regional consultations in a mix of premier institutions of higher learning in different disciplines. The intention was to have exclusive sessions at these institutions involving the faculty and students, to elicit fresh thinking and approach to the terms of reference. Five regional meetings were organised between April and June 2013, with wide participation of such experts and policy makers. These were held at the Indian Institute of Technology, Madras, Indian Institute of Management, Kolkata, Tata Institute of Social Sciences, Mumbai, Indian Institute of Technology, Guwahati and National Institute of Public Finance and Policy, New Delhi. Recognising the uniqueness of the North-eastern States and the salient features of each of them, a separate session was organised at Guwahati with retired administrators, Chairpersons of State Finance Commissions and members of the North Eastern Council, in order to learn from their individual and shared experiences. A list of the participants at these meetings is at Annexes 1.11 and 1.12. Needless to add, these meetings were most useful in helping us to have a preliminary understanding of the tasks before us.

1.14 Consultations with experts continued throughout our tenure. Selected experts and scholars were invited to share their ideas and knowledge and provide suggestions on the ToR, particularly those which were introduced for the first time. These interactions provided insights into the latest research and perspectives on various critical subjects having a bearing on public finances. We also had the benefit of receiving views on various issues relating to the ToR from a large number of eminent personalities from various walks of life, who met the Chairman, Members and Secretary of the Commission. The list is in Annex 1.13. The list of visitors who met the Chairman is placed in Annex 1.14.

1.15 A meeting with Members of previous Finance Commissions was held on March 1 2013 at New Delhi. A list of participants is placed in Annex 1.15. We subsequently met Dr. Vijay Kelkar, Chairman, Thirteenth Finance Commission, on 9 April 2013 and Dr. C. Rangarajan, Chairman, Twelfth Finance Commission, on May 28, 2014. These meetings provided very useful guidance to the Commission.

1.16 Before undertaking visits to the States, meetings were held with the respective Accountants General of each of the twenty-nine States. The Accountants General provided us with objective assessments of the strengths and weaknesses of the public finances of their respective States, in particular their fiscal and financial health and efficiency in resource mobilisation and expenditure. They also provided insights into the performance of various sectors, financial health of public sector enterprises and the local bodies in these States. The schedule of meetings held is listed in Annex 1.16.

1.17 We place on record our deep appreciation for the support and inputs provided by the C&AG in facilitating our interaction with the Accountants General and for the detailed views on the ToR of the Commission. Detailed discussions on various issues were also held with the C&AG on 13 August, 2014.

1.18 Prior to commencing our visits to the States, we had the benefit of meeting all the Finance Secretaries of the States during the Conference of State Finance Secretaries organised by the RBI on 23 May 2013. The Governor, RBI, very graciously provided us with this opportunity, enabling us to get the preliminary views of the States on the ToR. The RBI also gave us very valuable inputs on the debt position of the States, particularly contingent liabilities. It continued to provide all material and data that we needed, even at short notice. We are thankful to the Governor for all the cooperation and support extended.

1.19 A meeting with the Empowered Committee of the State Finance Ministers was held on 10 September 2014, to discuss the progress made in the introduction of goods and services tax(GST). While many States were represented at the ministerial level, the Union Government was represented by a senior officer of the Ministry of Finance. The meeting facilitated our understanding of the collective view of the States on the GST, the specific concerns of individual States and the views of the Government of India. A list of participants is at Annex 1.17.

1.20 We decided to organise a meeting with the Chairpersons and Members of the State Finance Commissions (SFCs) to obtain their views on a wide range of issues. A consultative conference was held with sitting Chairpersons of SFCs, wherever an SFC was in existence, and the immediate past Chairpersons from the States where the SFCs had completed their term and were not in position. Some Member Secretaries also participated, in the absence of the Chairperson. This conference provided us with insight on the functioning of the SFCs, the general performance of the local bodies in the States, their problems and issues that required our attention. We express our gratitude to all the Chairpersons of present and past SFCs and all other participants who participated and made the discussion fruitful. The list of participants is at Annex 1.18.

Consultations with the States

1.21 Consultations with the State Governments and other stakeholders in the States has been an essential and enduring feature of work for all previous Finance Commissions. We covered all twenty-nine States and held four meetings in each of them. The meeting with the Chief Minister, Ministers and officers of the State Government was one of the highlights of the State visits. Separate meetings were held with elected representatives of panchayats and municipalities, representatives of trade and industry, and representatives of recognised national and state political parties in the States. Anticipating the break in the schedule of State visits that was likely to arise due to elections for the Lok Sabha and some State legislative assemblies, we planned, coordinated and completed visits to twenty-five States between July 2013 and February 2014. We could not visit three States due to unforeseen circumstances beyond our control and these visits got completed in June 2014. This provided us adequate time to apply ourselves to addressing the issues raised by the States and undertake the consolidated assessment of their resources and needs and still meet the deadline of October 31 2014 for submission of our report to the President. However, on account of the bifurcation of the State of Andhra Pradesh on 2 June 2014 and the consequential delay in getting the projections of the two successor States, we could visit both the States separately only in September 2014. The State Governments sent their memoranda and projections in advance of the scheduled visits. The itinerary of the State visits is placed in Annex 1.19. A list of participants who attended the discussions during these visits is placed in Annex 1.20. We extend our deep appreciation and gratitude to the State Governments for making extensive arrangements to ensure fruitful discussions and for the warm hospitality extended during our visits.

Consultation with the Union Government

1.22 The meetings with the Ministries and Departments of the Union Government were generally held between February and May 2014. Prior to the meetings, we had received comments from most of them on the ToR of the Commission relevant to their functional domains. We met the Finance Secretary and the Secretary, Planning Commission to get their preliminary views, before commencing with our meetings with other Ministries and Departments. The Finance Secretary met us on 8 September 2014 and presented the memorandum on behalf of the Union Government and its projections for the award period. The list of participants is given in Annex 1.21. We are thankful to all Ministries and Departments in the Government of India, Planning Commission and other agencies for extending cooperation and support.

1.23 We made a courtesy call on the Union Finance Minister on 20 June 2014. This provided us with an opportunity to exchange views on several issues before us. Earlier, we also had a meeting with the Deputy Chairman and Members of the Planning Commission on 23 April 2014. Several aspects of the ToR were discussed, including financing arrangements for various Plan Schemes. We acknowledge our gratitude for the valuable insights we got in these meetings.

Studies

1.24 In order to obtain an overview of State finances in the 2002-2012 decade from local experts, we commissioned studies for every State, generally through universities and institutions located in those States. Barring one State, we could obtain studies on the economy of all the States. The reviews focussed on estimating the revenue capacities of the States, along with measures taken by them for improving their tax-gross state domestic product (GSDP) ratios, analysis of the States' own non-tax revenues, review of their expenditure patterns and analysis of their deficits and debt. These studies also gave us an understanding of the performance of the States on several parameters, including fiscal consolidation efforts, potential for additional resource mobilisation, performance of public sector enterprises, performance of the power sector and other issues covered in the ToR. Further, these studies gave us inputs for a broad understanding of the unique characteristics of individual States. A list of State studies is at Annex 1.22.

1.25 Three institutes were given a study each for developing a macro-econometric modelling for a medium-term sustainable fiscal framework. We also took assistance from a legal firm to study, from the legal and Constitutional perspective, the provisions for continuing the Union Government's control on state debt, approach to enhancing limits for taxes on professions and the working of the Inter-State Council. For an international perspective on fiscal arrangements for inter-governmental transfers in federal fiscal relations, we commissioned a study of five emerging economies – Indonesia, Brazil, South Africa, China and Russia.

1.26 We also commissioned studies on select subjects which, in our view, required in-depth research. The subjects covered aspects relating to assessing and measuring the conservation value of forests, cost disabilities of hill states, sustainability of small savings schemes and the National Savings Scheme Fund (NSSF), estimating the true fiscal capacity of States, and insulating public utility pricing from policy fluctuations. We commissioned two specific studies on the health sector. One analysed the approaches and cost of an essential health package for the country and the other studied inter-State comparisons on health outcomes in order to develop a framework

for resource devolution for the health sector. Two studies were commissioned on local governments, one each on panchayats and municipalities. A very detailed study was done on power sector operations across all States and their impact on state finances. The details of the studies commissioned and the institutions involved are at Annex 1.23.

1.27 It was our constant endeavour throughout our tenure to promote in-house capabilities by encouraging our officers to study key sectors not covered by any specific study that we commissioned. We note, with appreciation, the efforts put in by the officers in presenting papers of high quality and content on several subjects covered in the ToR. A list of the in-house studies is at Annex 1.24. We recommend that along with the studies commissioned, the in-house studies should also be placed on the website of the Finance Commission for public access, once our report is tabled in Parliament.

Other Features

1.28 Consistent with the nomenclature used in the Constitution, we decided to use, as far as possible, the term 'Union' instead of 'Centre' and 'Union Government' in place of the commonly used 'Central Government'. We have used the terms accordingly throughout the report. There are a few exceptions, such as use of the term 'Central loan', an accounting phrase used for the loans given by the Union Government to the States or 'Central team', a term used for the team of officers deputed to the States by the Government of India to assess the extent of a natural disaster. The term 'Central Government' has also been used whenever the ToRs are quoted, because of its usage there or while extracting a statutory provision.

1.29 In our report, we have also desisted from mentioning the names of the States, except where it became absolutely necessary, such as in the case of inter-state comparison of fiscal performance or where any specific issue required the names to be mentioned. In the report, we have attempted to faithfully reflect the views of the States on all important issues raised by them. As the States gave their views on a host of related items in the context of the ToR, naming them in each and every instance would have deflected attention from the issue to be considered. In our view, the objective could be better achieved by taking the common concerns of a group of States together. Accordingly, for the purpose of representing the views of the States, the reporting terminology used is the following: all States (100 per cent), almost all (between 90 per cent and 100 per cent), overwhelming majority of the States (between 75 per cent and 90 per cent), majority of the States (between 50 per cent and 75 per cent), half the States (50 per cent), nearly half of the States (40 per cent to 50 per cent), some States (between 25 per cent and 40 per cent), a few States (below 25 per cent).

1.30 In making our assessments, we had the complete audited accounts for both the Union and State Governments, based on the Finance Accounts prepared by the C&AG upto 2012-13. The revised estimates for 2013-14 and the budget estimates for 2014-15 were also made available by all the States. Some States also sent their pre-actuals for 2013-14. In addition, we received voluminous data from the Union Government, State Governments and several agencies working under them. This information formed the basis of our work and it would not have been possible to accomplish the task in time without these. We acknowledge our gratitude to all concerned.

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1.31 We introduced an internship programme for providing exposure to postgraduate students in economics, public finance, financial management and related disciplines on the working of the Finance Commission. Some of the interns who volunteered to continue were given long term assignment as Young Professionals. These young scholars performed competently and gave useful assistance to the officers.

1.32 We inherited an excellent website from the FC-XIII. It was redesigned with the help of the National Informatics Centre (NIC) to update the content and make it user friendly. The site enabled the States and Ministries and Departments of the Union Government to upload the information in any format. We are happy to note that over one million visitors have visited the site till now. We expect that the NIC Unit in the Ministry of Finance will maintain this website till the next Commission takes it over.

Acknowledgements

1.33 We would like to place on record our appreciation of the valuable and extensive contribution of the officers in the Commission. They worked tirelessly to collate, study, analyse and make available inputs on all the material received from multiple sources. Their efforts aided us in formulating our views on various issues arising from our ToR and in making our recommendations. We acknowledge our gratitude to Shri V.S. Senthil and Shri Mukhmeet S. Bhatia, Joint Secretaries, Dr. Pinaki Chakraborty, Economic Adviser, Shri Sanjay Pandey, Shri Sanjay Prasad, Shri Ashutosh Joshi, Shri Deepak Narain and Shri N.M. Jha, Directors. We are also thankful to Ms. Sunita Saxena, Shri Harish Pokhriyal, Dr. Amarendra Das, Deputy Directors, Ms. Shreya Pandey, Consultant, and all the other officers, members of the staff, consultants and interns, as listed in Annex 1.5, who contributed significantly to our work. The entire support staff, aided and assisted by those on contract ensured smooth housekeeping and the efficient functioning of the office. We would like to thank the team from the NIC, for managing the IT requirements of the Commission, as well as the Government of India Printing Press for printing this report on time.

1.34 Our deep appreciation of the valuable contributions made by the Commission's Secretary Shri Ajay Narayan Jha on multiple fronts has to be placed on record. He assembled the secretariat, identified the premises, equipped the office and coordinated all its activities with impressive efficiency. He provided stellar leadership in directing, coordinating and supervising consultations, and meeting with a wide range of stake holders, culminating in the finalisation of this report. Above all, his active participation in all the discussions in the Finance Commission, drawing upon his sound knowledge, varied experience and deep appreciation of political economy as well as public systems have been invaluable. The Chairman and Members of the Fourteenth Finance Commission are beholden to Shri Ajay Narayan Jha, who as the Secretary of the Commission anchored the work to its fruition.

Chapter 2

Issues and Approach

2.1 The core mandate of the Finance Commission, as laid out in Article 280 of the Constitution, is to make recommendations on “the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them”, “the allocation between the States of the respective shares of such proceeds” and “the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India”. The role of the Finance Commission has widened after the 73rd and 74th Constitutional amendments to recognise the rural and urban local bodies as the third tier of government. Article 280 (3) (bb) and Article 280 (3) (c) of the Constitution mandate the Commission to recommend measures to augment the Consolidated Fund of a State to supplement the resources of Panchayats and Municipalities based on the recommendations of the respective State Finance Commissions (SFCs).

2.2 The remit of the Finance Commission, as laid out in its terms of reference (ToR), has expanded over the years due to the Presidential order under Article 280 (2c) which provides for the Commission to consider “any other matter referred to the Commission by the President in the interests of sound finance”. In respect of the Fourteenth Finance Commission (FC-XIV), these include: assessment of the resources of the Centre and the States for the five-year award period; taxation efforts and the potential of additional revenue mobilisation; demands on the resources of the Central Government; the demands on the resources of States under different heads, including the impact of debt levels on resource availability in debt-stressed states; the requirement of States to meet the non-salary component of the maintenance expenditure on capital assets and Plan schemes; the objective of not only balancing receipts and expenditure but also generating surpluses for capital investment; the need for insulating the pricing of public utility services from policy fluctuations through statutory provisions; and the need to make public sector enterprises competitive and market-oriented with listing, disinvestment and relinquishing of non-priority enterprises. The ToR also expects us to take into consideration the impact of the proposed implementation of goods and services tax and the mechanism for compensation in case of revenue loss; the level of subsidies that are required and an equitable sharing of these between the Union Government and State Governments; and the need to manage ecology, environment and climate change consistent with sustainable development.

2.3 The ToR requires us also to review the present public expenditure management systems, including the budgeting and accounting standards and practices, the existing system of classification of receipts and expenditure, linking outlays to outputs and outcomes and best practices within the country and internationally. We are mandated also to review the deficit and debt levels of the Union and States, keeping in view the fiscal consolidation roadmap recommended by the FC-XIII and recommend measures for ensuring a stable and sustainable fiscal environment, including amendment of the Fiscal Responsibility and Budget Management Acts. Another mandate

is to review the prevailing arrangements regarding disaster management with reference to the funds constituted under the Disaster Management Act, 2005 and make appropriate recommendations regarding these.

2.4 With the passage of the Andhra Pradesh Reorganisation Act, 2014, we were given an additional ToR to consider the resources available to the successor or reorganised States of the erstwhile undivided State and make recommendations for them on matters under our reference. Though we were severely constrained in getting reliable information required to make our recommendations for this purpose, we have completed this task by drawing upon data from all relevant sources, including the Accountant General and the relevant State Governments.

Features of Terms of Reference

2.5 The core mandate of the Commission remains no different from that of the previous Commissions — the distribution between the Union and the States of the net proceeds of taxes, the principles which should govern the grants-in-aid of the revenues of the State out of the Consolidated Fund of India and the measures needed to augment the Consolidated Funds of the States to supplement the resources of the rural and urban local bodies in each State. However, a reading of the ToR as a whole shows two striking aspects that have a bearing on this core task. *First*, unlike the FC-XIII, there is no specific mention of the treatment of gross budgetary support (GBS) to Plan as a committed liability of the Union Government. The ToR also does not bind us to look only at the non-Plan revenue expenditure of the States. We, therefore, had the opportunity to take a comprehensive view of the revenues and expenditures of the Union and the States. As a result, it became possible to take a comprehensive view of all transfers from the Union to the States. It also became possible to address more comprehensively the issue of generating surpluses for capital investment at the levels of the Union and State Governments. *Second*, contrary to the earlier requirement that the Commission shall generally take the base of population figures as of 1971, in all cases where population is a factor, our ToR indicates that we may also take into account the demographic changes that have taken place since 1971, which are best captured by the census figures of 2011.

2.6 We are required to review the finances of both the Union and the States with particular reference to debt levels, keeping in view the fiscal consolidation roadmap recommended by the FC-XIII. In addition, we are required, in a departure from the past, to make suggestions to amend the Fiscal Responsibility and Budget Management (FRBM) Acts currently in force. Accordingly, the Commission had to assess the working of the fiscal responsibility legislations and consider making suggestions based on the experience gained.

2.7 Our ToR requires us to consider specifically the impact of debt levels on resource availability in debt-stressed States during our award period. Consequently, we had to review the circumstances under which States have ended up being debt stressed and explore mechanisms for resolving this issue during the award period. In addition, given the magnitude and involuntary nature of the borrowing from National Small Savings Fund (NSSF), a review of this became necessary.

2.8 The ToR also requires us to take into account the impact of the proposed goods and service tax (GST) on the finances of the Centre and States and the mechanism for compensation in case of revenue loss. However, the structure and operational details of GST are yet to be finalised and, thus, we are not in a position to take into account the impact of the proposed tax.

2.9 Our ToR included, as in the past, financing of disaster management. However, our remit has been limited to financing of disaster management with reference to funds already constituted by law.

2.10 In a departure from the past, we are required to consider relinquishing of non-priority public enterprises. For this, we had to take a comprehensive view of all the public enterprises and consider prioritising them, with fiscal implications as the main focus. This task necessitated an in-depth examination of the policies relating to Central public sector enterprises.

2.11 We had to address the issue of insulating the pricing of public utility services from policy fluctuations through statutory provisions. However, we had to recognise the fact that the pricing of these services is often governed by the regulatory framework under several statutes. The issues relating to the level of subsidies that are required and equitable sharing of subsidies between the Union Government and the State Governments were also referred to us. We have been asked to review the present public expenditure management systems. In doing so, we noted several recommendations made in this regard in the past and also the work under progress at the level of the Union Government.

Our Approach

2.12 Our approach has been based on the fundamental principle that we should strictly adhere to the ToR. At the same time, we recognise the importance of taking a comprehensive view of federal fiscal relations. As a result, we have given priority in our work to the views and expectations of the Union, States and local bodies on the relevant ToR. We took account of the recommendations of the previous Finance Commissions as well. In this light, we reviewed the trends and existing arrangements to the extent possible. This approach has helped us in identifying the issues of concern to the main stakeholders.

2.13 Our primary objective has been to address the issues that arose out of our understanding of the views of the stakeholders and the current situation as well as emerging challenges. In doing so, we drew upon the relevant Constitutional provisions, debates in the Constituent Assembly and the reports of various Commissions and the Committees that had addressed such issues in the past. In this regard, we did not have an agenda that was independent of the views and issues that were posed to us during our consultations. We have drawn upon theoretical contributions and global experiences in understanding the problems and making proposals, though these considerations have not been articulated in the report. Above all, we respect the importance of continuity, even while being conscious of the need to change the nature of federal fiscal relations consistent with emerging challenges and expectations.

2.14 We took note of the broader issues relating to the need for rebalancing the roles of Union and State in economic management in general, and fiscal management in particular. The issues raised by the States may be summarised as follows: *First*, there is greater focus by the States on their own development models. *Second*, the States have acquired capabilities of designing their strategies for development and have matured in terms of economic management, though there is considerable diversity among them in this regard. *Third*, there is considerable variation in the expectations of the people of different States about the level and nature of public services. *Fourth*, some States argued for the need to give State Governments greater policy space *vis-à-vis* the

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Union Government, pointing out that apprehensions in the past that doing so would strengthen fissiparous tendencies have proved unfounded. *Fifth*, States highlighted the emerging fiscal implications for them arising from the Union Government's policies relating to natural resources, as for example forests and allocation of spectrum. *Finally*, in terms of the functioning of the Finance Commission, the States have argued that, apart from the merits and demerits of the 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.

2.15 In their presentations, various Ministries of the Union Government made a strong case for making larger resources available to them to fulfil their respective obligations. They also explained the rationale for nation-wide approaches to sectoral policies and the need for the Union Government to provide guidance, incentives and disincentives to the States. They have also indicated that there is an increasing awareness among Union Government Ministries about the need to provide greater flexibility to the States in implementing CSS.

2.16 We were also made aware of the increasing international obligations that the Union Government is entering into, the discharge of which require the cooperation of the States, making a degree of centralisation inevitable. Further, the increasing economic integration with the global economy requires the Union Government to be empowered to manage global shocks, assure financial markets and to adopt counter-cyclical policies. We recognise that global opinion makers and credit rating agencies give over-riding importance to the Union Government's fiscal position in their assessment of the national economy. We also recognise that the Union Government should have adequate fiscal space to transfer resources to the States in regard to overlapping functions and for political economy considerations.

2.17 The presentations by the local governments were essentially in terms of insistence on untied grants. They felt constrained not only by the lack of resources, but also by the inadequate administrative infrastructure, as well as by the lack of discretion available to them in providing basic services. They argued that they are the most appropriate level of government for the provision of most of the local-level public goods. They also pointed out the constraints on them in raising local resources.

2.18 In brief, the balance between the public and private sectors, the government and the public enterprises, the domestic and global economy, and the fiscal and non-fiscal elements of the government have dramatically changed over the years, and this cannot but have a significant impact on the Union-State fiscal relations. Several of these fundamental issues have been included in our ToR, though they may not be covered by the narrow definition of Union-State fiscal relations. These ToR relate to disinvestment, subsidies, regulatory policies, environmental concerns, etc. Therefore, we have to take cognisance of the new realities of macro-economic management. We have to place the fiscal situation and the relationship between the Union and the States in this broader current context, in order to fulfil the mandate given to us.

Symmetry, Comprehensiveness and Trust

2.19 A distinctive feature of our ToR is that we are required to take a comprehensive and symmetric view of Union-State fiscal relations in the current context. This point was also made in the representations made by the Union and the State Governments. We have assessed the

resources and needs of Union and State Governments in a symmetric manner. We did not make a distinction between Plan and non-Plan, but we recognised the distinction between revenue and capital expenditure. While detailed assessment was made only of the revenue account, the implicit capital outlay has also been indicated in our assessment of Union and State finances. In addition, the requirements of the Union and of individual States for additional borrowing have been carefully worked out and indicated. We also recognise that the Union is in a position to enforce the fiscal rules on the States, but there is no effective institutional arrangement to enforce fiscal responsibility on the Union Government and make it incumbent on it to adhere to fiscal responsibility. We considered the issue of fiscal environment and legislative changes, as required by our ToR, keeping in view the relevant provisions in the Constitution. Finally, we have recognised the importance of transfers from the Union to the States outside those based on the recommendations of the Finance Commission.

2.20 We believe that the recommendations of Finance Commission should contribute to greater trust between the three layers of government – Union, State and local –and promote cooperation and competition. As a step in this direction, we have kept conditionality and tied grants to the absolute minimum in our award. We have adopted transparent formulae in our award and avoided categorisation of States, to the extent possible. We have, in the process, recognised and articulated a legitimate role for the Union in effecting transfers to States and provided fiscal space for the purpose.

2.21 We recognise that there is a case for transfers from the Union to the States for specific sectors or areas, especially those with a high degree of externalities. Given the vast variation in systems and institutions, the involvement of States in the design of such schemes is critical for the desired outcomes. To this effect, we have proposed a new institutional arrangement embodying the principles of cooperative federalism. This suggested institutional arrangement should also serve as a platform for integrating economic and environmental concerns in decision making, in view of their externalities.

2.22 We have been particularly sensitive to the needs of local bodies and their role in providing public services as required by their respective statutes. We have emphasised the predominant role of States and, in particular, SFCs in empowering the local bodies. Our recommendations seek to enhance the flow of resources in an assured, objective and untied manner. In our view, the rewards that come from placing trust in local bodies far exceed the costs associated with administering and complying with conditionalities. We have provided strong incentives, at the margin, for performance in terms of maintaining audit and accounts. We have, however, suggested certain areas in which the States can enable additional resource mobilisation by local bodies. In brief, we have proceeded on the assumption that, though their scope and perspectives differ, all three layers of government are equally endowed with wisdom, knowledge, integrity and effectiveness appropriate for the tasks assigned to them in the Constitutional and legal framework.

Outlook for the Economy

2.23 We have analysed growth forecasts for the Indian economy prepared by different agencies. While the Planning Commission had originally envisioned an annual real growth target of 9 per cent for the Twelfth Five-Year Plan period (2012-17), this was revised downwards to 8 per cent, taking cognisance of the structural weaknesses of the economy and decline in growth in recent

years. The Union Government indicated in its memorandum to the Commission that it expects a nominal annual gross domestic product (GDP) growth rate in the range of 13.4 per cent to 13.5 per cent in the period from 2014-15 (BE) to 2019-20. The Union Government has based its forecast on the assumptions of a modest industrial revival, benign outlook on oil prices and absence of pronounced destabilising shocks.

2.24 Given the inter-linkages between the Indian economy and the global economy, we have also taken into consideration the economic outlooks released by various international agencies. We find these in broad agreement on the point that the global economy is making a transition towards a period of stable, but slower growth. According to the International Monetary Fund's (IMF) World Economic Outlook 2014, economic activity in developing and emerging economies is projected to improve in 2014-15, but at a rate that is lower than previously estimated. While the post-global financial crisis risks have receded, other downside risks have increased and new challenges have emerged, as noted in the economic outlooks of various international agencies like IMF, Organisation for Economic Cooperation and Development (OECD) and the World Bank. Short-term risks include worsening of geo-political tensions and continuing volatility in financial markets. Medium-term risks include a low potential growth in advanced economies and a decline in potential growth of the emerging economies. However, these agencies have predicted a benign outlook on global commodities in the near to medium term.¹

2.25 In our view, global and domestic macroeconomic indicators signal an economic recovery in the country. We believe that the softening of global commodity prices, particularly oil prices, would have a tangible effect on both the fiscal and current account deficits. The resultant easing of inflation, coupled with the expectation of domestic policy changes to address structural constraints, indicate a more optimistic macroeconomic outlook in our award period. Given the available growth forecast and our assessment of the prevailing macroeconomic situation, we have assumed a nominal GDP growth rate of 13.5 per cent during the award period.

Vertical Balance

2.26 On the revenue side, there has been stability in the relative shares of the Union and States, after taking into account the Central transfers to States. However, the composition and character of these transfers have changed over time. While the Finance Commission transfers through tax devolution have remained the primary source of resource transfers to States, the share of these transfers in aggregate transfers has declined, particularly in the last decade. The share of Plan grants has increased, with an increase in the share of transfers for CSS primarily through the implementing agencies, bypassing the State budgets till 2013-14. However, from 2014-15, the transfers to implementing agencies are being routed through the State budgets.

2.27 We have noted the arguments advanced by the Union Government for adequate resources to discharge functions listed in the Union list, such as defence, and also to continue to transfer funds to States for area-specific and sector-specific projects. We recognised the plea of States for larger devolution, in view of the public services they have to provide and the expectations of the people. We have also noted the concern expressed by the States regarding the narrowing of their

¹This has been aided by the structural changes in the global energy supply chain with an increase in shale production in the United States and an expected increase in non-OPEC oil production, which has also mitigated the geo-political risks to crude prices to some extent.

fiscal policy space, with the intervention of the Union Government in subjects in the State List on account of the widening ambit (often conditional) of CSS. Additionally, we have examined the submissions made by the States with respect to the size of the divisible pool on account of non-inclusion of cess and surcharges whose share in the gross tax revenues of the Union Government has been increasing in recent years. We have also taken note of the revenues foregone by the Union Government due to large-scale tax exemptions and concessions and the corresponding reduction in the divisible pool. This was also an issue that many States highlighted. Our approach towards the vertical fiscal balance has taken account of these concerns of both the Union and the States, keeping in view the respective responsibilities and expenditure commitments.

2.28 We have noted that aggregate transfers accounted for around 50 per cent of the gross revenue receipts of the Union. Keeping in view the Union Government's expenditure responsibilities, and the need for fiscal adjustment at the Union level, we do not see the scope for increasing the transfers beyond the current level. However, we believe that there is a need to alter the existing composition of transfers by increasing the share of untied transfers. This should provide enhanced fiscal flexibility to the States to meet their expenditure needs and make expenditure decisions in line with their own priorities. While doing so, we have ensured appropriate fiscal space to the Union to finance its own expenditure responsibilities and commitments, including continued transfers to States.

Horizontal Balance

2.29 We did not make a distinction between special and general category states in determining our norms and recommendations. We believe that while there are certain common factors that impact cost disability and fiscal capacity of States, there exist circumstances that are unique to individual States. Our endeavour has been to take a comprehensive view of these commonalities and special characteristics of individual States while making our assessment and recommendations. In our assessment of State resources, we have taken into account the disabilities arising from constraints unique to each State to arrive at the expenditure requirements. In this regard, we have observed that the North-eastern and hill States have several unique features that have a bearing on their fiscal resources and expenditure needs, such as low level of economic activity, remoteness and international borders. Our objective has been to fill the resource gaps of each State to the extent possible through tax devolution. However, we have provided post-devolution revenue deficit grants for States where devolution alone could not cover the assessed gap.

2.30 Many States, in their submissions, suggested that intra-state inequality should be factored into the devolution formula or in determining grants, instead of only broad indicators such as per-capita income being considered. In this context, some of these States also highlighted the areas within the States as identified in Article 371 of the Constitution. We are of the view that intra-state inequality is within the policy jurisdiction of the States and provisioning of adequate resources through tax devolution should enable them to address intra-state inequalities in an effective manner.

Tax Devolution

2.31 The devolution formulae as adopted over time have reduced the weight for fiscal need indicators like population, increased the weight for measures of equity and have introduced some

measure of fiscal efficiency. The criteria used by earlier Finance Commissions for *inter-se* distribution of tax shares across States could be broadly grouped under the following heads: a) factors reflecting needs, such as population and its composition or infrastructure distance, b) revenue disability measures such as fiscal capacity distance and per-capita income distance from the highest per-capita income or inverse of it, c) cost disability indicators, such as area and d) fiscal efficiency indicators, such as tax effort and fiscal discipline. While the weight assigned to population has declined considerably, weights assigned to income distance and efficiency factors have increased.

2.32 One of the issues that we have considered in designing our tax devolution formula has been the choice of the base year of population to best reflect the financial needs of the States. Our ToR mandates us to take the population figures of 1971 when framing our recommendations, but, at the same time, allows us to consider subsequent demographic changes.

2.33 Our ToR has mandated us to consider the need to balance management of ecology, environment and climate change consistent with sustainable economic development. We recognise that this is a wide area with several dimensions. We have approached it from the fiscal perspective, in keeping with our primary mandate. The FC-XIII had introduced a forward-looking incentive-based grant rewarding the States with forest cover and linking it to the quality of forests in a State. Forests and the externalities arising from them impact both the revenue capacities and the expenditure needs of the States. We have noted that there is a need to address the concerns of people living in forest areas and ensure a desirable level of services for them. At the same time, it is necessary to compensate the decline in the revenues due to existing policy prescriptions. In our view, forests, a global public good, should not be seen as a handicap but as a national resource to be preserved and expanded to full potential, including afforestation in degraded forests or forests with low density cover. Maintaining a green cover, and adding to it, would also enable the nation to meet its international obligations on environment related measures. **We recognise that the States have to be enabled to contribute to this national endeavour and, therefore, we are designing our approach to transfers accordingly.**

Grants-in-Aid

2.34 The general principles that have underlined the Finance Commission grants were articulated by the FC-I itself. These included determining the need of a State from its budget, recognising efforts made by States to realise their potential revenue and equalising standards of basic services across States. The FC-I also argued that grants could be given to take care of any special burden or obligations of national concern within the States' sphere, as well for providing any beneficent service of national interest to less advanced States. However, previous Finance Commissions have predominantly adopted a gap-filling approach to determine the quantum of grants to States to cover the deficit in the non-Plan revenue account.

2.35 We have primarily relied on tax devolution to cover the assessed revenue expenditure needs of the States. It is only in the case of some States that we had to give revenue deficit grants to cover their revenue expenditure requirements after assessing their post-devolution revenue deficits derived from their projected fiscal capacities and needs.

2.36 Our review of sector-specific grants from the Finance Commission in the past indicated that the quantum of these grants as a proportion of actual State expenditure on a sector was quite small. Further, actual grant utilisation was even lower than the allocation because of the non-fulfilment of conditionalities. In our view, sector-specific grants, if found necessary, should be carefully designed taking into account the variations in local conditions and institutional realities across States. We have, therefore, desisted from recommending such grants.

2.37 In framing our recommendations for grants to local bodies, we have considered the following factors - enhancement of grants, minimal conditionalities, strengthening the role of the SFCs and placing trust in local bodies. We have studied and analysed the recommendations of SFCs, and made these central to our approach in making recommendations.

2.38 In regard to grants for disaster management, we have adopted the procedure of the FC-XIII and used past expenditures on disaster relief to determine the State Disaster Response Fund (SDRF) corpus. While making our recommendations, we have taken note of the additional responsibility cast on States and their district administrations under the Disaster Management Act. We have also taken note of the location-specific natural disasters not mentioned in the notified list, which are unique to some States.

Fiscal Sustainability

2.39 In formulating our approach to fiscal sustainability, we have taken a consolidated view of the debt and deficit of both the Union and States. Although we have adopted the basic framework of the FC-XIII relating to fiscal rules, we have considered the issue of flexibility in the rule for higher borrowing limits for States. We have adopted a symmetric approach in the treatment of the Union and States with regard to the compliance with fiscal rules. We have also assessed the capital outlays of both the Union and State Governments implicit in our assessment and roadmap for fiscal consolidation.

Continuity and Change

2.40 The approach we have followed represents continuity to a considerable extent and change and rebalancing wherever found necessary. In our view, continuity is important to ensure stability in the conduct of fiscal policy at both the Union and individual State levels. Therefore, we have built on the approach adopted by the previous Finance Commissions. At the same time, we have taken into account the changing realities in order to rebalance the fiscal system in a way that will ensure fair distribution of resources and strengthen the federal fabric of the country.

2.41 Our approach to the overall division of resources between the Union and States clearly represents continuation of the past. We have given primacy to tax devolution in the overall scheme of transfers. The devolution formula contains elements of revenue and cost disabilities, in keeping with approach of the past Commissions. Continuity is also seen in the approach to recommending the contribution to the SDRF and grants to augment the Consolidated Funds of the States to supplement the resources of local governments, based on the recommendations of the SFCs. Like the past Commissions, we have recommended that both the Union and State Governments should adopt fiscal deficit targets for calibrating sustainable fiscal policy.

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2.42 Prompted by the distinguishing features of our ToR and an assessment of the evolving environment, we have made some changes in the approach and methodology wherever necessary. We have recommended an institutional mechanism to oversee the implementation of fiscal rules at the Union Government level. We have made a comprehensive assessment of the revenue budgets of the Union and States without making a distinction between the Plan and non-Plan. We have considered demographic changes, in addition to using the 1971 population in our devolution formula. We have addressed the “need to balance the management of ecology, environment and climate change consistent with sustainable development”. We have not categorised States for the purpose of devolution. We have minimised the use of conditionalities and incentives. We have also increased untied transfers. This reflects our trust in all tiers of governments.

Chapter 3

Review of Union Finances

3.1 The terms of reference (ToR) of this Commission requires it 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 . . .” (paragraph 5). Accordingly, we reviewed the major trends in Union finances with a focus on the trends between 2004-05 and 2014-15. The period 2004-05 to 2007-08 was a phase of impressive fiscal consolidation by the Union Government. High growth of the economy, tax reforms leading to increases in revenue combined with fiscal prudence led to considerable improvement in the finances of the Union Government until 2007-08, with the revenue and fiscal deficits declining in line with targets set in the Fiscal Responsibility and Budget Management (FRBM) Act, 2003. However, the period from 2008-09 is characterised by an expansionary fiscal policy and consequent deterioration in the fiscal health of the Union Government.

3.2 Since 2009-10, the revenue and fiscal deficits of the Union as a ratio of gross domestic product (GDP) increased to levels higher than targets in the fiscal adjustment path set by the FC-XIII. While the tax-GDP ratio of the Union declined from the high level reached in 2007-08, the revenue expenditure to GDP ratio continued to increase from 2008-09 even as the pressure to contain deficits resulted in a decline in capital expenditure as a proportion to GDP. Thus, after the global crisis in 2008-09, even as the growth rate remained high up to 2011-12, fiscal parameters deteriorated. Since 2012-13, there has been a significant deceleration in economic growth as well.

Fiscal Balance

3.3 We have analysed the three major fiscal indicators – fiscal deficit, revenue deficit and primary deficit – and have compared their relative performance since 2007-08 with the targets set under the FRBM Act and the revised roadmap of fiscal consolidation given by the FC-XIII. The FRBM Act had laid down the target of bringing the fiscal deficit down to 3 per cent of GDP and eliminating revenue deficit by 2008-09. Table 3.1 brings out the profile of different fiscal indicators in respect of the Union Government and the performance vis-à-vis the targets set by the FC-XIII.

Table 3.1: Profile of Fiscal Indicators of the Union Government

(per cent of GDP)

Year	Fiscal Deficit	Revenue Deficit	Primary Deficit	Effective Revenue Deficit	Ratio of Revenue Deficit to Fiscal Deficit (%)		
2001-02	6.1	4.3	1.5	-	71.06		
2004-05	4.0	2.5	-0.1	-	62.57		
2007-08	2.5	1.1	-0.9	-	41.42		
2008-09	6.0	4.5	2.6	-	75.24		
2009-10	6.5	5.2	3.2	-	81.01		
Performance on fiscal indicators Against *FC-XIII targets							
2010-11	4.8	5.7	3.2	3.2	1.8	2.1	67.52
2011-12	5.7	4.8	4.4	2.3	2.7	2.9	76.43
2012-13	4.8	4.2	3.6	1.2	1.8	2.5	74.31
2013-14 (RE)	4.6	3.0	3.3	0.0	1.3	2.0	70.59
2014-15 (BE)	4.1	3.0	2.9	-0.5	0.8	1.6	71.23

*FC XIII Targets are shown in bold with no annual targets specified for the primary deficit.

Source: Basic data from Union budget documents (excluding bonds)

Fiscal Deficit

3.4 The fiscal deficit of the Union Government relative to GDP declined steadily from 6.1 per cent in 2001-02 to 4.5 per cent in 2003-04. The FRBM Act mandated reducing the fiscal deficit to 3 per cent by 2008-09. The Union Government achieved this target in 2007-08, with the fiscal deficit declining to 2.5 per cent of GDP. However, in 2008-09 the Union Government undertook several fiscal expansionary measures such as revision of pay scales based on the recommendations of the Sixth Pay Commission, waiver of farm loans and the expansion of the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) to all districts from the 200 districts it was originally slated to cover. In addition, oil prices escalated sharply, leading to a rise in subsidy. As a consequence of all this as well as the global crisis, the fiscal deficit of Union Government increased to 6 per cent in 2008-09 and 6.5 per cent in 2009-10.

3.5 Another consequence was that the total expenditure as a ratio of GDP increased by 1.5 percentage points from 14.3 per cent in 2007-08 to 15.8 per cent in 2009-10. At the same time, the gross tax revenues declined by more than 2 percentage points from a peak of 11.9 per cent of GDP in 2007-08 to 9.6 per cent in 2009-10. Though the fiscal deficit declined in 2010-11 to 4.8 per cent of GDP, this was mainly on account of additional revenue from the proceeds of the auction of telecom spectrum.

3.6 Most of the expansionary measures were irreversible. Further, rising expenditure on major subsidies and stagnant tax-GDP ratios limited the return to the fiscal correction path laid down by the FC-XIII. The fiscal deficit again increased sharply to 5.7 per cent of GDP in 2011-12. In 2012, the Union Government amended the FRBM Act and laid down a revised fiscal adjustment path of achieving fiscal deficit of 3 per cent of GDP by 2016-17 and reducing revenue deficit to below 2 per cent of GDP by 2014-15.

3.7 The growth rate of the economy, which was initially maintained after the global crisis through the expansionary measures, registered a rapid decline after 2011-12. In the two consecutive years of 2012-13 and 2013-14, the growth rates were 4.5 per cent and 4.7 per cent, respectively. In this situation, the Union government severely compressed expenditures to achieve the budgeted levels of fiscal deficit. The fiscal deficit was contained at 4.8 per cent in 2012-13 and 4.6 per cent in 2013-14 largely by compressing Plan expenditure. In 2014-15 (budget estimates), the Union Government proposes to bring down the fiscal deficit to 4.1 per cent of GDP.

Revenue Deficit

3.8 The revenue deficit of the Union stood at 4.3 per cent of GDP in 2001-02 and was brought down to 2.5 per cent of GDP in 2004-05 and 1.1 per cent of GDP in 2007-08. It then rose to 5.2 per cent in 2009-10 because of a substantial increase in revenue expenditures on subsidies, interest payments and salaries and pensions. Plan transfers to the States and implementing agencies also showed increases due to the expansion of existing schemes and launching of major new schemes. The revenue deficit remained high at 3.3 per cent in 2013-14 (revised estimates) and is projected to decline marginally to 2.9 per cent in 2014-15 (BE). Thus, there was a slippage of 3.4 percentage points over the FC-XIII fiscal correction path of a revenue surplus target of 0.5 per cent of GDP in the terminal year.

3.9 The Union Government introduced the concept of effective revenue deficit through an amendment to the FRBM Act in 2012. Effective revenue deficit makes a distinction between the grants given to the States and implementing agencies for the creation of capital assets and grants for meeting revenue expenditures. We have noted that the concept of effective revenue deficit is not recognised in the standard government accounting process.

3.10 The amended FRBM Act has revised the target of revenue deficit – it is now to be brought below 2 per cent of GDP by 31 March 2015 against the original goal of eliminating it entirely. However, it appears that even this revised target may not be met. The projected budget estimates for 2014-15 has a revenue deficit of 2.9 per cent, indicating a clear revenue imbalance in Union finances.

Primary Deficit

3.11 The primary deficit of the Union Government improved substantially between 2001-02 and 2007-08, moving from a deficit of 1.5 per cent of GDP in 2001-02 to a primary surplus of 0.9 per cent of GDP in 2007-08. However, like other deficit indicators, primary deficit of the Union Government increased to 2.6 per cent of GDP in 2008-09 and 3.2 per cent of GDP in 2009-10. It was kept under 2 per cent of GDP in the last two financial years and is projected at 0.8 per cent of GDP in 2014-15 (BE).

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3.12 The ratio of revenue deficit to fiscal deficit broadly measures the extent of borrowings used for revenue expenditure. Table 3.1 also brings out this imbalance and shows that the ratio had improved from almost 71 per cent in 2001-02 to 41 per cent in 2007-08. However, this ratio almost doubled within a span of two years to over 81 per cent in 2009-10 and has since remained consistently above 70 per cent (with the exception of 2010-11), thereby reflecting the levels of persistent structural imbalance in Union Government expenditures.

Sources of Fiscal Imbalance

3.13 Table 3.2 highlights the extent and sources of fiscal imbalance between 2007-08 and 2012-13. Between 2007-08 and 2012-13, the revenue receipts of the Union Government declined by about 2.2 percentage points to GDP, while net tax revenue fell by almost 1.5 percentage points. The non-debt capital receipts fluctuated due to slippages in achieving the projected disinvestment targets. On the expenditure side, the total expenditure as a ratio of GDP has shown a consistent decline since 2008-09. However, the decline was sharper in the case of capital expenditures. Consequently, the ratio of revenue deficit to fiscal deficit has shown a steady increase.

Table 3.2: Fiscal Performance of the Union

(as percentage of GDP)

Sl. No.	Particulars	2001-02	2004-05	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	Change in 2012-13 over 2007-08	2013-14 (RE)	2014-15 (BE)
I	Total Revenue Receipts (a+b)	8.55	9.44	10.87	9.60	8.84	10.13	8.34	8.69	-2.17	9.06	9.24
a)	Non Tax Revenue	2.88	2.50	2.05	1.72	1.79	2.81	1.35	1.36	-0.69	1.70	1.65
b)	Net Tax Revenue	5.67	6.93	8.81	7.87	7.05	7.32	6.99	7.34	-1.48	7.36	7.59
II	Revenue Expenditure	12.80	11.85	11.92	14.10	14.08	13.37	12.72	12.30	0.38	12.33	12.18
	Of which: Interest Payments	4.56	3.92	3.43	3.41	3.29	3.01	3.03	3.10	-0.33	3.35	3.32
III	Capital Expenditure	2.58	3.50	2.37	1.60	1.74	2.01	1.76	1.65	-0.72	1.68	1.76
IV	Total Expenditure (II+III)	15.38	15.35	14.29	15.70	15.82	15.38	14.48	13.95	-0.34	14.01	13.94
V	Revenue Deficit (II-I)	4.3	2.5	1.1	4.5	5.2	3.2	4.4	3.6	2.5	3.3	2.9
VI	Fiscal Deficit	6.1	4.0	2.5	6.0	6.5	4.8	5.7	4.8	2.3	4.6	4.1
VII	Non-debt Capital Receipts	0.85	2.05	0.88	0.12	0.51	0.45	0.41	0.40	-0.48	0.32	0.57

Source: Union Budget for various years.

Trends of Union Debt and Liabilities

3.14 In the fiscal consolidation path laid down by the FC-XIII, the target of combined debt of Union and State Governments was set at 68 per cent of GDP, to be achieved by 2014-15. It also recommended the reduction in the debt stock of the Union Government to 44.8 per cent of GDP by 2014-15. At the end of March 2014, internal debt constituted 92.9 per cent of outstanding debt of the Union Government and external debt accounted for 7.1 per cent. A large part of the increase in the share of internal debt was due to substantial increase in the fiscal deficit of the Union after 2008-09. The net quantum of Union borrowings increased from Rs.1, 31,768 crore in 2007-08 to Rs.4,84,000 crore in 2013-14. Despite such increase in the quantum of borrowings, the debt position of the Union government remained within the limits recommended by the FC-XIII. In 2013-14 (RE), the total outstanding debt of the Union Government is estimated at 39 per cent of GDP and is estimated at 38.5 per cent of GDP in 2014-15 (BE).

3.15 The total liability of the Union Government, which includes the debt stock and liabilities in public account, stood at 56.9 per cent of GDP in 2007-08 and has shown steady decline in spite of increase in borrowings since 2008-09. In 2012-13, it declined to 50.1 per cent and is estimated to decline further to 48.3 per cent in 2014-15 (BE). After adjusting for the external debt at current exchange rates and excluding National Small Savings Fund (NSSF) securities of State Governments as well as securities issued for the Market Stabilisation Scheme (MSS) which is sequestered by the Reserve Bank of India (RBI), liabilities of the Union Government are estimated to decline to 45.4 per cent of GDP in 2014-15 (BE). The reduction in the ratio of liabilities to GDP was mainly due to high levels of nominal GDP growth, particularly on account of high rates of inflation. Public debt is estimated to account for about 80 per cent of the Union liabilities while the share of other liabilities is estimated at 20 per cent in 2014-15 (BE). Table 3.3 shows the position of outstanding debt and liabilities of the Union Government as a per cent of GDP.

3.16 The liabilities of the Union government, however, do not include contingent liabilities in the form of sovereign guarantees and the future annuities committed by the government. High-risk-guarantees have a high probability of transforming into actual liabilities. Similarly, annuities which are confirmed liabilities are also excluded from the accounting of liabilities. This additional liability is likely to extend the existing levels of debt and liabilities. In the absence of reliable data, it has not been possible for us to assess these liabilities. We, however, recognise that a realistic assessment of the liabilities should take extended debt and liabilities into account.

Table 3.3: Outstanding Liabilities of the Union Government

(per cent of GDP)

Sl. No.	Particulars	2001-02	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14 (RE)	2014-15 (BE)
I	Public debt of which	41.79	41.23	40.18	38.37	38.51	38.22	38.01	36.29	37.74	38.98	39.04	38.52
a)	Internal debt	38.76	39.35	37.63	35.97	36.26	36.03	35.94	34.26	35.86	37.22	37.43	37.06
b)	External debt	3.04	1.88	2.55	2.39	2.25	2.19	2.07	2.03	1.89	1.75	1.61	1.46
II	Other liabilities of which	16.21	20.28	21.01	20.74	18.39	17.90	16.48	14.31	12.39	11.16	10.17	9.81
	Reserve funds and deposits	3.10	2.87	2.96	3.06	2.55	2.29	1.84	1.65	1.49	1.38	1.35	1.27
	Total liabilities (I+II)	58.00	61.51	61.19	59.11	56.90	56.11	54.49	50.60	50.14	50.14	49.21	48.33

Note : Other Liabilities include National Small Savings Funds, State Provident Funds, Other accounts such as Special Deposits of Non-Government Provident Funds and Reserve funds and Deposits.

Source: Union Budget for various years

Revenues

3.17 Union revenues comprise of tax revenues net of States' share, non-tax revenues and non-debt capital receipts. Net Union revenues, excluding non-debt capital receipts, increased from 9.4 per cent of GDP in 2004-05 to 10.9 per cent in 2007-08, but thereafter declined to 8.3 per cent in 2011-12- the lowest since 2004-05. However, there was a marginal recovery to 8.7 per cent in 2012-13 and to 9.2 per cent in 2014-15 (BE). Collections under non-debt capital receipts have been fluctuating from 2.05 per cent in 2004-05 to a meagre 0.12 per cent in 2008-09. Non-debt capital receipts have averaged less than 0.5 per cent since 2009-10, with receipts in 2013-14 (RE) estimated at a low of 0.3 per cent. The performance of the Union Government on each of these sources of revenues has been discussed below.

Overview of Tax Performance

3.18 The revenue from direct taxes as a ratio of GDP after showing a sharp increase until 2007-08, has fallen thereafter mainly on account of the decline in revenues from corporation tax. In the case of indirect taxes, there has been a substantial decline in both Union excise duty and customs duty, compared to the levels in 2007-08. The ratio of service tax has risen consistently, particularly since the introduction of a negative list in 2012-13. Table 3.4 shows the trends of major taxes relative to GDP and their share in relation to the gross tax revenues.

3.19 The gross tax to GDP ratio of the Union Government increased significantly from 7.9 percent in 2001-02 to 9.4 per cent in 2004-05 and 11.9 per cent in 2007-08. The increase in direct tax revenue was due to high growth of GDP and improvement in tax administration, particularly the introduction of the Tax Information Network. The increase in indirect tax was mainly on account of a steady expansion in the base of service tax. The overall tax buoyancy during this period was about 1.5.

3.20 The trend of high growth in tax revenue was reversed in the wake of the global economic crisis in 2008-09. The counter-cyclical measures included a duty cut of 4 percentage points in Union excise and 2 percentage points in service tax. As a result, gross tax revenue as percentage of GDP declined from 11.9 per cent in 2007-08 to 9.6 per cent in 2009-10. The additional fiscal space and the tax capacity created since 2003-04 was, therefore, almost entirely wiped out within a span of two financial years.

3.21 With signs of recovery and partial roll back of stimulus measures given on the indirect taxes front in 2010-11, the tax-GDP ratio recovered marginally to around 10.2 per cent in 2010-11, only to fall to 9.9 per cent in 2011-12. While it again increased marginally to 10.2 per cent in 2012-13, the provisional accounts show it to be falling back to 10.0 per cent in 2013-14. Thus, the tax-GDP ratio has been stagnating at around 10 per cent.

Major Direct and Indirect Taxes

3.22 Revenues from personal income tax as a percentage of GDP has gone up from 1.5 per cent in 2004-05 to about 2 per cent in 2012-13 and is estimated at 2.2 per cent in 2014-15 (BE). The average annual growth of revenue from this tax during the period 2007-08 to 2012-13 has been 18.3 per cent. The share of income tax in gross tax revenues has gone up from 17.3 per cent in 2007-08 to 19.0 per cent in 2012-13 and is projected to further increase to about 20.4 per cent in 2014-15 (BE).

3.23 Corporation tax showed higher buoyancy than the personal income tax between 2004-05 and 2007-08. It registered an annual growth of 42.5 per cent in 2006-07 and 34 per cent in 2007-08, the two years preceding the global economic crisis. During the period 2007-08 to 2012-13, the average annual rate of growth of corporation tax decelerated to 16.6 per cent.

3.24 On the indirect taxes front, the revenues from both excise and customs have shown a declining trend since 2007-08, both as percentage of GDP as well as percentage of gross tax revenues of the Union Government.

3.25 Tariff reductions across rate categories, including peak rates, has caused a decline in the revenue collection from customs duties even in nominal terms during 2008-09 and 2009-10, compared to 2007-08. After a brief recovery in 2010-11, the growth of customs duties has continued to show a downward trend, indicating a fairly entrenched impact of the economic downturn on imports. The share of customs duty is estimated at 15.1 per cent of gross tax revenues in 2013-14 (RE) and below 15 per cent in 2014-15 (BE).

3.26 In 2007-08, Union excise duties constituted the largest share of indirect taxes, at 20.8 per cent of gross tax revenues. The impact of economic slowdown and introduction of stimulus measures by way of across the board reduction in excise duty rates (by 6 percentage points from 14 per cent to 8 per cent) saw revenue collections from the tax falling even in nominal terms in 2008-09 and 2009-10. The rate reduction was partially rolled back in 2010-11 with general excise rates increasing from 8 per cent to 10 per cent, followed by a further increase to 12 per cent in 2012-13. However, growths of revenue from excise duties have fluctuated considerably since 2010-11. Year-on year-growth went up to 34 per cent that year, then dropped to 5.2 per cent in 2011-12 and again accelerated to over 22 per cent in 2012-13. As a ratio of GDP, revenue from excise duties has shown a steady decline from around 3.1 per cent in 2001-02 to 2.5 per cent in

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2007-08. In 2014-15 (BE), it is estimated at 1.6 per cent, which, for the first time, is lower than service tax-GDP ratio of 1.7 per cent.

3.27 The share of revenue from service tax in total indirect tax revenues has shown a steady increase on account of expansion in the tax base as well as the adoption of the “negative” list approach in 2012-13. The service tax is estimated to contribute 15.8 per cent of gross tax revenues in 2014-15 (BE). There is still scope for further pruning the negative list and including certain services provided by the Department of Posts, railways passenger and goods traffic and advertisements in the print media in the tax net.

Table 3.4: Performance of Major Taxes of the Union

(per cent of GDP)

Year	Corporation Tax	Income Tax	Total Direct Tax	Customs duties	Union excise duties	Service Tax	Total indirect Tax	Total Union tax revenues (Gross)
2001-02	1.55	1.36	2.94	1.71	3.08	0.14	5.00	7.9
2004-05	2.55	1.52	4.08	1.78	3.06	0.44	5.33	9.4
2007-08	3.87	2.06	5.93	2.09	2.48	1.03	5.96	11.9
2008-09	3.79	1.88	5.68	1.77	1.93	1.08	5.07	10.8
2009-10	3.78	1.89	5.68	1.29	1.59	0.90	3.97	9.6
2010-11	3.84	1.79	5.63	1.74	1.77	0.91	4.56	10.2
2011-12	3.58	1.83	5.42	1.66	1.61	1.08	4.45	9.9
2012-13	3.52	1.94	5.48	1.63	1.74	1.31	4.77	10.2
2013-14 (RE)	3.47	2.08	5.56	1.54	1.57	1.45	4.65	10.2
2014-15 (BE)	3.50	2.16	5.67	1.57	1.60	1.68	4.93	10.6

(Per cent of Union’s Gross Tax Revenue)

2001-02	19.57	17.11	36.99	21.53	38.79	1.77	63.01	100
2004-05	27.11	16.16	43.34	18.89	32.50	4.66	56.66	100
2007-08	32.52	17.30	49.89	17.55	20.84	8.65	50.11	100
2008-09	35.25	17.52	52.84	16.50	17.94	10.07	47.16	100
2009-10	39.19	19.61	58.87	13.34	16.49	9.35	41.13	100
2010-11	37.66	17.54	55.29	17.12	17.36	8.95	44.71	100
2011-12	36.31	18.50	54.89	16.79	16.30	10.97	45.11	100
2012-13	34.39	18.96	53.43	15.96	16.97	12.80	46.57	100
2013-14 (RE)	33.97	20.38	54.43	15.11	15.43	14.23	45.57	100
2014-15(BE)	33.05	20.39	53.52	14.79	15.12	15.83	46.48	100

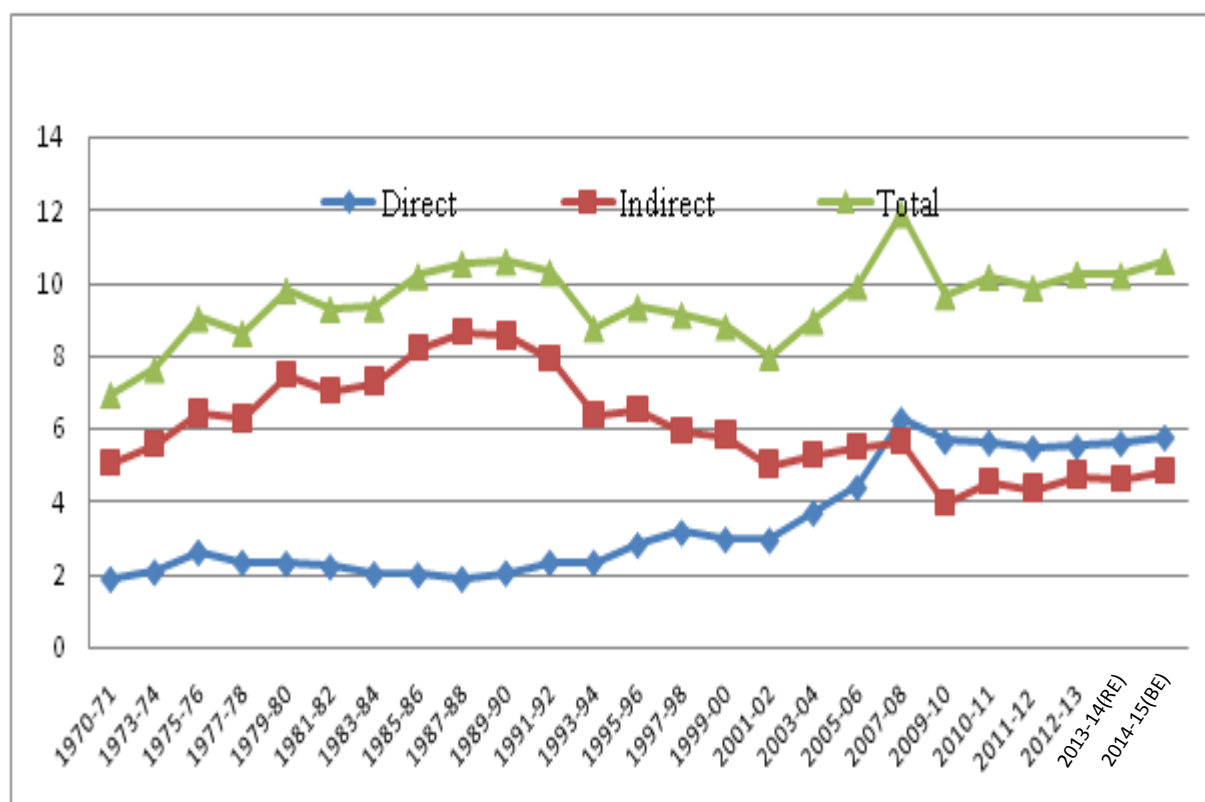
Note : Total Direct Taxes includes apart from Corporation tax and Income tax, taxes on Wealth, Interest, Gift and Other taxes on Income and expenditure).

Source: Union Budget for various years..

Changing Composition

3.28 The share of revenue from indirect taxes has been higher than that of direct taxes for the most part of the post-Independence period. However, in 2007-08 the share of direct taxes became higher than that of the indirect taxes for the first time. This trend was maintained and is estimated to continue despite a marginal decline in the share of direct taxes. Figure 3.1 shows the trends of direct and indirect taxes from 1970-71 onwards.

Figure 3.1: Union Tax GDP Ratio: Direct, Indirect and Total



Revenue Foregone

3.29 The various tax concessions and exemptions given by the Union Government reduces the revenue collections and adversely affects the resources accruing to both Union and State Governments. Revenue forgone as estimated by the Union Government reached a peak of 8.1 per cent of GDP in 2008-09 and as a percentage of gross tax revenues, it was the highest (77.3 per cent) in 2009-10. Since 2004-05, revenue foregone has always been in excess of 5 per cent of GDP. In nominal terms, the estimated revenue foregone for 2013-14 (RE) stands at Rs.5,72,923 crore. This accounts for a little over 5 per cent of estimated GDP of 2013-14 and about a half of the total tax collections estimated during the year. The trend since 2004-05, as estimated by the Union Government in the Statement of Revenue Foregone and tabled in Parliament as required under the FRBM Act, is shown in Table 3.5.

Table 3.5: Trends of Revenue Foregone

(Rs. Crore)

	2004- 05	2005- 06	2006- 07	2007- 08	2008- 09	2009- 10	2010- 11	2011- 12	2012- 13	2013- 14 (RE)
Direct taxes	71081	49800	77177	100256	104471	118023	94738	101140	102256	116530
Indirect taxes	123010	194490	212580	241061	354045	364409	364967	432442	463979	456393
Total revenue foregone	194091	244290	289757	341317	458516	482432	459705	533582	566235	572923
Revenue foregone as % of gross tax revenue	63.65	66.48	61.19	57.54	75.75	77.25	57.97	60.01	54.64	49.44
Revenue foregone as % of GDP	5.99	6.61	6.75	6.84	8.14	7.45	5.91	5.92	5.60	5.05

Source: Statements of Revenue Foregone in the Union Budget documents

3.30 The revenue foregone under excise duties includes general exemptions, which largely reflect the fiscal policy of the Union Government, as well as area-based exemptions. Area-based exemptions are of two types - refund-based exemptions determined on the aggregate refunds sanctioned (for the North-eastern States and Jammu & Kashmir) and outright exemptions, where revenue foregone is calculated using the difference between the general effective rate and the duty actually paid (in Himachal Pradesh and Uttarakhand). On customs duties, the revenue foregone is shown under ten broad commodity groups based on the difference between the tariff rates and effective rates. On the direct tax side, the magnitude of revenue foregone is comparatively lower and is due to thirty-five categories of tax incentives. The main tax incentives, accounting for a bulk of revenue foregone, are deduction of expenditure on specified activities from the tax base and accelerated depreciation. The revenue foregone in individual income tax is primarily from deductions allowed on certain tax-saving investments and payments. According to the 2014-15 Budget, the proportion of revenue foregone is the highest for exemptions on customs duties (45.5 per cent) followed by countervailing excise duties (34.2 per cent). The revenue foregone on account of corporation tax and personal income tax are comparatively lower, at 13.3 per cent and 7 per cent respectively.

3.31 A realistic assessment of tax exemptions and concessions is necessary in order to evaluate the costs and benefits of achieving various objectives through such tax preferences. However, this requires application of more robust methodology than what is employed at present for estimating the revenue foregone. In particular, the present methodology estimates the revenue impact assuming that the discretionary changes in the rates do not impact the tax base. Further, application of the difference between the tariff rates and effective rate in the case of customs duty gives an exaggerated picture of revenue foregone when the effective rates are reduced to zero whenever essential commodities are imported to overcome acute shortages or to control their prices, as in the case of edible oil and pulses.

Cesses and Surcharges

3.32 Another tax-related issue pertains to the levy of cesses and surcharges on taxes by the Union Government. Article 270 of the Constitution enables the Union Government to levy and retain any cess levied for a specific purpose. Article 271 empowers Parliament to levy a surcharge on any taxes which fall within the Union Government's taxing powers. The total cess and surcharges constituted over 12.4 per cent of gross tax revenues in 2012-13 (actuals). These are excluded from the divisible pool. Cesses are meant to be fully utilised for the purposes for which they are levied. The Comptroller and Auditor General (C&AG) has drawn our attention to the lack of transparency and incomplete reporting in accounts on the utilisation of amounts collected under cesses. Similarly, surcharges are meant to be levied only for short periods. A majority of the State Governments are of the view that cesses and surcharges should either be eliminated or, if continued beyond a specified period, should form part of the divisible pool.

Non-Tax Revenues

3.33 The major sources of non-tax revenues of the Union Government are interest receipts from the States and Central public sector enterprises (CPSEs), dividend receipts, user charges, royalty from off-shore oil fields, profit petroleum and receipts from the telecom sector. The FC-XIII estimated that non-tax revenue as a proportion of GDP would increase from 2.01 per cent projected in 2010-11 to 2.24 per cent in 2014-15, assuming a high potential of revenue from the telecommunications and petroleum sectors. This, however, was not realised. The non-tax revenue of the Union Government, which stood at 2.05 per cent of GDP in 2007-08, declined to 1.4 per cent in 2012-13. The highest collection from non-tax revenue was 2.8 per cent in 2010-11, which was the result of revenue from the auction of 3G spectrum, and this was an exception. If spectrum auction receipts are excluded, the non-tax revenue of 1.36 per cent of GDP in 2012-13, was comparable with the 2010-11 figures. From 2012-13 onwards, non-tax revenues again show an increasing trend, mainly due to enhanced dividends from RBI and the public sector financial institutions. Non-tax revenue is, therefore, projected to increase to 1.65 per cent of GDP in 2014-15 (BE) but remains far short of the FC-XIII projection of 2.24 per cent for the year.

3.34 Interest receipts from States have come down considerably after disintermediation of Union Government loans to States, following the recommendations of the FC-XII. Revenue from interest on loans to CPSEs has also declined, as these enterprises borrow mainly from financial institutions and not the government.

3.35 Dividend receipts constitute the largest source of non-tax revenues of the Union Government. Their share in non-tax revenue is estimated at 42.5 per cent in 2014-15 (BE). Dividends are received from two broad sources - dividends paid by RBI and public sector financial institutions as well as the CPSEs. The dividend from RBI increased from Rs.15, 009 crore in 2011-12 to Rs.33, 000 crore in 2012-13 as well as 2013-14. It is estimated at Rs.46, 000 crore in 2014-15 (BE)¹. The share of the other financial institutions in the dividend receipts is similarly projected to more than double from Rs.7,406 crore in 2012-13 to Rs.16,414 crore in 2014-15 (BE). Dividends from CPSEs, on the other hand, have fluctuated from year to year, and are estimated at Rs.27, 815 crore in 2014-15 (BE).

¹ RBI has made a transfer of Rs.52, 000 crore against the dividend estimate of Rs.46, 000 crore in 2014-15 (BE).

Non Debt Capital Receipts

3.36 The two key items in the Union Government's non-debt capital receipts are recoveries of loans and proceeds from disinvestments. The quantum of repayment of loans shows a declining trend in view of the discontinuation of loans from the Union Government to the State Governments and the Debt Consolidation and Relief Facility (DCRF) extended to the States based on the FC-XII recommendations. The trends in non-debt capital receipts are shown in Table 3.6. The FC-XIII had projected an increase in these receipts, from 0.5 per cent of GDP in 2010-11 to 1 per cent of GDP in 2014-15. However, these could not be realised. In 2012-13, non-debt capital receipts accounted for only 0.40 per cent of GDP. The total non-debt capital receipt in 2014-15, the terminal year of the FC-XIII award period is budgeted at 0.57 per cent of GDP. Though this is an improvement over the previous year's figure of 0.32 per cent, it remains far short of the FC-XIII target. Keeping in view the large Union Government holdings in CPSEs, there is potential for generating more revenues from this source.

Table 3.6: Non-Debt Capital Receipts

(Rs. Crore)

	2001-02	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14 (RE)	2014-15 (BE)
Non-debt capital receipts (of which)	20049	66467	12226	6427	43895	6705	33194	35266	36938	40950	36643	73952
Recoveries of loans and advances	16403	62043	10645	5893	5100	6139	8613	12420	18850	15060	10802	10527
Disinvestment of equity	3646	4424	1581	534	38795	566	24581	22846	18088	25890	*25841	*63425

*RE 2013-14 and BE 2014-15 includes receipts on account of disinvestment of stake in non-government companies and 'Other' miscellaneous capital receipts pertaining to transfer of SDRs and consideration received in lieu thereof.

Source: Union Budget for various years.

Trends of Expenditure

3.37 The total expenditure of the Union Government declined by over one percentage point of GDP from 15.4 per cent in 2004-05 to 14.3 per cent in 2007-08. However, the impact of pay revision based on the recommendations of Sixth Pay Commission, debt waiver scheme on farm loans, substantial expansion of the flagship social sector schemes and increase in subsidies led to a substantial increase in 2008-09 and 2009-10. Thus, total expenditure reached the level of 15.8 per cent of GDP in 2009-10. However, since then there has been a decline and total expenditure contracted to 14 per cent in 2012-13 from 14.5 percent in 2011-12. The trends of revenue and capital expenditure with major components on revenue expenditure are shown in Table 3.7.

3.38 The share of capital expenditure in the total expenditure of the Union Government declined from 22.8 per cent in 2004-05 to 10.2 per cent in 2008-09 and has remained in the range of 11 per cent to 13 per cent since then. Correspondingly, the revenue expenditure increased to 89.8 per cent in 2008-09, and thereafter declined only marginally, despite expenditure tightening measures. As a ratio of GDP, the revenue expenditure of the Union Government increased from 11.9 per cent in 2004-05 to 14.1 per cent in 2009-10 and is estimated at 12.2 per cent in 2014-15 (BE). The major components of revenue expenditure comprising subsidies, interest payments, defence expenditure, pay and allowances and pensions are briefly analysed in the following paragraphs.

Table 3.7 : Trends of Union Government Expenditure*(per cent of GDP)*

Year	Revenue Exp.	Interest payments	Pay and allow- ances*	Pension	#Defence	Subsidies	Capital Exp.	Total Exp.
	1	2	3	4	5	6	7	8
2001-02	12.80	4.56	1.33	0.61	2.30	1.32	2.58	15.38
2004-05	11.85	3.92	1.19	0.56	2.34	1.42	3.50	15.35
2007-08	11.92	3.43	0.93	0.49	1.84	1.42	2.37	14.29
2008-09	14.10	3.41	1.20	0.59	2.03	2.30	1.60	15.70
2009-10	14.08	3.29	1.39	0.87	2.19	2.18	1.74	15.82
2010-11	13.37	3.01	1.14	0.74	1.98	2.23	2.01	15.38
2011-12	12.72	3.03	1.06	0.68	1.90	2.42	1.76	14.48
2012-13	12.30	3.10	1.07	0.69	1.80	2.54	1.65	13.95
2013-14 (RE)	12.33	3.35	-	0.65	1.79	2.25	1.68	14.01
2014-15 (BE)	12.18	3.32	-	0.64	1.78	2.02	1.76	13.94

*Source : Brochure on Pay and Allowances of Central Government (excluding Defence Services).

#Includes both Revenue and Capital expenditure on Defence Services.

Source: Union Budget for various years.

Major Subsidies

3.39 The major explicit subsidies of the Union Government are on food, fertilizers and petroleum and they have significant implications on expenditure management and fiscal consolidation. This is evident from the fact that while the total expenditure of the Union Government declined by 0.34 percentage points of GDP between 2007-08 and 2012-13, expenditure on subsidies actually increased by 1.12 per cent of GDP. The performance on each of the major subsidies has been analysed in this backdrop.

3.40 Between 2007-08 and 2009-10, there was an average annual increase of over 35 per cent in food subsidy. This was because of increases in the minimum support price (MSP) and the carrying costs due to accumulation of large stocks of grains, the central issue price (CIP) not being revised despite rising economic costs as well as the expansion of the welfare schemes like the Mid-Day Meals scheme. Though the increase in food subsidies moderated between 2010-11 and 2012-13, the enactment of the National Food Security Act (NFSA), 2013 could lead to an increase. The likely impact, even in the initial stages of its implementation, is evident in the provision of Rs.1,15,000 crore in 2014-15 (BE), an increase of Rs.23,000 crore over the allocation in 2013-14 (RE).

3.41 Petroleum subsidy has been the single largest contributor to the increase in the quantum of total subsidies. There have been two episodes of sharp increases in subsidies in recent years, first due to the administered price mechanism (APM) being brought back and second, due to rising international prices of crude oil. The first increase happened after 2004-05, when subsidies on petroleum products increased from Rs.2, 956 crore to Rs.19, 946 crore in 2005-06. This increase was met by issuing oil bonds. The oil bonds continued to be issued until 2009-10. In 2008-09, the oil bonds amounted to a huge Rs.75, 942 crore. As a result, the budgetary deficits in these years were, to that extent, under-reported. Based on the recommendations of the FC-XIII, the practice of issuing bonds was discontinued in 2010-11. With the Union Government's inability to adjust the retail prices in line with international prices, petroleum subsidies continued to rise till 2012-13 and expenditure on these peaked to almost 1 per cent of GDP in 2012-13. However, the amount would be higher if the under-recoveries of the oil companies (reported to be about Rs.1, 61,029 crore in 2012-13) are added. However, the pressure of petroleum subsidies is likely to ease in 2014-15 since the international price of crude oil has recently shown a decline and the Union Government has also deregulated the price of high-speed diesel.

3.42 The FC-XIII had noted that fertiliser subsidy needs to be targeted in order to ensure food security and self-sufficiency, while preventing wasteful and sub-optimal use of fertilisers. It was mentioned that India, as a large importer of fertilisers, would stand to gain from lower international prices if it restricts inefficient fertiliser consumption. Taking these considerations in view, the FC-XIII assumed that subsidy should be restricted to 120 kilograms of fertiliser per cultivator household and estimated the fiscal requirement of fertiliser subsidy at Rs.10, 980 crore in 2014-15. It recommended a phased reduction starting from the provisions made in 2009-10, in order to reach this figure. However, the provision for Rs.72, 970 crore as fertiliser subsidies in the budgeted estimates for 2014-15 is substantially in excess of the estimates made by the FC-XIII for the year. While the Government introduced a Nutrient Based Subsidy (NBS) regime for the phosphorous and potassium (P&K) sector, the price of urea remained unaltered, thereby distorting the consumption pattern.

3.43 Table 3.8 shows the share of explicit subsidies in terms of the Union Government's revenue receipts. Total subsidies (including bonds²) increased sharply from 18.3 per cent of the revenue receipts in 2007-08 to 41.8 per cent in 2008-09 and declined thereafter to about 26.5 per cent in 2009-10. Expenditure on subsidies decreased to about 22 per cent of revenue receipts in 2010-11, but increased thereafter in 2011-12 and 2012-13. However, it is budgeted lower at 21.9 per cent of revenue receipts in 2014-15 (BE).

² The Union Government issued special bonds/securities to oil/fertiliser companies in lieu of cash subsidies to avoid immediate fiscal impact as it did not involve immediate cash outgo. These bonds could be used by the oil/fertiliser companies as collateral to raise additional borrowings from the banks. The issue of bonds in lieu of cash subsidies was discontinued in 2010-11.

Table 3.8: Explicit Subsidies Relative to Union Government's Revenue Receipts*(per cent of revenue receipts)*

Year	Food	Fertiliser	Petroleum	Others	Bonds	Total
2001-02	8.69	6.25	0.00	0.38	4.47	19.79
2004-05	8.43	5.19	0.97	0.39	0.00	14.98
2007-08	5.78	6.00	0.52	0.79	5.18	18.27
2008-09	8.10	14.18	0.53	1.20	17.76	41.77
2009-10	10.20	10.70	2.61	1.17	1.80	26.48
2010-11	8.10	7.90	4.87	1.13	0.00	21.99
2011-12	9.69	9.32	9.11	0.88	0.00	29.00
2012-13	9.67	7.46	11.02	1.09	0.00	29.24
2013-14 (RE)	8.94	6.60	8.31	0.98	0.00	24.83
2014-15(BE)	9.67	6.13	5.33	0.78	0.00	21.91

Source: Union Budget for various years.

Interest Payment

3.44 Interest payments form the largest component of Union Government expenditure. The ratio of interest payments to net tax revenue of the Union Government declined by over 10 percentage points from 49.1 per cent in 2005-06 to 38.9 per cent in 2007-08 because of fiscal consolidation measures as well as softening of interest rates. However, the high quantum of borrowings since 2008-09, along with hardening of interest rates, has reversed the trend and in 2009-10 the ratio of interest payments to net tax revenue rose to 46.7 per cent. In 2013-14 (RE), it was 45.5 per cent and is estimated at 43.7 per cent in 2014-15 (BE). The current levels of interest payments are unlikely to ease without greater efforts at fiscal consolidation.

Defence Expenditure

3.45 Defence expenditure, on both revenue and capital accounts, are shown in Table 3.7. It increased from 1.8 per cent of GDP in 2007-08 to 2.2 per cent in 2009-10, mainly because of the impact of pay revision. There has been a marginal decline from about 2 per cent in 2010-11 to 1.9 per cent in 2011-12 and it has remained at around 1.8 per cent since 2012-13. Defence expenditure as a per cent of total expenditure is estimated to come down by about one percentage point from 13.8 per cent in 2009-10 to 12.8 per cent in 2014-15 (BE).

Pay and Allowances and Pensions

3.46 Pay and allowances of Union Government employees more than doubled between 2007-08 and 2011-12, from Rs.74, 647 crore to Rs.166, 792 crore due to the implementation of the Sixth Central Pay Commission recommendations³. As a ratio of GDP, it jumped from a little

³ Including Defence Services

Fourteenth Finance Commission

over 0.9 per cent in 2007-08 to 1.2 per cent in 2008-09 and about 1.4 per cent in 2009-10 on account of both pay revision and payment of arrears. However, it moderated to a little over 1 per cent in 2012-13.

3.47 As in the case of salaries, expenditure of the Union Government on pensions, which had declined to less than 0.5 per cent of GDP in 2007-08, increased to about 0.9 per cent of GDP in 2009-10 due to the impact of revision in pensions. Subsequently, it came down to 0.7 per cent in 2010-11 and is estimated at 0.6 per cent in 2014-15 (BE).

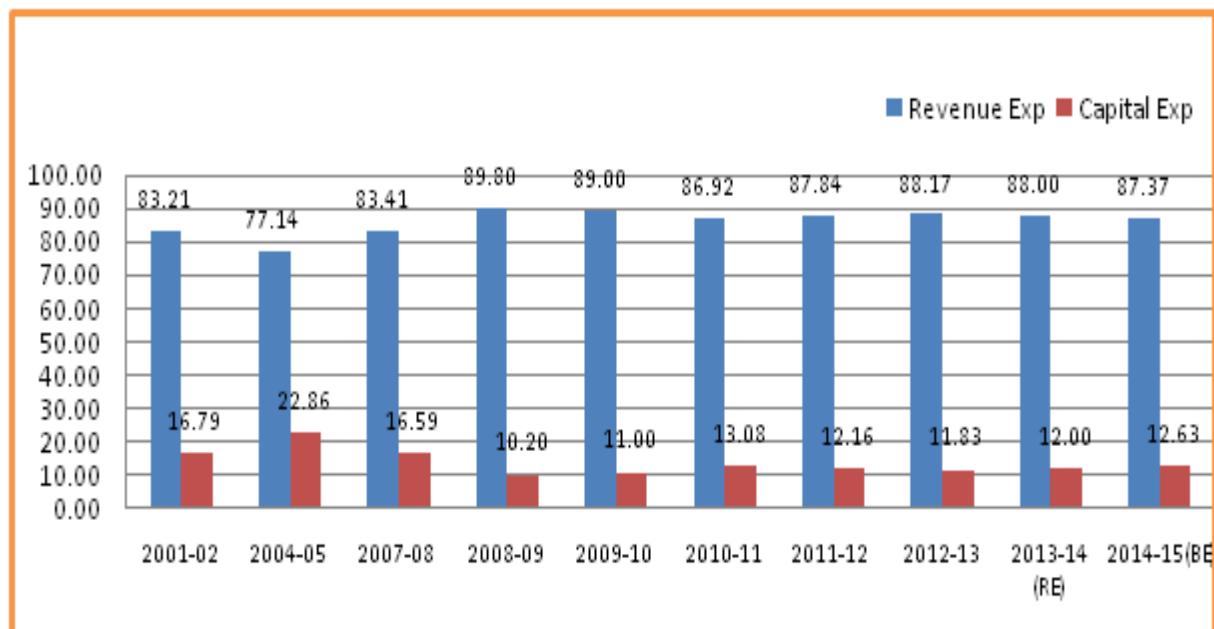
3.48 Expenditure on salary, pensions and interest payments together accounted for 5.67 per cent of GDP in 2004-05 but declined marginally to 5.56 per cent of GDP in 2009-10, with the rise in expenditure on salaries and pensions being more than compensated by the decline in interest expenditure. These expenditures declined further to 4.9 per cent of GDP in 2012-13.

Revenue-Capital Expenditure Balance

3.49 Expenditure on general administrative services, which was increasing continuously prior to the enactment of the FRBM Act, remains the dominant component of the revenue expenditures of the Union Government. In 2004-05, the Union Government's revenue expenditure was 11.9 per cent of GDP and capital expenditure 3.5 per cent of GDP. By 2007-08, while the revenue expenditure remained at 11.9 per cent, the capital expenditure declined to 2.4 per cent of GDP. However, in 2009-10, the revenue expenditure rose to 14.1 per cent and the capital expenditure contracted to 1.7 per cent, showing a continuous deterioration in the quality of Union Government expenditure. With declining revenues and with expenditure consolidation measures being put in place, the revenue expenditure of the Union Government declined to 12.3 per cent of GDP in 2013-14 and capital expenditure continued to stagnate at about 1.7 per cent. The trends of revenue and capital expenditure balance are shown in Figure 3.2 below.

Figure 3.2 : Revenue and Capital Expenditure Balance

(percentage of total expenditure)



Overview of Union Finances

3.50 The outstanding Union debt has remained within the limits set by the FC-XIII. However, this is primarily due to a high nominal growth in GDP. With a strong policy commitment to contain inflation in future, there will be need for caution in projecting the position regarding debt-sustainability during the award period.

3.51 The gross tax revenues levied and collected by the Union Government, after reaching a peak of 11.9 per cent of GDP in 2007-08, declined by over 1.7 percentage points in 2012-13. This, to some extent, reflects the deceleration in the growth of the economy and is also the effect of the reduction in the rates of Union excise duties and service tax in response to the global economic crisis. Even after the tax rates were partially restored in 2013-14, the tax-GDP ratio remained at the same level. There is, therefore, considerable scope for increasing the tax-GDP ratio during our period, which would provide greater fiscal space for increase in productive expenditures.

3.52 The decline in the tax-GDP ratio has been accompanied by a decline in non-tax revenues and fluctuation in non-debt capital receipts as a percentage of GDP, over the same period. The reduction in non-tax revenues is primarily due to declining interest receipts on loans outstanding from State Governments. This source is likely to dry up further in future, since no fresh loans are being extended to the States. However, the dividends from CPSEs are abysmally low, indicating considerable scope in the future for obtaining higher levels of dividends through appropriate policy initiatives.

3.53 Disinvestment receipts have generally fallen short of the estimates, mainly due to the highly uncertain conditions prevailing in the financial markets. Though these uncertainties may continue, it is safe to assume that this could be a potential source for generation of additional revenues in the award period. The investment portfolio of the Union Government, in CPSEs, could be reviewed in the near future, to take account of the new realities in the context of the role of public enterprises in economic development.

3.54 Large revenues foregone or tax expenditures, and expanding cesses and surcharges during the review period, represent significant exclusions of States from the divisible pool. No doubt, these are entirely in the jurisdiction of the Union Government. However, in reality, they are eroding transferable resources to States. Under the circumstances, it will be necessary to keep in view these developments while determining the share of the states in the divisible pool during the award period.

3.55 As regards the quality of fiscal management, the period is characterised by a less than desirable growth in revenues and a steep reduction in capital expenditures, accompanied by a high level of subsidies. Overall, therefore, there is a case for reversing the trend of dilution in the quality of fiscal management that has set in during the review period. However, such reversal may have to be projected in the award period in a realistic manner.

Chapter 4

Review of State Finances

4.1 The terms of reference (ToR) of this Commission require it 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 . . ." (paragraph 5). We found that the pre-dominant feature of state finances, between 2004-05 and 2014-15, is the overall improvement in fiscal indicators. This came about mainly due to an increase in the aggregate revenue receipts, accompanied by compression of revenue expenditures, relative to gross domestic product (GDP). The process of fiscal consolidation in the States has been reinforced by the enactment of fiscal responsibility and budget management (FRBM) legislations. By 2010-11, all States had enacted FRBM legislations.

4.2 It is noteworthy that many States had drawn up medium-term reform programmes, with specific monitorable fiscal targets, even before the introduction of rule-based fiscal legislations. Against the backdrop of the general fiscal stress at the state level, a number of States had undertaken various policy initiatives aimed at both augmenting revenues and increasing the efficiency of tax mobilisation. On the expenditure side too, many States had undertaken rationalisation measures such as increases in retirement age to contain the outgo on pensions, introduction of voluntary retirement schemes, imposition of restrictions on new recruitments and changes in the discount rates for commutation of pension. In addition, some States had taken steps towards imposition of ceilings on guarantees, as well as the creation of sinking funds and guarantee redemption funds. In fact, some States had enacted fiscal responsibility legislations even before the FC- XII recommended this.

4.3 The FC-XII had also recommended the creation of a Debt Consolidation and Relief Facility (DCRF), which involved the rescheduling and consolidation of certain loans from the Union Government to the States. The debt waiver under this scheme was linked to States undertaking fiscal correction through their respective FRBM legislations.

4.4 The fiscal roadmap drawn up by the FC-XII mandated the elimination of revenue deficits of the States, as well as limiting their fiscal deficits to a maximum of 3 per cent of gross state domestic product (GSDP), by 2008-09. The state-level FRBM legislations, enacted subsequent to the recommendation of the FC-XII, provided a platform for the implementation of prudent revenue and expenditure policies. The DCRF brought a measure of relief to the States by reducing interest payments due to write-off and rescheduling of Central loans after 2005. There was also improvement in the fiscal position of States due to various factors including: (i) increase in revenue collections as a result of the adoption of value-added tax (VAT) by all the States (ii) retirement of high-cost debt, under the debt-swap scheme floated by the Union Government, (iii) buoyant economic growth, (iv) increased tax devolution on account of the high revenue buoyancy of central taxes and (v) a low interest rate regime. Many States introduced measures such as the New Pension Scheme to rationalise their expenditures and reduce future fiscal risks.

4.5 The FC-XIII's 'Revised Roadmap for Fiscal Consolidation' provided further direction and impetus for fiscal consolidation. After taking into account the circumstances arising from the global economic crisis in 2008-09 and 2009-10, as well as the varying progress made by the States in achieving the targets laid down by the FC-XII, the FC-XIII provided for State-specific paths for fiscal consolidation. In all States, revenue deficit was to be progressively reduced and eliminated by 2014-15. Similarly, all States were required to contain their fiscal deficit below 3 per cent of GSDP¹ by 2014-15.

4.6 The period 2004-05 to 2014-15 was also marked by pay revisions undertaken by most States, following the implementation of the recommendations of the Sixth Central Pay Commission by the Union Government. The revision in pay and pension was carried out in the States mainly between 2009-10 and 2011-12, with significant expenditure outgo in arrears on both counts. Despite a large increase in the absolute salary and pension of employees, the States were able to cope better with the additional burden cast upon them, unlike in the past, when such revisions had led to a fiscal shock in most States.

4.7 The overall improvement in state finances was driven by States' own initiatives to increase revenues and rationalise expenditure, higher tax devolution because of buoyancy in Central taxes, increased collections from VAT and the benefits of the DCRF. By 2012-13, most States became revenue surplus, with their combined gross fiscal deficit being well below the target of 3 per cent of GSDP.

Studies on State Finances

4.8 Past Finance Commissions benefitted from the assessments of state finances by the Accountants General (AsG) of individual States, based upon the audited accounts. While continuing with the practice of such consultations, we additionally commissioned studies on the major aspects of state finances for the period 2002-03 to 2012-13 by universities and institutions located in different states. The reviews focussed on estimating the revenue capacities of States, along with measures taken by them for improving their tax-GSDP ratios, analysis of the States' own non-tax revenues, review of their expenditure patterns and analysis of their deficits and debt. These studies also gave us an understanding of the performance of the States on several parameters, including: (i) conformity to their FRBM Acts, (ii) decentralisation initiatives (including transfers made to rural and urban local bodies), (iii) the impact of state-level public sector enterprises on their finances and measures taken for improving their performance, (iv) public expenditure reforms, (v) impact of power sector reforms on state finances, (vi) analysis of contingent liabilities and (vii) evaluation and targeting of subsidies by the States.

4.9 The studies made some suggestions on the measures to enhance tax and non-tax revenues and to improve the allocative and technical efficiency of public expenditures. We have benefitted by the analysis in most of these studies which, though limited in their approach, provided inputs for a broad understanding of the unique characteristics of individual States.

Trends in Aggregate Fiscal Indicators

4.10 The movement of the aggregate gross fiscal deficit of the States as a percentage of GDP has gone through three different phases between 2004-05 and 2012-2013 (Table 4.1). In the first

¹Translating to 2.4% of GDP, for all States combined, by 2014-15 (as estimated by the FC-XIII)

phase, from 2004-05 to 2007-08, it declined sharply from 3.3 per cent in 2004-05 to 1.4 per cent in 2007-08. It then increased sharply, almost touching 3 per cent in 2009-10. This can be attributed to the global downturn and an expansionary fiscal stance by the Union Government to deal with this, the consequent relaxation of FRBM targets and the impact of pay revisions. In the third phase, starting 2010-11, it remained below 2 per cent in 2011-12 and 2012-13. The budget estimate (BE) for 2014-15 projects it at about 2.4 per cent, which is within the target laid down under the fiscal consolidation roadmap recommended by the FC-XIII and incorporated in the FRBM Acts.

4.11 In 2004-05, States had an aggregate revenue deficit-GDP ratio of 1.2 percent, but this became a surplus of about 0.7 percent in 2006-07. The revenue surplus improved further to about 0.9 percent in 2007-08, before declining to 0.2 per cent in 2008-09. In 2009-10, States had an aggregate revenue deficit of about 0.6 per cent. Since 2010-11, however, the revenue account has again registered surpluses, with the surplus figure reaching 0.2 per cent of GDP in 2012-13. The revised estimates for 2013-14, however, indicate the aggregate revenue deficit as almost zero, while the budget estimate of 2014-15 projects a surplus of about 0.3 per cent.

4.12 The aggregate primary deficit as a percentage of GDP of all States, which stood at 0.6 per cent in 2004-05, turned to a surplus of about 0.6 per cent of GDP in 2006-07 as well as 2007-08. Subsequently, as in the case of the fiscal and revenue deficits, the primary deficit widened to 1.2 per cent of GDP in 2009-10 and remained below 0.5 per cent till 2012-13. The revised estimate for 2013-14 indicates an increase in this deficit to about 1 per cent, while the budget estimate for 2014-15 projects it at about 0.9 per cent.

4.13 The ratio of revenue deficit to fiscal deficit, an indication of the extent to which borrowing is used for meeting revenue expenditures, also showed a marked improvement, declining from 36.8 per cent in 2004-05 to (-) 10.4 per cent in 2012-13. The outstanding debt-GDP ratio declined steadily, from 31.1 per cent in 2004-05 to 21.6 per cent in 2012-13.

Table 4.1: Trends in aggregate fiscal indicators of States

Gross Fiscal Deficit (GFD), Revenue Deficit (RD), Primary Deficit (PD) and Outstanding debt as a percentage of GDP

All States aggregate	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14 (RE)	2014-15 (BE)
GFD/GDP	3.3	2.5	1.6	1.4	2.4	3.0	2.1	1.9	1.9	2.5	2.4
RD/GDP	1.2	0.2	-0.7	-0.9	-0.2	0.6	0.0	-0.3	-0.2	0.0	-0.3
PD/GDP	0.6	0.2	-0.6	-0.6	0.6	1.2	0.5	0.4	0.4	1.0	0.9
RD/GFD	36.8	7.5	-42.0	-62.4	-8.4	19.2	-1.9	-14.1	-10.4	-1.0	-11.8
Outstanding Debt & liabilities/ GDP	31.1	30.5	28.2	26.0	25.5	24.8	23.0	21.9	21.6	21.4	21.0

Note 1: (+) indicates deficit, (-) indicates surplus

Note 2: Outstanding debt & liabilities include internal debt of State Governments, loans and advances from the Union Government and other liabilities viz., small savings, provident funds etc., reserve funds and deposits (both interest-bearing and non-interest bearing)

Source: Finance Accounts; State Budgets, 2014-15; GDP: CSO (2004-05 series)

Trends in Aggregate Revenues

4.14 Most aggregate indicators of revenue receipts on the whole showed improvement till 2007-08 and deterioration thereafter, for 2008-09 and 2009-10 (Table 4.2). The trend seems to have reversed again from 2010-11, with revenue receipts showing significant increases.

4.15 The States' aggregate 'own revenues' (the sum total of 'own tax revenues' and 'own non-tax revenues'), as a percentage of GDP, showed an upward trend, increasing from 7.0 per cent in 2004-05 to 7.6 per cent in 2012-13. They were projected to increase further to 7.8 per cent in 2013-14 (RE), and decline marginally to 7.7 per cent in 2014-15 (BE). Aggregate own tax revenues increased more or less steadily from 5.6 per cent in 2004-05 to nearly 6.5 per cent in 2012-13 (with marginal decreases in 2008-09 and 2009-10). However, aggregate own non-tax revenues decreased from 1.4 per cent in 2004-05 to about 1.2 per cent in 2012-13, thus partly offsetting the buoyancy of own tax receipts.

4.16 Value added tax (VAT) has constituted around 61 per cent of aggregate own tax revenues of the States, remaining almost unchanged throughout the period 2004-05 to 2012-13. On the other hand, royalty earnings, as a percentage of aggregate own non-tax revenues rose from 11.6 per cent in 2004-05 to 21.8 per cent in 2012-13.

4.17 Aggregate tax devolution as a percentage of GDP increased from 2.4 per cent in 2004-05 to about 3.1 per cent in 2007-08. Thereafter, it declined sharply, reaching 2.5 per cent in 2009-10. The raising of the States' share of Central taxes to 32 per cent from 2010-11 by the FC-XIII contributed to a steady increase in the aggregate tax devolution, as a percentage of GDP, to 2.9 per cent in 2012-13. Aggregate grants-in-aid to States, as a percentage of GDP, increased from 1.7 per cent in 2004-05, to about 2.3 per cent in 2008-09, before declining to about 1.9 per cent in 2012-13. Changes in transfers from the Union, under State Plans and Centrally sponsored schemes (CSS), account for this variation. However, grants-in-aid are estimated to reach a level of 3.5 per cent in 2014-15 (BE), as a result of the decision by the Union Government in that year to route funds earlier going directly to state-level implementing agencies, through the Consolidated Fund of the States. The aggregate transfers from the Union to States, including through tax devolution and grants-in-aid, increased from 4.1 per cent of GDP in 2004-05, to about 4.8 per cent of GDP in 2012-13. They are expected to further increase to 6.5 per cent of GDP in 2014-15 (BE), mainly on account of the change in the routing of funds in the 2014-15 Union Budget.

4.18 The aggregate revenue receipts, including aggregate own revenues and aggregate transfers from the Union, showed an overall increasing trend (except in 2008-09 and 2009-10), from about 11.2 per cent of GDP in 2004-05 to nearly 12.4 per cent in 2012-13. They are expected to increase further to 13.2 per cent of GDP in 2013-14 (RE) and 14.2 per cent in 2014-15 (BE).

Table 4.2: Trends in aggregate revenue receipts of the States*(per cent of GDP)*

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14 (RE)	2014-15 (BE)
I. Total revenue receipts	11.2	11.6	12.4	12.5	12.3	11.7	12.0	12.2	12.4	13.2	14.2
a. Own tax revenue	5.6	5.7	5.9	5.8	5.7	5.6	5.9	6.2	6.5	6.6	6.5
b. Own non tax revenue	1.4	1.3	1.6	1.5	1.4	1.4	1.2	1.1	1.2	1.2	1.2
Total Own Revenue (a + b)	7.0	7.0	7.4	7.3	7.1	7.0	7.1	7.3	7.6	7.8	7.7
c. Tax Devolution	2.4	2.6	2.8	3.1	2.9	2.5	2.8	2.8	2.9	2.9	3.0
d. Grants-in- Aid	1.7	2.0	2.2	2.2	2.3	2.3	2.1	2.1	1.9	2.5	3.5
Total Transfers from the Union (c + d)	4.1	4.6	5.0	5.2	5.1	4.8	4.9	4.9	4.8	5.4	6.5

Note : (+) indicates deficit, (-) indicates surplus

Source : Finance Accounts; State Budgets, 2014-15; GDP: CSO (2004-05 series).

Trends in Aggregate Expenditure

4.19 Aggregate revenue expenditure of the States, as a percentage of GDP, declined from 12.4 per cent in 2004-05 to 11.6 per cent in 2007-08 (Table 4.3). Thereafter, it increased to about 12.1 per cent in 2008-09 and 12.3 per cent in 2009-10. It remained below 12 per cent in 2010-11 and 2011-12, but reached about 12.2 per cent in 2012-13. It is projected to increase to 13.2 per cent in 2013-14 (RE) and 13.9 per cent in 2014-15 (BE). Interest payments, pensions and salaries constitute a significant proportion of the revenue expenditure.

4.20 There was a decline in aggregate interest payments, from about 2.7 per cent of GDP in 2004-05 to 1.5 per cent in 2012-13. This was largely due to the combined effect of the debt swap scheme introduced by the Union Government and the DCRF recommended by the FC-XII. Under the debt swap scheme, high-cost debt, amounting to Rs. 102,034 crore, was swapped with lower interest bearing debt, in the period 2002-03 to 2004-05, resulting in significant savings in interest payments for the States. Subsequently, during the 2005-06 to 2009-10 period, outstanding Central loans, amounting to Rs. 122,350 crore, were consolidated. The aggregate interest relief to the States in this period was Rs. 18,690 crore. The aggregate debt relief (in the form of waiver) that the States obtained² from the DCRF during the same period amounted to Rs. 19,730 crore.

² Excluding Sikkim and West Bengal. These two States failed to receive the benefit of debt consolidation during the period since they had not met the condition of enacting a FRBM law. However, the FC-XIII extended the DCRF to them during 2010-15, provided they put their FRBM Act in place.

Table 4.3: Trends in aggregate State expenditure

(per cent of GDP)

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14 (RE)	2014-15 (BE)
I. Revenue Expenditure	12.4	11.8	11.7	11.6	12.1	12.3	12.0	11.9	12.2	13.2	13.9
<i>General Services</i>											
of which:	5.5	5.0	4.8	4.5	4.3	4.6	4.4	4.3	4.3	4.4	4.5
<i>Interest Payments</i>	2.7	2.3	2.2	2.0	1.8	1.7	1.6	1.5	1.5	1.5	1.5
<i>Pension</i>	1.2	1.1	1.1	1.1	1.2	1.3	1.4	1.4	1.4	1.4	1.5
<i>Other general services</i>	1.7	1.6	1.5	1.3	1.3	1.5	1.4	1.3	1.3	1.4	1.5
<i>Social Services</i>	4.0	4.1	4.1	4.2	4.6	4.8	4.8	4.8	4.9	5.5	5.6
<i>Economic Services</i>	2.6	2.5	2.5	2.7	2.8	2.6	2.5	2.5	2.7	3.0	3.4
<i>Assignment & Compensation to Local Bodies and Aid Materials</i>	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.4	0.4
II. Capital Expenditure	2.3	2.5	2.5	2.6	2.8	2.5	2.2	2.3	2.2	2.6	2.7
III. Total Expenditure (I+ II)	14.7	14.4	14.3	14.2	14.9	14.9	14.1	14.3	14.4	15.8	16.7

Source: Finance Accounts; State Budgets, 2014-15; GDP: CSO (2004-05 series).

4.21 The increase in pension, on account of pay revision by most States between 2008-9 and 2010-11, resulted in the aggregate pension expenditure, as a percentage of GDP, increasing from about 1.2 per cent in 2008-09 to about 1.4 per cent in 2010-11 and further to about 1.5 per cent in 2014-15 (BE). The increase in pensions recommended by successive Pay Commissions, removal of distinctions earlier being made among people retiring at different points of time, with all pensioners being treated alike in the matter of their pension rights, taking over of liabilities on account of pensions payable to retired employees of aided institutions and local bodies, as well as the increase in longevity, notably contributed to this rising trend.

4.22 From the time of the Fifth Central Pay Commission, salaries and allowances in the States have tended to converge with those of the Union Government. After the Sixth Central Pay Commission, most of the States adopted the Union Government's pattern of pay scales, albeit with modifications. Many also followed the Union Government in revising pay scales and disbursing arrears. Salary expenditure is one of the key components of committed expenditures of State Governments. Salary, interest payments and pension together constituted 64.1 per cent of the combined revenue expenditure of all States in 2011-12. Within this, expenditure on salary constituted the largest share (39.2 per cent), followed by interest payments (12.6 per cent) and pension (12.3 per cent). However, there are wide variations across States in the magnitude of salary expenditure, per employee salary, number of employees, and employment growth. Between 2007-08 and 2012-13, the number of regular employees in all State Governments taken together grew at an annual rate of about 2.8 per cent. Consequently, most States could not fulfil the norm of salary expenditure not exceeding 35 per cent of revenue expenditure (excluding interest payments and pensions), adopted by the FC-XIII in its projections.

4.23 The combined revenue expenditure of all States on general services, as a percentage of GDP, declined from 5.5 per cent in 2004-05 to about 4.3 per cent in 2012-13. However, this decline was partly offset by the increase in the combined revenue expenditure on social services, as a percentage of GDP, from 4.0 per cent in 2004-05 to about 4.9 per cent in 2012-13. The combined revenue expenditure on economic services, as a percentage of GDP, also increased from about 2.6 per cent in 2004-05 to 2.7 per cent in 2012-13.

4.24 Aggregate capital expenditure, as a percentage of GDP, was largely stagnant during the 2004-05 to 2012-13 period, fluctuating in the range of about 2.2 per cent to 2.8 per cent. The budget estimates for 2014-15 peg this figure at 2.7 per cent. This was despite the availability of adequate headroom for many states in the borrowing limits prescribed in the FRBM Act.

A Comparative Perspective of State Finances

4.25 Although most fiscal indicators of States show improvement at an aggregate level, there are wide variations across individual States.

Revenue Deficits

4.26 In 2004-05, only ten States (Bihar, Chhattisgarh, Jammu & Kashmir, Karnataka, Madhya Pradesh, Manipur, Mizoram, Nagaland, Sikkim and Tripura) showed surpluses in their revenue account; all the others had deficits. By 2008-09, the target year set by the FC-XII for eliminating revenue deficits, barring six States (Haryana, Himachal Pradesh, Kerala, Punjab, Rajasthan and West Bengal), all the others had eliminated their revenue deficits (Annex 4.1). The FC-XIII had, after taking into account the fiscal situation, prescribed separate targets for Kerala, Punjab and West Bengal - they were required to eliminate their revenue deficits by 2014-15. All other States were expected to eliminate the revenue deficit by 2011-12 or earlier. However, in 2012-13, six States (Goa, Haryana, Himachal Pradesh, Kerala, Punjab, and West Bengal) still registered deficits of varying magnitudes in their revenue accounts. The States of Kerala and West Bengal consistently incurred revenue deficits between 2004-05 and 2012-13, while Punjab had a revenue surplus in 2006-07 and revenue deficits during the rest of this period. The extent of revenue surplus was higher in the case of some hill states and the North-eastern states, mainly due to the large share of transfers in their revenue receipts. In the case of other States, the surplus was due to both augmentation in their own revenues and compression of expenditures.

Gross Fiscal Deficits

4.27 In 2004-05, only seven States (Bihar, Chhattisgarh, Haryana, Karnataka, Odisha, Tamil Nadu and Tripura) had gross fiscal deficits of 3 percent of GSDP or less (Annex 4.2). However, by 2008-09, the number of such States had increased to fourteen. The FC-XIII had laid down varying fiscal deficit targets for Kerala, Punjab, West Bengal and the hill states. Barring Jammu and Kashmir and Mizoram, all of them were required to achieve the fiscal deficit target in 2013-14 or before, according to the prescribed roadmap. Both Jammu and Kashmir and Mizoram were to achieve the 3 per cent target by 2014-15. By 2012-13, except for eight States (Goa, Himachal Pradesh, Jammu & Kashmir, Kerala, Mizoram, Nagaland, Punjab and West Bengal), all other States had reduced their gross fiscal deficits to below 3 per cent of GSDP. As many as twelve States are expected to breach this target in 2013-14 (RE) and 2014-15 (BE).

4.28 It is seen that a number of low-income states, such as Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Odisha, Rajasthan, Uttarakhand and Uttar Pradesh, had fiscal deficits less than 3 per cent of GSDP. These are States with large infrastructure deficits and their inability to use the fiscal space available to them points, in part, to capacity constraints. It is important for States to ease these constraints and utilise the fiscal space available to them efficiently to achieve equitable growth.

Debt and Liabilities

4.29 The aggregate outstanding debt and liabilities, as a percentage of GDP, showed a declining trend (Annex 4.3), decreasing from 31.1 per cent in 2004-05 to about 21.6 per cent in 2012-13.

4.30 The FC-XIII had recommended that States should bring down their debt-GDP ratio to 25 per cent by 2014-15. In 2012-13, thirteen states had a debt-GSDP ratio of less than 25 per cent, but fifteen remained above the threshold, despite a declining trend. Some of the hill states and North-eastern states-such as Himachal Pradesh, Jammu and Kashmir, Manipur, Mizoram and Nagaland - continue to have high debt burdens. This could be due to the small size of their GSDP and the widely fluctuating nature of GSDP growth.

4.31 Ten states achieved reduction of 15 percentage points or more in their debt to GSDP ratios between 2004-05 and 2012-13. These were Mizoram (38), Sikkim (36), Bihar (30), Odisha (29), Himachal Pradesh (27), Rajasthan and Uttarakhand (21), Punjab and Uttar Pradesh (17) and Madhya Pradesh (15).

4.32 The fiscal positions of States have been impacted by exposure to guarantees provided to power utilities and other public sector units, including those in the transport sector. The liabilities on account of guarantees provided to power units are quite significant in a number of States. By assigning a weight of 90 per cent to the power sector guarantees and 10 per cent to other guarantees, including transport sector guarantees, the extended debt of all States, in aggregate, was around 23.3 per cent of GDP in 2011-12³.

Own Tax Revenues

4.33 In most States, the own tax revenue to GSDP ratios indicated a rising trend (Annex 4.5), increasing from 5.6 percent in 2004-05 to 6.4 per cent in 2012-13 for all States combined. The increase in the own tax revenue to GSDP ratios was 1.5 percentage points or more in seven States (Chhattisgarh, Goa, Gujarat, Jammu & Kashmir, Meghalaya, Tripura and Uttar Pradesh).

Own Non-Tax Revenues

4.34 The own non-tax revenue to GSDP ratios of most States, on the other hand, showed a fluctuating trend between 2004-05 and 2012-13 (Annex 4.6), and for all States taken together, the ratio declined from 1.4 per cent to 1.2 per cent of GDP over the same period. Seventeen States recorded a decline with seven showing a reduction of one percentage point or more. These are: Sikkim (4.9), Punjab (4.6), Arunachal Pradesh (2.5), Madhya Pradesh (2.1), Karnataka (1.9), Tripura and Haryana (1.3).

³A review of the power sector is at Annex 4.4

4.35 The States in which the own non-tax revenues amounted to more than 2.5 per cent of GSDP in 2012-13 include Chhattisgarh, Goa, Jammu & Kashmir, Meghalaya, Mizoram, Odisha, Rajasthan and Sikkim. In many cases, this can be attributed to royalties from minerals and petroleum. In the case of some hill states and North-eastern states, the inclusion of power receipts of their departmental power undertaking contributes to the high share of non-tax revenues.

Transfers from the Union

4.36 Despite an overall increase of about 0.7 percentage points in the aggregate Union transfers to States as a percentage of GDP between 2004-05 and 2012-13, there was a decrease in the level of these transfers relative to GSDP in the case of nine States (Andhra Pradesh, Bihar, Jammu & Kashmir, Kerala, Mizoram, Rajasthan, Sikkim, Tamil Nadu and Uttarakhand) (Annex 4.7). However, except in the case of Sikkim, which saw a decline of 21.1 percentage points, the decline exceeded one percentage point only in three States (Bihar: 2.0; Uttarakhand: 1.6; and Jammu & Kashmir: 1.1). At the same time, there have been fluctuations in the levels of transfers from the Union, over this period, for individual States. In Rajasthan, for example, transfers increased from 5.6 per cent of GSDP in 2004-05, to 6.9 per cent in 2007-08. Thereafter, they declined, to 5.4 per cent in 2012-13. The budget estimates for 2014-15, however, project the figure at 8.9 per cent. Similarly, in the case of Jharkhand, transfers from the Union stood at 5.4 per cent in 2004-05, touched 8.6 per cent in 2008-09 and 2011-12 and declined to 7.9 per cent in 2012-13.

4.37 In the case of nine States, the transfers from the Union, as a percentage of GSDP, have increased by two percentage points or more between 2004-05 and 2012-13. These are: Manipur (21.2), Nagaland (9.3), Arunachal Pradesh (6.0), Meghalaya (4.8), Assam (2.6), Jharkhand (2.5), Uttar Pradesh (2.3), Madhya Pradesh (2.2), and Chhattisgarh (2.0).

Revenue Expenditure and Fiscal Consolidation

4.38 It is evident that higher revenue mobilisation contributed significantly to fiscal consolidation during the period 2004-05 to 2012-13. However, there was also a notable compression in revenue expenditure in many years over this period (Table 4.3). The decline in interest payments - from an aggregate level of about 2.7 per cent to 1.5 per cent of GDP - was offset by increases in revenue expenditure on pension, economic services and social services. Aggregate capital expenditure increased from 2.3 per cent of GDP in 2004-05, to about 2.8 per cent in 2008-09, before declining to 2.2 per cent by 2012-13. The revised estimate for 2013-14 places the figure at 2.6 per cent, whereas the budget estimate for 2014-15 projects it at 2.7 per cent.

4.39 The 2004-05 to 2012-13 period witnessed stagnation or reduction in revenue expenditure in sixteen States (Annex 4.8). Most of the other States could not contain their revenue expenditure, despite substantial decline in their interest burdens (Annex 4.9). However, eleven states raised their levels of capital expenditure during the same period. The States which compressed their revenue expenditure, while increasing their capital expenditure, included Bihar, Gujarat, Haryana, Himachal Pradesh and Odisha.

Cash Balances

4.40 In the period under review, the State Governments, in aggregate, have reported sizeable cash balances. The cash balances of States stood at Rs. 119,630 crore in end-March, 2012,

Rs. 145,735 crore in end-March 2013 and Rs. 140,229 crore in end-March 2014. In this regard, the FC-XIII had recommended that "there should be a directed effort by States with large balances towards utilising their existing cash balances before resorting to fresh borrowings."

4.41 The 'RBI Study on State Finances: A Study of Budgets of 2013-14' mentions that such accumulation has come through: (i) surpluses in the revenue account of some States, (ii) borrowing in excess of requirements, (iii) funds being earmarked for meeting certain expenditures, to be utilised as and when the identified expenditures get crystallised, (iv) funds transferred to lower parastatals/agencies/schemes, but not yet utilised by them and (v) unanticipated funds transfer from the Union. The study added that build-up of large surplus cash balances increases the interest cost burden for State Governments, if it is built from borrowed resources.

Overview of State Finances

4.42 Improvement in the fiscal position of all States taken together, during the period 2004-05 to 2012-13, was reflected in a reduction of the aggregate gross fiscal deficit and revenue deficit, relative to GDP, by 1.4 percentage points each, as well as a reduction in the primary deficit, relative to GDP, by 0.2 percentage point. There is a need to ensure that the momentum gained in improvement in the fiscal position of all States is maintained in the award period also.

4.43 Fiscal improvement primarily resulted from an increase in the aggregate revenue receipts by 1.2 percentage point relative to GDP. At the same time, capital expenditures fell marginally relative to GDP. This may be indicative of the need to address state-specific issues of resource constraints, policy inertia or lack of absorptive capacity. In States where revenue expenditures were unduly compressed, it is inevitable that some corrections will take place in the years ahead.

4.44 The increase in the aggregate revenue receipts was contributed by a rise in own tax receipts relative to GDP (0.9 percentage point), as well as higher tax devolution (0.5 percentage point) and grants-in-aid (0.2 percentage point). However, own non-tax revenues decreased (0.2 percentage point). The reasons for reduction in non-tax revenues are varied, as are future prospects.

4.45 There was a reduction in interest payments (1.2 percentage point) and resultant reduction in the revenue expenditure on general services (1.2 percentage point). At the same time, there was an increase in the revenue expenditure on pensions (0.2 percentage point), social services (0.9 percentage point) and economic services (0.1 percentage point).

4.46 Although there was a reduction in the expenditure on interest payments, the increase in expenditure on social services and economic services resulted in only a marginal change in overall expenditures relative to GDP. Thus, fiscal consolidation at the State level, up to 2012-13, was mainly on account of increasing revenues, particularly the own tax revenues and transfers from the Union Government.

4.47 It is noteworthy that many States had not fully utilised the fiscal space available to them within the fiscal targets prescribed by the FC-XIII to incur capital expenditure. This indicates the scope for paying increased attention to this issue in the years ahead. However, it is seen that some of the States which did not utilise the available fiscal space and had low capital expenditures as a ratio of GSDP, are low-income States. From the perspective of accelerating growth and promoting

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equitable growth, increasing capital expenditures by enhancing the absorptive capacity of these States could be of importance.

4.48 While it is necessary for States to keep adequate cash balances to cover risks, excessive balances entail costs, both in terms of interest payments and lower capital expenditures. There is merit in analysing the reasons that led to holding of such costly large cash balances during the period and addressing the relevant issues.

4.49 The aggregate outstanding debt and liabilities, as a percentage of GDP, also progressively reduced from 2004-05 to 2012-13. The States in general, with a few notable exceptions, are spared of undue stress on fiscal management due to outstanding debt in the years ahead, provided fiscal rules are adhered to.

Chapter 5

Review of Inter-Governmental Transfers and Consolidated Public Finance

5.1 The terms of reference (ToR) of this Commission require it 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..." (paragraph 5).

5.2 The previous two Finance Commissions gave their reports in an environment when the economy was showing strong growth and the revenue buoyancy was generally high. In contrast, the situation before this Commission is characterised by low growth in recent years and the prospects of only a gradual revival in the medium term. This poses challenges in reconciling the resource requirements of the Union and State Governments, especially in view of the entrenched expectations of the States for higher devolution and larger fiscal space. This analysis of the major trends in combined finances of Union and State Governments provides the background for formulating our views.

Trends in Inter-Governmental Transfers

5.3 The Constitution assigns revenue raising powers and expenditure responsibilities to both the Union and State Governments. Union Government transfers to States comprise of tax devolution and grants recommended by the Finance Commission, grants for Plan purposes given by the Planning Commission and grants for Centrally sponsored schemes (CSS) designed by different Union Government ministries. In addition, the Union Government was making direct transfers to State-level implementing agencies until 2013-14; these are being channelised through the State budgets from 2014-15.

Components of Transfers

5.4 The relative shares of Finance Commission transfers and other channels of revenue transfers to State Governments are presented in Table 5.1. The trends show that Finance Commission transfers, comprising tax devolution and grants to the States, have remained the major source of transfers to the States. These transfers increased from 60.1 per cent of total transfers in the award period of the FC-VIII to 68.6 per cent in the award period of the FC-X and remained stable till the award period of the FC-XII. In 2014-15, direct transfers have been brought within the ambit of the non-statutory Plan transfers to State Governments.

Table 5.1: Revenue Transfers from the Union to States

(Percentage of revenue transfers)

Commission	Finance Commission Transfers			Other Transfers			Total Transfers (4+7)	Total Transfers as percentage of GDP
	Share in Central Taxes	Grants	Total Finance Commission Transfers	Plan Grants	Non-Plan Grants	Total Other Transfers (5+6)		
1	2	3	4	5	6	7	8	9
FC-VIII	53.48	6.65	60.13	35.8	4.07	39.87	100	4.83
FC-IX	52.98	8.48	61.46	35.91	2.63	38.54	100	4.89
FC-X	62.06	6.55	68.61	29.52	1.87	31.39	100	4.09
FC-XI	58.38	11.00	69.38	28.65	1.97	30.62	100	4.16
FC-XII	56.79	12.12	68.91	28.34	2.75	31.09	100	4.86
FC-XIII	57.94	9.51	67.44	31.14	1.42	32.56	100	4.95
2010-11	58.60	8.42	67.02	28.32	4.66	32.98	100	4.81
2011-12	59.29	10.21	69.50	28.96	1.54	30.50	100	4.78
2012-13	62.46	9.70	72.16	27.44	0.40	27.84	100	4.62
2013-14 (RE)	61.91	10.76	72.67	26.27	1.06	27.33	100	4.53
2014-15 (BE)**	51.25	8.67	59.92	39.49	0.59	40.08	100	5.79

Note: These are revenue account transfers (excluding the direct transfers to the state implementing agencies). Prior to the FC-XII, Plan assistance also carried a loan component, which varied as a share of total assistance from 70 per cent for general category states to 10 per cent for special category states. Prior to 1999-2000, there was also on-lending by the Union to States of net collections in small savings schemes.

**Includes all transfers, including those which prior to 2014-15 were routed to implementing agencies directly by the Union government.

Source: Basic data from Indian Public Finance Statistics, Union Finance Accounts and Union Budget documents.

5.5 The Finance Commission transfers are predominantly in the form of tax devolution and, to a lesser extent, grants. The grants include non-Plan revenue deficit grants, grants to local bodies, grants for disaster management, sector-specific grants and state-specific grants. The Finance Commission Grants accounted for 11 per cent of revenue transfers in the FC-XI period and the FC-XII raised the share to over 12 per cent. However, it declined to 9.5 per cent in the FC-XIII award period.

5.6 The share of Plan grants in total transfers to the States has shown an increasing trend in recent years, particularly since 2006-07. However, within Plan grants, the share of normal Plan assistance distributed under the Gadgil-Mukherjee formula has shown a declining trend, particularly after the practice of the Union Government giving Plan loans to State Governments was stopped following the recommendations of the FC-XII. Only the North-eastern States as well as the hill states of Himachal Pradesh, Jammu and Kashmir and Uttarakhand continue to receive substantial portion of Plan grants by way of normal assistance for state Plans. The decline in the share of formula-based grants also reflects the faster expansion of discretionary grants for CSS. In fact, when the grants given directly to implementing agencies for CSS are taken into account, the decline in the formula-based transfers is even sharper. In 2014-15, with these grants being channelled through the State budgets, the share of both Finance Commission transfers and the overall formula-based transfers will show a further decline.

5.7 Grants other than Finance Commission and Plan grants are insignificant. In the FC-XIII period, these were estimated at 1.4 per cent of total revenue transfers to the States. Though their share increased briefly in 2010-11 on account of grants released by way of compensation to States for phasing out of Central sales tax (CST), it declined overall in the FC-XIII award period.

Impact of Direct Transfers to Implementing Agencies

5.8 In calculating the share of transfers from the Union to the States, the standard approach used is to include only those transfers that are received in the Consolidated Funds of States. Direct transfers to implementing agencies are not taken as part of State Finance Accounts and are captured only in the Union Government's accounts. However, to get clarity on the structural shifts in the transfer system, it is important to include the direct transfers to implementing agencies in the States as part of the total transfers to the States. This is mainly because of three reasons: (i) States are required to make matching contributions, (ii) the implementing agencies are manned by State Government officials and, in some cases, headed by ministers and (iii) the implementing agencies perform quasi-government functions of delivering public services. The Union Government has now recognised this and has included them in the transfers to State Governments from 2014-15. For comparative purposes, we have included these in the Union transfers to States to analyse the trends, in Table 5.2.

5.9 The implications of direct transfers on the relative shares of statutory and non-statutory transfers are evident when they are included in the transfers to States. Table 5.2 indicates the changes in the relative share of Finance Commission and other transfers by including the direct transfers to implementing agencies. When this is done, the share of Finance Commission transfers to the States averaged 56.7 per cent during the FC-XIII award period, whereas it averaged 67.4 per cent if direct transfers were not included. With the inclusion of direct transfers, the Finance Commission's share amounts to about 60 per cent in 2014-15.

Table: 5.2: Trends and Structure of Union Transfers, Including Direct Transfers

		<i>(Percentage)</i>							
		2007- 08	2008- 09	2009- 10	2010- 11	2011- 12	2012- 13	2013- 14 (RE)	2014- 15 (BE)
1	2	3	4	5	6	7	8	9	10
1.	Total FC transfers as percentage of total Union transfers	57.4	51.2	50.2	50.7	55.2	58.5	59.8	59.6
2.	Non- FC transfers as percentage of total Union transfers	42.6	48.8	49.8	49.3	44.8	41.5	40.2	40.4
3.	Normal Central Assistance as percentage of Union assistance for State Plans	26.1	21.7	22.0	22.3	20.9	23.1	24.0	8.6
4.	Union assistance for State Plans as % of total Plan expenditure	28.7	26.7	26.1	23.7	24.3	25.2	23.9	57.5
5.	Union assistance for State Plans as % of gross revenue receipts	9.9	12.2	12.7	11.3	11.3	10.1	9.8	24.2
6.	Direct transfers as % of total expenditure	7.4	10.0	9.0	10.0	8.6	7.7	7.0	0.2
7.	Direct transfers as % of Plan expenditure	25.9	32.2	30.3	31.7	27.1	26.3	23.3	0.7

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		2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14 (RE)	2014-15 (BE)
1	2	3	4	5	6	7	8	9	10
8.	Direct transfers as % of Union assistance for State Plans	90.2	120.4	116.3	134.0	111.5	104.3	97.7	1.2
9.	Total Union transfers as % of total expenditure	43.7	41.9	38.4	41.3	41.6	40.8	39.3	41.8
10.	Total Union transfers as % of gross revenue receipts (GTR+NTR)	44.7	52.8	53.2	48.9	53.7	49.0	46.2	47.5
11.	Union transfers as % of gross tax revenue	52.5	61.2	63.1	62.4	61.0	55.5	53.9	54.9
12.	Union transfers as % of divisible pool	58.3	68.9	71.2	71.4	69.3	63.9	61.7	61.9

Note: From 2014-15, direct transfers to implementing agencies have been added to State Plan schemes and include transfers to district-level autonomous bodies/Implementing Agencies.

Plan and Non-Plan Grants to States are as per the Union Budget figures assigned under the major head 3601.

Source: Union Budget documents for various years.

Ceiling on Transfers

5.10 The FC-XIII had noted that the trends in revenue transfers had exceeded the indicative ceiling of 38 per cent of the gross revenues of the Union Government set by the FC-XII for its award period. Keeping in view the increase in the tax devolution, the FC-XIII recommended raising the indicative ceiling to 39.5 per cent. The shares of revenue transfers from the Union Government to State Governments are shown in Table 5.3. The estimated 41 per cent total revenue transfers in the entire FC-XIII period have already exceeded the indicative ceiling. This can be attributed mainly to revenue transfers increasing to 47.3 per cent in 2014-15 (BE), with direct transfers included as part of the Plan transfer to States. However, when the direct transfer component is added, the level of transfers go up from 48.9 per cent in 2010-11 to 53.7 per cent in 2011-12 before declining to 49 per cent in 2012-13 (Table 5.2). It is estimated that the level of Union transfers to the States in 2014-15 will remain at about 47 per cent. The indicative ceiling prescribed by the previous Finance Commissions, therefore, has not restrained the Union Government from making larger transfers to States under the CSS.

Table 5.3: Transfers from the Union to States as Percentage of Gross Revenue Receipts

(Percentage of gross revenue receipts)

Commission	Finance Commission Transfers			Other Transfers			Total Transfers (4+7)
	Share in Central Taxes	Grants	Total Finance Commission Transfers	Plan Grants	Non-Plan Grants	Total Other Transfers (5+6)	
FC-VIII(1984-89)	20.25	2.52	22.77	13.56	1.54	15.1	37.86
FC-IX(1989-95)	21.37	3.42	24.79	14.49	1.06	15.55	40.33
FC-X(1995-2000)	22.22	2.34	24.56	10.57	0.67	11.24	35.79
FC-XI(2000-2005)	20.59	3.88	24.47	10.10	0.70	10.80	35.27
FC-XII(2005-10)	22.03	4.70	26.73	10.99	1.07	12.06	38.79
FC-XIII (2010-15)	23.95	3.93	27.87	12.87	0.59	13.45	41.33

Commission	Finance Commission Transfers			Other Transfers			Total Transfers (4+7)
	Share in Central Taxes	Grants	Total Finance Commission Transfers	Plan Grants	Non- Plan Grants	Total Other Transfers (5+6)	
2010-11	21.68	3.12	24.79	10.48	1.72	12.20	36.99
2011-12	25.27	4.35	29.62	12.34	0.66	13.00	42.61
2012-13	24.84	3.86	28.70	10.91	0.16	11.07	39.77
2013-14(RE)	23.54	4.09	27.62	9.99	0.40	10.39	38.02
2014-15(BE)	24.24	4.10	28.34	18.67	0.28	18.95	47.29

Source: Basic data from Indian Public Finance Statistics, Union Finance Accounts and Union Budget documents.

Combined Revenues, Expenditure and Transfers

5.11 The proportion of transfers from the Union to the States in the combined revenues is shown in Table 5.4. The share of the Union, taking into account its resources net of statutory and non-statutory transfers, has been in the range of 35 per cent to 39 per cent, with the exception of the FC-XI period. The transfers have varied in a narrow range of 24 per cent to 26 per cent of the combined revenue receipts of the Union and States. However, when the direct transfers are taken to account, the proportion of transfers in the combined revenues increases to 30.5 per cent in the initial three years of the FC-XIII period.

Table 5.4: Relative Share of Union and States in Combined Revenue Receipts

(per cent)

FC Period	Union			States		
	Revenue Receipts before transfers	Transfers (Statutory + non- statutory)	Revenue receipts after transfers	Revenue receipts before transfers	Transfers (statutory+ non- statutory)	Revenue receipts after transfers
FC-VIII	65.40	26.70	38.70	34.60	26.70	61.30
FC-IX	62.80	27.50	35.30	37.20	27.50	64.70
FC-X	60.80	24.50	36.30	39.20	24.50	63.70
FC-XI	58.50	25.20	33.30	41.50	25.20	66.70
FC-XII	63.81	25.36	38.45	36.19	25.36	61.55
FC-XIII*	61.08	24.64	36.44	38.91	24.64	63.55
2010-11	64.36	24.17	40.19	35.64	24.17	59.81
2011-12	60.62	26.09	34.53	39.38	26.09	65.47
2012-13	58.89	23.80	35.09	41.11	23.80	64.91

* Average for three years. Direct transfers to State Implementing Agencies are excluded.

Source: Finance Commission Division/Indian Public Finance Statistics and Union Budget documents. The figures do not include direct transfers to the State Implementing Agencies.

5.12 Table 5.5 indicates the relative share of the Union Government and State Governments in the combined revenue and total expenditure. The share of Union Government expenditure in total expenditure has been increasing since the FC-XII period, but remains lower than the share of States' expenditure. However, if expenditure by States' implementing agencies is taken as expenditure having been incurred in the States, then the skew in the relative balance of the respective shares of the Union and the States is set right.

Table 5.5: Relative Shares of Union and States in Revenue and Total Expenditures

(Relative shares)

Finance Commission Periods	Total expenditure		Revenue expenditure	
	Union	States	Union	States
FC-I	43.83	56.17	40.77	59.23
FC-II	49.47	50.53	41.83	58.17
FC-III	50.51	49.49	46.10	53.90
FC-IV	47.69	52.31	41.77	58.23
FC-V	43.14	56.86	40.00	60.00
FC-VI	47.35	52.65	44.19	55.81
FC-VII	44.79	55.21	41.98	58.02
FC-VIII	47.86	52.14	44.22	55.78
FC-IX	45.58	54.42	43.45	56.55
FC-X	43.35	56.65	43.18	56.82
FC-XI	43.77	56.23	44.03	55.97
FC-XII	46.08	53.92	47.59	52.41
FC-XIII*	46.64	53.36	47.16	52.84
Overall Average	46.16	53.84	43.56	56.44

Note: * Average of three years (2010-11 to 2012-13). Expenditure on direct transfers is not accounted for in the States.
 Source: *Indian Public Finance Statistics*.

5.13 Even though the Finance Commission transfers have gone up on account of increases in the share of Central taxes, the shift in the relative shares of the Union and the States in the combined revenues and expenditure since the FC-XII period is primarily due to increases in non-statutory transfers.

Consolidated Public Finances

5.14 In this section we have analysed the position of the consolidated finances of the Union and State Governments on the basis of developmental and non-developmental expenditures. This is done through the assessment of function-wise expenditures, performances on tax to Gross Domestic Product (GDP) ratio and on crucial deficit indicators, based on Indian Public Finance Statistics 2013-14. We are constrained in the assessment of combined accounts on account of two factors. Firstly, even in the last quarter of 2014-15, the combined finance statistics are available only for actuals up to 2011-12. Secondly, the combined statistics, particularly for functional categories, do not reconcile with the Union and States statistics presented separately. As a result, they are not comparable and this limits the assessment of their respective shares in the combined statistics. It is, however, still useful to assess the position on combined finances.

Major function-wise expenditure

5.15 The function-wise expenditures in the Indian Public Finance Statistics have been organised into the broad categories of developmental and non-developmental expenditures. The developmental expenditures have been defined broadly as expenditures on socio-economic major heads given in the budget, including grants to States and Union Territories but excluding some

non-Plan expenditure like pension and social security. Expenditures other than developmental expenditure, except loans and advances, constitute non-developmental expenditure. The combined finance statistics indicate relatively stable non-developmental expenditure in the range of 47.5 per cent to 49.5 per cent of total expenditure during the period 2007-08 to 2011-12. The revised estimate for 2012-13 and budget estimate for 2013-14 indicate a marginal decline. Similarly, developmental expenditure has also been stable since 2007-08, in the range of 49 per cent to 52 per cent of total expenditure. However, the picture changes when function-wise developmental expenditure is analysed. Expenditure on social and community services has shown a consistent increase since 2007-08 from 20.9 per cent in 2007-08 to 25.3 per cent in 2012-13 (RE). The combined expenditure on Other Economic Services has been stable throughout the period of 2007-08 to 2012-13 at around 24 per cent, except during 2008-09 when it increased to 27 per cent. The combined expenditure on Loans and Advances, though constituting a small portion of capital expenditure, has been consistent at about 2 per cent during 2007-08 to 2009-10, but was projected to decline in 2013-14 (BE).

5.16 Despite data constraints, it is observed from Indian Public Finance Statistics that the overall developmental expenditures of the States have been higher than that of the Union Government. In Social and Community services, in particular, it is the States who have incurred the predominant share of expenditure. In the General Economic Services, the shares of both Union and the States have shown significant fluctuations. The position of combined finances, in terms of non-development expenditure and function-wise developmental expenditure, along with expenditure on gross loans and advances has been shown in Table 5.6.

Table 5.6: Revenue and Capital Expenditure of Union and States in Combined Expenditure

	<i>(percentage)</i>						
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13 (RE)	2013-14 (BE)
Combined (Union and States)							
Net of lending							
Non-developmental expenditure	48.4	47.9	49.5	47.5	47.5	46.7	47.1
Developmental expenditure	50.1	51.1	49.0	50.5	51.3	52.3	51.9
Social & Community Services	20.9	22.1	22.9	23.5	23.9	25.3	25.0
General Economic Services	4.7	1.3	1.0	1.9	1.6	2.4	3.2
Other Economic Services	23.9	27.0	24.2	24.2	24.9	23.7	23.0
Loans and Advances (Gross)	1.8	1.8	1.7	1.9	2.6	2.0	1.4
Developmental	1.7	1.7	1.7	1.9	2.5	2.0	1.3
Centre	0.4	0.4	0.4	0.7	0.7	0.6	0.3
States	1.3	1.3	1.2	1.2	1.8	1.3	1.1
Non-developmental	0.1	0.1	0.0	0.0	0.1	0.1	0.1
Centre	0.0	0.0	0.0	0.0	0.0	0.1	0.0
States	0.1	0.0	0.0	0.0	0.0	0.0	0.0

Note: As per definition in the Indian Public Finance Statistics, developmental expenditure broadly includes socio-economic major heads given in budget excluding some non-Plan expenditure like pension, social security and is inclusive of grants to States and Union Territories. Expenditures other than developmental expenditure, except loans and advances given by the government, constitute non-developmental expenditure.

Source: Indian Public Finance Statistics, 2013-14.

Tax-GDP ratio

5.17 The combined tax-GDP ratio of the Union and States decreased by 2 per cent of GDP from 17.5 per cent in 2007-08 to 15.5 per cent in 2009-10, but later increased to 16.3 per cent of GDP in 2010-11 and 2011-12. The Union tax-GDP ratio has fluctuated around 10 per cent of GDP during the period 2008-09 to 2012-13. On the other hand, the States' tax-GDP ratio has shown a consistent upward trend since 2008-09, increasing from 5.5 per cent that year to 6.4 per cent in 2011-12. It was estimated to increase further to 6.8 per cent in 2012-13 (revised estimates). The revised estimates of 2012-13 indicate a combined tax-GDP ratio of 17.1 per cent, which is closer to the 2007-08 level of 17.5 per cent. This recovery was on account of higher tax buoyancy in the States in 2012-13, which improved the combined tax-GDP ratio despite lower tax performance by the Union Government compared to 2007-08. Table 5.7 shows the trends of the tax-GDP ratios of the Union and the States, along with the combined tax-GDP ratios.

Table: 5.7: Tax-GDP Ratio and Deficits

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
	(Per cent)					
	deficit (+)/surplus (-)					
	(RE)					
Union Tax-GDP Ratio	11.9	10.8	9.7	10.2	9.9	10.3
States Tax-GDP Ratio	5.6	5.5	5.8	6.1	6.4	6.8
Combined Tax-GDP Ratio	17.5	16.3	15.5	16.3	16.3	17.1
Revenue deficit of Union	1.1	4.5	5.2	3.2	4.4	3.9
Revenue deficit of States	-1.0	-0.3	0.4	-0.2	-0.3	-0.2
Combined Revenue Deficit	0.1	4.2	5.7	3.0	4.1	3.7
Fiscal deficit of Union (Net)	2.5	5.9	6.4	4.6	5.7	5.1
Fiscal deficit of States(Net)	1.3	2.1	2.8	1.8	1.6	2.1
Combined Fiscal Deficit (Net)	3.8	8.0	9.1	6.4	7.3	7.2
Primary deficit of Union	-0.9	2.6	3.2	1.8	2.7	2.0
Primary deficit of States	-0.4	0.5	1.2	0.4	0.4	0.8
Combined Primary Deficit	-1.0	3.2	4.5	2.3	3.2	2.9

Source: Indian Public Finance Statistics 2013-14, Ministry of Finance.

Deficits

5.18 A sharp increase was observed in combined fiscal deficit as a ratio of GDP from 3.8 per cent in 2007-08 to 9.1 per cent in 2009-10, on account of substantial fiscal expansion in that period. Public finance statistics show the Union's fiscal deficit increasing from 2.5 per cent of GDP in 2007-08 to 6.4 per cent of GDP in 2009-10. An increase is also seen in the fiscal deficit of States which, as a ratio of GDP, increased from 1.3 per cent in 2007-08 to 2.8 per cent in 2009-10, mainly due to enhanced borrowing limits allowed by the Union Government.

5.19 While the fiscal deficit of the Union Government continued to be much higher than the FRBM ceiling of 3 per cent of GDP, the combined States' fiscal deficit has mostly remained below the ceiling of 3 per cent of GSDP. Similarly, there has been a pronounced decline in the

revenue-capital expenditure balance in case of the Union Government, with the revenue deficit remaining above 3 per cent of GDP from 2008-09 till 2012-13. The States have, in contrast, consistently managed to run a revenue surplus except for one year - 2009-10 - when they ran a revenue deficit of 0.4 per cent of GDP. The Union and State Governments together had a primary surplus of 1 per cent of GDP in 2007-08, which deteriorated to a primary deficit of 4.5 per cent of GDP in 2009-10. The Union Government has run a consistently high level of primary deficit since 2008-09. Though States have also failed to get into a position of primary surplus since 2008-09, the levels of primary deficit are much smaller than that of the Union Government. However, this position was expected to worsen in 2012-13 (RE). The year-wise performance of the Union, the States and combined statistics on major fiscal indicators are shown in Table 5.7.

Overview of Consolidated Finance

5.20 The review of public finances shows that the fiscal situation continues to be a challenge. The consolidated fiscal deficit of the Union and State Governments in 2014-15 (BE) is estimated at 6.2 per cent of GDP and the revenue deficit at 2.7 per cent of GDP, implying that a large proportion of borrowing is used to finance revenue expenditures. Capital expenditure is estimated at 4.5 per cent of GDP in 2014-15 (BE), as compared to 5 per cent in 2007-08, and the overwhelming proportion of this (2.8 percentage points) is at the level of the States. The estimated aggregate government liability as a ratio of GDP in 2014-15 (BE) works out to 66.4 per cent (after adjustments for National Small Savings Fund and excluding liabilities under the Market Stabilisation Scheme). This implies that, besides pre-empting a significant proportion of household financial savings for government consumption, interest payments will continue to remain a significant proportion of revenues. It is, therefore, important to effectively contain deficits and debt by increasing revenues and rationalising expenditures.

5.21 The fiscal position of the Union Government improved during the period 2002-03 to 2007-08, coinciding with the high growth in GDP. However, it deteriorated in 2008-09 and 2009-10, partly due to the impact of the global crisis, and partly due to domestic expenditure policy decisions unrelated to the crisis. Despite the crisis, growth performance was impressive during 2009-10 and 2010-11, even though there was considerable structural deterioration in the state of public finances. In other words, growth was maintained by the Union Government with borrowed money and borrowed time. Since 2012-13, there has been a deceleration in growth, along with some efforts towards fiscal correction. However, the structural weaknesses continue to pose significant challenges, necessitating a credible medium-term framework for appropriate fiscal consolidation during our award period.

5.22 The review indicates that, within the overall fiscal activity in the country, there has been greater expansion in the fiscal activity of the Union than of the States. The issue that the Commission has to address is whether the observed balance in the fiscal activity of the Union and the States is in consonance with Constitutional intent in setting out expenditure commitments and revenue sources and current economic realities, including the expectations of the people.

5.23 It is also relevant to note that the transfers from the Union to the States have increased substantially. Overall transfers- the Finance Commission transfers and other transfers put together- have been well beyond the indicative ceilings prescribed by previous Finance Commissions. A view has to be taken on the usefulness of such ceilings in the scheme of Union-State relations, particularly taking recent trends and ground realities into account.

Fourteenth Finance Commission

5.24 Within the transfers from the Union to the States, discretionary components have increased in the review period, undermining the role of the Finance Commission. It is essential to take a view on maintaining or reducing the share of discretionary transfers, independent of the overall balance in fiscal activity between the Union and the States. In other words, the relative shares of transfers from Finance Commission and others, during the award period, need to be examined.

5.25 Above all, an important lesson from the review is that the management of fiscal policies needs to take into account likely risks arising from external shocks, such as a global crisis or fluctuating oil prices. Moreover, it is necessary to recognise that counter-cyclical policies have been warranted in the review period. The need for headroom for meeting shocks and undertaking counter-cyclical policies makes it necessary to ensure that structural weaknesses in the fiscal position are rectified during the award period.

5.26 In conclusion, the review leads us to take a comprehensive view on several aspects of Union and State finances. *First*, it is necessary to consider Union finances as a whole, of which the divisible pool of taxes is one component. *Second*, the total transfers from the Union Government to the States should be considered, of which transfers on account of the Finance Commission are one component. *Third*, the revenue expenditure of the Union and the States should be considered as a whole, of which revenue expenditure under non-Plan is one component, albeit a major one. *Fourth*, the consolidated public debt of the Union and the States should be considered in dealing with the fiscal environment. Consequently, the aggregate debt of the States and fiscal rules should be seen as one component, and the debt and responsible fiscal management of the Union Government as the other component. *Fifth*, both the Union and the States have to take appropriate fiscal consolidation measures in order to create the space to undertake counter-cyclical policies when needed as well as to manage the impact of shocks such as global uncertainties and uncertain monsoon conditions. Union finances are crucial in this context. *Sixth*, while a conducive fiscal environment in both the Union and the States is important for the national economy, the Union Government's fiscal policies have a more critical role to play for all the reasons mentioned above. In fact, in view of the current state of fiscal stress in the Union finances, there is need for responsible and credible fiscal policies during the award period in order to ensure inclusive growth. *Finally*, during the review period, concerns on the credibility front caused considerable uncertainties in the conduct of fiscal policies. This indicates the need for institutional mechanisms that will promote, in an assured manner, greater reliability in fiscal policy, which is most critical for the credibility of public policy in general.

Chapter 6

Union Finances : Assessment of Revenue and Expenditure

6.1 The terms of reference (ToR) require this Finance Commission, while making its recommendations, to take into consideration the resources of the Union Government for five years commencing on 1 April 2015, on the basis of the level of taxation and non-tax revenues likely to be reached during 2014-15 as well as the demands on the resources of the Union Government, especially on account of the expenditures on civil administration, defence, internal and border security, debt servicing and other committed expenditure liabilities. The ToR also emphasises the objective of not only balancing revenue receipts and revenue expenditures of all the States and the Union, but also generating surpluses for capital investment.

6.2 Our ToR is broadly similar to those for earlier Finance Commissions. However, in the case of the FC-XIII, there was an explicit reference that gross budgetary support (GBS) to the Plan be treated as a committed liability of the Union Government. Like earlier Finance Commissions, our assessment of Union finances has taken into consideration the forecast of receipts and expenditure submitted by the Ministry of Finance in its memorandum. Other Ministries and Departments of the Union Government and the Planning Commission have also presented their views to us. These have helped us in formulating our approach and assessment for the period from 2015-16 to 2019-20. In this regard, we have taken note of the amended Fiscal Responsibility and Budget Management (FRBM) Act, 2003 and the Medium-Term Fiscal Policy (MTFP) Framework presented with the Union Budget of 2014-15 in July 2014 in compliance with the amended FRBM Act. **We have also kept in view the various observations that States have made on Union Government finances.**

Views of the Union Government

6.3 The Commission had a preliminary interaction with the Ministry of Finance in January 2014. The Ministry later submitted its memorandum to us in September 2014. The projection of Union finances submitted along with the memorandum was in line with the fiscal deficit reduction targets indicated in the MTFP 2014-15, that is, reducing the fiscal deficit to 3 per cent of gross domestic product (GDP) by 2016-17 and maintaining it at that level thereafter. According to the memorandum, the revenue deficit is projected to decline from 2.2 per cent of GDP in 2015-16 to 0.9 per cent of GDP in 2019-20. It estimates that there would be a marginal increase in the gross tax revenue-GDP ratio of the Union Government from 10.6 per cent to 10.9 per cent, while net revenue (net of tax devolution to States) would increase from 7.6 per cent to 7.8 per cent of GDP. The memorandum shows a decline in total expenditure from 12.9 per cent to 11.9 per cent of GDP between 2015-16 and 2019-20, with revenue expenditure declining from 11.2 per cent to 9.7 per cent and capital expenditure increasing from 1.7 per cent to 2.2 per cent of GDP. The outstanding debt-GDP ratio is also forecast to decline from 43.6 per cent to 36.3 per cent of GDP

during the same period. In the memorandum, the growth rate of nominal GDP was assumed to be 13.4 per cent per annum for 2015-16 and 2016-17; after that GDP is assumed to grow at 13.5 per cent per annum every year for three years.

6.4 In its submission to the Commission, the Ministry of Finance highlighted the fact that the Union Government's commitment to fiscal consolidation and macroeconomic stabilisation through reduction of deficits, and meeting the demands of development expenditure was imposing constraints on its fiscal space. The memorandum underlined the increasing demands on the Union's resources on account of expenditure commitments on items in the Union List, such as defence, internal security and energy security. It justified the need for the Union Government's intervention in State subjects on the grounds of meeting the principle of horizontal equity. Citing how projects relating to certain items on the State List, such as water, have inter-state spill-over effects, the Ministry suggested that the Union Government should have a greater role in the design and implementation of such projects. The memorandum also pointed out that the Union had a significant role to play in State subjects, like the provision of urban amenities, in the form of financial and technical assistance. It added that the role of the Union Government is also important for projects which require inter-state cooperation, such as smart cities and expressways. The memorandum emphasised the need for the Union Government to retain fiscal space for its development agenda, including expenditure commitments arising from the statutory rights-based obligations which are imperative to ensure minimum standards of public services. It also argued that the Union Government has an obligation to ensure welfare programmes, particularly for backward States, to address inter and intra-State disparities.

6.5 The memorandum highlighted the fact that the fiscal consolidation achieved by the Union Government in 2012-13 and 2013-14 came through a reduction in Plan and capital expenditure. In this context, it noted that in order to improve the quality of fiscal adjustment, the path to fiscal consolidation in the FC-XIV award period should be aided by improvements in the efficiency of government expenditure. It highlighted that an early implementation of the goods and services tax (GST) and further reforms in tax administration could result in more buoyant revenues. Pointing out that States, at an aggregate level, have achieved the fiscal consolidation targets set by the FC-XIII, the Ministry noted that it was time to move to the second stage of fiscal consolidation at the state level, going beyond deficit and debt targets and looking into the quality of fiscal consolidation. To this end, the Commission, it suggested, could incentivise revenue generation, reduction of committed liabilities and improvement in the quality of expenditures as measured against forward-looking predetermined prescribed outcomes by States. The memorandum urged that grants by the Finance Commission be treated as catalytic and be used to incentivise improved outcomes in focus areas.

Views of the States

6.6 In general, almost all the States referred to the narrowing of their available fiscal space relative to the Union in recent years and demanded that this trend be reversed. The States pointed out that this contraction of their fiscal space came from various policy actions by the Union Government which placed a significant fiscal burden on them. These policy actions include: (i) expansion of the Centrally sponsored schemes (CSS) to State subjects; (ii) shifting of the entire burden of implementing such schemes to the States, after initiating them with partial funding;

(iii) the frequent recourse to and continuation of cesses and surcharges that fall outside the shareable pool of taxes; (iv) the increase in the Union's tax expenditures through tax exemptions and tax concessions; (v) legislative measures by the Parliament which are not fully funded; (vi) exemptions of Union Government properties from paying taxes that are collected by local bodies, etc.; (vii) the Pay Commission awards; and (viii) a rising tendency to make States pay for Railway and national highways projects that are clearly the responsibility of the Union Government.

6.7 For many States, the significant expansion of the Union Government's CSS, implemented through the States, was itself an indication of the excess fiscal space that has been made available to the Union Government, which should be corrected. States argued that the application of fiscal rules between the Union Government and the States should be symmetric so that there is no asymmetric impact on fiscal space. In their view, the same principle should apply while normatively assessing the needs of the Union and State Governments.

6.8 A few States argued that since Union Government expenditure on various Plan schemes are on the subjects assigned to the States under the Constitution, these expenditures should not be considered while assessing the resource requirement of the Union Government. One State suggested that while taking the 2014-15 estimates of revenue and expenditure as the basis for projections for the Union and States, the Commission should consider adjustments for any abnormal changes that may have been observed in the base year.

Current Status

6.9 The fiscal imbalance of the Union Government has widened since 2008-09 due to the increasing revenue deficits. The 2014-15 budget estimates (BE) indicate that the ratio of revenue and fiscal deficits to GDP are 2.9 per cent and 4.1 per cent, respectively. The outstanding debt for the year is estimated at 45.4 per cent of GDP.¹ These deficit levels are above the targets in the original FRBM Act of 2003. The rules of the original Act required the Union Government to eliminate revenue deficits and restrict the fiscal deficit to 3 per cent of GDP by 31 March 2009. In addition, the Act required the Union Government to, starting from 2004-05, cap guarantees issued in a year to 0.5 per cent of GDP and to limit additional liabilities including external debt at the current exchange rate to 9 per cent of GDP every year, reduced progressively by 1 per cent of GDP every year. A temporary deviation from the FRBM Act targets was allowed in 2008-09 and 2009-10 to enable a fiscal stimulus to mitigate the adverse impact of the global financial crisis on the Indian economy.

6.10 In 2012-13, the fiscal targets were revised in line with the fiscal consolidation path recommended by the FC-XIII for 2010-15. In the Finance Act 2012-13, the FRBM Act was amended to allow the Medium-Term Expenditure Framework Statement to be laid before both Houses of Parliament after the session in which the Medium-Term Fiscal Policy Statement, Fiscal Policy Strategy Statement and Macroeconomic Framework Statement were presented. The MTFP is expected to indicate three-year rolling targets for prescribed expenditure indicators, specifying

¹ The outstanding debt of the Union Government is estimated by deducting the bonds issued for market stabilisation schemes and adjusting the external debt at the current exchange rate. Also, the special securities issued to States under the National Small Savings Fund (NSSF) have not been considered as a part of the liability, consistent with past practices.

the underlying risks and assumptions. The amendments also shifted the targets in the original Act from 31 March 2009 to 31 March 2015. Along with these amendments, the FRBM Act introduced the concept of an effective revenue deficit, defined as the difference between the revenue deficit and grants for the creation of capital assets. The FRBM targets were reset to eliminate the effective revenue deficit by 31 March 2015, and to achieve a revenue deficit of not more than 2 per cent of the GDP by that date. The amendment also requires the Union Government to mandate the Comptroller and Auditor General (C&AG) to periodically review compliance of the provisions of the Act and for these reviews to be presented in both Houses of Parliament.²

Approach to Committed Liabilities: An Overview

6.11 In assessing Union finances, the FC-XII and FC-XIII included interest payments, defence revenue expenditure, pensions and internal and border security (including police) as committed liabilities. The FC-XII estimated expenditure on subsidies separately before projecting the remaining major items of non-Plan revenue expenditure under the heads of *Other General Services, Economic Services and Social Services*. The FC-XIII, however, made normative projections for subsidies, keeping in view the need for fiscal consolidation and subsidy reform. Although expenditure on salaries is considered committed expenditure and constitutes an important component of total revenue expenditure, both the FC-XII and FC-XIII did not separately project the salary and non-salary expenditure components for the purpose of assessing Union finances. Instead, aggregate growth rates for these services, namely, General, Social and Economic Services, were used for projections.³ To project Plan revenue expenditure, both Commissions treated it as a residual, keeping in mind the targets laid down for the revenue deficit, and assessed non-Plan revenue expenditure. The ToR of the FC-XIII required a consideration of the demands on the Union Government's resources arising from the projected budgetary support to the Union and State Plans. The Commission highlighted the methodological issues involved in treating GBS as a committed demand, such as the non-availability of five-year Plan GBS projections for the Commission's award period as well as year-wise estimates of Plan projections. The Commission noted that if GBS projections were fully provided for, that would not leave sufficient fiscal headroom for non-Plan expenditure by the Union and the States, which was mostly committed in nature. Citing such practical difficulties in treating GBS for Plan as a demand, the FC-XIII continued with the earlier Finance Commissions' practice of arriving at GBS residually.

6.12 Our ToR does not bind us to consider only the non-Plan revenue expenditure of the Union Government or to treat GBS for Plan as committed expenditure. Over the years, there has been considerable expansion of outlay under the CSS, which has resulted in an increase in the revenue component of the Plan. We have kept these factors in mind while determining our approach towards committed liabilities. Accordingly our approach was guided by the following overriding principles:

² Issues related to the FRBM Act and its compliance are separately treated in Chapter 14. The brief discussion here is to put in perspective the implication of the state of fiscal balance on the assessment of Union Finances for the next five years.

³ The salary expenditure of the Union Government for 2014-15 (BE) is estimated to be 10.69 per cent of total revenue expenditure, excluding the Railways.

- a. **The Commission is required to balance the Union and States' revenue powers with expenditure responsibilities listed in the Seventh Schedule of the Constitution. Resources should be allocated according to the responsibilities specified in the Union, State and Concurrent Lists.**
- b. On the Union Government side, we have ensured in our assessment that appropriate fiscal space is provided for expenditure as defined in the Union List in the Seventh Schedule of the Constitution. This implies not only taking committed liabilities as defined in our ToR into consideration, but also factoring in what the Union Government requires to spend on functions assigned to it Constitutionally. The assessment recognises the scope for revenue mobilisation through taxes/non-taxes, disinvestment proceeds and the likely fiscal burden arising from providing compensation to States for the GST. We have also provided appropriate fiscal headroom for the Union Government to carry out transfers to States by way of expenditures, with externality considerations and equalisation in select sectors.
- c. On the State side, as a first principle, we have ensured that the aggregate volume of transfers to States does not fall short of the existing level of transfers vertically. The overriding principle has been of structuring a transfer mechanism that ensures greater fiscal autonomy to the States, while providing sufficient fiscal space to the Union Government for transfers to States to carry out expenditure having redistributive, externality and equalisation considerations.

6.13 This approach leaves open the policy option of continuing or not continuing with the distinction between Plan and non-Plan expenditure for both the Union and individual States. The capital outlays of both the Union and the States will continue to be determined by their revenue balance, capital receipts and the scope for borrowing within the parameters set by the respective fiscal responsibilities legislations.

Treatment of Committed Expenditure

6.14 An assessment of the expenditures of the Union Government should take into account the resources required to meet its commitments for providing the public services detailed in the Union List. In addition, it should also take into account the expenditure commitment of the Union Government on some services that are listed in the Concurrent and State Lists but are provided by it due to its comparative advantage in terms of economies of scale or the need to ensure country-wide uniformity in the minimum standards of services, to the extent feasible.

6.15 Entries in the State List specify the functional domains of the States, which are responsible for providing public services for carrying out these functions. In addition, there are certain functions in the Concurrent List which have been traditionally undertaken by States. However, even in the State and Concurrent Lists, there are functions which are of national interest because of nationwide externalities or redistribution (provision of minimum standards of service, for example) which have to be carried out by both the Union and State Governments in the spirit of co-operative federalism. Equity requires that people receive some services of minimum standards, irrespective of where they reside, and it is the joint responsibility of both the Union and State Governments to ensure that such services are provided. While State Governments would have to meet the bulk of

financing requirements taking into account local conditions, information and knowledge and institutional realities, the Union Government would have to supplement the efforts of some or all the States as appropriate. In the spirit of cooperative federalism, the sectors and the schemes should be well defined, clearly focused and broadly acceptable to the Union and State Governments in terms of their scope, coverage, inter-state distribution and design.

6.16 There is some degree of subjectivity involved in assessing and classifying Union expenditure according to the Constitutional division of powers. This is because of data constraints and Constitutional interpretations of functional space, particularly in respect of the items in the Concurrent List. Moreover, there are some entries in the three Lists for which resource requirements cannot be quantified.

6.17 Our examination of the past data shows that between 2002-05 and 2005-11, revenue expenditure by the Union Government on State List subjects increased from an average of 14 per cent to 20 per cent and on Concurrent List subjects from an average of 13 per cent to 17 per cent. This implies a reduction in expenditure in percentage terms on Union List subjects.⁴ Expenditure functions under the Union List fall predominantly under General and Economic Services. The share of expenditure on these has progressively declined from 66.3 per cent in 2001-02 to 53.2 per cent in 2014-15(BE). Our assessment of Union finances has taken note of this and provided appropriate fiscal space to the Union to carry out its Constitutionally assigned expenditure responsibilities.

6.18 Although salary expenditure is committed, we have not projected salary separately for the Union Government. The aggregate growth of each item of expenditure should factor in the implicit salary component inbuilt in the expenditure. Our analysis of the employment structure and growth in salary expenditure and its share in the revenue expenditure of the Union Government has revealed that the number of employees declined from 2007-08 to 2011-12, and the share of salary expenditures increased marginally between these two time points. The share of salary expenditure in the revenue budget remained stable between 2007-08 and 2012-13, despite a doubling of the per-employee salary expenditure of the Union Government.⁵

Re-Assessment of the Base Year and Norms for Projection

6.19 The assessment of Union finances was conducted in two stages. In the first stage, we assessed revenues and expenditure for the base year 2014-15. In the second stage, we applied norms for individual items of receipts and expenditure for the purpose of forecast. For re-assessment of the base year, we have examined in detail the revenue and expenditure data for 2014-15 presented in Union Budget 2014-15, and broadly adopted this, with some modifications on the receipt side of the Budget. Specifically, we have included the telecom license fee

⁴ The FC-XII had estimated that on average 9.6 per cent of the total expenditure of the Union Government was on subjects in the State List and around 9.4 per cent was on subjects in the Concurrent List. Although our analysis only looked at the distribution of Union revenue expenditure on different Lists, the revenue expenditure as a percentage of total expenditure estimated for the Concurrent and State Lists in 2002-05, was higher than the estimates of the FC-XII, which dealt with total expenditure distribution and not merely with revenue expenditure. This mismatch is possibly a result of different approaches which may have been used in estimating these expenditures.

⁵ Per employee salary expenditure of the Union Government increased from Rs. 1,50,683 in 2007-08 to Rs. 3,13,515 in 2012-13.

(Rs.13,200 crore), spectrum user charges (Rs. 6,995 crore), and one-time spectrum charges (Rs. 4,165 crore) as per the memorandum submitted by the Department of Telecom to the Commission. We have not included estimates of the auction revenue in our assessment, as it is presumably a one-time receipt. We have also used the data on the surplus transferred from the Reserve Bank of India (obtained from the RBI Annual Report 2013-14) which amounted to Rs. 52,679 crore as against the Rs. 46,000 crore reported in 2014-15(BE). With these adjustments, the corresponding revenue receipts worked out to Rs. 15,62,597 crore instead of the Rs. 15,77,029 crore reported in the 2014-15 BE. The reassessed revenue deficit worked out to 3.05 per cent instead of 2.9 per cent of GDP and the fiscal deficit also worked out to 4.24 per cent of GDP instead of 4.1 per cent of GDP reported in the 2014-15(BE). On this re-assessed base year, 2014-15, we have applied norms for the assessment of revenues and expenditure from 2015-16 to 2019-20.⁶

6.20 The reference period for growth and buoyancy in the assessment of Union finances has been 2001-02 to 2012-13. A nominal GDP growth rate of 13.5 per cent has been used for the assessment period. The revenue deficit has not been capped for the projection, but its path has been determined based on the norms for revenues and expenditure. For the fiscal deficit, we have followed a path that reduces it to 3 per cent of GDP by 2016-17 and maintains it at that level for the period of our assessment. For tax revenue projections, we have taken the buoyancy of individual Union taxes. On the expenditure side, we have calculated interest payments by applying the 2013-14 effective rate of interest⁷ on the assessed outstanding liabilities of the Union Government for the period 2015-16 to 2019-20.

Union Revenues: 2015-16 to 2019-20

Tax Revenues

6.21 **Our assessment of tax revenue for the Union Government for the period 2015-16 to 2019-20 is based on tax-specific buoyancies estimated using data from 2001-02 to 2012-13. However, for corporation and service taxes, we have made a downward adjustment to the trend** because corporation and service tax revenues have grown at the rate of 19.08 per cent and 39.28 per cent, respectively, between 2001-02 and 2012-13, implying buoyancies of 1.52 per cent and 2.36 per cent, respectively. The buoyancies of these two taxes were much higher than the aggregate tax revenue buoyancy of 1.11 per cent during the same period. The faster growth of corporation tax revenues during this period could be attributed to buoyant economic growth from 2003-04 to 2007-08. Year-wise estimates of corporation taxes also showed that the increase in buoyancy between 2001-02 and 2012-13 was due to the high growth of this tax between 2003-04 and 2007-08. There has been a spectacular growth of revenue from service taxes thanks to the steady expansion of the tax base, by bringing additional services into the tax net and introducing a negative list of services in 2012-13.⁸ **It would be unrealistic to assume that such a high level of corporation and service tax growth would continue, even if the economy**

⁶ We also have not taken into account the likely revenue receipts from the auction of coal blocks during our assessment period.

⁷ The effective rate of interest is estimated by dividing interest payments at the end of the fiscal year by the outstanding liabilities at the beginning of the year.

⁸ The increasing use of technology in tax administration also helped improve revenue collections during this period.

returns to the anticipated growth rate projected in our assessment period. However, if the negative list is pruned further to bring more services into the tax net, revenues could be higher and, to that extent, additional fiscal space will be available to the Union Government.

6.22 We have, therefore, assumed buoyancies for corporation and service tax growth rates of 1.27 and 1.38, respectively. These buoyancies were observed during 2004-05 to 2012-13 for corporation tax and during 2008-09 to 2012-13 for service taxes. For the other taxes, we have applied the tax buoyancies observed for the period 2001-02 to 2012-13, which is 1.24 for income tax, 0.9 for customs and 0.5 for Union excise duty. For other minor taxes we have used a buoyancy of 0.4. Applying these tax buoyancies to base-year tax revenues, we project an increase in the gross tax-GDP ratio from 10.7 per cent in 2015-16 to 11.4 per cent in 2019-20, that is, an increase of 0.67 percentage point of GDP.

6.23 The average tax-GDP ratio for the Union Government during the entire assessment period worked out to 11.04 per cent of GDP, which, in our view, is a modest increase over the course of five years, when compared with the 2014-15 (BE) tax-GDP ratio of 10.6 per cent. When compared with the MTFP estimates of tax-GDP ratios for 2015-16 and 2016-17,⁹ our estimates for these two years are marginally lower (See Annex 6.1 and 6.2). Historical data shows that the average tax-GDP ratio remained at 10.1 per cent for the period 2001-02 to 2007-08, 10.5 per cent between 2003-04 and 2007-08, and 10.1 per cent between 2008-09 and 2012-13. **For the purpose of the assessment, we have assumed that the introduction of the GST would be revenue-neutral. However, in practice, a tax like the GST is likely to result in significant revenue gain, in which case the tax revenue increase we envisaged in our assessment would be even easier to achieve.**

Non-Tax Revenues

6.24 The major components of the non-tax revenues of the Union Government are interest receipts, dividends and profit, receipts from the petroleum and telecom sectors and other fees and fines collected under General, Social and Economic Services. We have applied different norms for the different components of non-tax revenues.

6.25 The share of interest earnings in non-tax revenues declined from 52.4 per cent in 2001-02 to 9.3 per cent in 2014-15 (BE), primarily on account of a sharp decline in the share of interest earned on loans and advances to the States from 41.7 per cent to 4.0 per cent during this period. This decline was the outcome of two recommendations of the FC-XII - to discontinue the practice of the Union Government lending to States and to reschedule Union Government loans to States at lower interest rates for a longer maturity period.¹⁰ Interest earning in absolute terms declined from Rs. 35,538 crore in 2001-02 to Rs. 19,751 in 2014-15 (BE). Other sources of interest earnings are public sector undertakings and railways, which in 2014-15 (BE) together contributed 5.3 per cent of the non-tax revenues.

6.26 For the assessment of interest earnings, we have considered interest receipts against outstanding loans of the Union Government. We believe that as a norm, interest earning should

⁹ The tax-GDP ratios for 2015-16 and 2016-17 assumed in the MTFP are 10.83 and 11.09 per cent, respectively.

¹⁰ Outstanding loans and advance to the States as on 1 April 2005 were rescheduled at an interest rate of 7.5 per cent and for a maturity period of twenty years as a part of the debt consolidation and relief facility recommended by the FC-XII.

cover the cost of borrowing, even if the actual recovery is lower than the cost. For 2012-13, outstanding loans and advances by the Union stood at Rs. 2,30,434.99 crore and the average effective interest earning against this for 2013-14 worked out to 9.12 per cent, which was well above the current cost of borrowing. However, we do not have adequate information on the loans and advances to be disbursed by the Union Government during the next five years. The trend growth rate of interest earning for the period from 2001-02 to 2012-13 was (-) 0.6 per cent per annum. This negative growth was due to the decline in interest earning on loans and advances from the Union to the States arising from the loan disintermediation by the former to the latter. In respect of interest earnings, we have applied the same rate of growth as observed between 2001-02 and 2012-13 for the purpose of projection. In our projection, the interest earnings of the Union are expected to fall from Rs. 18,519 crore in 2015-16 to Rs. 14,315 crore in 2019-20.

6.27 Dividends and profits are other important components of non-tax revenue, and they increased from Rs.17,290 crore in 2001-02 to Rs.90,229 crore in 2014-15 (BE). Their share in non-tax revenue increased from 25.5 per cent to 42.5 per cent over the same period, primarily because of an increase in the RBI's contribution via dividends and surpluses, the share of which increased from 13.8 per cent to 21.7 per cent. Given this increase in the share of RBI's contribution, we have projected this revenue stream separately and applied a growth rate of 14.5 per cent per annum on this component during our assessment period. We have also used data from the RBI Annual Report 2013-14 on surpluses transferred to the Union Government in 2014-15, which were higher than what was assumed in the 2014-15(BE). Similarly the residual revenue from dividends and profits (after excluding the RBI's share) has been projected at its trend growth rate of 10.9 per cent observed from 2001-02 to 2012-13. If the Government policies on public enterprises are conducive to their efficient functioning, along with an ample capital base and turnover, receipts on account of dividends should exceed our estimate. In Chapter 16, we have recommended a rational dividend policy, keeping in view fiscal considerations. This would provide additional resources to the Union Government. In such an event, we would have underestimated receipts which, by their nature, accrue exclusively to the Union.

6.28 Earnings from various economic services have become a major contributor to non-tax revenues, with their share increasing from 13.69 per cent in 2001-02 to 37.43 per cent in 2014-15 (BE). This growth has mainly been driven by the contributions of the petroleum and telecom sectors. Under Economic Services, non-tax revenue from petroleum includes royalties, profit petroleum, and production exploration and license (PEL) fees. Past data shows that non-tax revenues from the petroleum sector (excluding dividends) grew at an impressive rate of 16.75 per cent from 2001-02 to 2012-13. However, its growth from 2008-09 to 2014-15 (BE) was only 9.89 per cent, while its growth rate between 2008-09 and 2012-13 was 13.89 per cent. We recognise the deceleration in the growth of revenues from this sector between 2013-14 and 2014-15 (BE), which has also been noted in the memorandum submitted by the Ministry of Petroleum and Natural Gas to the Commission. The revenue forecast submitted by the Ministry indicates that revenues from royalties, profit petroleum and PEL fees are expected to decline from Rs. 20,244 crore in 2015-16 to Rs. 10,869 crore, with a negative trend growth rate of (-)15.86 per cent. This estimate was based on the assumption that the gas price will continue at the current rate of \$4.2/ mmbtu, without factoring any future monetisation of discoveries from 2016-17. While we recognise the risks of depleted production from existing gas fields owing to their increased vintage, and the uncertainty of monetising economically extractable discoveries,

we believe that the estimates of the Ministry are unduly conservative.¹¹ Considering all the above factors, our assessment assumes that non-tax revenues from the petroleum sector would grow at the rate of 13.5 per cent per annum in our forecast period.

6.29 Telecommunication receipts are also an important source of non-tax revenue, and we have made a separate projection for them. We have considered the revenue forecast submitted by the Department of Telecommunication (DoT) to the Commission, which projects telecom revenue to grow from Rs. 26,896 crore in 2015-16 to Rs. 39,540 crore in 2019-20. However, the DoT's assessment of revenues indicates significant volatility in the growth of telecom revenue. Its growth rate is expected to more than double from 16 per cent in 2015-16 to 33.17 per cent in 2016-17, before stabilising in the range of 2 per cent to 4.5 per cent in the period from 2017-18 to 2019-20. While this forecast assumes growth in the license fee at 8 per cent per annum and in spectrum user charge at the rate of 4.7 per cent per annum, the volatility could be explained by the assumption of one-time spectrum charges for the relevant years, along with the instalment amounts in the case of deferred payments of the auction-bid amounts. According to the DoT, average growth for the entire assessment period works out to be 5.35 per cent, which is in sharp contrast with the past trend growth rate in this sector of 16.1 per cent for the period 2001-02 to 2012-13. We have assumed a revenue growth of 13.5 per cent per annum in the telecom sector. After assessing interest receipts, dividends and profits, petroleum receipts and telecom receipts, we have assessed the residual component of the Union Government's non-tax revenues on the basis of its trend growth rate of 17.75 per cent per annum.

6.30 Based on these norms, the aggregate non-tax revenue of the Union Government as a percentage of GDP is expected to remain at around 1.53 per cent during our assessment period. Gross revenue receipts of the Union Government, aggregating tax and non-tax revenue, are expected to increase from 12.25 per cent to 12.92 per cent of GDP between 2015-16 and 2019-20, which translates into a less than one percentage point increase. Net revenue (net of tax devolution) receipts of the Union Government are projected to increase from 8.25 per cent of GDP in 2015-16 to 8.62 per cent in 2019-20.

Revenue Expenditure

6.31 The basic fiscal data for 2001-02 to 2014-15 (BE) for revenue and capital expenditure was taken from the Union Budget documents, mapped with the Finance Accounts data and reconciled by carrying out the adjustments required to arrive at the fiscal and revenue deficits.

6.32 The major components of the Union Government's revenue expenditure are interest payments, defence revenue expenditure, pensions, and subsidies and grants to States. According to the 2014-15 (BE) figures, these components together constitute more than 80 per cent of revenue expenditure. Within this, the share of grants to the States works out to more than 23 per cent, and the share of subsidies (excluding food) accounts for 9.3 per cent. The objective of our assessment is to apply norms for Union Government expenditure in such a way that there is appropriate fiscal head-room for meeting committed liabilities like interest payments, pensions, and defence and other expenditure functions specified in the Union

¹¹However, we have not taken into account the recent revision in gas prices by the Government of India in our assessment.

List. When making our expenditure assessments, we have also taken note of the submissions of various Union Ministries to the Commission. We have specified a compression in expenditure on certain items where such a reduction is considered desirable, such as subsidies.

Interest Payments

6.33 Interest payment is a major component of revenue expenditure, with its share estimated at 27.23 per cent in 2014-15 (BE). It is a charged expenditure and we have made full provision for it in our assessment of Union finances. We have taken the 2014-15 (BE) figure as the base-year estimates of interest payment. For the assessment, we have taken the base-year outstanding debt and added the fiscal deficit projected for each year to the debt stock.¹² We have applied the base-year average effective interest rate on the estimated debt stock to arrive at the path of interest payments for our period of assessment. The average effective interest rate on the outstanding debt of the Union for the base year works out at 8.07 per cent. We have adopted this for our projections. The base-year average effective rate of interest has been estimated by taking the outstanding interest payment during the year as a percentage of the outstanding stock of debt at the beginning of the year. The average effective rate of interest for 2012-13 and 2013-14 was 7.54 per cent and 8.07 per cent, respectively. It may be noted that there has been a progressive increase in the weighted average rate of interest on government securities from 7.69 per cent in 2008-09 to 8.36 per cent in 2012-13. Thus, we have decided to take the 2013-14 average effective interest rate of 8.07 per cent for our projection of interest payments. However, if the stated policies of the RBI and Union Government are adopted, both inflation and interest rates should decline, thus reducing expenditure on fresh borrowing. To that extent, there is an overestimation of interest payments in our assessment.

Pensions

6.34 Pensions are another committed liability which has been fully provided for in our assessment. The assessment of pensions is based on the growth rate of pension expenditure obtained from past data. The year-on-year growth of pension expenditure has shown volatility, with growth declining to a low of 0.42 per cent in 2002-03 and increasing to a high of 70.46 per cent in 2009-10. Given these fluctuations, it is not appropriate for us to take a long-run trend growth rate for this expenditure as a norm for assessment. It would be more appropriate to use the observed growth in the recent past. However, a potential fiscal liability may arise in the future with the introduction of the 'one rank one pension scheme' for Defence Services. The Budget 2014-15 has also made an additional allocation for this scheme, which is reflected in the increase in the growth of pension expenditure to 10.67 per cent over the 2013-14 (revised estimates) growth of 6.62 per cent. While the Ministry of Finance projects an increase in pension payments by 8.7 per cent in 2015-16, a 30 per cent increase is expected in 2016-17 on account of the impact of the Seventh Pay Commission, followed by an annual growth rate of 8 per cent in subsequent years. Pension expenditures between 2011-12 and 2014-15 have grown on a year-on-year basis at the rate of 9.35 per cent per annum. We are of the view that annual revisions in the Dearness

¹²We are assuming that the change in debt stock in a given year corresponds to the fiscal deficit of that year during our period of assessment. As was the practice in the past, no provision has been made for the impact of the exchange rate on interest liabilities since these are captured in the trend also.

Allowance and annual accretions in the number of pensioners and the corresponding pension obligations can be covered by this growth in pension expenditure during our assessment period.

Defence Revenue Expenditure

6.35 Revenue expenditure on defence has grown at an annual rate of 11.21 per cent between 2001-02 and 2012-13 and at the rate of 10.1 per cent between 2008-09 and 2012-13. In its submission to the Commission, the Ministry of Defence argued that there has been a decline in the defence expenditure-GDP ratio over the years and defence expenditure allocation in the Union budget needs to be increased to expand the acquisition of arms and improve defence preparedness. The Ministry pointed out that it has not been able to make necessary procurements because of the constraint of funds and large amounts of committed expenditure. The Ministry also mentioned that a substantial part of the defence capital budget went into meeting committed expenditures. The Ministry of Finance has also highlighted the need to increase defence outlays in order to modernise and maintain defence assets and to finance defence acquisitions. Accordingly, its projections have provided for an increase in defence revenue expenditure (including salaries) of 30 per cent in 2016-17 which will incorporate the Pay Commission impact, with a stable growth rate of 20 per cent per annum in the remaining years.

6.36 We have given due consideration to the suggestions made by the Ministries of Defence and Finance. In our view, defence expenditure is important and hence resource allocation would have to be done carefully by analysing the competing demands on resources from all sectors, within the overall resource envelope available to the Union Government. Much of the demand on resources from the Ministry of Defence has been in the nature of capital expenditure, which is beyond the scope of our assessment. Recognising that revenue expenditure is critical for defence preparedness and maintenance, we have kept the defence revenue expenditure-GDP ratio constant during our projection period, instead of allowing growth to decelerate as was the case in the past. In other words, the rate of defence revenue expenditure has been allowed to increase at the same rate as the GDP, which is substantially higher than the past growth of defence revenue expenditure.

Police

6.37 Our ToR requires us to consider demands on the Union Government relating to its expenditure on internal and border security. The trend growth rate of police expenditure under General Services for the period 2001-02 to 2012-13 has been 16.86 per cent. However, the year-on-year growth rate shows that police expenditure grew at the rate of 42.77 per cent and 31.22 per cent during 2008-09 and 2009-10, respectively, and that the growth rate was as low as 2.9 per cent in 2007-08. We have applied a 13.5 per cent growth rate to project police expenditure during our assessment period, implying that expenditure as a percentage of GDP remains constant.

Subsidies

6.38 Subsidies have become an important component of Union Government expenditure, with the bulk of the subsidy bill accounted for by food, fertilisers and petroleum. Among these components, the fastest-growing subsidy is for petroleum, which increased from Rs.65,000 crore in 2013-14 (BE) to Rs. 85,485 crore in 2013-14 (RE). Total expenditure on all subsidies is budgeted at 2 per cent of GDP in 2014-15 (BE). The MTFP statement pegged the subsidy bill at

1.7 per cent of GDP for 2015-16 and 1.6 per cent of GDP for 2016-17. The MTFP also suggested that the Government should, in order to achieve fiscal targets, progressively reduce the subsidy expenditure through an improved targeting of beneficiaries. The memorandum submitted by the Ministry of Finance has projected a trend growth rate of 6.1 per cent per annum for the total subsidy bill of the Union in the period 2015-20. This is notwithstanding the Ministry's expectation of a rationalisation of subsidy expenditure following the recommendations of the recently constituted Expenditure Management Commission on improved targeting as well as a reduction in commodity prices. The Ministry has pointed out that while the direct benefit transfer scheme could undoubtedly reduce subsidy expenditure, the subsidy bill has still been projected to remain at the current level, in anticipation of a delay in resolving problems relating to the rollout of the scheme. The Ministry's memorandum has projected subsidy expenditure on fertilisers to increase, given its linkage to farmers' incomes and food security and said that any rationalisation would be contingent on reforms. Similarly, the Ministry expects expenditure on food subsidy to increase with implementation of the National Food Security Act, and as a result of issues related to the fixation of minimum support prices (MSPs), economic costs of procuring and distributing foodgrains and the issue price of grains, and the volatility of agricultural prices.

6.39 There is general acknowledgement of the fact that volatility in petroleum subsidies as a result of changes in international crude prices, coupled with delays in domestic price corrections, pose significant challenges for fiscal consolidation, especially for controlling the Union's total subsidy bill. However, the Union Government de-controlled diesel prices in October 2014 and that is expected to have a significant impact on reduction of subsidy bill.

6.40 In the case of the fertiliser subsidy, the need to introduce pricing reform for urea has often been highlighted. This would be critical for a reduction in the subsidy bill and the balanced use of the NP&K (nitrogen, phosphorous and potassium) nutrients. As mentioned in the MTFP 2014-15, the New Investment Policy announced in January 2012 should encourage investment in the urea sector, leading to an increase in indigenous capacity and a reduction in our import dependence.

6.41 On the food subsidy front, the implementation of the National Food Security Act, under which two-thirds of the population is entitled to food subsidy, would have a bearing on the quantum of subsidy for this sector. As of November 2014, eleven states have adopted the Act, and other States are likely to follow. The MTFP hopes that restructuring the Food Corporation of India (FCI), the use of technology to increase the efficiency of the public distribution system (PDS) and better targeting of beneficiaries may help streamline the food subsidy.

6.42 In its memorandum to the Commission, the Ministry of Finance had delineated a gradual path for the rationalisation of subsidy expenditure from the present level of 2 per cent of GDP in 2014-15 (BE) to 1.5 per cent of GDP in 2019-20. We noticed that the Union Government, in its MTFP, had indicated a path for subsidy reduction up to 2016-17. We have accepted the MTFP target of 1.6 per cent of GDP for subsidy reduction as the norm up to 2016-17 and, relying on this trend, we believe it is possible to have greater rationalisation of subsidy expenditure. Accordingly, in our projection, we have followed the consolidation path for subsidies as prescribed in the MTFP till 2016-17 and provided for subsidies at the rate of 1.4 per cent, 1.2 per cent and 1.0 per cent of GDP in 2017-18, 2018-19 and 2019-20, respectively, on the assumption that the trend of reduction will continue till 2019-20.

Other Expenditure

6.43 For the remaining items of expenditure, under General Social and Economic Services, we have disaggregated functions that are exclusively in the Union List and projected a specific growth path. The residual components have been allowed to grow at their past trend of 2001-02 to 2012-13 growth rates.

Grants to States

6.44 We have taken into account the transfer of grants-in-aid to States in our assessment period (as discussed in detail in the Chapter on Grants-in-aid). Grants-in-aid has been provided for those States whose assessed revenue expenditure needs exceed the sum of own-revenue capacity and tax devolution. In addition, we have taken into account grants to States for financing disaster management funds and supplementing resources to local bodies. Appropriate fiscal space has been provided to the Union Government to effect other transfers as determined through the mechanism and framework of cooperative federalism described in Chapter 12.

6.45 The Commission is convinced that some of the schemes funded by transfers from Union relate to subjects that can be best handled entirely by the States and, hence, should be in the fiscal space of the States. There are also schemes that are normally in the State domain, but for reasons of externality and equalisation and the special needs of some States, need to be kept in the Union fiscal space. There is an overlap of responsibilities in these sectors.

6.46 Broad sectors that fall under the category of overlapping responsibilities include education, health, water supply and sanitation, child nutrition, where principles and objectives of externality, redistribution and equalisation are critical. Adequate fiscal space for these functions has been provided to the Union Government in the assessment.¹³ Based on the restructuring of transfers, tax devolution is expected to increase from 2.97 per cent of GDP in 2014-15(BE) to 4.27 per cent in 2019-20, while grants to States are expected to decline from 2.82 per cent to 2.22 per cent during the same period.

GST Compensation

6.47 The design and structure of the GST is still evolving. While the introduction of the GST would have a favourable impact on both the Union and State finances, there may be a case for revenue compensation to States by the Union Government for the transitional years. The Commission's mandate is to recommend the mechanism to be adopted for such compensation. Since the structure of the GST is yet to be decided, it is difficult to arrive at reliable estimates of the nature of gains and losses it could entail. Specifically, in the absence of clarity on the taxes to be merged into GST, rate structure, exemption thresholds and design, we are unable to set aside the amount required for GST compensation to States. However, in case there is a revenue loss to States due to the introduction of the GST, the Union Government should be able to make resources available for compensation. In our view, the volume of compensation would not impose an excessive burden on Union finances. We also believe that a moderate increase in the tax-GDP ratio, conservative estimates of non-tax revenue and non-debt capital receipts (including

¹³The institutional mechanism for consultation between the Union and States in the design and implementation of schemes covering these sectors are discussed in the Chapters 11 and 12.

privatisation) in our assessment of Union finances leave sufficient fiscal space to accommodate additional spending on the compensation.

Overview of Revenue Expenditure : 2015-16 to 2019-20

6.48 The revenue expenditure-GDP ratio of the Union Government was 12.4 per cent for the period from 2001-02 to 2007-08. This ratio increased to 13 per cent between 2007-08 and 2012-13. The Budget indicates this ratio was 12.2 per cent in 2014-15 (BE), while the MTFP estimates it at 12.3 per cent in 2015-16 and 11.8 per cent in 2016-17. Our revenue expenditure estimates for the 2015-16 to 2019-20 period is projected to decline from 10.8 per cent to 9.6 per cent of GDP (see Annex 6.1 and 6.2) primarily due to the reduction in the subsidy expenditure from 1.70 per cent in 2015-16 to 1 per cent in 2019-20.

Overview of Aggregate Fiscal Transfers to States: 2015-16 to 2019-20

6.49 The Commission, in making its assessment, has also analysed the aggregate fiscal transfers to States through Central schemes, discretionary transfers, tax devolution and Finance Commission grants. In the period 2010-11 to 2012-13, these transfers averaged around 50 per cent of the gross revenue receipts of the Union (excluding loans to the States but including direct transfers to States through implementing agencies). **In our assessment, the share of grants and tax devolution to States in the gross revenue receipts has been projected to increase from 47.5 per cent in 2014-15 (base year) to 49.4 per cent in 2019-20 (see Annex 6.4). Thus, the equivalent share as a percentage of divisible pool is set to increase from 61.9 per cent to 63.9 per cent (See Annex 6.3) during this period.**

Capital Receipts and Expenditure: 2015-16 to 2019-20

6.50 In accordance with the ToR, we considered the issue of generating a surplus for capital investment. Non-debt capital receipts have two components - recovery of loans and advances and proceeds from public sector disinvestment. The assessment of Union finances submitted by the Ministry of Finance shows a decline in capital receipts, excluding borrowings, from Rs. 73,952 crore in 2014-15 (BE) to Rs. 20,000 crore in 2019-20 and, as a percentage of GDP, from 0.6 per cent to 0.1 per cent during this period. We believe this is unduly conservative. In our assessment, we have allowed the recovery of loans and advances to grow on the basis of past trend growth rates observed from 2001-02 to 2012-13. Disinvestment proceeds have been projected to grow at the rate of 25 per cent during our projection period.

6.51 We have incorporated the requirement of the FRBM Act in terms of the fiscal deficit correction as a percentage of GDP. Our assessment shows that the fiscal deficit-GDP ratio will reach 3 per cent by 2016-17, in line with the fiscal consolidation roadmap as indicated in the MTFP of 2014-15. We have recommended a realistic path of revenue deficit correction by 2019-20. According to our projection, the revenue deficit-GDP ratio would decline from 3.05 per cent in 2014-15 to 0.93 per cent in 2019-20, which indicates a correction in the revenue account to the order of 2.12 percentage points of GDP. The capital expenditure-GDP ratio in our assessment period would increase from 1.8 per cent in 2014-15 to 2.9 per cent in 2019-20.

Chapter 7

State Finances: Assessment of Revenue and Expenditure

7.1 According to the terms of reference (ToR) 6(iii), the Commission needs to assess "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 from 1 April 2015, on the basis of the levels of taxation and non-tax revenues likely to be reached during 2014-15". ToR 6(iv) requires the Commission to consider "the objective of not only balancing receipts and expenditure on revenue account of all the States but also generating surpluses for capital investment". ToR 6(v) mandates the Commission to examine "the taxation efforts of . . . each State Government and the potential for additional resource mobilisation to improve the . . . tax-gross state domestic product ratio". Thus, in making our recommendations on tax devolution and grants-in-aid to the States, in line with our primary mandate, we are required to assess revenues and expenditures of each of the States for the period 2015-16 to 2019-20. Our assessment of revenue receipts and revenue expenditure has been guided by these terms of reference.

7.2 With the formation of the two separate States of Andhra Pradesh and Telangana as per the Andhra Pradesh State Reorganisation Act, 2014, the ToR has been expanded to take into account the reorganisation of the State of Andhra Pradesh in accordance with this Act and the Ministry of Home Affairs notification number S.O. dated 655 (E) dated 4 March 2014, and make recommendations for the successor States on matters under reference to the Commission. This assessment has been undertaken notwithstanding several constraints, including the non-availability of past data pertaining to the reorganised States.

7.3 The previous Finance Commissions had generally followed a two-step approach in formulating their projections: (i) re-assessment of the base year data on revenues and expenditures for individual States to ensure comparability and (ii) application of norms for receipts and expenditures for the award period. **The basic approach to assessment remained similar, to a large extent, across Commissions, but there were differences in projecting individual items of receipts and expenditure.**

Views of the States

7.4 A majority of the States have mentioned that in the past there had been under-estimation of the non-Plan revenue expenditures and over-estimation of the own revenue receipts of the States as compared to States' own projections. A majority of the States mentioned that the normative approach for assessing revenues and expenditures adopted in the past did not generally reflect the true fiscal positions of the States. In their view, this approach assumed high trend growth rates for own revenue receipts and low growth rates for revenue expenditures and consequently led to an under-estimation of deficit in the non-Plan revenue account.

7.5 Many States have also suggested that the implications of the economic slowdown in recent years on the revenue position of States be taken cognizance of while assessing their own revenue receipts. Some States, particularly those with a low revenue base, have pointed out that expenditure on the maintenance of assets (building, roads, irrigation works) worked out on the basis of budget estimates would be inadequate, since they were compelled to make budget provisions much below the required level due to paucity of resources. According to these States, any projection based on such low level of expenditure will not be adequate. Some States have argued that the assumption of a meagre 5 per cent annual rate of growth in many items of expenditure, made by previous Finance Commissions, artificially depressed their resource requirements for the provision of various services. Some States have proposed that the growth rates for projection of maintenance expenditure of major, medium and minor irrigation projects should be indexed to inflation, based on the consumer price index (CPI), instead of assuming an annual growth rate of 5 per cent over the base year estimates. In the case of roads, many States have suggested that the norm recommended by the Ministry of Road Transport and Highways for maintenance expenditure projections may be adopted and, in addition, indexed for inflation based on CPI.

7.6 Some States have also pointed out the huge backlog in filling up sanctioned posts due to the fiscal restraint exercised in adhering to fiscal consolidation targets set in the state-level Fiscal Responsibility and Budget Management (FRBM) Acts. Maintaining that they need to undertake fresh recruitment in the future, they suggested that expenditure assessment should take into account the consequent increase in salary expenditure. Most of the States have urged that the implications of the Seventh Central Pay Commission's recommendations on the fiscal position of States should be factored into the assessment of expenditure. Some States have also highlighted that in the past the salary projection norm of 35 per cent of the revenue expenditure (net of interest payment and pension) resulted in under-assessment of expenditure needs since, in reality, the share of salary expenditure was more than 60 per cent in many States. Some States have suggested accepting their salary expenditure projections based on inflation-linked releases of dearness allowance (DA), proposed new recruitments and anticipated pay revision rather than adopting any normative criteria.

7.7 Most of the North-eastern States have stated that the scope for increasing tax revenue is very limited due to low levels of commercial activity and low levels of consumption. A few of them have proposed that different growth rates should be applied for them while projecting their tax revenues. They suggested that the growth rate applied to make revenue projections in their case should be lower than that of the general category States. These as well as other hill States have also pointed out that the severe disadvantages they faced due to cost disabilities need to be kept in view while undertaking assessment.

7.8 According to many States, the projection of deficit in the non-Plan revenue account estimated by States should be taken into account while determining the non-Plan revenue deficit grants. The States have urged that the borrowing limits should be related to the gross state domestic product (GSDP) of the State and not as assumed by the Finance Commission while assessing their compliance with the targets.

An Overview of States' Forecasts

7.9 We have received forecasts of revenue and expenditure for the period from 2015-16 to 2019-20 from all the States. We have carefully examined these estimates. The consolidated picture of State forecast is given in Table 7.1 (For State-wise details see Annex 7.1). As per States' projections, the pre-devolution non-Plan revenue deficit is expected to increase from Rs. 3,91,999 crore in 2015-16 to Rs. 7,07,296 crore in 2019-20. As a per cent of GDP, the non-Plan revenue deficit is expected to increase from 2.7 per cent to 2.9 per cent during the same period. Taking into account the projected Plan-revenue expenditure at around 3.4 per cent of GDP during this period, the pre-devolution revenue deficit is projected to increase from 5.9 per cent to 6.3 per cent.

7.10 According to States' projections, own revenue receipts would remain around 7.4 per cent of GDP between 2015-16 and 2019-20 and own tax revenue around 6.4 per cent of GDP. The non-tax revenue to GDP ratio has been projected to decline from 1 per cent to 0.8 per cent. Total revenue expenditure has been projected to increase from 13.3 per cent of GDP to 13.7 per cent, with a corresponding increase in non-Plan revenue expenditure from 9.9 per cent of GDP to 10.2 per cent and a marginal increase in Plan revenue expenditure from 3.4 per cent to 3.5 per cent. Capital expenditure has been projected to remain stagnant at around 2.7 per cent of GDP during this period. Own revenue deficit has been projected to increase from 5.9 to 6.3 per cent of GDP while the non-Plan revenue deficit has been projected to increase from 2.7 per cent to 2.9 per cent.

7.11 **These forecasts by the States provided us useful insights on the States' perception about the likely fiscal situation during the award period and their revenue and expenditure needs. However, we are fully conscious of the fact that the forecasts by States are not strictly comparable, due to the differences in methodology adopted by individual States as well as in their assumptions about key fiscal and state-level macro-aggregates like growth and inflation rates.**

Table 7.1: Summary of Projections Submitted by States: 2015-16 to 2019-20

(Rs. crore)

Item	2015-16	2016-17	2017-18	2018-19	2019-20
Own Revenue Receipts	1079164	1220502	1379810	1573578	1788295
Own Tax Revenue	930832	1062121	1212484	1384966	1583052
Own Non Tax Revenue	148332	158381	167325	188612	205243
Total Revenue Expenditure	1947039	2236309	2562388	2912848	3321708
Non Plan Revenue Expenditure	1451492	1669250	1920863	2179224	2476847
Plan Revenue Expenditure	495547	567060	641525	733624	844861
Interest Payment	216215	243470	275336	310362	348541
Pension Payment	207255	243973	280016	319505	364844
Capital Outlay	397316	446216	496420	569342	658305
Own Revenue Deficit	867875	1015808	1182578	1339270	1533413
Pre-Dev. NPRD	391999	458296	553146	621235	707296

States' projections as a percentage of GDP: 2015-20

Item	2015-16	2016-17	2017-18	2018-19	2019-20
Own Revenue Receipts	7.4	7.4	7.3	7.4	7.4
Own Tax Revenue	6.4	6.4	6.4	6.5	6.5
Own Non Tax Revenue	1.0	1.0	0.9	0.9	0.8
Total Revenue Expenditure	13.3	13.5	13.6	13.6	13.7
Non Plan Revenue Expenditure	9.9	10.1	10.2	10.2	10.2
Plan Revenue Expenditure	3.4	3.4	3.4	3.4	3.5
Interest Payment	1.5	1.5	1.5	1.5	1.4
Pension Payment	1.4	1.5	1.5	1.5	1.5
Capital Outlay	2.7	2.7	2.6	2.7	2.7
Own Revenue Deficit	5.9	6.1	6.3	6.3	6.3
Pre-Dev. NPRD	2.7	2.8	2.9	2.9	2.9

Approach

7.12 **We have taken a comprehensive approach to the assessment of expenditure needs by taking both Plan and non-Plan expenditure in the revenue account. The expenditures and revenues of States have been assessed based on actual and normative expenditure needs, as detailed later. While assessing expenditure needs, we have taken into consideration the differences among the States in fiscal capacity and expenditure need, including cost disabilities.** For our projection of receipts and expenditures, we have taken the fiscal data of States for the period from 2004-05 to 2012-13 from the Finance Accounts. We have also examined the revised estimates of 2013-14 and budget estimates of 2014-15 obtained from the budget documents of the States. Accepting the 2014-15 budget estimates of receipts and expenditure obtained from the States as base year estimates would have been the simplest option. But there are several challenges in accepting the budget estimates provided by the States. The first and foremost is that estimates across States are not strictly comparable; also we have observed substantial variations between budget estimates and actuals in both revenue receipts and expenditures in earlier years. **Like previous Finance Commissions, our assessment of revenue and expenditure is also based on a two-step approach.**

7.13 **The assessment required developing a comparable data set from the Finance Accounts of the States. We have developed comparable State fiscal data for the period from 2004-05 to 2014-15 (BE) by making the following adjustments:**

a. Lotteries: We have taken net receipts from lotteries (that is, expenditure on lotteries Major Head (MH) 2075 has been deducted from receipts under MH 0075). If net receipts from lotteries after adjustment were negative, we have assumed that as zero.

b. Interest receipts/payments: Interest receipts are adjusted for contra entries, for example, in the case of agriculture, irrigation or any other interest waiver obtained from the State.

c. Elections: We have removed the expenditure on elections and receipts for the purpose of calculation. However, we have taken into account all the election expenditure on a state by state basis, keeping in view the past trends and the likely elections due in each State. In this regard, an inflation adjustment of 6.5 per cent has been incorporated in the assessment.

d. Milk schemes: Expenditure and receipts on Dairy (MH 0404/2404) has been retained as reported in the Finance Accounts as it constituted a very small amount.

e. Power sector: For adjustment of power sector receipts and expenditure, we have carried out the following adjustments: (i) for all the States we have removed Revenue Receipts on Power (MH 0801) and from the Revenue Expenditure side, deducted Grants and Subsidies on Power (from MH 2801); (ii) for States where the power sector is being run departmentally, if the Net Receipts on Power (MH 0801-MH 2801) is negative, the same has been taken as zero to make the data set of all States comparable. However, if the net receipt is positive, we have factored that into the assessment of receipts.

f. Transport undertakings: For the transport sector we have carried out adjustments similar to that of the power sector. For States where the transport sector is being run departmentally, again adjustments similar to that for the power sector have been carried out.

g. VAT/CST Compensation: The value-added tax (VAT) and Central sales tax (CST) compensation received by States have been added to the receipts from sales tax, but deducted from other non-Plan grants.

h. Calamity relief: Expenditure on Calamity Relief (2245) has been excluded. However, considering that the States have to provide matching share in the State Disaster Response Fund, this portion has been added as State Government expenditure under the major head 2245.

i. Sinking Fund: Except for contribution to the Consolidated Sinking Fund and Guarantee Redemption Fund, all other Reserve funds related expenditures have been netted out.

j. Debt waiver: All receipts on account of debt write off and waivers have been removed from MH 0075.

k. Receipts under non-Plan grants: Non-Plan non-Finance Commission grants received by the State Governments have been retained.

7.14. **These adjustments gave us a data set comparable across States for the purpose of assessment of revenue receipts. However, these adjustments do not take care of the differences in expenditure arising from differences in their fiscal capacity. This has been partly addressed by phasing in additional expenditures such that States with low fiscal capacity are enabled to achieve 80 per cent of the all-States' average per capita expenditures (excluding interest payment and pension) by the terminal year of the award period, as detailed in the section on equalisation.**

Assessment of GSDP

7.15 In order to make GSDP projections for the period 2015-20, we have obtained comparable current price GSDP data at factor cost for the period 1999-00 to 2012-13 from the Central Statistics Office (CSO), Government of India.¹ In order to arrive at the base year (2014-15) GSDP for all States, we have estimated the trend growth rate of comparable aggregate GSDP for the period from 2004-05 to 2012-13 and adjusted the growth rates of individual States taking the overall GDP growth rate as the control parameter. These have been projected for the period from 2015-16 to 2019-20 (See Annex 7.2).

7.16 In the case of Andhra Pradesh and Telangana, the CSO was unable to provide comparable GSDP data for these two newly-formed States. However, we have received non-comparable GSDP of the two successor States of Andhra Pradesh and Telangana for the period from 2004-05 to 2012-13 from CSO. We have also obtained comparable GSDP data for undivided Andhra Pradesh for the period from 2004-05 to 2012-13. To obtain comparable GSDP data for Andhra Pradesh and Telangana, we have applied the share of these two States in non-comparable GSDP to the comparable GSDP series of undivided Andhra Pradesh.

Assessment of Own Tax Revenues

7.17 ToR 6(v) requires the Commission to take into account the taxation effort of individual States. The own tax revenue of States consists of VAT, State excise duties, stamp duty and registration fee, motor vehicle tax, goods and passenger tax and other minor taxes. The projection of the own tax revenue of individual States may be undertaken by either of the two methods: (a) by assigning norms for individual taxes or (b) by applying norm for aggregate own tax revenue. The FC-X followed individual tax-specific projections. But the FC-XI, FC-XII and FC-XIII had considered own tax revenue as one group and projected it as a single category. The VAT/ sales tax constitute almost two-thirds of the State revenue for almost all the States. **In view of the observed similarity in the composition of revenue, we have projected aggregate own tax revenue as a single category. This is similar to the methodology adopted by the preceding three Finance Commissions.**

7.18 **In making our projection, we have followed a two-step methodology. The first step involved reassessment of the base year 2014-15.** For this purpose state-specific trend growth rates of own tax revenue for the period from 2004-05 to 2012-13 have been applied to the 2012-13 level of own tax revenue to arrive at own tax revenue estimates for the years 2013-14 and 2014-15. We have compared these estimates with the 2014-15 (BE) of own tax revenues of States and taken the higher of the two estimates as the base year own tax revenues. These estimates of the base year gave us the own tax-GSDP ratio both in aggregate and for individual States. The base year tax-GSDP ratio for all States through this method works out to be 8.26 per cent. A similar approach has been followed for the two bifurcated States of Andhra Pradesh and Telangana. We have arrived at the 2014-15 estimates by taking into consideration the data submitted by the States of Andhra Pradesh and Telangana and the information obtained from the Accountant General's office as detailed in Annex 7.4.

¹ GSDP figures computed by States available as State series of GSDP from CSO are not comparable. Comparable GSDP data was obtained from the CSO for the use of the Finance Commission.

7.19 The second step involves application of normative growth rates for projections. In formulating our norms for assessment, we have kept in view the ToR 6(v) which mandates us to consider the taxation efforts of States and the potential for additional resource mobilisation to improve their tax-GSDP ratios. For States with above average tax-GSDP ratio, that is, 8.26, we have assumed an own tax buoyancy of 1.05 implying a moderate increase in own tax revenue to GSDP ratio during the assessment period. For those States with tax-GSDP ratio below the average of 8.26, we have assumed a higher buoyancy of 1.5. However, once a State reaches the target tax-GSDP ratio or exceeds the tax-GSDP ratio of 8.26 in any particular year of assessment, the lower buoyancy at 1.05 has been assumed for the remaining years and a tax-GSDP ratio of 8.26 for that particular year.

7.20 Our norm resulted in an improvement in the assumed aggregate tax-GSDP ratio from 8.26 per cent of GSDP in the base year (2014-15) to 9.00 per cent in the terminal year of the award (2019-20) (See Annex 7.3). In this regard, we have not assumed any additional revenue from the introduction of GST. However, it is likely that GST reform would result in additional revenues.

Assessment of Own Non-tax Revenues

7.21 Unlike own tax revenue, the non-tax revenue structure differs widely across States. Hence we have projected major items of non-tax revenue separately for each State. The components of non-tax revenue projected are: (a) interest receipt and dividends; (b) royalty; (c) receipts from forestry and wild life; (d) other miscellaneous general services including lotteries; and (e) earning from irrigation projects. The minor components of non-tax revenue were clubbed together as a residual category and a uniform norm was applied for projection.

7.22 Interest earnings of the States come from 'loans and advances' provided by the State Government primarily to state-level public sector enterprises, including State Electricity Boards, Road Transport Corporations and other commercial and non-commercial enterprises. It is important to note that the effective rate of earnings through interest on outstanding loans in these entities has been very low. For the year 2012-13, the average earning of all States was only 1.6 per cent of the outstanding loans and advances given by the State Governments. The earning from dividend too was insignificant. The FC-XII and FC-XIII assumed an effective rate of return of 7 per cent on outstanding loans and advances and 5 per cent on equity during the respective forecast period. We are of the view that for the purpose of assessment, the interest earnings and dividends should at least cover the current cost of borrowing of the States. This principle has been applied for the purpose of projection, keeping the loans and advances and equity level as on 1 April 2012 constant during the assessment period for individual States. Similar norms have been applied for the assessment of non-tax revenue from these two sources for the Union Government as well.

7.23 The revenues from royalty come from coal, petroleum and other minerals. Therefore, the royalty revenue collection is not strictly under the jurisdiction of the State Governments since the royalty rates for major minerals are determined by the Union Government. The States with mineral resources have argued that the Government of India has not been revising royalty rates on a regular basis, resulting in the loss of legitimate revenue to the States. For assessment of revenue from royalty, the view taken by the FC-XII and FC-XIII was that since the States did not have

discretion to determine the royalty rates, one can only allow a growth in royalty revenue equivalent to the rate of inflation. However, for our purpose we have undertaken a detailed analysis of the major royalties in each State. We have also obtained data from the Ministry of Mines on state-wise royalty revenue from major minerals and have compared this with States' forecasts. For major minerals, we have adopted the royalty projection of Ministry of Mines, for the period 2015-16 to 2019-20. The residual amount of royalties has been given an increase of 6.5 per cent every year.²

7.24 Many States have raised concerns over declining revenue from forests due to the implementation of the National Forest Policy. The exploitation of forest resources, including felling of trees, can be carried out only on the basis of a centrally approved, scientific and sustainable regeneration plan. This, they have argued, has deprived the States with large forest cover of an important source of revenue. The States have suggested that these structural limitations in realising the potential forest revenue should be taken into consideration while assessing revenues of the States. Analysis of the forest revenue shows that the receipts from these services are extremely volatile and the restriction on exploitation of forest resources resulted in an across the board reduction in forest revenues for States in nominal terms. Since the broad trend in forestry revenue shows a decline, we have projected this on the basis of the past trend growth rates.

7.25 The FC-XIII had applied the growth rates of 8 per cent, 12 per cent and 13 per cent to estimate non-tax revenue receipts under general services (excluding miscellaneous general services, interest receipts, dividends and profits), social services and economic services (except forest, power, irrigation and royalties) respectively. It had done so based on an all-State trend growth rate of aggregate receipts under these services. A few States stated that these assumptions were overly optimistic, considering that these were basic public services and cost recovery was possible only to a limited extent. This is more so in States where the cost of public service delivery is very high. This is also a very small component of the non-tax revenue of the States. We have projected residual components of receipts under general services on the basis of state-specific trend growth rates. We have projected the receipts from lottery, which appear in the revenue stream of only a few States, by netting lottery expenditures, and if the net receipt is negative, we have considered the receipts to be zero.

7.26 The recovery rate on account of irrigation receipts has been generally very low in most of the States. It has been pointed out that the operation and maintenance (O&M) cost of irrigation system is very high, and it is much beyond the paying capacity of the users. Therefore, a few States have suggested that only nominal receipts should be assumed. In this regard, the FC-XIII had assumed cost recovery to increase from 25 per cent of non-Plan revenue expenditure in 2010-11 to 75 per cent in 2014-15. We have estimated irrigation receipts as a percentage of non-Plan revenue expenditure in irrigation for the base year 2014-15. We have applied a norm for recovery for the purpose of projection at 35 per cent of the non-Plan revenue expenditure under irrigation Major Heads 2701 and 2702.

7.27 The residual component of own non-tax revenues has been projected on the basis of state-specific trend growth rate.

² Our assessment of royalty revenue does not take into consideration the recently announced upward revision of royalty rates, and the coal auction proceeds that will accrue to the States in our award period, as estimates were not received from the Government of India at the time of submission of the report

Assessment of Revenue Expenditure

7.28 **As mentioned in our approach, we have taken a holistic view of revenue expenditure on various services without making a distinction between Plan and non-Plan.** We have projected individual items of expenditure separately, based on normative principles and added them to arrive at the aggregate expenditure requirement. This approach does not require us to estimate committed liabilities of Twelfth Five-Year Plan schemes separately. **For the purpose of our assessment of Plan revenue expenditure we exclude Centrally sponsored scheme (CSS) grants but includes States' contribution towards share of CSS.**

7.29 **We have reassessed the base year expenditure for the purpose of our projections, as was done by previous Finance Commissions.** We have estimated the disaggregated expenditure profile for each State for 2013-14 and 2014-15 by applying the trend growth rates of expenditures observed during 2004-05 to 2012-13. These growth rates were applied on the 2012-13 actual expenditure for individual items in order to arrive at the expenditure estimates of 2013-14 and 2014-15. We have compared these with the 2013-14 (RE) and 2014-15 (BE). For interest payment, pension and irrigation expenditure under non-Plan, we have adopted state-specific estimates of 2014-15 (BE). For the remaining items of expenditure, the methodology of assessment is detailed in the following paragraphs.

Interest Payment

7.30 **Interest payments are a charged expenditure and hence treated as committed expenditure. Accordingly, we have considered the 2014-15 (BE) data provided by the States as the base year estimate for interest payment. For the purpose of our projections, we have first estimated effective interest rates for each State in 2012-13 by dividing the actual interest payments of States in 2012-13 with their respective outstanding debt stocks in 2011-12. Assuming that the effective rate of interest would remain constant for our award period, we have estimated interest payments by multiplying this rate with the estimated outstanding debt stock at the beginning of each year of the award. To estimate the outstanding debt stock of each State, we have taken the incremental increase in debt stock of a State at 3 per cent of GSDP each year, which is the fiscal deficit target under the fiscal responsibility legislations. We have not factored in the possibility of shortfall in the utilisation of the borrowing limit or States taking advantage of the flexibility in the fiscal consolidation roadmap that we are proposing for the award period.**

Pension

7.31 Pension payments are committed expenditure of any government, along with expenditure on salary and interest. We find that the pension estimates presented in State budgets, by and large, reflect the actual pension obligations due for that year and are comparable to the expenditure of the past few years. Accordingly, we have taken the state-wise 2014-15 (BE) data on pension payments as our base year estimates.

7.32 In developing our projections for pension payments, we analysed the trend in expenditure on this at the all-State level from 2004-05 to 2012-13. We observed that pension payments of the

States witnessed a high trend growth rate of 20 per cent during this period. This high growth rate is largely due to the revision in pay and pension in most States which happened after the implementation of Sixth Central Pay Commission award, increase in DA on account of high inflation and staggered payment of arrears. The all-State pension expenditure growth declined to 13.8 per cent during the period 2012-13 to 2014-15 (BE). For the purpose of projection, we believe that the past pension growth rate needs to be further moderated and, accordingly, we have adopted a normative annual growth rate of 10 per cent for pension payments, which factored in the increase in DA and the rise in the number of pensioners due to the normal retirement process.

Police

7.33 Our base year estimates for expenditure on the police have been calculated by applying a growth rate of 13.5 per cent on the expenditure incurred in 2012-13. For the purpose of our projections, we have applied a normative growth rate of 10 per cent for police expenditure. This should, in our assessment, adequately cover the needs of the States due to the high assessed base of expenditure.

Other Revenue Expenditure

7.34 The all-State combined pension liability and interest payment together constituted 23.2 per cent of the revenue expenditure. The residual revenue expenditure, net of interest payment and pension, includes expenditure on other general services, social services and economic services. We have examined the trends in expenditure in respect of these items and, after considerable deliberations, applied specific norms for projections, which are discussed below.

Other General Service

7.35 Other General Services include expenditure on the organs of State, administration of justice, fiscal services and administrative services, including district administration. We have applied state-specific growth rates in aggregate to project the Other General Services expenditure.

Social Services

7.36 The all-State non-Plan revenue expenditure on education (comprising general education and technical education) and health witnessed trend growth rates of 16.7 per cent and 16.1 per cent respectively during the period 2004-05 to 2012-13. As earlier Finance Commissions also observed, the revenue expenditure on these sectors is largely driven by personnel and, thus, includes a substantial component of salaries. We have applied a growth rate of 13.5 per cent on the actual 2012-13 data on the non-Plan revenue expenditure on general education, technical education and public health, to arrive at the base year estimates. On this, a normative trend growth rate of 10 per cent has been applied to arrive at our projections for the period 2015-20.

7.37 We have also made a separate assessment for revenue expenditure incurred on water supply and sanitation by States. For the purpose of the base year assessment as well as the projections, we have applied the state-specific trend growth rates observed during the period from 2004-05 to 2012-13 on the non-Plan revenue expenditure on water supply and sanitation incurred in 2012-13.

Fourteenth Finance Commission

7.38 The residual social service category includes revenue expenditure on art and culture, family welfare, housing, urban development, information and broadcasting, social security and welfare, labour and labour welfare, nutrition and other social services. The expenditure on residual social services has been projected at a normative growth rate of 10 per cent.

Economic Services

7.39 The revenue expenditure incurred by States on Economic Services consists of expenditure on irrigation, roads and bridges, power, transport and other economic services. We have included maintenance expenditure on roads and bridges and irrigation in our assessment. We have made separate projections for irrigation and the residual economic services after adjusting for power and transport, as discussed in the beginning of this chapter.

7.40 We have assessed irrigation under the two heads of major & medium irrigation and minor irrigation. The aggregate expenditure on irrigation witnessed a trend growth rate of 14.2 per cent during the period 2004-05 to 2012-13. For the purpose of base year estimates, we have assumed irrigation expenditure as indicated in the 2014-15 (BE) of the States. For our projections for 2015-20, we have applied state-specific past trend growth rates on these two heads to our base year expenditure. This approach factors in the maintenance expenditure on irrigation and roads and bridges, including the FC-XIII maintenance grants.

7.41 The residual category includes revenue expenditure on agriculture and allied activities, rural development, industry, transport (after adjustment for road transport), science, technology and environment and other economic services. The residual economic services have been projected on the basis of state-specific trend growth rates observed from 2004-05 to 2012-13.

Compensation and Assignment to Local Bodies

7.42 The expenditure under this major head reflects the transfer in the form of grants-in-aid to local bodies by the States. The state-wise analysis of expenditure under this head did not show a clear trend. We have applied a normative 8 per cent growth rate for the purpose of projection, as was adopted by the FC-XII and FC-XIII.

Plan Revenue Expenditure

7.43 **Plan revenue expenditure of States is financed by States' own resources, borrowing and Plan grants from the Union. The Plan grants include normal Central assistance, which is untied, additional Central assistance for specific-purpose schemes and transfers, special Plan assistance, special Central assistance, Central Plan schemes and CSS.** For the purpose of our assessment of Plan revenue expenditure of States, we have included expenditure incurred on State Plans and States' contribution to CSS. This excludes Union expenditure on CSS, Central Plan schemes and North Eastern Council Plan schemes and externally aided projects financed through grants from the Union. We have estimated the 2014-15 base year Plan revenue expenditure (as defined above) for each State, applying an annual growth rate of 13.5 per cent over 2012-13 and 2013-14. For the purpose of our projection period, we have assumed an annual growth rate of 13.5 per cent over base year estimates for all the States, implying that the Plan revenue expenditure will increase at the same rate as the GDP growth rate.

Assessment of Revenues and Expenditure of Andhra Pradesh and Telangana:

7.44 In accordance with the new ToR 5A of the Commission and the provisions of the Andhra Pradesh State Reorganisation Act, we assessed the resources available to the States of Andhra Pradesh and Telangana to undertake their expenditure responsibilities during our reference period. We reviewed the methodology and approach adopted by the FC-XII to address the requirements of the then newly-formed States of Jharkhand, Chhattisgarh and Uttarakhand. While the mandate of the FC-XII was broadly similar to ours in terms of scope, it had the benefit of data regarding the finances of the new States for two full years (2001-02 and 2002-03) while formulating the assessment of States' finances. However, for making our projections, we only had the estimated data for 2014-15 submitted by the two States in their respective budgets and memorandum. Thus, our first challenge in the absence of finalised accounts was to address the issues involved in the division of past finances between Andhra Pradesh and Telangana before undertaking a detailed assessment.

7.45 We had the treasury-wise/head-wise Finance Accounts for the erstwhile State in addition to the 2014-15 estimates made available by the two States. To make projections for the reorganised States, assumptions had to be made regarding their existing and previous or prior fiscal/financial positions, in the absence of audited finance accounts. We have consolidated this raw data and apportioned them between the two States on the basis of some objective principles. (For details see Annex 7.4).

Equalisation

7.46 **In formulating our assessment, we have not only taken a comprehensive view of the expenditures of the States, but also attempted to address the goal of equalisation. Our approach to equalising expenditures across States is not sector specific, but an aggregate assessment of the per capita expenditure needs of States to enable all States to spend a certain minimum expenditure, to the extent feasible within the overall resource envelope. The methodology used by us for equalisation first involved a baseline assessment of the revenue expenditure (net of interest and pension payments and CSS transfers) of all States based on the norms assumed for individual items of expenditure discussed earlier in this chapter. Subsequently, we estimated the per capita revenue expenditures of States for the period from 2015-16 to 2019-20, using our State-wise projections of population. States were ranked on the basis of per capita expenditure, thus obtained, in the terminal year. In the equalisation exercise we made additional expenditure provision to ensure that in the final year of our projections, every State reached at least 80 per cent of the all-State average projected per capita revenue expenditure (excluding interest payment and pension and CSS transfers).**

Summary of Assessment

7.47 **The summary of assessment shows the result of this detailed exercise of revenue expenditure and pre-devolution revenue deficit of each State for each year. State-specific assessment of assessed deficit and assessed post-devolution deficit is given in Annex 7.5. A summary view of the result for all States combined is presented in Table 7.2. The assessment shows that the own revenue receipt-GDP ratio will be 8.58 per cent between 2015-16 and**

2019-20 as against 7.36 per cent projected by the States. The assessment of expenditure needs, as per our assessment, would be 11.12 per cent of GDP against 13.57 per cent projected by the States. The pre-devolution deficit, as estimated by us, is 2.70 per cent of GDP. This gap has been covered by tax devolution and revenue deficit grants.

Table 7.2: Summary of State Assessments

(Rs. crore/per cent of GDP)

Item	States' Projections	Our Projections	Difference (3-2)
(1)	(2)	(3)	(4)
i. Own Revenue Receipts	7041349 (7.36%)	8209352 (8.58%)	1168003 (1.22%)
ii Revenue Expenditure	12980292 (13.57%)	10632315 (11.12%)	-2347977 (-2.45%)
iii Pre-Devolution Revenue Gap	-5938943 (-6.21%)	-2577919 (-2.70%)	3361024 (3.51%)

Note: As a percentage of projected GSDP (comparable) our projection of own revenue receipts works out to be 10.11%, revenue expenditure 13.09% and pre-devolution revenue gap -3.17%.

Chapter 8

Sharing of Union Tax Revenues

8.1 Article 280 (3) (a) of the Constitution and para 4 (i) of the terms of reference (ToR) mandated us to make recommendations regarding "the distribution between the Union and the States of the net proceeds of taxes, which are to be, or may be, divided between them" as well as the allocation between the States of the respective shares of such proceeds. We have considered six factors in determining the approach to sharing of Union taxes: (i) the Constitutional provisions and intent; (ii) the approaches of the previous Finance Commissions; (iii) the need for continuity, to the extent possible; (iv) the requirement for rebalancing in the sharing of resources needed in the context of overall fiscal relations; (v) the anticipated macroeconomic environment during the award period; and (vi) the views of the Union and State Governments in the macroeconomic context of our award period. **The challenge we faced was to weigh the arguments by the Union and States advanced before us and attempt appropriate rebalancing to meet the evolving circumstances.**

Vertical Devolution

8.2 The main task of the FC-XIV was to make a realistic estimate of the vertical imbalance of resources between the Union and the States. This assessment required careful estimation of the expenditure needs of each level of Government and the revenue resources available with them. We have made assessments of the Union and State finances which are presented in Chapters 6 and 7 respectively. While making assessments of vertical imbalance, we have, like the past Finance Commissions, considered the views of the Union and State Governments and also taken into consideration the emerging macroeconomic and fiscal scenarios having implications for Union-State fiscal relations during our award period.

Views of the Union and States

8.3 The Ministry of Finance, in its memorandum, has argued in favour of retaining the existing level of tax devolution in accordance with the recommendations made by the FC-XIII. The Ministry has contended that the Union Government is faced with the dual challenges of meeting its new fiscal consolidation roadmap as well as increasing allocation of resources for developmental investment in critical sectors for the purpose of reviving growth. In this context, the Ministry has argued that any change in vertical devolution in our reference period would prove to be detrimental for the Union Government's fiscal health.

8.4 The States have made a number of suggestions on vertical devolution, which can be broadly grouped under four categories: (a) increase in the share of tax devolution, (b) expansion of the divisible pool by including non-shareable cess and surcharges and non-tax revenues, (c) ensuring minimum guaranteed tax devolution, and (d) reduced role of Centrally sponsored schemes (CSS).

8.5. A majority of the States have, in their memorandum, demanded that at least 50 per cent of the net tax revenue of the Union Government should be devolved to the States. While one State has demanded that 36 per cent of gross revenue proceeds of the Union Government should be the quantum of vertical devolution, a few States have sought a share of 36 per cent to 40 per cent of the net tax proceeds. Almost all States have argued that cess and surcharges should form part of the divisible pool, with some suggesting that this should be done if cess and surcharges continue for more than three years. A few States have proposed a minimum guaranteed tax devolution to insulate States' finances from the volatility of Union revenues for the purpose of predictability of transfer and stability in the management of State finances. Two special category States have argued that 30 per cent of the divisible pool should be earmarked for such States. One of the North-eastern States has argued that at least 10 per cent of the overall tax devolution should be earmarked for these States. Some of the small States have suggested that in order to protect their interest, a minimum 1 per cent of the tax share within the divisible pool should be earmarked for them. Some States have argued that service tax must remain in the shareable pool and the same criteria that are used for distribution of the divisible pool should be used to distribute the proceeds of service tax. One State has demanded that the annual monetary value of all types of area-specific exemptions granted by the Union Government should be estimated and be notionally added to the divisible pool.

8.6. Another dominant view has been that a majority of the resources should flow in the form of tax devolution rather than grants. A few States have pressed for an increase in the indicative ceiling on overall revenue account transfer to States from 39.5 per cent of gross revenue receipts as proposed by the FC-XIII to 60 per cent. One State has suggested the removal of this indicative ceiling, as it constrains the scope of Union transfer to the States. Given that the non-tax revenues of the Union Government are buoyant, a majority of the States have proposed that proceeds from sources such as spectrum and off-shore royalty and disinvestment proceeds should form part of the divisible pool. The States' demand for significant increase in the share of vertical devolution proceeded on the assumption that they would still continue to obtain significant transfers on the Plan account. However, States were also of the view that these Plan transfers should be non-discretionary and formula-based, with a reduced role for CSS.

8.7. An overwhelming majority of States have suggested reducing the number of CSS as well as outlays on them. Some States have suggested that the Union Government bear the entire cost of new CSS launched in the future. According to them, this would act as an effective check on the introduction of new CSS. The States have pointed out that apart from requiring them to provide matching contributions, conditions are also imposed for them to access Central funds for CSS. This makes it difficult for the States to provide the required level of budgetary support from their own expenditure programmes. The States, the Commission was told, also often get penalised for their inability to make matching contribution and thus cannot access CSS funds. Further, the CSS impinges upon the fiscal autonomy of the States, as they do not have any say in design of these schemes and face many restrictions in their implementation. In this context, many State Governments are of the view that FC-XIV should raise the aggregate share of tax devolution in the divisible pool. A few States have also suggested that there should be only formula-based transfers from the Union to States, and CSS funds should be routed through the State treasury for better monitoring, outcome assessment and accountability. Another view that has been expressed is that the funds transferred by the Union for expenditure on State subjects

through various schemes should be subsumed under vertical devolution. Some States have suggested that the FC-XIV may provide special grants to States with zero revenue surplus for meeting the State share of CSS.

8.8 The States have pointed out that introduction of CSS midway during the year and changes in the sharing pattern of existing CSS imposes an unpredictable fiscal burden on the States and distorts their expenditure priorities. It also creates a mismatch between the budget provisions of the CSS, the quantum approved and the actual amount released by the Union Ministries. States suggested that the introduction of CSS and release of funds should be done in one go at the beginning of a Five-Year Plan and should continue over the five-year period to ensure continuity of CSS. During our discussions, some States proposed that the Union Government could consider levying and collecting a surcharge on income tax to be transferred to those States to augment their resources. This proposal found favour with a few States in the North-east, where private sector economic activity is weak. Some States advocated enhancement of limit of the ceiling on professional tax or its abolition.

Our Approach and Recommendations on Vertical Devolution

8.9 Conceptually, two issues become important in assessing the vertical imbalance. One, a realistic estimation of revenue accruing solely to the Union as well as its expenditure needs and the resources required to meet its obligations under the Constitution. Two, a realistic assessment of the revenue capacities of the States and the expenditures required to meet obligations mandated under the Constitution. As mentioned in Chapter 7, the States have argued that functional overlap has led to an increase in the Union Government's expenditure and a concomitant reduction in the revenues available for vertical devolution. We would have to be conscious of States' submissions that increasing Union Government spending on various State subjects has increased the expenditure at the Union level for functions, which are primarily in States' domain. **In this context, we have examined three factors: (a) the spirit of Constitutional provisions; (b) the concerns about fiscal space expressed by States and Union; and (c) the need for clarity on the respective functional and expenditure responsibilities of Union and States in the interest of sound federal fiscal relations.**

8.10 **A related issue in the assessment of vertical imbalance is the issue of the non-divisible pool of resources, namely cess and surcharges.** The share of cess and surcharges in gross tax revenue of the Union Government has increased from 7.53 per cent in 2000-01 to 13.14 per cent in 2013-14. The States have argued that this denies the States their rightful share in the devolution. However, Constitutionally, it is not possible to include cess and surcharges in the divisible pool, as under Article 270, taxes referred to in Article 268 and 269 - surcharges on taxes and duties and cesses levied for specific purposes - should not form part of the divisible pool. Earlier Finance Commissions had recommended that the Union Government review the current position with respect to the non-divisible pool arising out of cess and surcharges and take measures to reduce their share in the gross tax revenue. However, this has not happened. There are two ways of addressing this legitimate concern of the States - by amending the Constitution to include these items in the divisible pool, or increasing the share of the divisible pool to compensate States on this account. We ruled out the first option given the record of experience so far.

8.11 **We believe that we have to take a comprehensive view on the aggregate transfers from the Union to the States.** Total transfers are comprised of tax devolution, non-Plan grants, Plan grants and grants for various CSS including those which were transferred directly to the implementing agencies bypassing the State budget¹ until 2013-14. To illustrate, the aggregate transfer as percentage of gross revenues of the Union Government constituted around 52 per cent for the period from 2009-10 to 2014-15 (BE). While the relative share of tax devolution in total transfer remained at 46.8 per cent during this period, the share of Plan grants, including CSS, and non-Plan grants have remained at 54 per cent of the total transfers. The share of non-Plan grants, including the grants provided by Finance Commissions, in total transfer declined from 11.3 per cent in 2009-10 to 8.7 per cent in 2014-15 (BE). The States demanded higher resources for vertical devolution and also emphasised the need for more unconditional transfers through the Finance Commission route. **We are of the view that tax devolution should be the primary route of transfer of resources to States since it is formula based and thus conducive to sound fiscal federalism. However, to the extent that formula-based transfers do not meet the needs of specific States, they need to be supplemented by grants-in-aid on an assured basis and in a fair manner.**

8.12 The aggregate resource flow for the year 2012-13 accounted for 50.4 per cent of gross revenues, 57.1 per cent of the gross tax revenues and is equivalent to 63.9 per cent of the divisible pool of resources of the Union Government. **We recognise that amounts equivalent to more than 60 per cent of the divisible pool goes to the States in various forms of transfers and keeping in view the Union Government's expenditure responsibilities, there is little scope to increase the share of aggregate transfers.**

8.13 **However, a compositional shift in transfers from grants to tax devolution is desirable for two reasons. First, it does not impose an additional fiscal burden on the Union Government. Second, an increase in tax devolution would enhance the share of unconditional transfers to the States. We have factored in four important considerations: (i) States not being entitled to the growing share of cess and surcharges in the revenues of the Union Government; (ii) the importance of increasing the share of tax devolution in total transfers; (iii) an aggregate view of the revenue expenditure needs of States without Plan and non-Plan distinction; and (iv) the space available with the Union Government. Considering all factors, in our view, increasing the share of tax devolution to 42 per cent of the divisible pool would serve the twin objectives of increasing the flow of unconditional transfers to the States and yet leave appropriate fiscal space for the Union to carry out specific-purpose transfers to the States.**

8.14 Some States mentioned the issue of minimum guaranteed tax devolution for the purpose of predictability of transfers in regard to vertical devolution. Trends in actual tax devolution during the FC-XII and FC-XIII award periods were compared with the recommended tax devolution. The experience in the past does not warrant concern in this regard. In any case, a formula to determine such a minimum guarantee is difficult to derive. **Hence, we have not consented to the submission of States on minimum guaranteed devolution.**

States' Views on Horizontal Sharing

8.15 A summary view of the States on horizontal distribution is presented in **Annex 8.1. Most indicators proposed by various States can be grouped into six broad categories - population,**

¹The Interim Budget 2014-15 reversed this by announcing fund flow through the Consolidated Fund of the States instead of directly to the implementing agencies.

income and fiscal capacity distance, fiscal performance, area, social and economic backwardness, and availability of infrastructure. State's views on each of these indicators are discussed below.

Population

8.16 Some States have suggested that since public goods and services have to be provided to the entire population, the 2011 Census data on population should be used for the purpose of devolution. However, nearly half the States have suggested that the 1971 population data should be the sole criteria for distribution of resources. They have argued that use of the latest population data would penalise those States that have taken effective population control measures. A few States have also suggested that growing urbanisation imposes challenges for States in terms of providing services to its population. Therefore, they have argued, some weight should be given to the States where population is growing rapidly and which are also urbanising at a fast pace. Within the population criterion, there have been suggestions for additional weights being given for scheduled caste/scheduled tribe population in order to introduce an element of equity. One State has suggested that the 1971 population figures along with population growth between 1971 and 2011 should be used for *inter-se* distribution. Another State has argued that short and long term migration imposes a huge fiscal burden on the destination State, as it needs to provide public goods and services to the migrant population. Therefore, it suggested, migration should be an indicator in the horizontal devolution. Since short term migration is not captured in the Census estimates, the State has argued that a proxy parameter like growth in urban population could be used as an indicator for *inter-se* distribution with a 5 per cent weight being assigned to it.

Income and Fiscal Capacity Distance

8.17 Nearly half the States have favoured the continuation of the criterion of fiscal capacity distance used by the FC-XIII, with the weights proposed varying from 10 per cent to 50 per cent. However, a minority view among the States has been that "better performing States" are penalised when this criterion is used and hence it should be discontinued; if it is retained, its weight should be reduced. One State has proposed 5 per cent weight for reducing the fiscal capacity distance, as reflected in some development outcome like improvements in per capita net state domestic product (NSDP) or per capita consumption over a three-year period, a decrease in Gini coefficients or achievements of Millennium Development Goals. A few States have suggested the use of 'income distance' as a criterion for *inter-se* distribution, with one of them proposing that 25 per cent weight should be given to fiscal capacity distance and 20 per cent for income distance. States that have preferred the use of 'income distance' over 'fiscal capacity distance' proposed weights varying from 20 to 70 per cent. Two States also wanted State's contribution to the aggregate gross state domestic product (GSDP) to be used as an indicator for *inter-se* distribution.

Fiscal Performance/Discipline

8.18 A majority of the States have favoured continuation of the fiscal discipline criteria as an indicator for *inter-se* distribution. While the existing weight, as used by the FC-XIII, is 17.5 per cent, States suggested weights varying from 5 per cent to 33.3 per cent. However, some States have argued that this criterion places an extra burden on States with revenue deficits and, therefore,

its weight should be reduced. A few States have proposed an increase in the weights of fiscal discipline to reward fiscal prudence. Four States have proposed that tax effort should be introduced as a criterion, as was done by the FC-XII, and suggested weights for this varying from 10 per cent to 50 per cent.

Area

8.19 A majority of the States favoured retaining area as an indicator of 'need' in the devolution formula and proposed weights varying from 5 per cent to 25 per cent. Three States with hilly terrain have suggested the use of area as a three-dimensional space instead of two dimensional, since the latter does not capture the undulating topography of the hill States and the cost disability arising as a result. One of these States has also suggested that in case it is not possible to take three-dimensional area as a criterion, then 10 per cent weight should be assigned to the proportion of hilly areas in the total area of a State and 5 per cent weight should be given to the two-dimensional area. There have been other suggestions on the use of area as an indicator, like the use of cultivable area, international border length and forest area, with the proposed weights of these indicators varying within a range of 5 per cent to 10 per cent.

Social and Economic Backwardness

8.20 Some States have argued that the concept of development is now more comprehensive and favoured the use of non-material dimensions like education, health and access to basic amenities captured by the Human Development Index (HDI). One State has suggested the use of inequality-adjusted HDI² which reflects not only the average achievements of a State on the three parameters of HDI but also how those achievements are distributed among its citizens by "discounting" each dimension's average value according to its level of inequality. This State suggested a weight of 20 per cent in the devolution formula for this inequality-adjusted HDI. One State has proposed that along with income distance, poverty ratio should be used as an indicator for inter-se distribution with a weight of 10 per cent. A few States have proposed the use of an index of social and economic backwardness for the purpose of *inter-se* distribution with a 10 per cent weight. There were also suggestions to consider the index of backwardness proposed by the Committee for Evolving A Composite Development Index of States (2013) headed by Raghuram Rajan³.

Availability of Infrastructure

8.21 The States have argued for factors like inadequate infrastructure and communication facilities, cost of living and cost disability, administrative efficiency, revenue raising capacity as well as historical factors like lack of capital, absence of scientific knowledge and industrial technology and absence of marketing and financial institutions for consideration in determining *inter-se* distribution. Some of these States have suggested that apart from earmarking certain percentage of devolution for special category States, a separate devolution procedure should also be adopted in order to reduce the existing horizontal inequality between them and the general category States.

² Since HDI is an average across the three dimensions of health, education and income, it conceals disparities in human development across the population within the same State. Two States with different distributions of achievements can have the same average HDI value.

³ The Committee for Evolving a Composite Development Index of States (2013), Ministry of Finance Government of India.

Our Approach and Recommendation on Horizontal Sharing

8.22 While determining the *inter-se* share of the States, the basic aim of Finance Commissions has been to correct the differentials in revenue raising capacity and expenditure needs, taking into account the cost disability factors to the extent possible. To achieve these goals, the past Finance Commissions have generally followed the principles of equity and efficiency. The criteria used by earlier Finance Commissions can be categorised as: (a) factors reflecting needs, such as population and income; (b) cost disability indicators, such as area and infrastructure distance; and (c) fiscal efficiency indicators such as tax effort and fiscal discipline. Our Commission is of the view that the devolution formula should continue to be defined in such a way that it attempts to mitigate the impact of the differences in fiscal capacity and cost disability among States. While doing so, we have kept in view the approaches suggested by individual States for horizontal distribution.

Population and Demographic Change

8.23 Views of the States regarding the use of 1971 population figures were deeply divided. This Commission is bound by its ToR which specifies that "in making its recommendations on various matters, the Commission shall generally take the base of population figures as on 1971 in all cases where population is a factor for determination of devolution of taxes and duties and grants-in-aid; however, the Commission may also take into account the demographic changes that have taken place subsequent to 1971" (para 7). In other words, the ToR recognised the changing demographic realities and provided a space for the demographic changes across States in the last forty years to be taken into consideration while deciding on the devolution. The Commission deliberated on the possible demographic changes that have taken place since 1971, the obvious ones being the change in the composition of population and also migration. While some States have achieved replacement level fertility, some others still have a very high total fertility rate.

8.24 Migration is an important factor affecting the population of the State, apart from natural factors like fertility and mortality. A large number of in-migrants in a State poses several challenges resulting in additional administrative and other costs. Nonetheless, it is to be noted that it is not only the pull factors of urban areas which are bringing in migrant but also equally there are strong push factors which are forcing individuals to move out of their native place in search of better opportunities. If net-migration in a State is taken as an indicator, it will place a double burden on States from where out-migration is taking place. As it is, these States do not have enough infrastructure to provide services to their citizens and that is why much of the labour force is moving out. So denying resources on the basis of net migration will mean penalising them for under-development-induced migration. Also, there is no denying the fact that migrants contribute to the income of the destination States and help the State of origin through remittances. However, the pressure of migration to bigger cities does impose fiscal challenges on the destination States and a grant mechanism may be more useful to deal with this specific problem.

8.25 We have taken the view that the weight assigned to population should be decided first and an indicator for demographic changes be introduced separately. Though we are of the view that the use of dated population data is unfair, we are bound by our ToR and

have assigned a 17.5 per cent weight to the 1971 population. On the basis of the exercises conducted, we concluded that a weight to the 2011 population would capture the demographic changes since 1971, both in terms of migration and age structure. We, therefore, assigned a 10 per cent weight to the 2011 population (See Annex 8.2).

Area

8.26 We agree with the views of the some of the previous Finance Commissions that a State with larger area will have to incur additional administrative and other costs in order to deliver comparable services to its citizens. These costs increase with the increase in area, but at a decreasing rate. It is necessary to put upper and lower caps on area due to the non-linear relationship between area and cost. We have noted that a large majority of the States have urged that area should continue as a criterion for devolution. **We have, therefore, followed the method adopted by the FC-XII and put the floor limit at 2 per cent for smaller States and assigned 15 per cent weight (See Annex 8.3).**

Forest Cover

8.27 Our ToR mandated us to give consideration to the need to balance management of ecology, environment and climate change consistent with sustainable economic development while framing our recommendations (para 6(x)). We recognise that States have an additional responsibility towards management of environment and climate change, while creating conditions for sustainable economic growth and development. Of these complex and multidimensional issues, we have addressed a key aspect, namely, forest cover, in the devolution formula. **We believe that a large forest cover provides huge ecological benefits, but there is also an opportunity cost in terms of area not available for other economic activities and this also serves as an important indicator of fiscal disability. We have assigned 7.5 per cent weight to the forest cover (See Annex 8.4 and 8.4A).**

Income Distance

8.28 Successive Finance Commissions have used the distance of actual per capita income of a State from the State with the highest per capita income as a measure of fiscal capacity. The FC-XIII, however, introduced a new criterion based on distance between estimated per capita taxable capacity for each State and the highest per capita taxable capacity and used this for *inter-se* devolution. However, we observed that the relationship between income and tax is non-linear, as the consumption basket differs between high, middle and low income States. **We have decided to revert to the method of representing fiscal capacity in terms of income distance and assigned it 50 per cent weight (See Annex 8.5).**

8.29 We have calculated the income distance following the method adopted by the FC-XII. A three-year average (2010-11 to 2012-13) per capita comparable GSDP has been taken for all the twenty-nine States. Income distance has been computed by taking the distance from the State having highest per capita GSDP. In this case, Goa has the highest per capita GSDP, followed by Sikkim. Since these two are very small States, adjustments are needed to avoid distortions and hence income distance has been computed from the State with the third highest per capita GSDP - Haryana. We have provided Goa, Sikkim and Haryana the same distance as obtained for the State with the smallest distance of income with Haryana.

8.30 Table 8.1 shows the criteria and weights assigned for inter-se determination of the shares of taxes to the States. State-specific share of taxes is presented in Table 8.2.

Table 8.1: Criteria and Weights

Criteria	Weight (per cent)
Population	17.5
Demographic Change	10
Income Distance	50
Area	15
Forest Cover	7.5

Table 8.2 Inter-se Share of States

States	Share of States (per cent)
Andhra Pradesh	4.305
Arunachal Pradesh	1.370
Assam	3.311
Bihar	9.665
Chhattisgarh	3.080
Goa	0.378
Gujarat	3.084
Haryana	1.084
Himachal Pradesh	0.713
Jammu & Kashmir	1.854
Jharkhand	3.139
Karnataka	4.713
Kerala	2.500
Madhya Pradesh	7.548
Maharashtra	5.521
Manipur	0.617
Meghalaya	0.642
Mizoram	0.460
Nagaland	0.498
Odisha	4.642
Punjab	1.577
Rajasthan	5.495
Sikkim	0.367
Tamil Nadu	4.023
Telangana	2.437
Tripura	0.642
Uttar Pradesh	17.959
Uttarakhand	1.052
West Bengal	7.324
All States	100.000

8.31 **As service tax is not levied in the State of Jammu & Kashmir, proceeds cannot be assigned to this State. We have worked out the share of each of the remaining twenty-eight States in the net proceeds of service taxes and presented this in Table 8.3.** If the service tax starts to be levied in Jammu & Kashmir during the award period of this Commission, the share of each State will be in accordance with Table 8.2. If in any year during our award period, any tax of the Union is not levied in a State, the share of that State in the tax should be considered as zero and the entire proceeds of that Union tax should be distributed among the remaining States by proportionately adjusting their shares.

Table 8.3: Share of States Other than Jammu & Kashmir in Service Tax

	(Per cent)
States	Share of States
Andhra Pradesh	4.398
Arunachal Pradesh	1.431
Assam	3.371
Bihar	9.787
Chhattisgarh	3.166
Goa	0.379
Gujarat	3.172
Haryana	1.091
Himachal Pradesh	0.722
Jharkhand	3.198
Karnataka	4.822
Kerala	2.526
Madhya Pradesh	7.727
Maharashtra	5.674
Manipur	0.623
Meghalaya	0.650
Mizoram	0.464
Nagaland	0.503
Odisha	4.744
Punjab	1.589
Rajasthan	5.647
Sikkim	0.369
Tamil Nadu	4.104
Telangana	2.499
Tripura	0.648
Uttar Pradesh	18.205
Uttarakhand	1.068
West Bengal	7.423
All States	100.000

Recommendations

- i. Considering all factors, in our view, increasing the share of tax devolution to 42 per cent of the divisible pool would serve the twin objectives of increasing the flow of unconditional transfers to the States and yet leave appropriate fiscal space for the Union to carry out specific purpose transfers to the States. (para 8.13)
- ii. We have not consented to the submission of States on minimum guaranteed devolution. (Para 8.14)
- iii. Though we are of the view that the use of dated population data is unfair, we are bound by our ToR and have assigned a 17.5 per cent weight to the 1971 population. On the basis of the exercises conducted, we concluded that a weight to the 2011 population would capture the demographic changes since 1971, both in terms of migration and age structure. We, therefore, assigned a 10 per cent weight to the 2011 population. (para 8.25)
- iv. For area, we have followed the method adopted by the FC-XII and put the floor limit at 2 per cent for smaller States and assigned 15 per cent weight. (para 8.26)
- v. We believe that a large forest cover provides huge ecological benefits, but there is also an opportunity cost in terms of area not available for other economic activities and this also serves as an important indicator of fiscal disability. We have assigned 7.5 per cent weight to the forest cover. (para 8.27)
- vi. We have decided to revert to the method of representing fiscal capacity in terms of income distance and assigned it 50 per cent weight. We have calculated the income distance following the method adopted by FC-XII. (Para 8.28 and 8.29)
- vii. Table 8.1 shows the criteria and weights assigned for inter-se determination of the shares of taxes to the States. State-specific share of taxes is presented in Table 8.2. (Para 8.30)
- viii. As service tax is not levied in the State of Jammu & Kashmir, proceeds cannot be assigned to this State. We have worked out the share of each of the remaining twenty-eight States in the net proceeds of service taxes and presented this in Table 8.3. (para 8.31)

Chapter 9

Local Governments

9.1 The terms of reference (ToR) of this Finance Commission require us to recommend "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."

9.2 Thus, we are expected to recommend, on the basis of the recommendations of the State Finance Commissions (SFCs), measures to supplement resources of duly constituted panchayats and municipalities. These measures could be recommendations on both grants in aid as well as suggestions for steps to be taken by the States in this regard. The measures are intended to add to the resources of panchayats and municipalities and by implication there is no stipulation about the criteria or the quantum of the grant that should be recommended.

Approach of Previous Finance Commissions

Framework for Recommendations

9.3 The FC-X did not have a ToR for local bodies but it gave an award regarding this as panchayats and municipalities were to discharge the new role assigned to them under the Constitution during its award period. Starting from the FC-XI, all subsequent Finance Commissions had ToR identical to those of this Finance Commission on panchayats and municipalities. In addition, the FC-XI was explicitly given the latitude to make its' own assessment in the matter in cases where SFC reports were not available.

9.4 For several reasons, the previous Finance Commissions could not base their recommendations entirely on the SFC reports. These included variations in the approaches adopted by the SFCs, difference in the periods covered by individual SFCs, non-synchronisation of the SFC report periods with that of the Finance Commission report and the quality of SFC reports. Under the circumstances, the previous Finance Commissions recommended ad-hoc grants and suggested the steps that State Governments could take to augment the consolidated fund of States to supplement the resources of local bodies.

Quantum of Flows

9.5 The FC-X recommended a grant of Rs. 4,380.93 crore for panchayats, estimated at the rate of Rs. 100 per capita of rural population as per the 1971 Census. A grant of Rs. 1,000 crore was recommended for municipalities. The FC-XI recommended a grant of Rs. 8,000 crore for panchayats and Rs. 2,000 crore for municipalities. The FC-XII allocated a grant of Rs. 20,000 crore for panchayats and Rs. 5,000 for municipalities. The FC-XIII recommended a percentage of the divisible pool for local bodies, estimated at Rs. 87,519 crore for the entire award period,

after converting it into grant-in-aid under Article 275 of the Constitution. For each year of the award period, the grant was to be determined on the basis of the divisible pool of the previous year. Of this, the grant to panchayats was Rs. 63,051 crore and the grant to municipalities was Rs. 23,111 crore, while a special area grant of Rs. 1,357 crore was given to the Schedule V and Schedule VI areas as well as other areas excluded from the operation of Part IX and Part IX A of the Constitution.

Basis of Horizontal Distribution

9.6 The FC-X distributed its award exclusively on the basis of population (based on the 1971 Census). The FC-XI assigned a weight of 40 per cent to population (1991 Census), 10 per cent to area and 20 per cent to distance from highest per capita income. The FC-XII retained the weights used by FC-XI for each of these three criteria, but used the 2001 population data for distribution. The FC-XIII increased the weight attached to population to 50 per cent and retained the weight assigned to area at 10 per cent. While they retained the weight assigned to distance from the highest per capita income at 20 per cent for urban local bodies, for rural local bodies this was reduced to 10 per cent and a new criteria- proportion of scheduled caste and scheduled tribe population - with a weight 10 percent was introduced. Apart from these three common criteria, others like index of decentralisation, revenue effort, index of deprivation, index of devolution and Finance Commission grant utilisation index have been used by different Finance Commissions. In the distribution of grants, factors such as population, area and deprivation related indices take into account the resource needs of the States. Other criteria such as index of decentralisation, index of devolution, revenue mobilisation linked the quantum of grants to the efforts of States to decentralise or to empower the local bodies.

Performance Requirements Associated with Grants

9.7 The FC-X stipulated that State Governments should prepare suitable schemes and issue detailed guidelines for utilisation of the grants. The local bodies were required to raise matching contributions for the purpose. No grant amount was to be used for expenditure on salaries and wages. The FC-XI stipulated that the first charge on the grants should be maintenance of accounts and audit, followed by the development of a financial database. The remaining amounts were to be utilised for maintenance of core services - provision of primary education, primary health care, safe drinking water, street lighting and sanitation including drainage and scavenging facilities, maintenance of cremation and burial grounds, public conveniences and other common property resources. These grants were untied, barring the stipulation prohibiting the payment of salaries and wages. The grants were to be distributed between rural and urban local bodies, on the principles recommended by SFCs.

9.8 The FC-XII stipulated that panchayats should use the grants to improve service delivery relating to water supply and sanitation. In towns with a population of over 100,000, 50 per cent of the grant was to be earmarked for solid waste management schemes in public-private-partnership (PPP) mode. The urban and rural local bodies were also expected to give high priority to expenditure for the creation of database on local body finances and maintenance of accounts through the use of modern technology and management systems.

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9.9 The FC-XIII provided grants for rural and urban local bodies in two parts - a general basic grant and a general performance grant. No conditions were set for accessing the basic grant. However, the FC-XIII set six conditions for panchayats to access the performance grant and nine conditions in the case of urban local bodies. All these conditions had to be met in each of the award years. In the case of States with Schedule V and VI areas, and the area exempted from the purview of Part IX and Part IX-A of the Constitution, a special area grant was provided without distinguishing between rural and urban areas. This grant also had two components - a special area basic grant and a special area performance grant. Four conditions had to be met to avail the latter. In case States were unable to draw their performance grant, the amount not drawn was to be redistributed in a specified manner. Both the general basic grant and the general performance grant were allocated to rural and urban local bodies on the basis of the 2001 population figures.

Accounts and Audit

9.10 Previous Finance Commissions have highlighted the lack of reliable financial data on panchayats and municipalities and the difficulty in realistically assessing the requirement of resources for carrying out core functions and development expenditure. The FC-XI noted the need for improvement of accounts as, over a period of time, progressively larger funds would flow to local bodies, and suggested the heads of account under which funds flow to local bodies should be streamlined. The FC-XI recommended that the Comptroller and Auditor General of India (C&AG) should be entrusted with the responsibility of exercising control and supervision over the maintenance of accounts and audit of all tiers of rural and urban local bodies and that the C&AG's audit report should be placed before a committee of the state legislature. It also recommended grants to States for the compilation of accounts and creation of a database on local body finances. Subsequent Finance Commissions also stressed the need for proper accounts and audit. The maintenance of accounts of local bodies and entrusting technical guidance and supervision over audit to the C&AG were among the conditions that States had to fulfil in order to draw the performance grants recommended by FC-XIII.

Treatment of Excluded Areas

9.11 The previous Finance Commissions did consider the provision of grants to areas not covered by the 73rd and 74th amendments to the Constitution. While providing grants to these excluded areas, the FC-X noted that even in the States not required to have panchayats, the additional amounts would be required to be given to supplement the resources of similar local level representative bodies. The FC-XI stipulated that its award for excluded areas should be made available to the respective States only after the relevant legislative measures for extension of the provisions of the 73rd and 74th amendments to such areas are completed. After noting the proposal for amending Schedule VI of the Constitution to include extension of certain provisions of the 73rd and 74th amendments to these excluded areas under consideration in the Ministry of Home Affairs, the FC-XII did not indicate separate grants for normal and excluded areas and left it to the States to distribute the grants between them. After considering Parts IX and IX-A, Articles 244, 280 and 275 of the Constitution, the FC-XIII also recommended grants for excluded areas.

Measures for Augmenting States' Consolidated Funds

9.12 In order to augment the Consolidated Funds of States, the FC-XI suggested imposition of taxes on land and farm incomes, surcharge or cess on state taxes, levy of professions tax, improving efficiency of collection of property tax, assignment of a buoyant tax in lieu of octroi when it is abolished, levy of service charges and periodic revision therein. The FC-XII identified fourteen best practices, which included the following: (i) measures for augmenting resources of panchayats such as compulsory levy of major taxes and exploring all non-tax revenue sources; (ii) obligatory levy of user charges; (iii) insistence on collection of minimum revenue and providing incentive grants for collections beyond this prescribed minimum amount; (iv) identifying revenue-generating common property resources and ensuring adequate income from them; and (v) giving powers to intermediate or district panchayats to levy tax or cess or surcharge on agricultural holdings. The FC-XIII suggested that the States could do the following: (a) mandate some or all local taxes as obligatory at non-zero rates of levy; (b) provide matching grants for revenues raised; (c) explore market based financing through the issue of municipal bonds; and (d) share mining royalties with the local body in whose jurisdiction the income originates. It also suggested that the departments of the Union and State Governments could pay appropriate service charges to local bodies for civic services.

Views of Stakeholders

Views of the State Governments

9.13 In the memoranda presented to us, the States appreciated the grants for local bodies recommended by the previous Finance Commissions and were in favour of these being enhanced. A majority of States advocated that the local body grant should be specified as a percentage of the divisible pool, as was done by the FC-XIII. One State suggested increasing the grant to as much as 9 per cent of the divisible pool, while nearly half the States favoured increase to 5 per cent. Some States advocated specific sums of money as grants.

9.14 The criteria for horizontal distribution suggested by the States include area, index of devolution or decentralisation, scheduled caste and scheduled tribe population, income distance, Finance Commission grant utilisation, poverty ratio, fiscal discipline, index of deprivation, revenue effort, per capita transfer of funds, proportion of own resources transferred to local bodies, population and average population growth between 1971 and 2011. A majority of States did not indicate which census figure should be taken for the population criteria; of those that did some advocated use of the 2011 Census and a few suggested the 1971 Census data.

9.15 An overwhelming majority of States submitted that the conditions attached to grants either be dropped or reduced in number. A few suggested that the conditions stipulated should have flexibility in their application to accommodate local conditions. Some States suggested that if conditions were to be imposed, these could relate to timely release of grants to local bodies, entrusting technical guidance and supervision over audit to the C&AG and limiting the use of grants for core services. A few States proposed that the existing time limit for the release of grants to local bodies be increased.

9.16 While half the States did not express any specific view on the use of performance grants, some were against performance grants itself. Another suggestion was that the conditions imposed

for accessing these grants should be linked to the performance of the local body only, with flexibility given for local conditions. Most of the States submitted that only a few conditions should be used and releases should be in proportion to the number of conditions fulfilled, rather than being linked to the fulfilment of all the conditions. A few States were of the view that the bulk of the local body grants should be in the form of a general grant and only a smaller percentage should be given as a performance grant. Some other States urged that the limit on professions tax should be raised by Parliament and the local bodies should be allowed to recover service charges from Union Government properties.

9.17 A majority of the States sought grants for provision as well as maintenance of basic civic amenities. Others sought support for the construction of panchayat buildings, information technology (IT) infrastructure, e-governance, capacity building and honorarium for elected representatives. Other purposes for which support was sought included preparation of financial database, improving tax collections, accounting systems, public health and education.

9.18 For urban areas, a majority of States sought support for basic civic services while a few sought support for traffic management and parking lots, implementing e-governance, construction of municipal buildings, fire services, disaster management, public health and preparation of master plans.

Views of Representatives of Local Bodies

9.19 In their interaction with this Commission, the representatives of panchayats and municipalities in an overwhelming majority of States mentioned that they faced a paucity of funds for carrying out their own mandated functions. Most of them stated that the grants given to panchayats and municipalities should be untied. In almost all States these local body representatives sought funds for the improvement of basic services - water supply, sanitation, sewerage, storm water drainage, solid waste management, roads and street lighting, parks and playgrounds, burial and cremation grounds. Shortage of staff was another issue highlighted by them in a majority of the States.

9.20 In some States, the panchayat representatives expressed the need for further empowerment of panchayats to enable them to function as institutions of local self-government. A number of panchayat representatives sought support specifically for training and capacity building of their staff, for construction of training centres, for IT infrastructure, internet connectivity, buildings for panchayats as well as their repair and maintenance, salary for staff and honorarium for elected members.

9.21 Representatives of municipalities in a few States sought support for capacity building and training, public transport and infrastructure such as flyovers and roads, parks and playgrounds, maintenance of assets, salary for staff and honorarium for elected members. In some States, the representatives highlighted the need for special dispensation for pilgrim centres and for the protection of heritage sites.

9.22 In a few States, the municipal and panchayat representatives suggested that the grant for local bodies should be determined as a percentage of the divisible pool. While the municipal

representatives favoured setting the share at 5 per cent, suggestions from the panchayat representatives on this ranged from 6 per cent to 20 per cent.

9.23 The local body representatives of only two States raised the issue of the population data to be used for determining the quantum of local body grants, with those of one State favouring the use of the 1971 population data and those of the other favouring the 2011 data. In a few States, the local body representatives demanded that they should be allowed to levy service charges on the Union Government's properties and that the limit on professions tax should be raised so that their revenues can increase further.

Consultations with State Finance Commissions

9.24 We held discussions on the working of the SFCs with Chairpersons and Member Secretaries of the sitting SFCs or the last SFCs that had submitted reports to the States. It emerged that States had constituted SFCs at different times and with varying regularity. As a result, the latest SFC constituted across States (barring one state) ranged from the second SFC to the fifth SFC. In certain States, the latest reports submitted by the SFC were still under consideration by State Governments. In other States, the SFCs were yet to submit their reports.

9.25 It was noticed that sometimes the State Governments rejected SFC reports without recording reasons. In some States, even when the recommendations were accepted, the timeframe for implementation was not specified in the Action Taken Report presented to the legislature. Some Chairpersons highlighted the fact that the financial recommendations get acted upon while those dealing with systemic improvements are seldom addressed. They pointed out that lack of coordination between the finance department and those dealing with rural and urban affairs hinders the implementation of measures for augmentation of resources suggested by the SFC.

9.26 The Chairpersons of SFCs mentioned that the basic services that can be considered by us for support could include water supply, sanitation, solid waste management, drainage, public toilets, street lighting and maintenance of roads. They were of the view that the basic grant by the Finance Commission should be untied and should be allocated within each State according to the formula laid down by the respective SFC. They informed us that they had taken recourse to conditional grants and performance grants and favoured linking of Finance Commission grants with some conditionalities. They were of the view that if performance grants are given, there should be a few conditions and these should be transparent. They were also in favour of incentivising revenue mobilisation. Some of them expressed concern over the abolition of buoyant taxes such as property tax in their States. A few of them indicated that revenue incentivising measures have not been successful in their States. There was a general view that for such measures to be successful, the corpus for incentive grants should be large enough to induce the local bodies to act in this direction.

9.27 The SFC chairpersons felt that the Finance Commission could support several measures to improve the capacity of local bodies, including funding municipal cadres, setting up of training institutes and IT infrastructure. Other measures suggested by them included providing support for preparation of simple accounts and data formats, benchmarking of basic services and setting up of data collection centres in State Governments.

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9.28 The chairpersons submitted that promotion of accountability and transparency is important and social audits and public disclosure need to be encouraged. They were of the view that the Finance Commission could use recommendations in their reports to fulfil its constitutional mandate.

Views of the Union Government

9.29 The Ministry of Panchayati Raj of the Union Government sought support for initiatives aimed at improving governance, such as setting standards for delivery of core civic services and surveillance for monitoring actual service delivery. In order to promote the participation of citizens in local self-governance, it sought funds for conducting gram sabha meetings, payment of honorarium, travel allowance, daily allowance, sitting fee for elected members and some remuneration also for motivators engaged to ensure participation of all residents in gram sabha meetings. The Ministry also suggested funding the expenditure on secretariat staff for gram panchayats and for information communication technology (ICT) personnel at the intermediate panchayat level.

9.30 The Ministry sought assistance for States to set up supporting institutions such as Panchayat Finance Cells for compiling and analysing data on panchayat finances and helping panchayats improve their own revenue mobilisation as well as state-level regulators for determining tax rates and advising on fees or user charges for services.

9.31 Both the Ministry of Panchayati Raj and the Ministry of Rural Development sought support for capacity building of the panchayats. The Ministry of Panchayati Raj pointed out that capacity building was needed for delivering core services like water supply and sanitation assigned under various Acts, Rules and executive orders. The Ministry of Rural Development expressed the need to expand the infrastructure available for capacity building of elected representatives and functionaries of panchayats and requested a sum of Rs. 1886.50 crore for States for setting up district-level training centres for this purpose.

9.32 The Ministry of Drinking Water and Sanitation pointed out that the poor quality of water supply was adversely affecting people's health in rural areas, as the coverage of piped water supply was low and the capital assets created earlier had eroded and needed maintenance. The Ministry informed us that the problem of handling and disposal of solid and liquid waste including septage management would be important challenges before panchayats in the days to come. It pointed out that capital investment had to be increased to achieve and sustain the goal of covering 90 per cent rural population with piped water supply by 2022.

9.33 The Ministry of Panchayati Raj suggested that 4 per cent of the divisible pool be given to the local governments and that the vertical allocation of the grant should be 5 per cent for the State, 10 per cent for zilla parishad, 10 per cent for intermediate panchayats and 75 per cent for gram panchayats. Where no intermediate panchayat exists, the share of Gram Panchayats should be 85 per cent. For the horizontal distribution of grants across States, the Ministry suggested the following criteria and weights: population 50 per cent, scheduled caste and scheduled tribe population 10 per cent, geographic area 10 per cent, distance from national human development index (HDI) value 15 per cent and index of decentralisation 15 per cent.

9.34 The Ministry of Panchayati Raj supported the concept of basic and performance grants as proposed by the FC-XIII and advocated a ratio of 2:1 between the basic grant and the performance grant. It observed that the recommendations of the previous Finance Commission that States fulfil all conditions before becoming eligible for the performance grant led to many States forfeiting their share of the grant. To overcome this, the Ministry suggested that the performance grants should be disbursed in proportion to the conditions fulfilled by the states.

9.35 The Ministry of Drinking Water and Sanitation submitted that grants to local bodies could include conditionalities like the devolution by State Governments of funds, functions and functionaries in the rural drinking water and sanitation sectors to local bodies. It advocated that the management devolution index it had constructed may be used as an indicator for devolving funds to local bodies. The Ministry suggested that panchayats should give priority to spending on operation and maintenance of rural water supply and sanitation from the Finance Commissions' grants. However, the Ministry of Rural Development did not favour attaching conditions to grants except for improvement in service delivery.

9.36 The Ministry of Panchayati Raj submitted that capacity building was a major issue that needed attention in Schedule V areas and requested us to consider further strengthening of panchayats in these areas. It stated that in the case of areas falling outside Part IX of the Constitution, as in the North-east States, entities like Village Councils or Village Development Boards or District Councils could be considered eligible for grants. However, they would be required to satisfy certain conditions including being duly constituted through elections and reservations to ensure adequate representation for women.

9.37 Drawing our attention to the ToR's mandate that our recommendations be based on those of the SFC reports, the Ministry of Panchayati Raj pointed out that the quality of SFC reports has improved over the years. It therefore suggested that we may consider the latest SFC reports while making specific recommendations even if the period of these reports are not synchronous with our award period.

9.38 The Ministry of Urban Development drew our attention to the rapid urbanisation and submitted that this needs to be facilitated to sustain momentum of economic growth. It pointed out that basic services such as drinking water, sewerage, solid waste management, roads and street lights must be provided for all, with services related to water and sanitation meeting the Ministry's service delivery benchmarks.

9.39 The Ministry observed that while Finance Commission grants to urban local bodies have been growing over a period of time, these are inadequate to meet the operation and maintenance requirements of these bodies. It sought devolution of 3 per cent of the net proceeds of the divisible pool to urban local bodies. The Ministry pointed out that the conditions imposed by the FC-XIII for drawing performance grants were such that States had to fulfil all nine conditions each year. As most of the States were unable to fulfil all the conditions each year, these grants could not be availed. It felt that performance grants should be used for improving performance in the spheres of revenue augmentation, revenue productivity and revenue administration and added that conditions on grants should be limited to the areas of critical importance and should be oriented towards outputs.

9.40 The Ministry of Housing and Urban Poverty Alleviation indicated that the urban local bodies had limited capacity to implement poverty alleviation programmes and that there was a need for capacity building. The Ministry stated that funds should be made available to urban local bodies to maintain infrastructure created under different schemes of the Union Ministries. It also pointed out that the use of 1971 population data by the Finance Commission will not reflect the current urban reality as the urban population growth after that year has been phenomenal.

9.41 The Ministry of Finance urged that the grants recommended to urban local bodies be linked to a prescribed fiscal roadmap, including revenue generation and rationalisation of workforce.

Studies Commissioned

9.42 We commissioned studies on finances of municipalities and finances of panchayats through the Administrative Staff College of India (ASCI), Hyderabad and the Centre for Policy Research (CPR), New Delhi respectively. The data collected by us from the States was entrusted to these institutions to assess the gap in resources for the delivery of basic services. Both the studies revealed several gaps in the data provided by the States, as a result of which they had to rely largely on the use of secondary data to work out the resource gaps for the next five years.

9.43 The study on Municipal Finances and Service Delivery by ASCI highlighted the fact that governing cities is becoming a challenge because of inadequate finances, weak institutional framework and lack of capacity for service delivery. It suggested that a separate municipal revenue list should be inserted in the Constitution to assign assured and sustainable sources of income to urban local bodies. The suggested sources include property tax, vacant land tax, service charge on State and Union properties, trade licensing and building permission fee. The study expressed the view that urban local bodies should tap all resources allowed to them under the statutes to bridge the gap in finances and that they should prioritise property tax reforms in order to improve finances. It added that they needed to review their service charges and periodically revise them in line with service improvements to meet the escalating costs. The study also proposed that State Governments should remove restrictions on borrowings by urban local bodies.

9.44 The study on Review of Panchayat Finances highlighted the existence of a robust legal framework backed by activity mapping orders for the allocation of core functions to rural local bodies across the states. However, the study observed that this did not necessarily mean that the rural local bodies were equipped to undertake these functions. It added that the States had tended to empower village and district level panchayats more than the intermediate level panchayats in their enactments. The study suggested that the time for placement of an audit report of local bodies before State legislatures should be reduced to nine months. It also suggested that district-wise budget supplements could be prepared and circulated to enable the rural local bodies to know the details of funds entitlements in advance. The study also pointed out that there was potential for rural local bodies to raise much larger revenues by reforming the property tax systems.

Issues and Recommendations

Data Collection

9.45 Finance Commissions since the FC-XI have sought data from States on finances of local bodies but were hampered by the lack of reliable data. We recognised the difficulty in obtaining the data in a useable form from all panchayats and municipalities and, therefore, requested State Governments to collect information on a sample of the local bodies. Using two-stage sampling, 30 per cent of the districts were selected in the twenty-six states considered by us. In these districts, all zilla panchayats, 30 per cent of intermediate panchayats and 15 per cent of gram panchayats were selected, again using a simple random sampling. For the urban local body sample, all municipal corporations in the state, 30 per cent of the municipalities and 15 per cent of the nagar panchayats (the Tier 3 urban local bodies) were chosen. This was done using the probability proportional to size method of sampling from the same districts that were used for drawing the rural sample. The 2001 population data was chosen as the auxiliary variable. Despite our concerted effort, we found that the quality of the data that was supplied to us varied across States and was not in a useable form. **We were, therefore, handicapped, like the previous Finance Commissions, in using the supplied data to determine the resource gap at the level of rural and urban local bodies.**

Relying on the reports of the State Finance Commissions

9.46 For reasons beyond their control, the previous Finance Commissions had to make their recommendations independent of the SFC reports. In fact, they recommended that the Constitution be amended either to delete the requirement for the Finance Commission to base its recommendations on SFC reports or to require it to recommend merely keeping in view the SFC reports but not based on them. **The Constitution has not been amended so far and we have, therefore, decided to study the working of SFCs in depth and make it central to our recommendations in this regard.**

9.47 The Constitution allows the SFCs to determine their procedures. Therefore, they are free to choose their approach towards the determination of the requirement of local body finances within the respective States. Given the wide socio-economic, geographic diversity and also variation in the roles that are assigned to panchayats and municipalities across States, the diverse and often State-specific recommendations of SFCs may not provide a uniform basis for recommendations applicable to all States, though they may provide some ground for assessment of needs by us.

9.48 We have noted the submission of the Ministry of Panchayati Raj that we may consider the latest SFC reports even if they are not synchronous with our award period and then make specific recommendations. Five State Governments had made similar suggestions. The chairpersons of SFCs have also submitted that we can rely on the latest SFC reports to fulfil our mandate.

9.49 After a careful consideration of the provisions of the Constitution and views of various stakeholders, we propose to recommend measures for augmenting the Consolidated Fund of the State to supplement resources of panchayats and municipalities on basis of the recommendations of the SFCs. Doing so could mean either recommending grants using the data available in the

SFC reports, or addressing the common concerns raised in them on grants or other measures. We could not use the financial data in the SFC reports fully due to the fact that reports available to us were for different periods with some containing data nearly a decade old. It would not be reasonable to provide for the current resource requirements of the local bodies based on this data. **In our opinion, under the circumstances, recommendations that address common issues raised in SFC reports constitute recommendations made on the basis of the State Finance Commission report.**

Analysis of SFC reports

9.50 The Constitution provides for setting up of the SFCs within one year from the commencement of the Constitution (73rd Amendment) Act 1992, and, thereafter, at the expiry of every fifth year. Therefore, as per Constitutional provisions, setting up of a fourth SFC became due in the year 2009-10. Available information shows that two States have constituted the fifth SFC, while eleven have constituted the fourth. Six States have constituted the third SFC, six have set up the second SFC and one is yet to do so.

9.51 We noted that SFCs have faced several constraints in their functioning such as data availability, poor quality of available data, reconstitution of SFCs more than once during their tenure, shortage of staff and administrative resources and support. Despite facing such challenges, the SFCs have carried on and submitted their reports. They have recommended devolution of taxes, duties and grants to local bodies and also provided grants to panchayats and municipalities for meeting staff costs, maintenance of office and residential buildings, maintenance of basic infrastructure and other assets and also for the creation of financial database and capacity building.

9.52 A majority of SFCs have made recommendations to encourage local bodies to improve own revenue collections. Towards that end, they have sought to incentivise improvement in revenue mobilisation by providing performance grants, matching grants and cash awards to local bodies. Some SFCs have included incentive for own revenue mobilisation in the devolution formula. They have also indicated the action that the States and local bodies need to take to facilitate own revenue mobilisation by local bodies. The SFCs have stressed the need for proper accounting and auditing of local bodies. Finally, one of the key concerns SFCs have highlighted is that the local bodies need to improve the delivery of basic services to their residents.

9.53 Some of the SFCs have flagged issues for the consideration of the Finance Commission. These issues fall under two broad heads. The first relates to the Finance Commission recommending steps that would help the SFCs in the discharge of their functions. The second relates to the Finance Commission taking a view on certain factors while recommending measures for supplementing local body resources. The requests falling in the first category include: (i) setting up of an independent national agency for support of a common platform for exchange of information between SFCs; (ii) design of simpler accounts and data formats; (iii) studies on governance issues with respect to local self-governments and (iv) supporting studies on standards of essential civic services to help future SFCs assess the performance of local bodies in their core functions. In the second category are requests to the Finance Commission to consider doing the following: (i) use the 2011 Census data for the allocation of grants; (ii) provide grants for knowledge transfer and capacity enhancement; (iii) increase grants for audit, accounts and database, solid waste management and sanitation; and (iv) take cognisance of the large transfers being made to

the local bodies by the states. One SFC has requested the Finance Commission to take steps to make local bodies aware of the purpose of the Finance Commission grants.

9.54 In our view, a common issue that emerges from SFC reports is the need to have reliable data on the finances of local bodies in order to enable all stakeholders to make informed decisions. For this, the compilation of accounts and their audit assumes importance. Another common issue is that the local bodies need to be encouraged to generate own revenues and to improve the quality of basic services they deliver.

Giving Priority to Basic Services

9.55 Since the FC-XI, Finance Commissions have stressed the improvement of basic services provided by the local bodies to their constituents. In our discussions with representatives of local bodies, there was a strong consensus amongst the participants in favour of providing more funds for drinking water, sanitation, drainage, local roads, school buildings, solid waste management, street lighting, maintenance of burial and cremation grounds and parks. The States, in their memoranda to us, have also highlighted the need to support provision of these basic services relating to water, sanitation and solid waste management. Ministries of the Union Government also made similar points, with the Ministry of Drinking Water and Sanitation and Ministry of Urban Development focussing on adequate provisioning for drinking water and waste management. The Ministry of Drinking Water and Sanitation pointed out that managing solid and liquid waste including septage will be a challenge for the panchayats in the future. The Ministry of Urban Development submitted that basic services in urban areas needed to meet national level benchmarks set by it. The need for supporting these services has been brought out in most of the SFC reports, as well as in our consultations with the chairpersons of SFCs.

9.56 Improvements in the quality of basic services are likely to lead to an increase in the willingness of citizens to pay for the services. We are of the view that the measures that we recommend, including the grants to the local bodies, should go towards supporting and strengthening the delivery of basic services - water supply, sanitation including septage management, sewerage, storm water drainage and solid waste management, street lighting, local body roads and footpaths, parks, playgrounds, burial and cremation grounds. We recognise that the relevant statutes governing the local bodies would normally include these basic services. **Therefore, we recommend that the local bodies should be required to spend the grants only on the basic services within the functions assigned to them under relevant legislations.**

Accounts and Audit

9.57 Successive Finance Commissions have expressed concern on the near absence of financial data and its poor quality, wherever it is available. The C&AG informed us that in most States there are rules and regulations with regard to the formats of accounts for both rural and urban local bodies. However, the time schedule for completion of accounts was not being adhered to in a number of States. There were large gaps in monitoring mechanisms regarding schedule of preparation and finalisation of accounts. As a result, there are large arrears in local bodies' accounts. In PRIASoft, the accounting software used by several States for the compilation of panchayat accounts, 38 per cent gram panchayats had not closed their annual accounts for 2012-13 even by

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February 2014. Similarly, accounts of 2010-11 and 2011-12 were open and not complete for 43 per cent and 36 per cent of gram panchayats respectively. A similar situation was prevailing in other tiers of panchayats.

9.58 We were informed that one of the conditions of the FC-XIII for rural local bodies and municipalities to avail the performance grant was that they should maintain accounts based on the accounting framework and codification pattern consistent with the Model Panchayati Raj Accounting System and the National Municipal Accounts Manual respectively. While most States had self-certified the adoption of the accounting framework, the C&AG informed that the actual maintenance of accounts still needed improvement.

9.59 We were informed that the C&AG is now providing technical guidance and support to primary auditors in twenty-six states. The audit reports were being submitted to the State Government or State Legislature in twenty-one states, while the first audit report was under preparation in another five. Seventeen states had entrusted technical guidance and support to the C&AG or enhanced the scope of entrustment of this during 2011-13. The C&AG informed that in most of the States, system improvement regarding audit of local bodies by the primary auditor with technical guidance and support of C&AG was slowly gaining momentum and, over a period of time, its effectiveness is going to bear fruit.

9.60 We are of the opinion that proper accounts are the starting point for financial accountability. Non-maintenance or delayed compilation of annual accounts means compromised accountability. It also implies that reliable financial data for determining the need for resources for local bodies is not available. We observe that it has been more than twenty years that municipalities and panchayats were sought to be empowered, through a Constitutional amendment, to act as institutions of local self-governance and also to provide certain basic services to citizens. It is inconceivable, and certainly not desirable, that local bodies seek an ever increasing share of public moneys and yet continue to keep themselves beyond the ambit of accountability and responsibility for the public money placed with them.

9.61 We also note that on account of the efforts of the past Finance Commissions, there has been progress in the keeping of accounts and audit under the technical guidance and support of the C&AG. We also note the fact that further progress in this regard is needed. We, therefore, are of the opinion that it is necessary to continue the efforts initiated by past Finance Commissions for improving the maintenance of accounts, their audit and disclosure. For this, we have built suitable incentives in our performance grants. **We recommend that the books of accounts prepared by the local bodies should distinctly capture income on account of own taxes and non-taxes, assigned taxes, devolution and grants from the State, grants from the Finance Commission and grants for any agency functions assigned by the Union and State Governments. In addition to the above, we also recommend that the technical guidance and support arrangements by the C&AG should be continued and the States should take action to facilitate local bodies to compile accounts and have them audited in time.**

Grants to Local Bodies

Criteria for determination of grants to panchayats and municipalities

9.62 In the past, Finance Commissions have used two types of criteria for determining grants to States for panchayats and municipalities. The first related to the need for resources and the second related to the extent of devolution or decentralisation to local bodies by the States. We have examined requests put before us to use an index or indices based on extent of devolution or decentralisation for determining States' share of the grant for municipalities and panchayats. We noted that there are several practical difficulties in considering an appropriate index or indices for devolution, without assuming that there is an optimal model of devolution or decentralisation that is uniformly applicable to all States, irrespective of their socio-political and institutional context. Even assuming that such an index could be designed, it is not easy to assess the actual level of devolution relative to the optimal level, due to the unavailability of accurate, reliable information of the ground position.

9.63 Under the Constitution, the State legislature has the discretion to assign functions to panchayats and municipalities. We note that the overall scheme of the Constitutional provisions give primacy to the role of the States in this regard, by placing local government squarely in the State list. We have noted significant diversity in the legal, institutional and financial aspects of assignment of functions to panchayats and municipalities. In our view, neither the ToR nor the Constitution permits the Finance Commission to play any role in the devolution of powers to panchayats and municipalities or to promote a particular model of decentralisation. **Therefore, we considered it appropriate not to use an index or indices of devolution or decentralisation for the purpose of transfer of resources to States for panchayats and municipalities.**

9.64 Population and area are criteria used by past Finance Commissions that reflect need for resources. All the previous four Finance Commissions have used population and, barring the FC-X, all others have used area. The measures recommended or the grants given are ultimately intended to supplement the resources of panchayats and municipalities. The purpose of such supplementing is to aid these institutions in their primary function to deliver basic civic services. Therefore, we have used criteria that reflect needs in order to determine the grants to panchayats and municipalities, namely population and area. The delivery of basic civic services is related to the current population to be served within the administrative jurisdiction of the local body. Area is also relevant from the viewpoint of the costs of delivering such services. **Therefore, we recommend distribution of grants to the States using 2011 population data with weight of 90 per cent and area with weight of 10 per cent. The grant to each State will be divided into two - a grant to duly constituted gram panchayats and a grant to duly constituted municipalities, on the basis of urban and rural population of that State using the data of Census 2011.**

Quantum of grants

9.65 The FC-XIII recognised the need to support the local bodies through a predictable and buoyant source of revenue. It considered the demand by the States and local bodies for giving a share from the divisible pool to the latter. As the legal opinion provided to the FC-XIII indicated

that this was inconsistent with the provisions of the Constitution, the Commission recommended that the local bodies be transferred a percentage of the divisible pool of the previous year as stipulated by it, after converting this share into grants-in-aid under Article 275 of the Constitution. It had estimated this amount to be Rs. 87,519 crore for five years from 2010 to 2015.

9.66 We noted that States appreciated the fact that the FC-XIII had acknowledged the need for providing local bodies with a predictable, buoyant source of revenue and had recommended a grant which was equivalent to a specified percentage of the divisible pool. Most States have indicated that 5 per cent of the divisible pool should be given as grants to the local bodies.

9.67 Four SFCs whose recommendation periods are coterminous with ours have sought support ranging from Rs. 270 crore to Rs. 1,20,992 crore for the five-year period, 2015-20. In terms of per capita per annum, this ranges from Rs. 195 a year to Rs. 1,211 a year.

9.68 We note that the local bodies need to spend not only on the provision of basic services to the people, but also require support for administrative infrastructure and capacity building. In deciding the quantum of the grant, we have given importance to stability and predictability of resources that should flow to the local bodies. We have taken a pragmatic view on supplementing the resources of panchayats and municipalities. We are proposing a level of support that will provide financial stability to the local bodies through assured transfers for planning and delivering of basic services smoothly and effectively.

9.69 **We have worked out the total size of the grant to be Rs. 2,87,436 crore for the period 2015-20, constituting an assistance of Rs. 488 per capita per annum at an aggregate level. Of this, the grant recommended to panchayats is Rs. 2,00,292.2 crore and that to municipalities is Rs. 87,143.8 crore. The grant assessed by us for each State for each year is fixed.** This will ensure stable flow of resources at predictable intervals. The grants recommended by us should enhance resources available with gram panchayats and municipalities to enable them to discharge their statutorily assigned functions.

9.70 **We have recommended grants in two parts - a basic grant and a performance grant for duly constituted gram panchayats and municipalities. In the case of gram panchayats, 90 per cent of the grant will be the basic grant and 10 per cent will be the performance grant. In the case of municipalities, the division between basic and performance grant will be on a 80:20 basis. The shares of the States for these grants are set out in Annex 9.1.**

Basic grants

9.71 The own resources of gram panchayats and municipalities are meagre. They are required, as per the relevant statutes, to deliver a number of core services to their constituents. In addition, they have been assigned numerous agency functions by Union and State Governments. However, they depend on devolution from the State Government and grants from the State and Union Governments for providing core services. The purpose of the basic grant is to provide a measure of unconditional support to the gram panchayats and municipalities for delivering the basic functions assigned to them under their respective statutes. The grant provided is intended to be used to improve the status of basic civic services including water supply, sanitation including septage management, sewerage and solid waste management, storm water drainage, maintenance of community assets, maintenance of roads, footpaths and street-lighting, and burial and cremation grounds.

9.72 **The grants that we recommend should go to gram panchayats, which are directly responsible for the delivery of basic services, without any share for other levels. We expect that the State Governments will take care of the needs of the other levels. The earmarked basic grants for gram panchayats will be distributed among them, using the formula prescribed by the respective SFCs for the distribution of resources. Similarly, the basic grant for urban local bodies will be divided into tier-wise shares and distributed across each tier, namely the municipal corporations, municipalities (the tier II urban local bodies) and the nagar panchayats (the tier III local bodies) using the formula given by the respective SFCs. The State Governments should apply the distribution formula of the most recent SFC, whose recommendations have been accepted.**

9.73 **In case the SFC formula is not available, then the share of each gram panchayat as specified above should be distributed across the entities using 2011 population with a weight of 90 per cent and area with a weight of 10 per cent. In the case of urban local bodies, the share of each of the three tiers will be determined on the basis of population of 2011 with a weight of 90 per cent and area with a weight of 10 per cent, and then distributed among the entities in each tier in proportion to the population of 2011 and area in the ratio of 90:10.**

Performance Grants

9.74 Our analysis of the data on gram panchayat revenues provided to us by the States showed that in one State the gram panchayats played an advisory role and had no powers to collect tax or non-tax revenue and in four others they had powers to collect revenues but were not doing so. Of the remaining States, two accounted for most of the revenues collected at the gram panchayat level. For the local bodies to function effectively as institutions of local self-governance, it is important that they augment their own sources of revenue.

9.75 A common issue raised by most SFCs is that their work was hampered by lack of reliable data on receipts and expenditure at the local body level. The studies commissioned by us on panchayats and municipal finances faced similar problems. We note that despite the last three Finance Commissions raising the issue of reliable data and accounts and providing grants to address the issue, not much has happened. In our opinion, this is not a satisfactory state of affairs. **Therefore, we are providing performance grants to address the following issues: (i) making available reliable data on local bodies' receipt and expenditure through audited accounts; and (ii) improvement in own revenues. In addition, the urban local bodies will have to measure and publish service level benchmarks for basic services. These performance grants will be disbursed from the second year of our award period, that is, 2016-17 onwards, so as to enable sufficient time to State Governments and the local bodies to put in place a scheme and mechanism for implementation. The details of the performance grants are given in the paragraphs that follow.**

Performance grant - rural

9.76 **To be eligible for performance grants, the gram panchayats will have to submit audited annual accounts that relate to a year not earlier than two years preceding the year in which the gram panchayat seeks to claim the performance grant. It will also have to**

show an increase in the own revenues of the local body over the preceding year, as reflected in the audited accounts. To illustrate, the audited accounts required for performance grants in 2016-17 will be for the year 2014-15; for performance grants in 2017-18, the audited accounts will be for the year 2015-16; for performance grants in 2018-19, the audited accounts will be for 2016-17; and for performance grants in 2019-20, the audited accounts will be for 2017-18.

9.77 The underlying objective of the grant is to initiate action at the grassroots level for compilation of data so that all stakeholders have access to reliable information for decision making. At the same time, it enhances accountability of the local self-government institutions to the public. We are conscious that the revenue generation by gram panchayats is at different levels. **Therefore, we are of the opinion that it may be better that the detailed procedure for disbursement of the performance grant to gram panchayats based on revenue improvement be designed by the State Governments concerned, keeping in view the two conditions given above. The operational criteria, including the quantum of incentive to be given, is left to the discretion of the State Governments. In case some amount of the performance grant remains after disbursement to the eligible gram panchayats, this undisbursed amount should be distributed on an equitable basis among all the eligible gram panchayats. The scheme for disbursement of the performance grant will be notified by the State Governments latest by March 2016, in order to enable the preparation of the eligibility list of local bodies entitled to them. The concerned Ministries of the Union Government will also be informed in order to facilitate release of the instalment of performance grants.**

Performance grant - urban

9.78 As in the case of the performance grant for gram panchayats, **a detailed procedure for the disbursement of the performance grant to urban local bodies would have to be designed by the State Government concerned, subject to certain eligibility criteria. To be eligible, the urban local body will have to submit audited annual accounts that relate to a year not earlier than two years preceding the year in which it seeks to claim the performance grant. It will also have to show an increase in own revenues over the preceding year, as reflected in these audited accounts. In addition, it must publish the service level benchmarks relating to basic urban services each year for the period of the award and make it publically available. The service level benchmarks of the Ministry of Urban Development may be used for this purpose. The improvement in revenues will be determined on the basis of these audited accounts and on no other basis. For computing the increase in own revenues in a particular year, the proceeds from octroi and entry tax must be excluded. In case some amount of the performance grant remains after disbursement to the eligible urban local bodies, the undisbursed amount should be distributed on an equitable basis among all the eligible urban local bodies that had fulfilled the conditions for getting the performance grant.**

9.79 **These guidelines for the disbursement of the rural and urban performance grants will remain in force for the period of our award. We recommend that the Union Government accept the detailed procedure prepared by the State which incorporates our broad guidelines without imposing any further conditions.**

Trust-Based Approach to Release of Grants

9.80 We recognise that there is a need to trust and have respect for local bodies as institutions of local self-government. **Hence, we recommend that no further conditions or directions other than those indicated by us should be imposed either by the Union or the State Government for the release of funds.**

9.81 **The grants recommended by us shall be released in two instalments each year in June and October. This will enable timely flows to local bodies during the year, enabling them to plan and execute the works better. We recommend that 50 per cent of the basic grant for the year be released to the State as the first instalment of the year. The remaining basic grant and the full performance grant for the year may be released as the second instalment for the year. The States should release the grants to the gram panchayats and municipalities within fifteen days of it being credited to their account by the Union Government. In case of delay, the State Government must release the instalment with interest paid from its own funds.**

9.82 Central to the trust-based approach adopted by us is the understanding that the local bodies will discharge their statutory functions with all due care. The publishing of service level data and preparation and audit of accounts will provide the necessary transparency and accountability in this regard. **We recommend that stern action should be ensured if irregularities in the application of funds are noticed or pointed out.**

Strengthening Role of SFCs

9.83 During our interaction with the States, local bodies and SFCs we noticed that there is wide variation in the assignment of functions, funds and functionaries across States. Given this diversity of functional assignments to local bodies across States, it is not feasible for the Finance Commission to carry out a detailed assessment of the finances of local bodies in each State nor has such a role been assigned to it under the ToR or the Constitution. The Constitution envisages that the needs of local bodies within the State shall be assessed in detail by the SFC, which will recommend the required transfer of resources from the State to them. Therefore, it is appropriate that the needs of local bodies are assessed in detail by the SFC.

9.84 The SFC chairpersons have pointed out that despite the passage of time, SFCs in many States continue to work with a lot of disadvantages. Given the considerations set out in the preceding paragraph, we are of the opinion that there is a need for States to facilitate the effective working of SFCs. **Therefore, we recommend that the State Governments should strengthen SFCs. This would involve timely constitution, proper administrative support and adequate resources for smooth functioning and timely placement of the SFC report before State legislatures, with action taken notes.**

Measures to Augment the Consolidated Fund of States

9.85 The ToR mandates us to identify and recommend measures needed to augment the Consolidated Fund of States. In addition to the grants that we have recommended, we have

suggested the actionable measures that the State Governments and the local bodies can take to improve their own revenues, based on our examination of SFC reports. There is certainly a need to streamline revenue administration in the States in order to improve own resources of panchayats and municipalities.

9.86 States have classified levies assigned to local bodies as compulsory or optional. However, the classification is different across States. Per capita income from both tax and non-tax sources also varies widely. In the case of own revenue collections by local bodies, the bulk of overall collections were accounted for by local bodies in a few States. **We notice that there is considerable scope for the local bodies to improve revenues from own sources by taking steps as recommended by the SFCs and the Finance Commissions. In our view, States need to take the measures illustrated below to further augment the resources at the State and local bodies' level.**

Tax measures

Property tax

9.87 Property tax is recognised as the major source of revenue for local bodies the world over. However, we noted from the SFC reports that local bodies in a few States have not been given the powers to levy this tax so far; legislations for this purpose have either not been passed or still remain under consideration of those State Governments. In some other States, the panchayats are unable to levy this tax because the necessary regulations have not been framed. In most States where tax is being levied, the rates have not been revised periodically. The list of taxable properties is not being updated and a large number of properties remain outside the tax net.

9.88 A few SFCs have also pointed out that the tax is levied on annual rental value, which leads to lower buoyancy. Often State Governments have issued orders staying the adoption of revised assessment lists or have reduced the rental values. A few SFCs have pointed out that there is a need to review the exemptions that have been granted.

9.89 The study on municipal finances commissioned by us showed that the revenues from property tax of 478 sampled municipalities had risen from Rs. 5,555 crore in 2007-08 to Rs. 10,192 crore in 2012-13. The study indicates that the per capita revenue from property tax varied from Rs. 42 to Rs. 1,677 across States. The study on panchayat finances observed that nearly half of the States reported nil collections from property tax while the others reported low collections. The study has underlined that the potential for collection of property tax has not been fully tapped and suggested that panchayats can raise much more revenues even at the modest rates applicable to the existing tax base. **In our view, States need to ensure property tax reforms including objective determination of the base and its regular revision to adjust for inflation, strengthening of mechanisms for assessment, levy and collection and improving billing and collection efficiency.**

9.90 Review of SFC reports shows that States use different methods for the levy of property tax. However, we have noted that there is a convergence of views in SFC reports that property tax should be levied on plinth area basis. We endorse the views of the SFCs that all the State Governments should empower the panchayats and municipalities to levy property tax on this basis. **We suggest that the existing rules be reviewed and amplified to facilitate the levy of**

property tax and the granting of exemptions be minimised. The assessment of properties may be done every four or five years and the urban local bodies should introduce the system of self-assessment. We recommend that action be taken by the States to share information regarding property tax among the municipalities, State and Union Governments.

Use of Land-based Instruments

9.91 Some SFCs have observed that the urban local bodies do not have a systemic approach to listing of vacant lands. Therefore, such lands often go untaxed and the vacant land tax is demanded only when owners approach authorities for approval of building plans. The SFCs have observed the need to rationalise the rates of taxes on vacant land and have suggested that the tax be fixed as a percentage of the tax on buildings, depending on the class of the city. In our view, this tax, if administered properly, has the potential to earn large revenues for the urban local bodies. **We suggest that the levy of vacant land tax by peri-urban panchayats be considered. In addition, a part of land conversion charges can be shared by State Governments with municipalities and panchayats.**

9.92 Some SFCs have observed that betterment tax is available to both gram panchayats and municipalities as an optional tax. In rural areas, the tax was linked to the improvement in property under schemes carried out by the gram panchayat. As such works were generally small, these did not result in any appreciable improvement in the value of the property and so the tax realised does not increase substantially. The urban local bodies were generally not levying this tax, even though they are allowed to. **We, therefore, recommend that the States should review the position and prepare a clear framework of rules for the levy of betterment tax.**

Advertisement tax

9.93 The reports of some SFCs revealed the fact that panchayats reported low income from advertisement in cases where it was being collected by the district administration for passing on to the panchayats. Even in cases where the panchayats were empowered to collect the tax, most of them were not doing so. In the case of urban local bodies, the tax had two components - tax on hoardings and the tax on advertisements on buses, cars, lamp posts and compound walls. The SFCs also pointed out that in some States, relevant legislation allowed the municipal corporations to collect advertisement tax, but did not give powers to the Tier II and III municipalities to levy the tax. **We are of the view that there is no reason why the incomes of local bodies from advertisement tax cannot increase significantly. In this context, we suggest that States may like to consider steps to empower local bodies to impose this tax and improve own revenues from this source.**

Entertainment tax

9.94 The study on municipal finances indicates that the collection of entertainment tax reported by urban local bodies was low. Three States accounted for most of the collections reported by the States. The study suggests that States should exploit entertainment tax effectively through improved methods of levy and collection. In our view, the entertainment tax legislation and rules in States require a comprehensive review. Newer forms of entertainment such as boat rides, cable television

and internet cafes should be brought into the entertainment tax net and no exemptions should be given without compensating local bodies for the loss. **We, therefore, recommend that States review the structure of entertainment tax and take action to increase its scope to cover more and newer forms of entertainment.**

Tax on professions, trades, callings and employments

9.95 Article 276 of the Constitution provides for the levy of a tax on professions, trades, callings and employments for the benefit of the State or local bodies at a rate not exceeding Rs. 2,500 per tax payer per annum. The States, SFCs and local bodies have expressed the view that this tax can be a major source of income for the local bodies if the ceiling can be raised periodically and the tax can be collected efficiently.

9.96 At present, twenty-one states impose professions tax through various laws, adhering to the limit of Rs. 2,500. The coverage of the tax varies - it is generally applicable to all persons engaged in any employment or in any profession in some States, but only to certain specified professions in others. In some States, the tax is levied and collected by the State Government alone, while in others such as Kerala and Tamil Nadu, local bodies also levy and collect the tax under the State legislation. In our view, the low contribution of professions tax to the revenues of the State is largely due to poor collection mechanisms and enforcement at the State level as well as the low limit fixed. The FC-XI had suggested that the rates should be suitably revised to bring them nearer to the ceiling prescribed under the Constitution. They further recommended that the ceiling had been fixed in 1988 by amending the Constitution and needed suitable enhancement. The Commission suggested that Parliament should be empowered to fix this ceiling without going in for a Constitutional amendment each time. Even after fourteen years, no action has been taken to enhance the ceiling on professions tax.

9.97 In our view, professions tax could be one of the important sources of revenue for local bodies, if they are allowed to levy and collect it under the State legislations within the ceilings set by the Parliament. To arrive at a reasonable estimation of the ceiling for professions tax we considered three methods. First, was to index the ceiling on professions tax to the annual growth rate of per capita nominal GSDP. The second method was to consider the historic growth of professions tax in between 1935 and 1988 and from 1950 to 1988 using compound annual growth rate for the two periods as well as the trend growth rate from 1935 to 1988. The third method was to index it to the per capita emoluments of public sector employees. These methods yielded different estimates for the ceiling. **Therefore, taking into consideration all factors, we recommend raising the ceiling from Rs. 2,500 to Rs. 12,000 per annum. We further recommend that Article 276(2) of the Constitution may be amended to increase the limits on the imposition of professions tax by States. The amendment may also vest the power to impose limits on Parliament with the caveat that the limits should adhere to the Finance Commission's recommendations and the Union Government should prescribe a uniform limit for all States.**

Non-Tax Measures

9.98 We noted that the SFC reports have identified the main issues that affect the income of gram panchayats from non-tax revenue sources. First, certain productive assets such as village

ponds and orchards, which can generate revenues, have not been assigned to the gram panchayats in some States. Similarly, in some States, gram panchayats do not get incomes from market fees because these are assigned to market committees. Second, rates of fees have not been revised for several years, in some cases for more than five to six decades. Thirdly, in certain States the rural local bodies were unable to collect tolls, fees and duties as the rules for this purpose had not been framed and notified. To improve incomes by obtaining better rates, one SFC suggested that the annual sale value should be determined before auctioning common resources such as fisheries, ponds, ferries, markets and halls for rent. **In this context, we recommend that State Governments take action to assign productive local assets to the panchayats, put in place enabling rules for collection and institute systems so that they can obtain the best returns while leasing or renting common resources.**

9.99 The study on municipal finances pointed out that the urban local bodies are reporting an increase in user charges collected. However, the study suggested that the user charges need rationalisation and also need to be linked with improvement in service levels. We noted that the SFCs have observed that there was a need in urban areas to rationalise and collect charges for basic services provided and that the charges should be so fixed such that the local body is able to recover at least the operation and maintenance cost of the services from the beneficiaries. The SFCs have also stressed on the need to review and periodically update the charges and fees for all the services being provided by the local bodies. Some SFCs have pointed out the need to educate elected representatives, local body functionaries as well as the general public on the importance of own revenues for local bodies and the need to pay for improved delivery of public services. **We recommend that the urban local bodies rationalise their service charges in a way that they are able to at least recover the operation and maintenance costs from the beneficiaries.**

Income from cess or royalty on minor minerals

9.100 Royalty or cess on royalty on minor minerals is shared by some States with local bodies, mainly panchayats. In one State, the royalty on sand had been removed and regulation of sand mining had been entrusted to panchayats. In a few States where royalties were shared, SFCs have observed that the full amounts of the share were not being released to the local bodies. Another SFC noted that the revenues from royalty on minor minerals had not grown in proportion to the increase in the consumption of materials. The SFC of another State pointed out that only Class C municipalities were allowed a share of the cess on royalty.

9.101 **We are of the view that mining puts a burden on the local environment and infrastructure, and, therefore, it is appropriate that some of the income from royalties be shared with the local body in whose jurisdiction the mining is done. This would help the local body ameliorate the effects of mining on the local population.**

Service charges on government property

9.102 Article 285(1) of the Constitution exempts all properties of the Union Government from all taxes imposed by a State or any other authority within a State, unless Parliament expressly provides for such levy by law. The FC-XI had recommended that all government properties of the Union as well as the States should be subject to levy of user charges which should be regulated

by suitable legislations. The FC-XIII had urged that the Union Government and the State Governments issue executive instructions that all their respective departments pay appropriate service charges to the local bodies. In a number of States, local body representatives pointed out that the local bodies needed to be compensated for the civic services they provided. **In this context, we recommend that the Union and State Governments examine in depth the issue of properly compensating local bodies for the civic services provided by them to government properties and take necessary action, including enacting suitable legislation, in this regard.**

9.103 We are of the view that the local bodies are not able to meet even a fraction of their expenditure on providing basic services and have largely become dependent on the transfer of one fund or another. While we have sought to incentivise additional resource mobilisation through the performance grants, there is a need for the States to empower the local bodies to collect tax and non-tax receipts. To implement the measures outlined above, the State Governments may have to bring in necessary legislations as appropriate. In some cases, the State Governments may need to frame rules and fix rates of levy to allow the local bodies to effectively tap the existing sources of revenues. Alternatively, the local bodies may be given powers to decide the rates themselves, subject to a floor and ceiling rate set by the State. Besides, the State Government should not provide exemptions to any entity from the tax and non-tax levies that are in the jurisdiction of local bodies. In cases where the grant of such an exemption becomes necessary, the local bodies should be compensated for the loss.

Issue of Municipal Bonds

9.104 The resource requirements of local bodies for the delivery of basic services and creation of infrastructure are too large and no single source may be able to provide all the funds needed for this. In this context, we note that the Finance Commission's role is only to supplement the resources of the panchayats and municipalities, not substitute them. It is for the local bodies, particularly the urban local bodies, to take appropriate action, with the support of the State Governments, to augment their own revenue sources and also explore sources of borrowings, including issuance of bonds for meeting huge requirements for provision of basic civic services and creation of urban infrastructure.

9.105 The study on municipal finances points out that only ten States reported borrowings by urban local bodies. Of the Rs. 920 crore borrowed by them in 2012-13, Rs. 854 crore was borrowed by municipal corporations. Of these, municipal corporations in Madhya Pradesh and Maharashtra accounted for Rs. 548 crore. The study observes that market or institutional borrowings are less popular among urban local bodies. The study recommends that State Governments should remove restrictions on the borrowing powers of urban local bodies and give them freedom to mobilise resources, based on their credit ratings.

9.106 We note that the market for municipal securities has grown slowly but noticeably after the Corporation of Ahmedabad issued bonds. Since 1998, local bodies in other cities like Nashik, Nagpur, Ludhiana, and Madurai have accessed the capital markets through municipal bonds. In most cases, bond proceeds have been used to fund water and sewerage schemes or road projects. Tamil Nadu and Karnataka have experimented with pooled financing with an intermediary, set up by the State, borrowing for the purpose of on lending to small municipalities which may not be able to access the capital market on their own.

9.107 **In India, the market for municipal bonds is insignificant and the municipal bonds have played a limited role as a source of finance for funding urban infrastructure projects. We recommend that local bodies and States explore the issuance of municipal bonds as a source of finance with suitable support from the Union Government. The States may allow the larger municipal corporations to directly approach the markets while an intermediary could be set up to assist medium and small municipalities who may not have the capacity to access the markets directly.**

Excluded Areas

9.108 After detailed deliberations on the existing provisions in the Constitution and the ToR, we conclude that we cannot recommend grants to areas where Part IX and Part IX A do not apply, and also where the States have not enacted laws for establishing duly-elected panchayats and municipalities.

9.109 Areas under Schedule VI in Meghalaya, Mizoram, Tripura and Assam, the areas in the hill districts of Manipur, rural areas of Nagaland and Mizoram will remain outside the ambit of the measures we have recommended for panchayats and municipalities. However, we note the weight of the argument put before us by the concerned States that these areas are in pressing need of assistance. We note that the Constitution mandates the Union Government to play a direct role in supporting the development of these areas. However, going by the quantum of the assistance given over the years to these regions by the Ministries in Union Government, we note that the intervention of the Union Government under the proviso to Article 275(1) has been very limited.

9.110 **We urge the Union Government to consider a larger, sustained and more effective direct intervention for the upgradation of administration as well as development of the areas covered under the proviso to Article 275(1) and excluded from the consideration of Finance Commissions in the ToR, in order to bring such areas on par with other areas.**

Recommendations

- i. We recommend that the local bodies should be required to spend the grants only on the basic services within the functions assigned to them under relevant legislations. (para 9.56)
- ii. We recommend that the books of accounts prepared by the local bodies should distinctly capture income on account of own taxes and non-taxes, assigned taxes, devolution and grants from the State, grants from the Finance Commission and grants for any agency functions assigned by the Union and State Governments. In addition to the above, we also recommend that the technical guidance and support arrangements by the C&AG should be continued and the States should take action to facilitate local bodies to compile accounts and have them audited in time. (para 9.61)
- iii. We recommend distribution of grants to the States using 2011 population data with weight of 90 per cent and area with weight of 10 per cent. The grant to each State will be divided into two - a grant to duly constituted gram panchayats and a grant to duly constituted municipalities, on the basis of urban and rural population of that State using the data of Census 2011. (para 9.64)

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- iv. We have worked out the total size of the grant to be Rs. 2,87,436 crore for the period 2015-20, constituting an assistance of Rs. 488 per capita per annum at an aggregate level. Of this, the grant recommended to panchayats is Rs. 2,00,292.2 crore and that to municipalities is Rs. 87,143.8 crore. The grant assessed by us for each State for each year is fixed. (para 9.69)
- v. We have recommended grants in two parts - a basic grant and a performance grant for duly constituted gram panchayats and municipalities. In the case of gram panchayats, 90 per cent of the grant will be the basic grant and 10 per cent will be the performance grant. In the case of municipalities, the division between basic and performance grant will be on a 80:20 basis. The shares of the States for these grants are set out in Annex 9.1. (para 9.70)
- vi. We recommend that the grants should go to gram panchayats, which are directly responsible for the delivery of basic services, without any share for other levels. We expect that the State Governments will take care of the needs of the other levels. The earmarked basic grants for gram panchayats will be distributed among them, using the formula prescribed by the respective SFCs for the distribution of resources. Similarly, the basic grant for urban local bodies will be divided into tier-wise shares and distributed across each tier, namely the municipal corporations, municipalities (the tier II urban local bodies) and the nagar panchayats (the tier III local bodies) using the formula given by the respective SFCs. The State Governments should apply the distribution formula of the most recent SFC, whose recommendations have been accepted. (para 9.72)
- vii. In case the SFC formula is not available, then the share of each gram panchayat as specified above should be distributed across the entities using 2011 population with a weight of 90 per cent and area with a weight of 10 per cent. In the case of urban local bodies, the share of each of the three tiers will be determined on the basis of population of 2011 with a weight of 90 per cent and area with a weight of 10 per cent, and then distributed among the entities in each tier in proportion to the population of 2011 and area in the ratio of 90:10. (para 9.73)
- viii. We are providing performance grants to address the following issues: (i) making available reliable data on local bodies' receipt and expenditure through audited accounts; and (ii) improvement in own revenues. In addition, the urban local bodies will have to measure and publish service level benchmarks for basic services. These performance grants will be disbursed from the second year of our award period, that is, 2016-17 onwards, so as to enable sufficient time to State Governments and the local bodies to put in place a scheme and mechanism for implementation. (para 9.75)
- ix. To be eligible for performance grants, the gram panchayats will have to submit audited annual accounts that relate to a year not earlier than two years preceding the year in which the gram panchayat seeks to claim the performance grant. It will also have to show an increase in the own revenues of the local body over the preceding year, as reflected in the audited accounts. To illustrate, the audited accounts required for performance grants in 2016-17 will be for the year 2014-15; for performance grants in 2017-18, the audited accounts will be for the year 2015-16; for performance grants in 2018-19, the audited

accounts will be for 2016-17; and for performance grants in 2019-20, the audited accounts will be for 2017-18. (para 9.76)

- x. We are of the opinion that it may be better that the detailed procedure for disbursement of the performance grant to gram panchayats based on revenue improvement be designed by the State Governments concerned, keeping in view the two conditions given above. The operational criteria, including the quantum of incentive to be given, is left to the discretion of the State Governments. In case some amount of the performance grant remains after disbursement to the eligible gram panchayats, this undisbursed amount should be distributed on an equitable basis among all the eligible gram panchayats. The scheme for disbursement of the performance grant will be notified by the State Governments latest by March 2016, in order to enable the preparation of the eligibility list of local bodies entitled to them. The concerned Ministries of the Union Government will also be informed in order to facilitate release of the instalment of performance grants. (para 9.77)
- xi. A detailed procedure for the disbursement of the performance grant to urban local bodies would have to be designed by the State Governments concerned, subject to certain eligibility criteria. To be eligible, the urban local body will have to submit audited annual accounts that relate to a year not earlier than two years preceding the year in which it seeks to claim the performance grant. It will also have to show an increase in own revenues over the preceding year, as reflected in these audited accounts. In addition, it must publish the service level benchmarks relating to basic urban services each year for the period of the award and make it publically available. The service level benchmarks of the Ministry of Urban Development may be used for this purpose. The improvement in revenues will be determined on the basis of these audited accounts and on no other basis. For computing the increase in own revenues in a particular year, the proceeds from octroi and entry tax must be excluded. In case some amount of the performance grant remains after disbursement to the eligible urban local bodies, the undisbursed amount should be distributed on an equitable basis among all the eligible urban local bodies that had fulfilled the conditions for getting the performance grant. (para 9.78)
- xii. These guidelines for the disbursement of the rural and urban performance grants will remain in force for the period of our award. We recommend that the Union Government accept the detailed procedure prepared by the State which incorporates our broad guidelines without imposing any further conditions. (para 9.79)
- xiii. We recommend that no further conditions or directions other than those indicated by us should be imposed either by the Union or the State Governments for the release of funds. (para 9.80)
- xiv. The grants recommended by us shall be released in two instalments each year in June and October. This will enable timely flows to local bodies during the year, enabling them to plan and execute the works better. We recommend that 50 per cent of the basic grant for the year be released to the State as the first instalment of the year. The remaining basic grant and the full performance grant for the year may be released as the second instalment for the year. The States should release the grants to the gram panchayats and municipalities within fifteen days of it being credited to their account by the Union Government. In case

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- of delay, the State Governments must release the instalment with interest paid from its own funds. (para 9.81)
- xv. We recommend that stern action should be ensured if irregularities in the application of funds are noticed or pointed out. (para 9.82)
 - xvi. We recommend that the State Governments should strengthen SFCs. This would involve timely constitution, proper administrative support and adequate resources for smooth functioning and timely placement of the SFC report before State legislature, with action taken notes. (para 9.84)
 - xvii. We suggest that the existing rules be reviewed and amplified to facilitate the levy of property tax and the granting of exemptions be minimised. The assessment of properties may be done every four or five years and the urban local bodies should introduce the system of self-assessment. We recommend that action be taken by the States to share information regarding property tax among the municipalities, State and Union Governments. (para 9.90)
 - xviii. We suggest that the levy of vacant land tax by peri-urban panchayats be considered. In addition, a part of land conversion charges can be shared by State Governments with municipalities and panchayats. (para. 9.91)
 - xix. We recommend that the States should review the position and prepare a clear framework of rules for the levy of betterment tax. (para 9.92)
 - xx. We suggest that States may like to consider steps to empower local bodies to impose advertisement tax and improve own revenues from this source. (para 9.93)
 - xxi. We recommend that States review the structure of entertainment tax and take action to increase its scope to cover more and newer forms of entertainment. (para 9.94)
 - xxii. We recommend raising the ceiling of professions tax from Rs. 2,500 to Rs. 12,000 per annum. We further recommend that Article 276(2) of the Constitution may be amended to increase the limits on the imposition of professions tax by States. The amendment may also vest the power to impose limits on Parliament with the caveat that the limits should adhere to the Finance Commission's recommendations and the Union Government should prescribe a uniform limit for all States. (para 9.97)
 - xxiii. We recommend that State Governments take action to assign productive local assets to the panchayats, put in place enabling rules for collection and institute systems so that they can obtain the best returns while leasing or renting common resources. (para 9.98)
 - xxiv. We recommend that the urban local bodies rationalise their service charges in a way that they are able to at least recover the operation and maintenance costs from the beneficiaries. (para 9.99)
 - xxv. We are of the view that mining puts a burden on the local environment and infrastructure, and, therefore, it is appropriate that some of the income from royalties be shared with the local body in whose jurisdiction the mining is done. This would help the local body ameliorate the effects of mining on the local population. (para 9.101)

- xxvi. We recommend that the Union and State Governments examine in depth the issue of properly compensating local bodies for the civic services provided by them to government properties and take necessary action, including enacting suitable legislation, in this regard. (para 9.102)
- xxvii. We recommend that the local bodies and States explore the issuance of municipal bonds as a source of finance with suitable support from the Union Government. The States may allow the larger municipal corporations to directly approach the markets while an intermediary could be set up to assist medium and small municipalities who may not have the capacity to access the markets directly. (para 9.107)
- xxviii. We urge the Union Government to consider a larger, sustained and more effective direct intervention for the upgradation of administration as well as development of the areas covered under the proviso to Article 275(1) and excluded from the consideration of Finance Commissions in the ToR, in order to bring such areas on par with other areas. (para 9.110)

Chapter 10

Disaster Management

10.1 The financing of disaster relief has been an important aspect of federal fiscal relations. Successive Finance Commissions since the FC-II have provided 'margin money' for such contingencies. From the time of the FC-VI, the terms of reference (ToR) have specifically entrusted each Commission with the task of considering the arrangements between the Union Government and State Governments relating to financing disaster management and making recommendations on the subject. When earlier Commissions examined the issues, there was no specific law relating to disaster management. By the time the FC-XIII was constituted, Parliament had enacted the Disaster Management Act, 2005. However, the various funds envisaged under the Act had not been constituted. Some of the funds prescribed under the law have since been constituted, and arrangements for their operations put in place. Our mandate, under Para 9 of the ToR, requires us to "review the present arrangements on financing of Disaster Management with reference to the *funds constituted* under the Disaster Management Act, 2005 (53 of 2005) and make appropriate recommendations thereon".

10.2 The Disaster Management Act provides for the effective management of disasters and all related matters, including the mechanisms for funding disaster relief and response. The Act defines disaster in very broad terms to include both natural and man-made disasters. It envisages the constitution of two types of funds, one for disaster response and the other for mitigation. These are to be set up at the national, state and district levels. Thus, for disaster response, the Act envisages a National Disaster Response Fund (NDRF), a State Disaster Response Fund (SDRF) in each State and, within the States, a District Disaster Response Fund (DDRF) in each district. Similarly, the Act envisages a National Disaster Mitigation Fund (NDMF), State Disaster Mitigation Funds (SDMF) and District Disaster Mitigation Funds (DDMF) for disaster mitigation. So far, at the national level, only the NDRF has been constituted. All State Governments have constituted an SDRF, but only a few have constituted an SDMF. Very few State Governments have constituted District Disaster Response Funds (DDRFs). During a disaster, relief activities at the district level are generally carried out through transfers from the SDRF.

10.3 Considering that mitigation funds have not been established at the national level and in most States, replacement of the term '*envisaged*' with '*constituted*' is a significant departure in the scope of our ToR, compared to that given to the FC-XIII. Seen along with the fact that the ToR also requires us to "review the present arrangements as regards financing of Disaster Management", this implies that our recommendations be restricted to existing arrangements on the financing of constituted funds and not deal with those which are yet to be constituted, since these are not a part of the 'present arrangements'. We, therefore, limit our recommendations to the 'financing' of the 'funds constituted' - the NDRF, SDRFs and DDRFs - and examine issues related to the operations of these funds.

Existing Arrangements for Disaster Management

10.4 The primary responsibility for undertaking rescue, relief and rehabilitation measures during a disaster lies with the State Governments. The Union Government supplements their efforts through logistic and financial support during severe natural disasters. Based on the recommendations of the FC-XIII, the National Calamity Contingency Fund (NCCF) was merged with the newly constituted NDRF. Similarly, at the state level, the Calamity Relief Fund (CRF) was merged with the SDRF. Financing of the SDRF is based on the recommendations of the Finance Commissions, which determine the annual size of the Funds as well as the respective contributions of the Union and State Governments. The NDRF is financed through the levy of a cess on certain items, chargeable to excise and customs duty, and approved annually through the Finance Bill. The requirement for funds beyond what is available under the NDRF is met through general budgetary resources. The Union Government has issued guidelines on the items and norms of assistance, the natural calamities eligible for funding, accounting norms and audit arrangements, procedures for the release of funds and the respective share of each State as well as its contribution under the award of the FC-XIII towards the SDRF. The notified calamities based on the recommendations of successive Finance Commissions include cyclones, droughts, earthquakes, fires, floods, tsunamis, hailstorms, landslides, avalanches, cloud bursts and pest attacks. The Union Government has recently added 'cold waves' and 'frost' to that list. The norms under each type of disaster were last revised in November 2013.

10.5 The National Policy on Disaster Management (NPDM) issued under the Disaster Management Act envisages building a safe and disaster-resilient India by developing a holistic, proactive, multiple disaster-oriented and technology-driven strategy through a culture of prevention, mitigation, preparedness and response. Under the provisions of the Act, the National Disaster Management Authority (NDMA) has been set up and the National Disaster Response Force raised.

10.6 At the state level, the institutional mechanisms of State Disaster Management Authorities (SDMA) and the District Disaster Management Authorities (DDMAs) have been put in place. Existing institutions have been strengthened to give priority to, and enhance their capacities for, rescue, relief, rehabilitation and mitigation. Some States have raised a State Disaster Response Force along the lines of the National Disaster Response Force. States have also focussed on training and generating awareness to help cope with disasters.

Views of the State Governments

10.7 The frequency and severity of disasters, particularly cyclones, floods and droughts, are high in some States. Even in others where the severity and frequency may be moderate or low, the need for additional support is clearly evident from trends in expenditure over the years. This was articulated by States in their views on various aspects of disaster management as well as on financing of relief expenditure. In their memoranda submitted to the Commission, they sought an increase in the size of the SDRF and the relative share of the Union Government, a review of the methodology adopted by Finance Commissions, a streamlining of the processes for assistance under the NDRF, the need to revisit normative ceilings, expansion of the list of disasters covered and review of the accounting norms.

10.8 A major concern for the States has been the fiscal burden of financing disaster management, including relief and reconstruction, without a commensurate flow of resources from the Union Government. As a consequence, State Governments said, they were compelled to spend funds in excess of the SDRF from their own resources, particularly on post-disaster restoration and reconstruction. They asked for a substantial increase in the SDRF corpus based on expenditures they had incurred on calamity relief, including reconstruction and restoration of assets in the affected areas. Some States, particularly the North-eastern States, were of the view that the SDRF should be financed entirely by the Union Government as they find it difficult to provide matching contributions towards the SDRF. Others asked for an increase in the Union Government's share from the present level of 75 per cent, with some urging full funding by the Union Government.

10.9 Views were also expressed on the inter-state distribution of grants to be recommended by us. Many States argued that special weightage should be given to vulnerability of States rather than to actual expenditure incurred in the past. They stressed the need to consider the size of the calamity-prone area and the duration and frequency of calamities as determining factors. In this regard, some States raised the issue of developing a Hazard Risk Vulnerability Index which would reflect States' vulnerability to disasters and the consequent need for more funds. They also suggested using the profiles for droughts and cyclones that is prepared by the NDMA as the basis for fixing the size of the SDRF.

10.10 The State Governments asked for an increase in the size of the NDRF and advocated that the norms for expenditure under this Fund be expanded and made flexible in order to cover reconstruction and mitigation. They suggested that the Commission recommend an expansion in the scope of assistance from the NDRF to include all items of expenditure for post-disaster management, including response, relief, rehabilitation and reconstruction. A common concern was the cumbersome processes and delays in the assessment of relief assistance from the NDRF. They suggested that funds be released in a transparent and predictable manner to enable States to plan, execute and spend on reconstruction and rehabilitation. They also suggested that an adequate advance amount be released to States as soon as a severe calamity occurs, without waiting for the assessment of the Central team and its consideration by the High-Level Committee.

10.11 Many States stressed the need for an upward revision in the norms for assistance under almost all items of relief, and indexing these norms to inflation. They also complained that the norms for assistance had remained fixed for more than five years without taking annual inflation into account. Further, they argued that the input costs of labour and materials vary across States, so a normatively fixed, 'one-size-fits-all' formula discriminates against those States where the basic input costs are comparatively higher. Therefore, States advocated either the development of state-specific norms or permission to set their own norms for utilisation of the SDRF.

10.12 States urged the inclusion of various kinds of disasters in the eligible list for funding support from the SDRF and NDRF. Suggestions included soil erosion from river and sea waters, lightning and thunderbolts, landslides, tornados, cloudbursts, heat waves, ground cracks, water logging, snake bites, attacks by wild animals or pests, monkey menace and bamboo flowering. A case was also made for the inclusion of man-made disasters in our assessment. Some States suggested that a mitigation fund needs to be provided for, and specific grants be recommended by us for the SDMF and the DDMF.

10.13 On the funding and operationalising of the DDRF, the general view among the States is that they should have flexibility in its constitution as well as financing. It was argued that the States already have a well-established mechanism for the timely transfer of the funds to the district level when required. Constituting DDRFs at the district level and routing funds to them from the SDRF will result in funds being thinly spread across districts and becoming locked in areas not necessarily affected by a natural calamity, as well as the State Government losing its flexibility to pool funds for disaster management. Accordingly, they urged that constituting a DDRF should not be made mandatory. States which have already constituted a DDRF asked for the provision of additional grants-in-aid over and above the SDRF.

10.14 Considering the usefulness of grants and the continuing need for capacity-building for effective and efficient disaster response, States requested that the capacity-building grant recommend by the FC-XIII be continued. They added that they used these grants for capacity building, to improve their disaster response and to prepare district-level and state-level disaster management plans as envisaged in the Disaster Management Act.

10.15. The methodology for the calculation of balances under the SDRF for releases under the NDRF was also raised by some States. They suggested that SDRF balances be realistically assessed at the time of determination and release of assistance from the NDRF.

Views of the Union Government

10.16 Our consultations with the Union Government on the subject included discussions with the Union Ministry of Home Affairs, the nodal ministry for handling all types of disasters other than drought, the Union Ministry for Agriculture, the nodal ministry for drought relief, the Ministry of Finance, Ministry of Defence and the NDMA. The Ministry of Home Affairs and the NDMA felt that the size of the SDRF needs to be enhanced substantially, given the rising intensity and frequency of disasters. The Ministry of Home Affairs estimated that the funds for the SDRF during our award period could be increased by 50 per cent to Rs. 50,372 crore, from the allocation of Rs. 33,581 crore by the FC-XIII. In the NDMA's assessment, the SDRF needs to be augmented by 75 per cent to Rs 58,758 crore, on the grounds of the rapidly rising frequency of disasters. On the ratio of the shares of the Union Government and State Governments in the SDRF, the Ministry of Home Affairs advocated retaining the present 75:25 ratio for general category states and 90:10 for special category states. In addition, it suggested that a special component be created within the SDRF to specifically address the medium-term and long-term post-disaster restoration of damaged infrastructure.

10.17 While both the Ministry of Home Affairs and NDMA agreed with the usefulness of a Hazard Risk Vulnerability Assessment for States in determining the size of the SDRF, they pointed to the absence of such a validated assessment index at present. On our request, the NDMA shared with us the vulnerability index attempted on parameters of floods, erosion, tidal waves, earthquakes, droughts and landslides. However, they informed us that the index, which has been compiled by the Building Materials and Technology Promotion Council (BMTPC) under the Union Ministry of Housing and Poverty Alleviation, has not been validated by any scientific study. The Ministry of Home Affairs also concurred with their view that there is scope for further improvement by making use of a digital elevation model.

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10.18. On the constitution of DDRFs, the Ministry of Home Affairs felt that in view of the federal administrative system in the country, DDRFs may be financed out of the SDRF and their constitution or otherwise be left to the discretion of State Governments.

10.19. The Ministry of Home Affairs also informed us that the norms for relief expenditure are being periodically revised in line with rising costs of relief. The last revision took place in November 2013. The NDMA suggested that the Commission formulate guiding principles governing relief expenditure in consultation with the States, providing them more flexibility on the inclusion of items, costing and timelines.

10.20 On the issue of expanding the eligible list of natural calamities, both the Ministry of Home Affairs and the NDMA said they had received several representations from various State Governments to consider the inclusion of different types of events such as lightning, heat waves, snake bites, forest fires, sea erosion, rail/road/boat accidents, bamboo flowering, river bank erosion and coastal erosion as disasters, to enable the provision of financial assistance from the SDRF/NDRF to affected people. Although these disasters do not occur in every State, the State representatives felt that they have a major impact on large areas of various regions, leading to enormous damage and loss of crops and human lives. They left it to the Commission to make appropriate recommendations on the inclusion of disasters in the existing list.

10.21 On the NDMF, the Ministry of Home Affairs has informed us that no final view on its constitution has been taken. The NDMA strongly urged us to recommend the setting up of such a Fund as envisaged under the Disaster Management Act, with States contributing 25 per cent of the corpus, which will be used exclusively for mitigation projects, cross-cutting themes and gap areas. The Ministry of Finance has issued guidelines on 'flexi-funds,' under which 10 per cent of the funds available under Centrally Sponsored Schemes (CSS) can be used for disaster mitigation. The Ministry of Home Affairs submitted that the scheme for flexi-funds would be monitored to see whether the new guidelines notified on 1 April 2014 meet the needs of disaster mitigation.

10.22 The Ministry of Defence urged a review of the procedures for funding expenditure incurred by the Defence Services while rendering aid to State Governments during a natural calamity. The existing procedure is lengthy and complicated: the NDRF releases the funds to the respective State Governments, which, in turn, reimburse the Defence Services after the submission of bills. Further, the Ministry of Defence, in its accounts, categorises the funds received as receipts, which means they cannot be diverted to meet current expenditure. It urged that a more efficient mechanism needs to be devised to ensure that the defence budget is insulated from the impact of such expenditure.

Approach of the Previous Finance Commissions

10.23 At the national level, a dedicated fund for calamity relief was first recommended by the FC-IX. Prior to this, the Commissions set apart specific amounts under the 'margin money' scheme recommended by the FC-II to meet expenditures on relief measures. The FC-IX recommended the establishment of a CRF in each State, with 75 per cent contribution by the Union Government and 25 per cent by the State. For calamities of rare severity, the Union Government was asked to render assistance and support beyond that envisaged in the CRF. The FC-X put in place a formal mechanism and recommended the setting up of a National Fund for Calamity Relief (NFCR) to assist a State affected by a 'calamity of rare severity' through contributions from the Union and

State Governments. The fund was to be managed by a National Calamity Relief Committee with representation from both the Union and State Governments. The FC-XI modified this and recommended the setting up of a NCCF with an initial corpus of Rs. 500 crore. The funds were to be recouped by levying a special surcharge on Central taxes. The FC-XII continued with this arrangement.

10.24 With the enactment of the Disaster Management Act and consequent changes in the design and structure of disaster management, the FC-XIII recommended the merger and transfer of NCCF balances, as on 31 March 2010, to the NDRF which was accepted and notified by the Union Government. In the event of a disaster of 'a severe nature', in which the funds needed for relief operations exceeded the balances in the SDRF account, additional assistance would be provided from the NDRF after following prescribed procedures. Based on the recommendations of the FC-XIII, the available balances in the CRF on 1 April 2010 were merged with the SDRF. The NCCF's balance was similarly merged with the NDRF. Since financial year 2010-11, the Union Government has been financing the NDRF through the levy of a cess and the SDRF as grants-in-aid, based on the recommendations of the FC-XIII. The Disaster Management Act has not framed specific rules for the merger of funds or for the financing of the NDRF and SDRF.

Financing of National Disaster Response Fund

10.25 Currently, a National Calamity Contingency Duty (NCCD) is levied to finance the NDRF and additional budgetary support is provided as and when necessary. A provision also exists to encourage any person or institution to make a contribution to the NDRF. However, the Ministry of Home Affairs pointed out that this source has not yet been tapped. Table 10.1 gives details of the flow of funds to the NDRF (known as the NCCF prior to 2010) between 2002-03 and 2011-12.

Table 10.1: Collection of NCCD and Release from NCCF/NDRF (2002-03 to 2011-12)

(Rs. crores)

Year	National Calamity Contingent Duty (NCCD) Collected	Release from NCCF/NDRF
2002-03	1648.45	1600.00
2003-04	1740.13	1587.42
2004-05	1484.44	2583.12
2005-06	1274.67	3061.44
2006-07	1727.88	1962.05
2007-08	2268.36	373.38
2008-09	2319.73	2279.92
2009-10	2619.56	3261.52
2010-11	2966.51	4179.25
2011-12	3246.16	2458.12
Total	21295.89	23346.92

Source: Data provided by the NDMA

10.26 As evident from the data given by the NDMA for the period 2002-03 to 2011-12, total collection through the NCCD was Rs. 21,295.89 crore while releases under the NCCF/NDRF was Rs 23,346.92 crore, indicating that additional releases of Rs. 2,051.03 crore were met through budgetary resources. **The financing of the NDRF has so far been almost wholly through the levy of cess on selected items, but if the cesses are discontinued or when they are subsumed under the goods and services tax (GST) in future, we recommend that the Union Government consider ensuring an assured source of funding for the NDRF.**

10.27 In the subsequent paragraphs, we have set out the methodology for the assessment of the SDRF for each State for our award period. These funds should normally be sufficient to meet the challenges posed by disasters during our award period. However, when severe disasters occur, it must be ensured that the NDRF has sufficient funds to help the affected States. The pattern of expenditure from these funds over the last decade indicates the increasing frequency of disasters of rare severity. Expenditures have been so high in some years that they exceed inflows into the fund. It is important that budgetary allocations are sufficient to meet the demands arising from national calamities so as to avoid ad hoc arrangements. It is also necessary to reassure States that the Union Government would make available adequate resources to provide immediate support in times of crisis. The Disaster Management Act was legislated to provide for the effective management of disasters, and it clearly defines the roles of the Union and State Governments. Thus, the timely availability and release of adequate funds under the NDRF to meet the requirements of disasters of rare severity are essential. **We, therefore, recommend that while making appropriations into the NDRF, past trends of outflows from it should be taken into account to ensure adequacy of the Fund, while assuring the timely availability and release of funds to the States.**

10.28 The cause of disaster management will be served better if clear and transparent rules are framed on financing the NDRF. This would also help augment resources for disaster management through contributions from people or institutions. Currently, funds contributed to the Prime Minister's Relief Fund or the State Chief Minister's Relief Fund are exempt from income tax. The Ministry of Home Affairs has informed us that modalities are being explored for the extension of tax exemptions to private contributions to the NDRF as well. **Contributions could be another source of financing the NDRF and we recommend that a decision on granting of tax exemption to private contributions to the NDRF be expedited.**

10.29 The Union Government could also explore the possibility of incorporating in these rules on financing of the NDRF, expenditures that are categorised under the head of corporate social responsibility (CSR) under Section 135 of the Companies Act of 2013. Schedule VII of the Companies (Corporate Social Responsibility Policy) Rules 2014 relating to CSR states that companies may provide funds for the Prime Minister's Relief Fund or *'any other fund set up by the Central Government or the State Governments for socio-economic development and relief'*. **We recommend that the Union Government consider invoking the use of this as an enabling provision for financing the NDRF.**

10.30 **We recommend a review of the current arrangements for the reimbursement of expenditure incurred by the defence forces on disaster relief, since we are convinced that these could have an adverse impact on their operational efficiency.**

Financing of State Disaster Response Fund

10.31 Successive Finance Commissions have been concerned about funding disaster management so as to ensure adequate and timely relief to those in distress. They were also mindful of the impact of such expenditure on States' finances, as well as the adequacy of funds required to deal with disaster situations. As mentioned earlier, the FC-IX recommended setting up a Calamity Relief Fund for each State to which the Union Government was to contribute 75 per cent of funds while the balance was to be contributed by the States. Contributions by States were retained by successive Finance Commissions in order to bring in the commitment of States in disaster management. This arrangement was slightly altered by the FC-XIII, which reduced the State share for Special Category States to 10 per cent on the grounds that anything above that would overstretch their fiscal capacity. The States' contribution was built into the forecast of expenditure estimates of States.

10.32 The SDRF is the primary Fund available with States for disaster response. The Disaster Management Act mandates that States constitute a SDRF once the constitution of the State Authority is notified. While the Act clearly provides two sources of financing the NDRF, no source has been laid down for the SDRF. It is implied that the corpus of the SDRF will be the grant recommended by the Finance Commission under Article 275 (1) of the Constitution.

10.33 The States raised the issue of the increase in the frequency and intensity of disasters and the rising costs of relief, rehabilitation and reconstruction. Their views were echoed by the Ministry of Home Affairs and the NDMA. Estimates of the size of the SDRF and desired proportionate increases provided by them, however, vary considerably across States. The question is what would be an appropriate methodology to determine the quantum of funds considered adequate for dealing with disasters in different States over the next five years, after factoring in cost increases due to inflation.

10.34. Many States as well as the Ministry of Home Affairs and the NDMA emphasised the relevance of the Hazard Vulnerability Risk profiles of States as the basis of the SDRF. In the past, too, Finance Commissions stressed the need for indices which reflect a State's vulnerability to disasters. The proneness of States to disasters varies, as does the type of disasters affecting them. Some States may be prone to floods while others are prone to cyclones or earthquakes, requiring varied approaches in both the response as well as requirement of funds for rescue, relief and rehabilitation. Scientifically validated risk vulnerability indicators would be useful measures of the type, frequency and intensity of disasters confronting States. But we are handicapped by the fact that as of now no such reliable indicator is available and the index being developed is yet to be scientifically validated. **We recommend that in view of the very wide responsibility cast on governments at different levels by the statute, the Union Government expedite the development and scientific validation of the Hazard Vulnerability Risk Profiles of States.**

Corpus of the SDRF

10.35 In the absence of a validated index of hazard vulnerability, and for want of any better option, we have continued to adopt the expenditure-based approach, in line with previous Commissions.

10.36 We adopted the practice of previous Commissions and used past expenditure on disaster relief for the period 2006-07 to 2012-13 to determine the SDRF corpus for each State. Further, we followed the methodology of the FC-XIII to arrive at an aggregate corpus for all SDRFs of Rs. 61,219 crore for our award period (Annexe 10.1).

Contributions from State Governments

10.37 The FC-XIII had recommended differential State shares, with general category States contributing 25 per cent and special category States contributing 10 per cent, and the balance being contributed by the Union Government as grants-in-aid. The States suggested to us that their contribution to the SDRF be reduced. Some States urged that the SDRF be funded entirely by the Union Government while others advocated reducing the States' share from the current level of 25 per cent to 10 per cent. We also noted the extraordinary demands on States to incur expenses on relief, rehabilitation and reconstruction as part of disaster management activities, which are not eligible for funding either from the SDRF or NDRF. Further, the legal mandate under the Disaster Management Act ascribes several responsibilities to States without spelling out concomitant sources of financing.

10.38 There can be no dispute that the primary responsibility for providing relief to people affected by natural calamities is that of State Governments. Nor can there be any dispute that natural calamities, apart from causing loss of life and livelihoods, leave behind a trail of destruction of public assets and private property that require urgent and expeditious restoration, all of which cast a heavy financial burden on the State Government concerned.

10.39 Our examination of the existing arrangements leads us to conclude that the sharing formula of 75:25 between the Union and State Governments for contribution to the SDRFs (earlier the CRFs) is not appropriate, given the additional responsibility cast on States and their district administrations by the Disaster Management Act, and the scale, frequency and magnitude of relief and restoration undertaken in the recent past. In our view, there is a case for enhancing the share of the Union Government in SDRFs. At the same time, even though many States urged us to recommend that the SDRF be entirely funded by the Union Government, in our assessment State contributions to the Fund need to continue to bring in States' commitment towards, and ownership of, relief measures.

10.40 We, therefore, recommend that all States contribute 10 per cent to the SDRF during our award period, with the remaining 90 per cent coming from the Union Government. We have calculated the State-wise amount, with the respective shares of the Union Government and each individual State. State-wise shares are given in Annexe 10.2.

Financing of the District Disaster Response Fund

10.41 The Disaster Management Act spells out the details of the powers and functions of the District Authority in planning, execution and supervision of disaster management efforts. Once the notification constituting the state authority is issued, constitution of the DDRF is mandatory. In that sense, all States must constitute this fund at the district level, wherever State Authorities have been constituted. However, we note that only a few States have done so. During our

consultations, many States, as well as the Ministry of Home Affairs, explained that the creation of a DDRF locks up useful resources and reduces States' flexibility to react to disasters. The FC-XIII was also of the view that the mandatory constitution of DDRFs under the Disaster Management Act merited a review.

10.42 Although the Act provides that the national-level funds for both disaster response and mitigation are to be credited with an amount from the Union Government, after due appropriation by Parliament by law, there is no analogous provision for the state and district funds. Presently, there are 660 districts in the country and the Disaster Management Act requires as many DDRFs to be constituted. However, the setting up of DDRFs in each district may, in some cases, lock up funds and lead to a fragmentation of resources across districts. Considering that technology has made it possible to move funds quickly wherever needed, their utility may be limited in States with adequate penetration of technology. **We are, therefore, in agreement with the views of the FC-XIII that the decision of constituting DDRFs is best left to the wisdom of the State Governments, and hence, we do not recommend separate grants for the financing of DDRFs.**

Norms for Expenditure

10.43 The norms for relief expenditure would affect the adequacy and financing requirements of SDRFs as well as the NDRF. These norms are issued by the Ministry of Home Affairs and are revised periodically, with the last revision having taken place in November 2013.

10.44 State Governments can incur expenditures from the SDRF/NDRF only under the items and norms approved by the Union Government. These norms are based on the report of an Expert Committee consisting of representatives of the Union ministries and State Governments. Additional expenditure beyond the norms, if any, has to be met by States from their own resources. The Ministry of Home Affairs informed us that the norms are generally revised after the awards of successive Finance Commissions. Following the award of the FC-XIII, an Expert Committee was set up and its recommendations were circulated in January 2012 to the States for their views. Norms approved thereafter have been revised in September 2012, June 2013 and November 2013.

10.45 The States drew our attention to issues relating to the admissibility norms of expenditure items for payments out of the SDRF. Three types of issues were raised - the inadequacy and insufficiency of the norms in the light of inflation and cost escalations, the need for an expansion in the scope of the norms by the inclusion of more items and the freedom for States to fix their own norms.

10.46 **We note with satisfaction that the norms for expenditure have undergone periodic revisions and that the States are being consulted in the process of reviewing the norms. We urge the Union Government to take account of the genuine concerns of the States in the consultative mechanism already in place.**

Disasters Eligible for Funding

10.47 We have examined the definition of 'disaster' in the Disaster Management Act. Section 2 (d) defines a disaster to mean a `catastrophe, mishap, calamity or grave occurrence in any area,

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arising from natural or man-made causes, or by accident or negligence, which results in substantial loss of life or human suffering or damage to, and destruction of, property, or damage to, or degradation of, the environment'. This should be of a magnitude that is 'beyond the coping capacity of the community of the affected area'. We find that most natural disasters of this nature have already been included in the list of notified disasters.

10.48 Additions and deletions to the list of disasters eligible for funding would have an impact on the financing requirements of the SDRF and NDRF. Commissions in the past have prescribed a list of natural calamities which could be eligible for funding. This list was originally drawn by the FC-II, with periodic revisions recommended by subsequent Finance Commissions.

10.49 The FC-XIII had noted that although the Disaster Management Act uses terms like 'substantial loss of life, or human suffering', 'damage to and destruction of property' and 'nature or magnitude as to be beyond the coping capacity of the community of the affected area', it does not quantify these terms. The FC-XIII had further noted that earlier Finance Commissions had merely drawn up the 'eligible list' of natural calamities, while both the modus operandi of assessment and norms of relief were decided separately by the Union Government. The FC-XIII was satisfied that as far as the SDRFs were concerned, the existing list of natural disasters adopted by earlier Finance Commissions broadly covered the needs of the States. However, it recommended that specific events, which could be man-made and require very high levels of funding but may have a low chance of occurrence, may also be financed from the NDRF, after the list of eligible disasters has been finalised and the norms for funding carefully stipulated.

10.50 Most States proposed additions to the notified list, so that these become eligible for support under the NDRF. These range from lightning, snake bites, soil erosion (from seas and rivers), landslides, cloudbursts, and heat waves to monkey menace, bamboo flowering, etc. In a geographically vast and varied country like ours, different regions are prone to different kinds of disasters.

10.51 After having examined all the relevant aspects, we find merit in the requests of the States, supported by the Ministry of Home Affairs and NDMA, that there may be location-specific natural disasters not mentioned in the notified list, that are unique to some States. We are, however, not in a position to decide which of the disasters, as additionally suggested by the States for inclusion, fulfil the criteria laid down in the definition.

10.52 The State Governments are required to incur expenditure from SDRF/NDRF according to the items and norms approved by the Union Government which are based on the report of the Expert Committee. Additional expenditure, if any, incurred over and above the norms, is required to be met by the State Governments from their own resources. **In view of the above, and considering the need for flexibility in regard to state-specific disasters, we recommend that up to 10 per cent of the funds available under the SDRF can be used by a State for occurrences which it considers to be 'disasters' within its local context and which are not in the notified list of disasters of the Ministry of Home Affairs.** However, this flexibility would be applicable only after the State has listed the disasters for inclusion and notified clear and transparent norms and guidelines for disaster relief for such disasters with the approval of the State Authority. Any amount spent by the State for such disasters over and above the ceiling would be borne out of its own resources and would be subject to the same accounting norms.

10.53 Some States have suggested the inclusion of 'man-made' disasters within the purview of notified disasters for funding under the SDRF. The definition of 'disaster' in the Disaster Management Act includes disasters arising from both natural and man-made causes. The list of notified disasters, however, consists only of natural calamities. The FC-XIII was of the view that financing of relief arrangements for such man-made disasters, which may be sporadic but require a high level of funding, should be left out of the SDRFs. It further observed that the Union Government may consider financing disaster relief for such man-made disasters out of the NDRF, after the list of eligible disasters has been drawn up, the norms for funding carefully stipulated and adequate additional funds provided. We are in agreement with the views of the FC-XIII with regard to the financing of relief expenditure on man-made disasters.

Accounting Norms and Standards

10.54 Differences of opinion on how the balance available under the SDRF is to be calculated for considering release under the NDRF has been brought before the Commission by the States. This is an important issue as it impacts the timely availability of assistance from the NDRF to the States, as well as the amount available in the SDRF. The Ministry of Home Affairs is of the view that appropriate deductions should be made from the SDRF before releasing NDRF funds, since the first charge during a severe disaster is on the SDRF. The current practice is that the release of assistance from the NDRF is subject to an adjustment of 75 per cent and 90 per cent of the balances available in the SDRF with the general and special category States, respectively. The Ministry of Home Affairs has suggested this may be reduced to 50 per cent of the opening balance as on April 1 of that year as reported by the Accountant General of the State. The States also wanted more flexibility in this regard.

10.55 The logic behind deducting 75 per cent of the available fund under SDRF for general category States and 90 per cent for special category states before calculating the release under NDRF was to exclude the contribution already made by the Union Government to the SDRF and available with the States at the beginning of the financial year. The States are of the view that this methodology reduces the funds available under SDRF for disaster relief, especially during subsequent severe disasters that require funding support from the NDRF. The suggestion made by the Ministry of Home Affairs to reduce the deduction to 50 per cent of the available balance under SDRF is also meant to ensure that States have adequate funds under SDRF for tackling severe disasters. For our award period we have recommended that the Union Government's contribution to the SDRF be raised to 90 per cent for all States. The size of the SDRF has also been increased. This will make substantially more funds available to States for disaster relief during our award period. **We, therefore, recommend that while calculating the requirement of funds from the NDRF, during severe calamities, the existing practice of adjusting the contribution made by the Union Government to the SDRF should continue.**

10.56. Our analysis of the expenditures booked by States for disaster relief showed variations in the accounting process and a departure from the prescriptions of the FC-XIII, which had laid down detailed guidelines for transfers 'to' and 'from' the SDRF, accounting for receipts under the NDRF and concomitant expenditures. As proper accounting brings transparency to expenditure reporting and enables effective audit, we endorse the recommendations of the FC-XIII and urge States to strictly adhere to the prescribed norms.

Other Issues

10.57 The Ministry of Home Affairs, in its memorandum, has requested the Commission to consider recommending a sum of Rs. 80 crore for strengthening the State Disaster Management Authorities and District Disaster Management Authorities, and that the grant-in-aid for capacity building recommended by the FC-XIII be enhanced to Rs 1,050 crore. The NDMA has suggested doubling the capacity-building grant recommended by the FC-XIII and advocated providing funds for revamping civil defence and fire services and raising and equipping State Disaster Response Forces. In addition, the NDMA has asked for funds to set up emergency operation centres in the States and districts, especially those prone to multiple hazards, and a national-level National Emergency Operation Centre at the NDMA Control Room. We believe these measures are best considered by the Union Government and the State Governments concerned

Recommendations

- i. The financing of the NDRF has so far been almost wholly through the levy of cess on selected items, but if the cesses are discontinued or when they are subsumed under the GST in future, we recommend that the Union Government consider ensuring an assured source of funding for the NDRF. (para 10.26)
- ii. While making appropriations into the NDRF, we recommend that past trends of outflows from it should be taken into account by the Union Government to ensure adequacy of the Fund in order to assure timely availability and release of funds to the States. (para 10.27)
- iii. Recognising that contributions from the public and institutions could be another source of financing the NDRF, we recommend that a decision on granting tax exemption to private contributions to the NDRF be expedited and that the Union Government consider invoking the use of Schedule VII of the Companies (Corporate Social Responsibility Policy) Rules 2014 as an enabling provision for financing the NDRF. (paras 10.28 and 10.29)
- iv. We recommend a review of the current arrangements for the reimbursement of expenditure incurred by the defence forces on disaster relief, since we are convinced that these could have an adverse impact on their operational efficiency. (para 10.30)
- v. Considering the usefulness of a scientifically validated risk vulnerability indicator to measure the type, frequency and intensity of disasters, and in view of the very wide responsibility cast on governments at different levels by the statute, we recommend that the Union Government should expedite the development and scientific validation of the Hazard Vulnerability Risk Profiles of States. (para 10.34)
- vi. We adopted the practice of the previous Commissions and used past expenditure on disaster relief for the period 2006-07 to 2012-13 to determine the SDRF corpus for each State. Further, we followed the methodology of the FC-XIII to arrive at an aggregate corpus for all States of Rs. 61,219 crore for the award period. (para 10.36)
- vii. We recommend that all States contribute 10 per cent to SDRF during our award period, with the remaining 90 per cent coming from the Union Government. (para 10.40)

- viii. We are in agreement with the views of the FC-XIII that the decision of constituting DDRFs is best left to the wisdom of the State Governments, and hence, separate grants for the financing of DDRFs are not recommended. (para 10.42)
- ix. We note with satisfaction that the norms for expenditure have undergone periodic revisions and that the States are being consulted in the process of reviewing the norms. We urge the Union Government to take account of the genuine concerns of the States in the consultative mechanism already in place. (para 10.46)
- x. Considering the need for flexibility in regard to state-specific disasters, we recommend that up to 10 per cent of the funds available under the SDRF can be used by State Governments for natural disasters that they consider to be 'disasters' within the local context in the State and which are not included in the notified list of disasters of the Ministry of Home Affairs. (para 10.52)
- xi. While calculating the requirement for funds from the NDRF during severe calamities, the existing practice of adjusting the contribution made by the Union Government to the SDRF should continue. (para 10.55)

Chapter 11

Grants-in-Aid

11.1 Our terms of reference (ToR), paragraph 4(ii) requires us to make recommendations on "the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States which are in need of assistance 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". The ToR is derived from the provisions of the Constitution in Article 275(1), 275(2) and 280(3) (b). We note that the key words in the ToR - as in the Constitution - are "principles" and "sums to be paid to the states which are in need of assistance".

Approach of previous Finance Commissions

11.2 Previous Finance Commissions recommended both tax devolution and grants-in-aid to the States. The grants have varied from 7 per cent of Finance Commission transfers (FC-VII) to 26 per cent (FC-VI)¹.

11.3 On the relative roles of tax devolution and grants-in-aid, the FC-XI observed that the dominance of tax devolution weakens the equalising capacity of Finance Commission transfers, even though successive Commissions have tried to redress this shortcoming by introducing redistributive elements in the devolution formula. The FC-XII observed that State Governments generally favoured a large proportion of Finance Commission transfers as tax devolution rather than as grants-in-aid and that they viewed tax devolution as a matter of entitlement and, by its very nature, unconditional. However, despite this marked preference for tax devolution on the part of States, the FC-XII relied on grants-in-aid as an important instrument in its overall scheme of transfers. It held that grants-in-aid had unique characteristics, as they could take better account of cost disabilities and redistributive considerations that were not adequately captured in the tax devolution formula. The FC-XIII observed that grants-in-aid are an important instrument of financing that enabled more comprehensive transfers, especially to address various issues spelt out in its ToR. The FC-XIII also observed that grants allowed it to make corrections for cost disabilities faced by many States; this was possible only to a limited extent in the tax devolution formula.

11.4 Previous Finance Commissions have enunciated four main considerations governing grants-in-aid. First, grants-in-aid may be given to the States to meet their residuary budgetary needs after taking the devolution of taxes into account. Second, grants-in-aid have been recommended to facilitate the upgradation of standards of administrative and social services and to ensure minimum expenditures on such services across the country. Third, they have been recommended to meet the special needs, burdens and obligations of the States and also to address the specific sectors of national importance. Finally, grants-in-aid have been recommended for

¹ The percentage of grants to total transfers from the FC-I to the FC-XIII, in chronological order, have been 12.1, 18.8, 18.6, 24.2, 13.4, 26.1, 7.7, 9.6, 17.1, 9.0, 13.5, 18.9 and 18.03.

augmenting expenditures, rather than for substituting what a State Government is already spending.

Views of State Governments

11.5 A majority of the States expressed a preference for tax devolution over grants. Some States made the point that tax devolution is more buoyant and adjusted for inflation, whereas grants are fixed sums. A few States suggested that the grant amount should be adjusted for inflation so that its present value is not eroded.

11.6 Some States considered tax devolution as a Constitutional entitlement, while grants were seen as discretionary and not based on any formula. A few States suggested that there should be a cap on the amount of grants as a percentage of total Finance Commission transfers.

11.7 The States differed in their views on the primary purpose of Finance Commission grants. Some felt that grants should not address the revenue and cost disabilities of States, as these are being addressed through Plan transfers and special packages for backward and other regions. These States held that grants need to be restricted to certain core areas and special problems. Other States felt that grants need to focus on cost disabilities and redistributive considerations that are not adequately captured in tax devolution. A few States expressed the need for a comprehensive equalisation grant to balance the difference between revenue capacities and expenditure needs of the States.

11.8 Some States were critical of too many grants with small outlays. They pointed out that the effort required to comply with the requirements attached to them by Finance Commissions are hugely disproportionate to the amount of the grant. Some States added that the conditions are, at times, more demanding than the size of the grant.

11.9 Almost all States raised concern over the growing trend of attaching conditionalities to the grants, which adversely affected the overall utilisation of these grants. They pointed out that the Ministry of Finance and other Union ministries and departments stipulate their own conditions, in addition to those set out by the Finance Commissions. Some conditions, they said, are binary in nature - non-compliance of just one out of many conditions could lead to the entire amount of grant being forfeited. According to States, the stringent conditions attached to the release of grants were responsible for the utilisation of grants remaining low. A few States held that the condition-linked, discretionary transfers also violate the principle of State autonomy in fiscal matters. Some States suggested that the Finance Commission may ring-fence its conditions so that no additional conditions for the release of grants can be imposed by the different Union ministries. Overall, a majority of States felt that conditions, if required, should be minimum, pragmatic and implementable.

11.10 Nearly half the States advocated flexibility for inter-sectoral adjustments within the Finance Commission grants. This, they argued, would allow the States to improve overall utilisation of the grants. Some of them favoured this flexibility lying with the states, while others suggested that the Ministry of Finance should be empowered to approve such proposals. Some States also said that the mandated annual growth rate in expenditures stipulated in the grant guidelines put a financial strain on their resources.

11.11 Though the States largely expressed preference for untied and formula-based grants, they also submitted several proposals for sector-specific grants. They clarified that these proposals were made for consideration in case this Commission continued to recommend sector-specific grants, in addition to devolution. The States generally supported grant-in-aid for the education sector. Among the suggestions made were: (i) continuation with education grant for meeting the matching contribution States are required to make for the Sarva Shiksha Abhiyan (SSA), (ii) focus on secondary and technical education and (iii) funding 50 per cent of the estimated State share in various education-related schemes. The States supported the grant for the health sector to partially compensate their share of expenditure on the National Health Mission (NHM) and operations and maintenance (O&M) support. Almost all the States supported the continuation of the grant for maintenance of roads and bridges. A majority of them urged the Commission to include public buildings in the maintenance grants, as the FC-XII had done. The States also suggested measures such as inclusion of the entire physical assets in a State for maintenance grant on the basis of cumulative capital expenditures incurred by them; allocating 1 per cent of the divisible pool for maintenance of physical assets and its inter-state distribution based on the share of the States in total cumulative capital expenditure; maintenance grants for completed Plan schemes under the Twelfth Five-Year Plan period; adopting norms of the Ministry of Road Transport and Highways; and indexing the grants for inflation. Some States also suggested that special category states should get at least 75 per cent enhancement over the basic estimates. A majority of the States also supported grants for forest and environment.

11.12 In line with the previous practice of Commissions recommending grants for state-specific schemes and projects, all the States provided a list of proposals cumulatively worth Rs. 11,89,037 crore, covering almost the entire spectrum of the administrative, revenue and development functions of the State. This includes a request from Andhra Pradesh (successor State) and Telangana for amounts of Rs. 1,41,467 crore and Rs. 20,951 crore respectively in the context of the bifurcation of undivided Andhra Pradesh. The details are given in Annex 11.1.

Views of the Union Government

11.13 The Union ministries and departments generally advocated sector-specific grants-in-aid to the States. Some ministries and departments also proposed grants for state-specific schemes and projects. Some of the key proposals placed for our consideration have been discussed in the following paragraphs.

11.14 The Department of Justice suggested earmarked grants for the establishment of fast-track courts for speedy trial of cases involving not only heinous crimes, but also offences against the elderly, women and children. The Ministry of Home Affairs asked for support to States in the areas of police modernisation, police training, police housing and police reforms.

11.15 The Department of School Education and Literacy in the Ministry of Human Resource Development submitted a proposal for continued support for the elementary education sector in view of an additional financial responsibility cast on States by the Right of Children to Free and Compulsory Education (RTE) Act, 2009. The Ministry of Health and Family Welfare advocated increased overall allocation and spending on the health sector by both the Union and the States. The Ministry of Drinking Water and Sanitation underlined the importance of the water sector

from the point of the view of the health of the nation and drew attention to the demand for adopting a rights-based approach to water and sanitation. The Ministry requested us to incentivise the State Governments to maintain the assets created for piped water and sanitation and to encourage initiatives related to drinking water and sanitation.

11.16 The Ministry of Environment & Forests emphasised that our ToR provides the scope to confer 'green bonus' on States with a higher endowment of natural resources as well as to provide for meeting expenditure on preserving and regenerating depleted, degraded natural forests and environmental resources. The Ministry urged enhanced grants for forests and suggested earmarking at least 50 per cent of the grant for sustainable management of forests and protected areas and mitigation of human-wildlife conflicts. Apart from the existing criteria of incentivising forest preservation and growth, the Ministry suggested that due weightage should be given to open forest cover area of a State in the formula for distribution of forest grants.

11.17 The Ministry of Finance said that grants-in-aid recommended by the FC-XIII award (excluding the compensation for goods and services tax or GST) constituted about 16.8 per cent of total grants given to the States. The Ministry observed that Finance Commission grants in many sectors and schemes overlap with Central Plan assistance provided to the states through Plan schemes and Centrally sponsored schemes (CSS). The Ministry pointed out that the Central assistance as Plan grants, and Finance Commission grants as non-Plan grants, going through parallel sources, often overlap. It also noted that the state-specific grants recommended by the FC-XIII in various sectors duplicate the CSS/CS (Central Sector) schemes in many cases. Consequently, the Ministry had to involve the line ministries in the review of sanctions and implementation of projects to avoid duplication in funding. In view of this, the Ministry of Finance suggested that the Finance Commission should not recommend grants for sectors in which there are existing Plan schemes. Alternatively, Finance Commission grants may facilitate the States to leverage regular sources of funding.

11.18 The Ministry of Finance emphasised that the award of the Finance Commission may act as a catalyst to give a fillip to Constitutional objectives in core and identified reform areas. The Ministry raised the issue of whether Finance Commission grants should supplement the Central assistance available under CSS/CS/State Plans or, alternatively, be used to incentivise performance.

11.19 As regards conditionalities, the Ministry of Finance suggested that we may consider ranking conditions in order of their importance and accordingly attach weights to each condition. They felt that this would, to a large extent, address the issue of the binary nature of conditions. If all conditions with respect to a particular grant are considered to be of equal importance, equal weight may be assigned to each condition.

11.20 The Ministry of Finance suggested that the amount of grant recommended by the Finance Commission should be significant enough to incentivise the states for undertaking reforms. Further, a system of 'co-sharing' by States may be introduced to create a long-term stake for them in the schemes. The Ministry also suggested that Finance Commission grants should be linked to forward-looking outcome parameters and that this needs to be done while devising incentive mechanisms. This should be in synchronisation with relevant sector-specific schemes linked to outcomes such as reduction of non-Plan revenue expenditure, improvement in the Human Development Index,

reduction in poverty and illiteracy, improvements in the infant mortality rate and maternal mortality rate, child nutrition, employment creation, and maintenance of assets.

Review of Grants-in-Aid

11.21 The previous Finance Commissions recommended grants-in-aid for five purposes - revenue deficit, disaster relief, local bodies, sector-specific schemes and state-specific schemes. Each of these is discussed below.

Revenue Deficit

11.22 The objective was to give grants to those States which are projected, after due assessment of resources and needs by the Finance Commission, to have a post-devolution non-Plan revenue deficit in any year. These grants-in-aid, to cover the non-Plan revenue deficit, have generally been the largest component of Finance Commission grants. It was only in the FC-XIII that the grants to local bodies formed the largest component of grants-in-aid. The share of the revenue deficit grant in the total grants-in aid has come down from 39.9 per cent in the case of the FC-XII to 16.26 per cent in the case of the FC-XIII.

Disaster Relief

11.23 Prior to the FC-IX, Finance Commissions set apart specific amounts as grants-in-aid under the 'margin money' scheme recommended by the FC-II to meet expenditures on disaster relief. The FC-IX recommended a dedicated fund for calamity relief, which led to the establishment of a Calamity Relief Fund (CRF) in each State. The FC-X recommended the setting up of a National Fund for Calamity Relief (NFCR) to assist a State affected by a calamity of rare severity through contributions from the Union and State Governments. The FC-XI modified this and recommended the setting up of a National Calamity Contingency Fund (NCCF), with an initial corpus of Rs. 500 crore. The funds were to be recouped by levying a special surcharge on Central taxes. The FC-XII continued this arrangement. With the enactment of the Disaster Management Act, 2005 and consequential changes in the design and structure of disaster management, the FC-XIII recommended the merger and transfer of NCCF balances as on 31 March 2010 to the National Disaster Response Fund (NDRF), which was accepted and notified by the Union Government. Since 2010-11, the Union Government has been financing the NDRF through the levy of a cess and the State Disaster Response Fund as grants-in-aid, based on the recommendations of the FC-XIII.

Local Bodies

11.24 Since the FC-X, Finance Commissions have been recommending grants for local bodies. The ToRs of the last three Commissions required them to recommend "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". However, the FC-XI was given the latitude to make its own assessment in the matter where State Finance Commissions (SFCs) reports were not available. Since the FC-XI, the Commissions noted that they were required to base their recommendations on the report of individual SFCs. However, they did not do so, due to reasons like different approaches adopted

by the SFCs, difference in the periods covered by individual SFCs and non-synchronisation of the SFC report period with the Finance Commission report period. Instead, the previous Finance Commissions recommended ad-hoc grants and, in addition, indicated the steps that the States could take to augment their Consolidated Funds to supplement the resources of the local bodies. The FC-XII gave a grant of Rs. 25,000 crore and allocated the grants to the local bodies in the ratio of 80:20 between panchayats and municipalities. The FC-XIII recommended 1.93 per cent of the divisible pool of 2010-15, as estimated by it, for local bodies after converting it into grant-in-aid under Article 275 of the Constitution. This grant was estimated at Rs. 87,519 crore, of which the grant to panchayats was Rs. 63,051 crore and the grant to municipalities was Rs. 23,111 crore. A special areas grant of Rs. 1,357 crore was given to the areas excluded from the operation of Part IX and IX A of the Constitution.

Sector-specific

11.25 Starting from the FC-I, which provided special grants for expanding primary education to States having very low school enrolment ratio, successive Finance Commissions have recommended sector-specific grants. The FC-XII observed that grants-in-aid can be used to look at certain common, as well as specific, needs of the States. The FC-XIII listed three objectives in recommending grants. The first is to reduce disparities in the standards of various administrative and social services across states. The second is to enable particular States to meet special financial burdens emerging from their peculiar circumstances. The third is to provide resources for specific activities considered to be national priorities.

State-specific

11.26 Apart from the sector-specific grants, Finance Commissions from the FC-VI onwards have recommended grants-in-aid for specified needs of the States. The grants-in-aid recommended for state-specific schemes and projects have steadily increased from Rs. 1,246 crore (FC-X) to Rs. 27,945 crore (FC-XIII). While recommending state-specific grants, the FC-XIII noted that such grants are relevant where they address deprivation, generate significant externalities (especially environmental externalities), meet the needs of the marginal groups or areas and encourage policy innovations. Data provided by the Ministry of Finance shows that the overall expenditure on state-specific grants was 41.33 per cent of the total outlay after the completion of four years of the FC-XIII period.

Our Approach

11.27 We have made provisions for grants-in-aid for financing of local governments and disaster management funds, as required of us in the ToR. The principles relating to the grants for financing of local governments and the disaster management fund are discussed in detail in Chapters 9 and 10. We will now focus on other grants-in-aid, which, in the past, have taken the form of non-Plan revenue deficit grants, sector-specific grants and state-specific grants.

11.28 The assessment of revenues and expenditure of States, along with the norms adopted by us, are discussed in Chapter 7. On the basis of this assessment, we have worked out the pre-devolution revenue deficit for each State. In this regard, we have departed significantly from

previous Finance Commissions, by taking into consideration a State's entire revenue expenditure needs without making a distinction between Plan and non-Plan.

11.29 Our approach to sector-specific grants is based on our analysis of these grants recommended by the previous Finance Commissions. We observe a certain discontinuity in the sectors recommended for grants by the past Finance Commissions. For example, the FC-XI recommended upgradation grants for general administration, but the FC-XII discontinued it. Similarly, a maintenance grant for public buildings was recommended by the FC-XII but not by the FC-XIII. The FC-XIII discontinued grants-in-aid for protection of heritage sites that both the FC-XI and the FC-XII had recommended. Overall, we notice more of change than continuity in the sector-specific grants. Though the grants have covered a large number of sectors, only a few like health and education have been considered on a regular basis.

11.30 It is important to analyse the significance of Finance Commissions' sector-specific grants in terms of their relative magnitude. We note that these constituted a small percentage of total grants going to the States in a particular sector. For example, the health sector grant recommended by the FC-XIII is estimated to be only 1.57 per cent of the total likely revenue expenditure of all States for the award period (2010-2015). Similarly, the corresponding figure for the elementary education sector is 1.95 per cent of the total likely revenue expenditure of all States. The problem of the small size of the grants is further compounded by the poor utilisation of these on account of conditionalities. The limited tenure of the Commission also adds to the constraints in designing the grants. Finally, the flow of such grants through multiple channels tends to result in duplication and overlap. In this regard, we have also noted the view of the Ministry of Finance that a large number of Union Government schemes already existed in the sectors where previous Finance Commissions had recommended grants-in-aid.

11.31 Five key considerations have influenced our approach towards state-specific grants. First, the state-specific grants recommended by previous Finance Commissions constitute a small fraction of the proposals submitted by the States. Second, the state-specific grants were not allocated on the basis of any formula or any uniform principle. Third, state-specific schemes are best identified, prioritised and financed at the level of the State Government. Fourth, State Governments repeatedly raised the issue of the need for flexibility in the use of state-specific grants during our discussions with them. This need for flexibility arises as there is a minimum time lag of two years between the time state-specific schemes are originally proposed to the Finance Commission and when the implementation process actually begins. Due to changed circumstances, there is often a need to revisit the originally recommended schemes. This flexibility is not possible in grants recommended by Finance Commissions. After considerable deliberations, we have come to the conclusion that grants for both sector-specific and state-specific schemes by the Finance Commission are not necessary.

11.32 We see merit in the views of the Ministry of Finance on the overlap of Finance Commission grants and non-Finance Commission grants. Apart from the issue of duplication of funding, the support from multiple channels makes it difficult to take a comprehensive view on funding and renders monitoring of outputs and outcomes a difficult exercise.

11.33 Keeping in view the principles adopted by previous Finance Commissions, the views expressed by Union and States, the review of past experience and in the context of our overall approach to fiscal relations between Union and States, we have adopted the following four principles in our approach to grants-in-aid:

- i) The devolution of taxes from the divisible pool should be based on a formula which should, to a large extent, offset revenue and cost disabilities.**
- ii) The assessment of expenditures should build in additional expenditures in the case of those States with per capita expenditure significantly below the all-State average. The assessment of revenues should build in the scope for additional revenue mobilisation based on current tax-GSDP ratio relative to the all-State average. This will enable fiscally-disadvantaged States to upgrade their services without earmarking or specifying sectors.**
- iii) If the assessed expenditure need of a State, after taking into account the enabling resources for augmentation, exceeds the sum of revenue capacity and devolved taxes, then the State concerned will be eligible to receive a general purpose grant-in-aid to fill the gap.**
- iv) Grants-in-aid for state-specific projects or schemes will not be considered, as these are best identified, prioritised and financed by the respective States.**

Post-Devolution Revenue Deficit Grant

11.34 Finance Commissions in the past have recommended grants to cover the non-Plan revenue deficits. The objective was to give grants to those States which are projected to have post-devolution non-Plan revenue deficit in any year, on a normative basis. Since we have taken a comprehensive approach to the assessment of expenditure needs by taking both Plan and non-Plan expenditure in the revenue account, our grants are intended to cover the entire post-devolution revenue deficit as assessed by us.

11.35 The normatively assessed post-devolution revenue deficit for a State signifies the existence of a vertical imbalance that is yet to be corrected and an assessed need that is still to be met. As explained in Chapter 7, the expenditures and revenues of States have been normatively assessed to take into account the differences among them in fiscal capacity and expenditure needs. This ensures that the assessed deficit is not due to inadequate revenue effort or expenditure profligacy and takes into account the need for States with low average per capita expenditure to enhance their expenditures. On the basis of this assessment, we have worked out the pre-devolution revenue deficits for each State. Table 11.1 shows the pre-devolution revenue deficit of each State as assessed by us.

Table 11.1 : Pre- Devolution Revenue Deficit/ Surplus

State	(Rs. crore)				
	Deficit (+)/ Surplus (-)				
	2015-16	2016-17	2017-18	2018-19	2019-20
1	2	3	4	5	6
Andhra Pradesh	31646	33823	37817	42272	47240
Arunachal Pradesh	4609	5169	5786	6467	7215
Assam	21435	23396	25451	27734	30999
Bihar	50072	56081	60783	68630	99473
Chhattisgarh	8708	9817	10994	12238	13542
Goa	798	656	711	740	770
Gujarat	-11795	-15081	-19156	-24101	-30100
Haryana	2354	-998	-4950	-7253	-10176
Himachal Pradesh	12150	13010	13832	14593	15264
Jammu & Kashmir	18640	20860	23366	26194	29385
Jharkhand	14680	16489	18215	20266	25010
Karnataka	3800	4100	4347	4389	4125
Kerala	19151	20095	20877	21414	21584
Madhya Pradesh	19445	21790	24330	27073	30024
Maharashtra	5865	8174	10729	13531	16591
Manipur	5645	6227	6865	7564	8328
Meghalaya	4346	4837	5375	5964	6606
Mizoram	4809	5375	6005	6706	7485
Nagaland	6092	6785	7552	8401	9338
Orissa	21007	23059	25073	26947	30425
Punjab	7604	7476	7233	6824	6223
Rajasthan	10747	6401	76	-3764	-5610
Sikkim	1863	1862	1782	1594	1232
Tamil Nadu	16313	16298	15862	14913	13321
Telangana	-818	-2184	-3930	-6138	-8902
Tripura	4815	5388	6027	6739	7531
Uttar Pradesh	81921	92541	103185	115631	144057
Uttarakhand	5838	4896	3441	1865	700
West Bengal	50983	52394	53269	53566	57878
Total State (Deficit)	435337	466999	498984	542252	634347
Total States (Surplus)	-12613	-18263	-28036	-41255	-54788

11.36 In Chapter 8 we have laid down the share of each State in Central taxes and projected the share of each State based on the tax revenue of the Union Government, as estimated in Chapter 6. Further, based on the estimated pre-devolution revenue deficit and share of each State in Central taxes, we have projected the post-devolution revenue deficit/surplus for each State for the award period. The post-devolution revenue deficits, obtained by adding the share of respective States in Central taxes to the pre-devolution revenue deficit, are shown in Table 11.2.

Table 11.2 : Post-Devolution Revenue Deficit/ Surplus

State	(Rs. crore)				
	Deficit (+)/ Surplus (-)				
1	2	3	4	5	6
Andhra Pradesh	6609	4930	4430	3644	2499
Arunachal Pradesh	-3394	-4068	-4889	-5885	-7093
Assam	2191	1188	-210	-1953	-3387
Bihar	-6045	-8676	-14042	-17936	-791
Chhattisgarh	-9226	-10879	-12922	-15433	-18510
Goa	-1394	-1874	-2211	-2641	-3145
Gujarat	-29755	-35809	-43109	-51813	-62200
Haryana	-3932	-8252	-13331	-16949	-21406
Himachal Pradesh	8009	8232	8311	8206	7866
Jammu & Kashmir	9892	10831	11849	12952	14142
Jharkhand	-3569	-4571	-6120	-7888	-7600
Karnataka	-23619	-27541	-32216	-37914	-44874
Kerala	4640	3350	1529	-969	-4341
Madhya Pradesh	-24469	-28889	-34232	-40681	-48456
Maharashtra	-26281	-28924	-32140	-36069	-40861
Manipur	2066	2096	2091	2042	1932
Meghalaya	618	535	404	213	-55
Mizoram	2139	2294	2446	2588	2716
Nagaland	3203	3451	3700	3945	4177
Orissa	-5994	-8099	-10932	-14709	-17825
Punjab	-1542	-3078	-4961	-7284	-10117
Rajasthan	-21250	-30524	-42594	-53132	-62795
Sikkim	-266	-595	-1057	-1691	-2572
Tamil Nadu	-7076	-10694	-15327	-21171	-28475
Telangana	-15003	-18554	-22846	-28023	-34252
Tripura	1089	1089	1059	992	875
Uttar Pradesh	-22376	-27814	-35885	-45261	-42295
Uttarakhand	-274	-2157	-4709	-7564	-10221
West Bengal	8449	3311	-3445	-12048	-18119
Total State (Deficit)	48906	41308	35820	34581	34206
Total States (Surplus)	-205464	-260997	-337177	-427014	-489392

11.37 **A total revenue deficit grant of Rs. 1,94,821 crore is recommended during the award period for eleven States.** The year-wise details of States that are to receive this grant are given in Table 11.3. There are seven States - Andhra Pradesh, Himachal Pradesh, Jammu and Kashmir, Manipur, Mizoram, Nagaland and Tripura - that will need a revenue deficit grant for each of the years of our award period. In addition, there are four States - Assam, Kerala, Meghalaya, and West Bengal - that will need a revenue deficit grant for at least one of the years of our award period.

Table 11.3 : Grants-in-aid for Revenue Deficit (2015-20)

(Rs. crore)

State	2015-16	2016-17	2017-18	2018-19	2019-20	2015-20
1	2	3	4	5	6	7
Andhra Pradesh	6609	4930	4430	3644	2499	22113
Assam	2191	1188	Nil	Nil	Nil	3379
Himachal Pradesh	8009	8232	8311	8206	7866	40625
Jammu & Kashmir	9892	10831	11849	12952	14142	59666
Kerala	4640	3350	1529	Nil	Nil	9519
Manipur	2066	2096	2091	2042	1932	10227
Meghalaya	618	535	404	213	Nil	1770
Mizoram	2139	2294	2446	2588	2716	12183
Nagaland	3203	3451	3700	3945	4177	18475
Tripura	1089	1089	1059	992	875	5103
West Bengal	8449	3311	Nil	Nil	Nil	11760
Total State	48906	41308	35820	34581	34206	194821

Towards Equalisation

11.38 The objective of inter-governmental transfers is to offset the fiscal disabilities arising from low revenue raising capacity and higher unit cost of providing public services. The ultimate objective is to enable every State to provide comparable levels of public services that it is mandated to provide by the Constitution at comparable tax rates. Such enabling transfers are necessarily unconditional. At the same time, there is a case for inter-governmental transfers to ensure that people are provided with minimum standards of basic services which have significant inter-jurisdictional externalities irrespective of their state of residence. There are services which must be available at minimum specified standards to all and these include minimum standards of education, healthcare, water supply and sanitation.

11.39 The FC-XII attempted equalisation grants for elementary education and healthcare. However, the Commission found it difficult to fully equalise the expenditure levels and recommended the grant to cover only 15 per cent of the shortfall in the case of education and 30 per cent of the shortfall in the case of the health sector. While the intention to equalise the standards

of basic services is important, there are some shortcomings in the design of such transfers. First, there are already a number of sector-specific grants in the form of CSS to cover these basic services. Therefore, the Finance Commission grants, being small in magnitude, become insignificant in the overall scheme of transfers. Second, the Finance Commission does not have a system of monitoring sector-specific grants as it is not a permanent body. Third, while Finance Commission grants were recommended with conditions for the release of funds, aspects related to proper monitoring in terms of outputs and outcomes were left out. Therefore, there is a need to have a new institutional arrangement if the equalisation objective is to be achieved.

11.40 The past experience with sectors covered by grants-in-aid, conditionalities and outcomes has been varying. It was noted that the recommendations of previous Finance Commissions, *inter alia*, provided grants to the States for utilisation in specific sectors in order to enable them to provide the necessary services and an attempt has been made to "ensure" services through requiring matching contributions and stipulation of conditionalities. While the Finance Commissions decided the distribution of finances among sectors and States and gave broad indications about the conditionalities, the actual design was often left to the States themselves or to the Union Government. It is noteworthy that there was more of change than continuity in Finance Commission grants for the identified sectors. In their presentations, almost all the States preferred untied grants from the Finance Commission but they also pressed for sector-specific grants. Some States pointed out that they have lost the grants that would have normally accrued to them because they could not fulfil the conditionalities. The Union Government has also raised the issue of multiplicity of channels of Central support which raises the issue concerning overlap of assistance for the same purpose.

11.41 We note that the grants provided by the Finance Commissions constitute a very small part of the total expenditure by States on the concerned sectors. It is also difficult to establish the effectiveness of these sector-specific grants because there is no continuity in the sectoral priorities from one Finance Commission to another. In some cases, the links between the conditionalities and the outcomes have also been questioned by some states. Furthermore, there are far too many elements of discretion involved in identifying the sector, allocating the amounts and designing the conditionalities. If the sector-specific grants of the Finance Commission have not been effective, it may be partly because the Finance Commission is not a permanent body and it would not be possible for it to implement and monitor the conditionalities. The general discomfort of the States in regard to discretionary grants is discernible. We also note that the Ministry of Finance is not enthusiastic about Finance Commissions giving sector-specific grants.

11.42 Considering all these factors, we **conclude that there is a case for transfers from the Union Government to the States to augment expenditure in specific sectors with a high degree of externalities in order to ensure desired minimum level of expenditures in every State. However, past experience shows that achieving this through the mechanism of Finance Commission grants may not be appropriate. Further, we are informed that Finance Commission grants on this account often operate in parallel with other transfers. We, therefore, conclude that all such transfers, in whichever sectors are considered necessary, should be addressed through a different institutional arrangement described in Chapter 12.**

Requests for Sector Specific Grants

11.43 We would like to bring on record some important requests received by us for sector-specific grants and comment on them for consideration by the alternative institutional arrangement proposed for the purpose, as a part of the fiscal space of the Union. We have noted the views expressed by the Union ministries and State Governments in this regard and have identified the sector-specific grants-in-aid in four categories: general administration (including judiciary and police), environment (forests), maintenance (irrigation, roads and bridges) and social sector (education, health, drinking water and sanitation). Each of these sectors are discussed below:

General Administration (Judiciary and Police)

11.44 The Department of Justice in the Union Government has submitted a comprehensive proposal, which covers areas like reduction in pendency of cases, re-designing existing court complexes to make them more litigant friendly, enhancing access to justice and capacity building of personnel. We have noted that their proposal amounting to Rs. 9,749 crore has been arrived at after an extensive consultation process with the States and merits favourable consideration. The details of the proposal are given in Annex 11.2. **We endorse the proposal made by the Department of Justice to strengthen the judicial systems in the States and urge State Governments to use the additional fiscal space provided by us in the tax devolution to meet such requirements.**

11.45 The Ministry of Home Affairs submitted a detailed memorandum seeking support to States in the areas of police modernisation, police training, police housing and police reforms. We recognise that ensuring the safety of the citizens and security and protecting property rights is a basic public good necessary for the development of the country. We also note that additional funds for general administration, including district and revenue administration, is required, as these sectors generally receive a low priority in budget allocations. **Our assessment of the expenditure needs of the States has taken into account the high base of expenditure for both general administration and police. Therefore, in our view, the States have the appropriate fiscal space to provide for the additional expenditure needs as per their requirements. This should help them address the problems and facilitate them to build capacity and bridge the existing gaps in regard to general administration and police.**

Environment

11.46 A majority of the States has supported the grant for forest and environment. We also commissioned a study on "High Conservation Value Forests: An Instrument for Effective Forest Fiscal Federalism in India". The study highlighted that keeping areas under forests entails two major costs - the maintenance cost of keeping forests and the restoration cost required for improving the health of existing degraded forests. We believe that a large forest cover provides huge ecological benefits. But, apart from the maintenance costs, there is also an opportunity cost in terms of the forest area not being available for revenue-yielding economic activity. **Keeping in view the ecological benefits and the need to support States in shouldering the responsibility of managing the environment, we have decided to consider area covered by forests as one of the important criteria for horizontal devolution. The devolution formula, thus, captures both revenue and cost disability and also enables the States to consider forests as a national treasure that needs to be protected.**

Maintenance

11.47 We have carefully analysed the provisions made by States in major heads related to irrigation. We have ensured that maintenance expenditure requirements are built into the State forecasts, to the extent feasible, and the need for a separate maintenance grant for irrigation, therefore, does not arise. Almost all the States have supported continuation of the grant for maintenance of roads and bridges. A majority of States have urged the Commission to also include the maintenance of public buildings, as was done by the FC-XII, in the grants-in-aid. We have carefully analysed the maintenance provisions made by States and also examined in detail the projections made by them for the FC-XIV period. We have ensured that maintenance provisions are built into the forecasts to the extent feasible, and these have been factored into our assessment of each State.

11.48 We have provided appropriate fiscal space for maintenance expenditures and this should enable the States to meet the additional expenditure needs according to their requirements. We also urge the States to enhance expenditure on maintenance of capital assets to the appropriate levels.

Social Sectors (elementary education, health, drinking water and sanitation)

11.49 The States have generally supported grants for the elementary education sector and a majority of them pressed for the continuation of this support, as has the Department of School Education and Literacy in the Ministry of Human Resource Development. However a key question here is whether it is the responsibility of the Finance Commission to give grants for fulfilling the rights-based legal entitlements promised by the Union Government in its various Acts such as the Right of Children to Free and Compulsory Education (RTE) Act, 2009.

11.50 The SSA is a key initiative of the Government of India for achieving the goal of universalisation of elementary education in a time-bound manner and is being implemented in partnership with State Governments to cover the entire country. The SSA support is based on target population, assessment of infrastructure requirement and teacher's adequacy ratio. It has yielded visible progress, especially in the area of enrolment and retention. However, there is a need for flexibility in the implementation of the scheme at the State-level, given the fact that states are placed differently in educational achievements and requirements.

11.51 An overwhelming majority of States have requested the grant for the health sector and sought support in areas like reduction in the infant mortality rate, grants to partially compensate the State's share of expenditure on the NHM and O&M support. The Union Department of Health & Family Welfare has emphasised the need to facilitate increased overall spending on the health sector by both the Union and States by increasing allocation of funds for public health as a percentage of gross domestic product (GDP).

11.52 We commissioned a study on inter-state comparisons on health outcomes in major states and a framework for resource devolution for health. The study recommended that expenditures under piped water supply, sanitation and health infrastructure need to be shared by the Union and State Governments as a matter of principle, as addressing such basic needs ought to be the first charge on any developmental budget. In sharing a part of the burden, the States also get sensitised

to the real cost of the good. The study also stressed that it should be mandatory for States and the Union Government to create posts and appoint well qualified finance staff at all levels.

11.53 Another study was commissioned to determine an Essential Health Package for different States, both in terms of content and costing. This study noted that there is wide variation among States both in terms of their current level of health services and the interventions necessary as part of any essential health package. Therefore, one standard package would not serve the purpose and States would need to have flexibility in their packages. The flexibility would depend on the State's disease burden profile and availability of health infrastructure and personnel.

11.54 We recognise the existence of the NHM as a major instrument of financing and support to the States to strengthen public health systems and health care delivery.

11.55 In 1986, India launched a mission for the universal provisioning of protected piped water supply. Twenty-five years later, as per 2011 Census, only 70.6 per cent of the urban households and 30.8 per cent of the rural households have access to piped water supply. Piped water supply is important to check the occurrence of water-borne diseases like diarrhoea, dysentery, viral hepatitis and cholera. As piped water is chlorinated and filtrated, the safety factor is almost 99 per cent.

11.56 Sanitation is yet another critical determinant of health. According to Census 2011, an estimated 29 per cent of rural households had a toilet against 21.9 per cent in 2001. The utilisation of individual toilets is reportedly low because of the poor availability of water. Open defecation not only robs individuals, particularly women, of their right to dignity, but also enhances the risk of the spread of communicable diseases. Cholera and such water-borne diseases impair the retention and absorption of food and contribute significantly to malnutrition and substantial morbidity and mortality.

11.57 The importance of water and sanitation cannot be over-emphasised in view of nearly 4,54,000 persons dying every year on account of unsafe water and lack of sanitation in our country. Worse, 4,05,000 of these are children under five years of age. The death rate on account of these factors among children under five years old is 315 per 1,00,000 as compared to 0 in the United States and Canada, 56 in China and 59 in Thailand.

11.58 The existing CSS - National Rural Drinking Water Programme and Swachh Bharat Mission (earlier known as Nirmal Bharat Abhiyan) - on drinking water and sanitation respectively have not been able to provide safe drinking water and sanitation to about 60-70 per cent of population. Greater efforts are clearly required both in terms of commitment of greater financial resources and the focused intervention of the implementing agencies.

11.59 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 the purpose.

Grants-in-aid to States

11.60 Table 11.4 gives a summary of the grants-in-aid of the revenues of states, as recommended by us for the award period 2015-20.

Table 11.4: Grants-in-Aid to States

		<i>(Rs. crore)</i>
1	Local Government	287436
2	Disaster Management	55097
3	Post-devolution Revenue Deficit	194821
Total		537354

Recommendations

- i. A total revenue deficit grant of Rs. 1,94,821 crore is recommended during the award period for eleven States (Table 11.3). (para 11.37)
- ii. There is a case for transfers from the Union Government to the States to augment expenditure in specific sectors with a high degree of externalities in order to ensure desired minimum level of expenditures in every State. However, past experience shows that achieving this through the mechanism of Finance Commission grants may not be appropriate. Further, we are informed that Finance Commission grants on this account often operate in parallel with other transfers. We, therefore, conclude that all such transfers, in whichever sectors are considered necessary, should be addressed through a different institutional arrangement described in Chapter 12. (para 11.42)
- iii. We endorse the proposal made by the Department of Justice to strengthen the judicial systems in the States and urge State Governments to use the additional fiscal space provided by us in the tax devolution to meet such requirements. (para 11.44)
- iv. Our assessment of the expenditure needs of the States has taken into account the high base of expenditure for both general administration and police. Therefore, in our view, the States have the appropriate fiscal space to provide for the additional expenditure needs as per their requirements. This should help them address the problems and facilitate them to build capacity and bridge the existing gaps in regard to general administration and police. (para 11.45)
- v. We have provided appropriate fiscal space for maintenance expenditures and this should enable the States to meet the additional expenditure needs according to their requirements. We also urge the States to enhance expenditure on maintenance of capital assets to the appropriate levels. (para 11.48)

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- vi. 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 the purpose. (para 11.59)

Chapter 12

Towards Cooperative Federalism

12.1 The terms of reference (ToR) of this Commission, derived from Articles 275(1), 275(2) and 280 of the Constitution, enjoin us to recommend "the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States which are in need of assistance by way of grants-in-aid of their revenues, for purposes other than those specified in the provisos to clause (1) of that article". We have, after taking into account the resources and needs of the States and the recommended tax devolution, provided grants for fully meeting their revenue deficits, as assessed by us. The tax devolution, supplemented by revenue deficit grants in some States, should normally provide the States with the fiscal space to take informed decisions on their requirements. Nevertheless, as noted in Chapter 11, there is a case for transfers from the Union to the States for specific sectors and areas. Specifically, we have identified health, education, drinking water and sanitation as important sectors among such public services. We have noted that the grants to these sectors should be carefully designed and implemented, and a new institutional arrangement be put in place with the involvement of the Union and the States, duly assisted by domain expertise.

12.2 The entries in the State List specify the functional domains of the States. Many of the functions in the Concurrent List have traditionally been undertaken by the States and are in their area of responsibility. However, even in the State and Concurrent lists, there are functions which are best carried out by both the Union and State Governments in the spirit of cooperative federalism. For example, specified minimum standards of certain public services should ideally be available to people, irrespective of where they reside. Thus, both the Union and State Governments have an overlapping responsibility to ensure such specified minimum standards. We recognise that the primary responsibility for funding and providing most of these services rests with the State Governments. However, the Union Government has to play a supportive role in supplementing such efforts. We also recognise that it is difficult to clearly and definitively demarcate the overlapping responsibilities between the Union and the States. Further, the scope of such overlapping responsibilities and the relative roles of both could evolve over a period. Ideally, these should be agreed between the Union and the States through a continuing process of consultation.

12.3 In this regard, we have, in the chapter on grants-in-aid (Chapter 11), suggested an arrangement to determine such specific-purpose transfers. In our view, such an institutional arrangement could comprehensively, on a continuing basis, address the issues of fiscal transfers from the Union to the States to supplement the periodic awards of the Finance Commission, in pursuit of cooperative federalism. We believe that in proposing a new institutional arrangement towards strengthening cooperative federalism, we should take cognisance of the extant

arrangements for transfers, views of the State Governments, views of the Union Government and discussions in the National Development Council (NDC), views of Commissions and Committees and views of previous Finance Commissions on this subject.

Existing Arrangements for Transfers

12.4 The recommendations of previous Finance Commissions have covered both vertical and horizontal devolution, as well as grants-in-aid, including non-Plan revenue deficit grants, grants to local bodies, grants for disaster relief, as well as sector-specific and state-specific grants. The 'other transfers' flow mainly as Plan grants and the rest as non-Plan grants. The Plan grants comprise the following: (a) normal Central assistance, comprising untied assistance for the annual plans of States, based on the Gadgil-Mukherjee formula; (b) additional Central assistance for specific-purpose schemes and transfers; (c) special Central assistance, comprising untied assistance for the North-eastern and certain hilly States; and (d) special Plan assistance. In addition, there are Central Plan schemes and Centrally sponsored schemes, which are conditional upon the implementation of specified schemes and programmes. Up to 2013-14, funds for the Centrally sponsored schemes were routed through two channels - the Consolidated Funds of the States and directly to State implementing agencies. From 2014-15 onwards, direct transfers to State implementing agencies have been done away with, and all transfers to States for Centrally sponsored schemes are now being routed through the Consolidated Fund of the State. The non-Plan grants constitute a very small part of the 'other transfers'. Plan grants are utilised both for capital and revenue expenditures, though the share of the latter has been increasing in recent years.

12.5 We have analysed, in Chapter 5, the increasing share of Plan grants, relative to statutory Finance Commission transfers, in the total transfers to the States. Even within the Plan transfers, the share of untied normal Central assistance has shown a sharp decline, particularly after ending the intermediation of Plan loans to the State Governments by the Union Government, consequent to the recommendations of the FC-XII. This decline in the share of what is generally described as 'formula-based' grants has been mainly due to the expansion of grants for Centrally sponsored schemes. In fact, when grants given directly to implementing agencies are taken into account, the decline in the formula-based transfers to the States is even sharper.

12.6 **In recent years, the aggregate transfers from the Union to the States (including direct transfers), as a percentage of the gross revenue receipts of the Union, have ranged between 44.7 per cent and 53.7 per cent** (Table 12.1). Expressed as a percentage of the divisible pool, these transfers have been in the range of 58.3 per cent to 71.4 per cent. In 2012-13, the latest year for which firm data are available, the aggregate Union transfers to States were equivalent to 63.9 per cent of the divisible pool. The Finance Commission transfers comprised 58.5 per cent of the aggregate transfers from the Union to the States, with the 'other' transfers comprising 41.5 per cent. Only 10.1 per cent of 'other' transfers were through normal Central assistance. The remaining portion largely comprised of what are generally described as 'non-formula-based' or 'discretionary' transfers. It must be recognised that these 'non-formula-based' or 'discretionary' transfers are based on some criteria evolved by the Planning Commission for specific schemes and programmes.

Table 12.1: Trends and structure of Union transfers to States, including direct transfers*(per cent)*

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14 (RE)	2014-15 (BE)
1. Aggregate Union transfers to States as a percentage of gross revenue receipts of the Union	44.7	52.8	53.2	48.9	53.7	49.0	46.2	47.5
2. Aggregate Union transfers to States as a percentage of divisible pool	58.3	68.9	71.2	71.4	69.3	63.9	61.7	61.9
3. Aggregate Finance Commission transfers as percentage of aggregate Union transfers to States	57.4	51.2	50.2	50.7	55.2	58.5	59.8	59.6
4. Other transfers as percentage of aggregate Union transfers to States	42.6	48.8	49.8	49.3	44.8	41.5	40.2	40.4
5. Normal Central assistance as percentage of other transfers	11.6	8.8	8.9	8.2	8.6	10.1	10.8	9.4

Note: From 2014-15, direct transfers to implementing agencies have been added to State Plan schemes and include transfers to district-level autonomous bodies/implementing agencies.

12.7 A bulk of the 'discretionary' transfers from the Union to the States is for the Centrally sponsored schemes, accounting for nearly 62 per cent of the 'other' transfers in 2012-13 (including direct transfers to implementing agencies)¹. In 2012-13, actual expenditure for such schemes was Rs. 1,84,416 crore, with expenditure for the seventeen flagship schemes being Rs. 1,65,612 crore (90 per cent of the total allocation) and expenditure for the remaining forty-nine non-flagship schemes being Rs. 18,804 crore. In 2014-15 (budget estimates), the overall budget allocation for these schemes is Rs. 2,41,320 crore, with Rs. 1,96,670 crore (81 per cent) being allocated to the flagship schemes and Rs. 44,650 crore to the other schemes.

Views of the State Governments

12.8 The States, in general, have been critical of the rise in the share of non-statutory transfers, in particular non-formula-based transfers, at the expense of statutory transfers. The States mentioned that the Union Government has not only been introducing schemes which actually need to be implemented at the grass root levels, but has also not been allowing them to be managed in a decentralised manner. They stressed that there has been an increase in non-formula-based fiscal transfers from the Union ministries, particularly through the mechanism of Centrally sponsored schemes. These schemes, they added, are often formulated without adequate consultation and without keeping in mind state-specific variations and priorities, and have led to a significant burden on the resources of States. In their view, this has shrunk the fiscal space available to them and also forced them to adopt expenditure patterns that do not reflect their own priorities. Further, the significant increase in the number of Centrally sponsored schemes and the funds allocated for them have led to a corresponding decrease in the untied resources available to States.

¹ In July 2013, 137 CSS and five scheme-based additional Central Assistance (ACA) schemes were restructured into 66 schemes under CSS/ACA

12.9 The observations made by States regarding Centrally sponsored schemes broadly revolve around two points. One, apart from the merits and demerits of these schemes, which are essentially in the nature of discretionary resource transfers by the Union Government, the increase in their number as well as of Plan grants to States itself reflects the excess fiscal space available to the Union Government and, correspondingly reduced fiscal space available to the States. Two, the 'untied' resources available to the States have been shrinking with the corresponding increase in Centrally sponsored schemes and 'tied' assistance. In their view, there is an urgent need to review this situation. The States have, therefore, suggested that the funds transferred by the Union Government for expenditure on State subjects through various Centrally sponsored schemes should be subsumed under the funds transferred through vertical devolution. The States have emphasised that there is a need to enhance the existing level of formula-based fiscal transfers, with such transfers conforming to the principles recommended by the Finance Commission.

12.10 Some States felt that the situation can be redressed through: (a) transfer of Centrally sponsored schemes to the States, along with funds; (b) provision of greater fiscal autonomy to States, thereby enabling them to design their own expenditure priorities and undertake state-specific development schemes, based upon their own assessment; (c) allocation of more funds to States, as compensation for the implementation of Central legislation; and (d) reducing/rationalising the number of Centrally sponsored schemes and, above all, remedying the design problems in the architecture of these schemes in order to avoid rigidities/inflexibility in implementation. We noticed that there was an overwhelming preference among the States for untied funds. However, the States welcomed funds for earmarked schemes and programmes over and above the transfers made on the recommendations of the Finance Commissions. In case such funds are transferred, they preferred less discretionary distribution among the States, less intrusive conditionalities and significant flexibility for States in designing the schemes and programmes. They were also uncomfortable with demands for matching contributions by States and expressed concern at recurring commitments of States due to such schemes.

Views of the Union Government

12.11 In this regard, the Ministry of Finance highlighted the limited resource base available with the Union Government in the coming years. It felt that the finances of State Governments are comparatively in better shape and much of the fiscal impact of the development schemes, therefore, needs to be shifted to them. In its view, the States should bear a larger share of the financial burden of various welfare programmes. The Union Government felt that this would not only improve its own fiscal position, but would also help in streamlining Union-State relations. It added that the many of the Finance Commission grants overlap with the Central Plan assistance provided to the States through Plan schemes/programmes of line ministries, creating issues of duplication and support from multiple channels. The Ministry further highlighted the responsibility of the Union Government to make interventions, through programmes and schemes, for ensuring equalisation, promoting inter-state projects and ensuring specified minimum standards of services in sectors of national priority.

12.12 The Planning Commission mentioned that the Centrally sponsored schemes, implemented with the approval of the NDC, have helped to ensure that funds from the Union actually flow to critical sectors and have led to a matching contribution of States' funds into these sectors. It

stated that if the same resources were transferred to the States through the Finance Commission route, it was doubtful whether the desired sectoral allocations would be ensured. It added that it had found that States were, by and large, appreciative of the Centrally sponsored schemes, even though they had requested for modifications of the scheme guidelines so as to provide greater flexibility for addressing specific local conditions. In this regard, the Planning Commission highlighted the fact that, in the new system, States had been provided flexibility with respect to 10 per cent of the funds under Centrally sponsored schemes in order to accommodate state-specific requirements and to enable them to take up innovative projects.

12.13 The Union ministries and departments sought larger resources to ensure the fulfilment of national priorities, which could, among other things, be determined by the following: (a) the need to provide specific levels of public services, across the country, based upon the requirements of a welfare State, in line with the framework laid down under the Directive Principles of State Policy, (b) norms legislated by Parliament and (c) obligations in social sectors arising out of international commitments. They explained the rationale for nation-wide approaches to sectoral policies and the need for providing guidance, incentives and disincentives to the States, mentioning, in this context, that Centrally sponsored schemes are meant to ensure that spending is directed towards nationally-agreed priority sectors critical for ensuring inclusive growth. They also indicated that there is an increasing awareness in the Union ministries about the need to provide greater flexibility to the States in implementing Centrally sponsored schemes.

Discussions in the National Development Council

12.14 The subject of Centrally sponsored schemes has been extensively deliberated in the meetings of the NDC. During these meetings, the States have made representations against the tendency of the Union Government to resort to these schemes for the fulfilment of priorities which, in its opinion, are of national importance. The reasons offered by them for their disagreement on this issue are: (i) the proliferation of Centrally sponsored schemes has limited the fiscal and functional freedom of States to focus on their own state-specific priorities and (ii) the guidelines framed by the Ministries of the Union Government are quite inflexible and do not permit the States to design and implement these schemes according to their own priorities.

12.15 Suggestions made by the States relating to Centrally sponsored schemes in the NDC include transfer of these schemes to State Plans, reduction in their number by consolidating schemes with similar objectives and curbing the growth of these schemes in areas such as education, health and agriculture. Further, the States proposed that the funds freed by such reduction may be distributed among the States in an untied manner, with the flexibility to design and implement schemes as per state-specific conditions, preferences and requirements.

Views of Commissions and Committees

12.16 In the context of Central transfers, the First Administrative Reforms Commission (1966) had observed that the role of the Union Government in areas which are covered by the State List of subjects in the Constitution should be largely that of a 'pioneer, guide, disseminator of information, overall planning and evaluator'. It stated that while the Union Government cannot give up its general responsibility of overseeing that the States achieve the broad national objectives

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embodied in the Constitution, this does not mean that it should take upon itself the tasks and responsibilities which properly belong to the States or duplicate their functions. It felt that, except in the most essential areas and that too for a limited duration, the Union Government should not take upon itself the functions and responsibilities which are legitimately in the States' domain.

12.17 The Commission on Centre-State Relations, headed by Justice R.S. Sarkaria (henceforth, 'Sarkaria Commission'), in its report submitted in 1988, had recommended that the number of Centrally sponsored schemes should be kept to the minimum. It, however, recognised the need for the Union Government to initiate pilot projects, even in regard to subjects in the States' sphere, if those subjects had inter-State, regional or overall country-wide significance with high national priority. It added that these should be formulated in prior consultation with the States and once a programme had passed the pilot stage and was found desirable for scaling up, it should appropriately form a part of the State Plan. It also noted that assistance from the Union towards Centrally sponsored schemes should be kept to a minimum compared to Central assistance for the State Plans and that the State Governments should be involved in determining the contents and coverage of such schemes to cater to local variations.

12.18 The National Commission on Review of the Working of the Constitution (2002), chaired by Justice M.N. Venkatachaliah, had observed that the rationale of the Concurrent list stems from the fact that certain subjects require simultaneous jurisdiction of the Union and the States. It added that in view of the need for a uniform law or policy at the national level, as well as for operational flexibility at the local level to accommodate state-specific differences or problems, "harmonious operation of the Concurrent List could well be considered to be creative federalism at its best."

12.19 The Commission on Centre-State Relations, headed by Justice M.M. Punchhi (henceforth, 'Punchhi Commission'), in its report submitted in March 2010, had observed that the share of normal Plan assistance in the total budgetary support to the State Plan had come down drastically relative to that of Centrally sponsored schemes, additional Central assistance and special Plan assistance. It observed that the number of Centrally sponsored schemes should be restricted to flagship programmes of national and regional importance. Accordingly, the Commission recommended reduction in the number of these schemes and their funding in a phased manner, as well as flexibility in the guidelines governing their implementation to suit state-specific situations. The Commission also recommended a comprehensive review of all transfers to the States, particularly through Centrally sponsored schemes, with a view to minimising the component of discretionary transfers.

12.20 A Committee constituted by the Planning Commission to consider the issue of 'Restructuring of Centrally Sponsored Schemes', under the chairmanship of Shri B.K. Chaturvedi (henceforth, 'Chaturvedi Committee') noted the concerns raised by States regarding the lack of flexibility in Centrally sponsored schemes, the adverse implications of the counterpart funding requirement on State finances and the questionable utility of operating a large number of Centrally sponsored schemes with thinly spread resources at the field level. In its report submitted in September 2011, the committee reiterated the need for a "national effort in education, childhood care, health, unemployment and old age, and for minimising inequalities in income amongst States", guided by the Directive Principles of State Policy. Apart from providing greater operational

flexibility to States to address development gaps, the committee recommended reduction in the number of Centrally sponsored schemes.

Views of Previous Finance Commissions

12.21 Successive Finance Commissions had considered this issue, keeping in view the significant quantum of Central transfers being made through the route of Centrally sponsored schemes. The FC-XI had recommended that these schemes need to be transferred to the States, along with funds. It also recommended that all other schemes be implemented by panchayats and municipalities, on the basis of plans prepared by the District/ Metropolitan Planning Committees. The FC-XII had recommended that there should only be a grant element for all Centrally sponsored schemes without any grants linked to loans. It had further recommended that States be given their total entitlement of grants and allowed to select their own mix of Centrally sponsored schemes, within the limit of the total grant. The FC-XIII had recommended reduction in the number of Centrally sponsored schemes and restoration of the predominance of formula-based Plan transfers.

Issues and Approach

12.22 In our effort to take a comprehensive view of the fiscal relations between the Union and the States, we have reviewed the existing arrangements for transfers and also the views of the Union, States, various Commissions, Committees etc. This review leads us to several conclusions:

First, there is some convergence of views about the need for transfer of funds from the Union to the States, which go beyond tax devolution and grants from the Finance Commission. Some States wanted such transfers to be made entirely on the basis of the recommendations of the Finance Commission. Many States suggested that such transfers should, ideally, be untied. While it is reasonable to conclude that there is a convergence of views about the need for some specific-purpose transfers from the Union to the States, differences persist in regard to the desirable magnitude and current manner in which such transfers are taking place outside the tax devolution and Finance Commission grants.

Second, there is a convergence of views that the objective of transfers from the Union to the States should be for supplementing the transfers recommended by the Finance Commissions. In this regard, the Union Government has suggested avoidance of overlap between the Finance Commission grants and its own transfers, presumably in regard to sector-specific and state-specific schemes.

Third, there are differences of views about the scope or purposes for which such transfers outside the Finance Commission should take place. Concerns have been expressed that the scope and conditionality of such transfers have expanded considerably in recent years. Our data confirms that such a significant expansion did take place.

Fourth, the recommendations of various Committees have indicated their discomfort with the fact that the Union has been unilaterally deciding about the scope, nature and design of the Centrally sponsored schemes. While the fact that there are overlapping functions warranting

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transfers is generally accepted, there is a perception that the Union Government is stretching the interpretation of the Concurrent List in its favour and, in fact, treading into areas in the State list of the Constitution.

Fifth, most States have repeatedly expressed concerns that the Union Government exercises excessive discretion in distributing the resources among them through the transfer mechanism, especially in regard to Centrally sponsored schemes. The States have generally described these transfers as being 'non-formula-based' and 'discretionary'. Data reveal that the share of formula-based distribution (such as transfers based on the Gadgil-Mukherjee formula) in the aggregate transfers has been decreasing. It is noted that the Union Government does adopt certain criteria for allocation of funds in respect of Centrally sponsored schemes and some other forms of grants. However, the actual transfers to States are often noticeably different from the allocations based on these criteria for a variety of reasons, including non-compliance with conditionalities and the procedures laid down for releases.

Sixth, for several years, concern has been expressed that many of the Centrally sponsored schemes are based on a 'one size fits all' approach and that often the design of schemes is inappropriate for several States. There is a consensus that the design should be improved and flexibility to the States should be increased. However, despite some efforts to reduce the number of schemes and provide flexibility to States, there is a perception that the progress in this regard has been tardy.

Seventh, various Commissions and Committees have supported rebalancing the transfers of funds from the Union to the States in favour of formula-based untied transfers.

Eighth, the previous Finance Commissions have also expressed their views in regard to the significant quantum of Central transfers being made particularly through Centrally sponsored schemes. Their suggestions include transferring of all these schemes to the States along with funds and restoring the pre-dominance of formula-based Plan transfers.

Ninth, despite some differences of opinion, there is virtual unanimity on one issue - that there is universal dissatisfaction with the existing system of transfers from the Union to the States outside the awards of the Finance Commission. We also notice that the existing institutional arrangements have not adequately facilitated the agreed process of appropriate rebalancing of the existing system of transfers in favour of a greater role for the States, despite stated intentions and efforts. In the process, suggestions have been made implicitly and explicitly to expand the role of the Finance Commission.

12.23 We, therefore, conclude that a compelling case has been made for reforming the existing system of fiscal transfers from the Union to the States in a comprehensive manner. We recommend that the existing system be reviewed and necessary institutional changes be considered.

12.24 There are three possible ways in which specific-purpose grants for nationally important schemes or overlapping functions can be determined. *First*, the Finance Commission may recommend specific-purpose grants for programmes and schemes in a comprehensive and significant manner to encompass all fiscal transfers. *Second*, the Finance Commission may identify sectors with overlapping responsibilities between the Union and the

States, indicate the volume of assistance for these schemes and leave it to the Ministry of Finance and the relevant Union ministry to design and implement them. *Third*, the Finance Commission may determine the fiscal space available for specific-purpose grants, both those for which the States have made a strong plea for assistance with the Commission as well as those coming under the rubric of Central schemes. The design, implementation and monitoring of the schemes under this fiscal space can be left to a new institutional arrangement that addresses the current concerns of the States and objectives of the Union.

12.25 We believe that the option of entrusting the Finance Commission with responsibilities relating to all transfers from the Union to the States is not advisable. At the same time, we believe that a Finance Commission should take a comprehensive view of all fiscal transfers from the Union to the States. However, it should limit its own recommendations only to tax devolution, grants-in-aid and any other matter referred to it in the interest of sound finance.

12.26 We recognise that some of the current Centrally sponsored schemes relate to subjects that can best be handled entirely by the States and, hence, should be in the fiscal space of States alone. There are also schemes that normally need to be in the States' domain, but need support from the Union. **In our view, the Union Government should continue to have fiscal space to provide grants to States for functions that are broadly in the nature of 'overlapping functions' and for area-specific interventions.**

12.27 **We, however, believe that the existing arrangements for transfers between the Union and the States need to be reviewed with a view to minimising discretion, improving the design of transfers, avoiding duplication and promoting cooperative federalism, insofar as such transfers are required to be made outside of the recommendations of the Finance Commission.** To address the common concerns and issues in this regard, we believe that an institutional arrangement for consultation between the Union Government and the State Governments, and among the States *inter-se*, in the design and implementation of the relevant schemes, would be necessary. This must be supplemented by domain expertise, where appropriate. Also, it is not only the size and design of grants that is important; it is equally the design of incentives and monitoring which requires domain expertise and continuity. This would also lead to wider consultations on priorities and programmes, as well as on the flexibility to address the concerns of States on the design, discretion and uncertainties associated with the objectives, programmes and schemes tied to such transfers.

12.28 **In the light of this, we recommend for consideration the evolution of a new institutional arrangement, consistent with the overarching objective of strengthening cooperative federalism, for: (i) identifying the sectors in the States that should be eligible for grants from the Union, (ii) indicating criteria for inter-state distribution, (iii) helping design schemes with appropriate flexibility being given to the States regarding implementation and (iv) identifying and providing area-specific grants.**

North-eastern Region

12.29 In our approach to the assessment of State finances, we have analysed the States without any categorisation, but have taken into account the revenue expenditure requirement under both Plan and non-Plan heads. More important, we have built into the devolution formula serious

revenue and cost disabilities, to the extent feasible, supplemented by post-devolution deficit grants. The North-eastern and hill States have several unique features that have a bearing on federal fiscal relations. These States are characterised by: (a) low level of economic activity and the consequential low revenue capacity; (b) the disability arising from large forest cover and hilly terrain; (c) remoteness; (d) infrastructure deficit; (e) international borders and the law and order problems due to persistent insurgency; (f) high level of expenditures on public administration and police, relative to the overall gross state domestic product (GSDP) of the States and the large proportion of government employment in total employment. Most of these States are largely dependent on the resource flows from the Union Government, both for balancing their revenue account and for capital investment. There is, in addition, currently a special dispensation for flow of Plan grants to them.

12.30 Our ToR also requires us to not only take into consideration the objective of balancing the revenue account, but also that of generating surpluses for capital investment. In this regard, we noted the high dependence of the States in the North-eastern region on Central transfers, particularly for meeting their capital expenditure needs. Most of these States are faced with significant deficits in infrastructure. The relatively small sizes of their GSDP imply that market borrowings are insufficient for financing these deficits. We have also noted that inter-state issues and coordinated actions by these States play an important role in determining the viability of investments in the region. The North East Council, which is an advisory body to aid and advise the Union Government about development and security-related matters in the region, gets direct funding from the Union Government. Since 1996, all Union Government Ministries (with a few exceptions) have been required to earmark 10 per cent of their budget to this region, with any unspent balance being transferred to the Non-Lapsable Central Pool of Resources created in 1997-98 to support infrastructure development projects in the region.

12.31 While we have addressed the issues related to North-eastern States to the extent feasible, we assess that these States would continue to need a special focus, particularly in terms of social and economic infrastructure with inter-state significance. We, therefore, believe that the proposed new institutional arrangement should have a special focus on these States, particularly in terms making investments in infrastructure.

12.32 We, therefore, urge that the suggested new institutional arrangement also consider taking up issues related to identifying and recommending resources for inter-state infrastructure schemes in the North-eastern States.

Natural Resources

12.33 We also recognise that the fiscal implications of the endowment of natural resources have come to the fore in federal fiscal relations, as the current regulatory arrangements have led to shrinking policy space of the States in harnessing natural resources in a manner that promotes balanced management of the environment as well as accelerated economic development. A related issue is that of States with large areas covered by forests and their demand for adequate compensation for the global public good they generate, the income and taxes they lose on account of preserving the forests and the additional tasks of providing public services on account of forest cover.

12.34 Our ToR requires that we take into consideration 'the need to balance management of ecology, environment and climate change consistent with sustainable economic development', in formulating our recommendations. Promoting the objectives of sustainable development in policy making requires a conceptualisation of the benefits of economic activities, social and welfare needs being met and natural capital being conserved. The policy choices need to be proactive, anticipating the likely causes and consequences of economic policies on the environment with built-in corrective actions to remove or minimise the negative fall-outs. In practical terms, this would mean establishing mechanisms that integrate economic and environmental concerns in decision making across different tiers of government and in a host of government agencies that are involved in development tasks.

12.35 We have, in our tax devolution formula, included the area under forest cover as one of the criteria. But, in order to address these common concerns and issues that arise from the management of natural resources, global concerns on climate change and the issue of sustainable development, we are of the view that the Union and the States need to become partners in addressing the challenges of development in a manner that is sustainable and preserves the ecological balance. A consultative mechanism at the highest level will be able to address many of the apprehensions and concerns of stakeholders and provide policy thrust cutting across several line ministries and agencies. It would also serve to give a measure of participation and involvement to both the Union and the States within the overarching fiscal and economic policy concerns. **We accordingly, urge that the new institutional arrangement should also become the forum for integrating economic and environmental concerns in decision making.**

Towards a New Institutional Arrangement

12.36 The question of involving the States in matters related to fiscal transfers was considered during the drafting of the Constitution. The Expert Committee on the Financial Provisions of the Union Constitution, appointed by the Constituent Assembly in September 1947, recommended that two of the five members of the proposed Finance Commission be nominated by the States and another two from a panel nominated by the Central Government, while the President would appoint the Chairman. This suggestion was ultimately not adopted by the Constituent Assembly. Disputes between the Union and the States, or between States, were left to be resolved through an Inter-State Council that could be appointed under Article 263 of the Constitution.

12.37 Accepted theories of institutional design, as well as international practice, indicate the need for the States to play a role in the decision-making process relating to fiscal allocations from the Union to the States. This is a crucial element of co-operative federalism, which requires continuing consultations on issues that affect the interests of Union and State Governments. **In earlier chapters, we have observed that the actions of the Union Government impact the State Governments and vice versa. Further, although each level of government takes decisions independently, an exchange of views and information before each takes actions that impact the other is necessary. It is in this context that institutionalised channels of consultation between the Union and State Governments are of relevance. We have, accordingly, addressed these broader issues in proposing a new institutional arrangement.**

Role of the Inter-State Council

12.38 The Constitution already provides for a forum for deliberations between the Union and the States, and the States *inter-se*, on matters of common interest. Article 263 of the Constitution, which deals with the 'provisions with respect to an inter State Council', provides for the President to establish a council for the purpose of (a) inquiring into and advising upon disputes which may have arisen between States (b) investigating and discussing subjects in which some or all of the States, or the Union and one or more of the States, have a common interest or (c) making recommendations upon any such subject and, in particular, recommendations for the better co-ordination of policy and action with respect to that subject.

12.39 Though the Inter-State Council, envisaged under Article 263, is not a permanent Constitutional body for coordination between the Union and the States, and between the States themselves, it can be established 'at any time', if it appears to the President that doing so would serve the public interest. The first Administrative Reforms Commission (1966), in its thirteenth report, had recommended the establishment of the Inter-State Council.

12.40 The report of the Sarkaria Commission suggested the setting up of the Inter-State Council charged with duties embracing the entire gamut of clauses (b) and (c) of Article 263, other than socio-economic planning and development. Detailed recommendations were made on the structure and composition of the Council, its secretariat and functions. The Commission recommended that the separate identity of the NDC should be formalised and duties reaffirmed through a Presidential Order passed under Article 263, and the NDC be renamed as the National Economic and Development Council (NEDC).

12.41 The Inter-State Council was established under Article 263 of the Constitution, through a Presidential Order dated 28 May 1990. The order provided that the Council shall have the Prime Minister as its Chairman and the Chief Ministers of all States and Union Territories having a Legislative Assembly, as well as the Administrators of all Union Territories not having a Legislative Assembly, as members. In addition, six ministers of Cabinet rank in the Union Council of Ministers, to be nominated by the Prime Minister, would also be Members. The Presidential Order of 1990 has been amended twice through orders - the first time in July 1990, providing for the Governor of a State under President's rule to attend the meeting of the Council and the second time in December 1996, providing for the nomination by the Chairman of permanent invitees from among the other Union Ministers. The Inter-State Council itself has been reconstituted from time to time.

12.42 The Inter-State Council, as presently constituted, is a recommendatory body, invested with the following duties: (i) investigating and discussing such subjects, in which some or all of the States or the Union and one or more of the States have a common interest, as may be brought up before it; (ii) making recommendations upon any such subject and, in particular, recommendations for the better coordination of policy and action with respect to that subject; and (iii) deliberating upon such other matters of general interest to the States as may be referred by the Chairman to the Council.

12.43 However, we have noted that while the Inter-State Council is mandated to meet three times in a year, it has met ten times since its establishment in 1990 and twice in the last ten years.

The Secretariat of the Council is under-staffed and lacks functional autonomy. The Secretariat is under the jurisdiction of the Ministry of Home Affairs, which does not focus on a developmental role. In the recent past, several Commissions have also given suggestions and recommendations on adequately empowering the Council. The National Commission to Review the Working of the Constitution, in its report submitted in 2002, the Second Administrative Reforms Commission set up in 2005, in its seventh report titled 'Capacity Building for Conflict Resolution: Friction to Fusion' and the Commission on Centre-State Relations have all recommended strengthening and adequately empowering the Inter-State Council.

Institution for Cooperative Federalism: Redesigned Inter-State Council

12.44 **We commissioned a study to understand the manner in which the Inter-State Council could be strengthened or organised to cover, within its ambit, the function of allocation of financial resources to the States so as to supplement the statutory transfers recommended by the Finance Commission.** The study showed that, in both theory and practice, the role of an inter-governmental forum is limited to consultation and recommendation to the Union Government on matters related to fiscal allocations. We recognise that the Inter-State Council has the potential to ensure that there is meaningful participation by States. It can be strengthened by establishing clear norms for consultation between the Union and the States, inducting domain expertise either within the structure of the Council or through consultative mechanisms, providing adequate regional representation in the formulation of policies and strategy and, perhaps, in staffing the secretariat.

12.45 The Inter-State Council, headed by the Prime Minister, with representation from the Union Government as well as all the State Chief Ministers has the potential to become the forum for outlining, discussing and strategising the goals, objectives and direction for the national economy. It can set out the important national priorities through negotiation, bargaining and consensus building where all stakeholders will have ownership and participation. It has the potential to be a forum for sharing of experiences and exchange of important initiatives taken up by States. It can also serve the purpose of enabling disadvantaged States to achieve a measure of equality in competing with other States by providing and monitoring incentives. It would need to be supported in its duties by the Council Secretariat, which would not only process the issues for the consideration of the Council but also maintain constant liaison with the Union and the States.

12.46 **We, therefore, suggest that the present role of the Inter-State Council be expanded to include the functions envisaged in paragraphs 12.28, 12.32 and 12.35.**

Aggregate Transfers

12.47 The FC-XI recommended an indicative ceiling of 37.5 per cent of the Union Government's gross revenue receipts on the overall Union transfers to States. The FC-XII raised this to 38 per cent. The FC-XIII recommended raising this indicative ceiling to 39.5 per cent and also noted that transfers on the revenue account were already above 39 per cent of the revenue receipts of the Union in 2008-09 and 2009-10. **The indicative ceiling on transfers, suggested by the previous Finance Commissions, has, however, not restrained the Union Government from making larger transfers to the States.**

12.48 As per our recommendation, the tax devolution to the states is 42 per cent of the divisible pool. The aggregate grants recommended by us, expressed as a percentage of the divisible pool, are in the range of 6.4 per cent to 5.2 per cent, with an average of 5.7 per cent, over the award period. The total Finance Commission transfers, including the tax devolution projected by us, amount to an average of 37.2 per cent of the projected gross revenue receipts of the Union during our award period.

12.49 As we had noted in Chapter 5, when the direct transfer component is added, the level of aggregate Union transfers to States, as a percentage of gross revenue receipts, went up from 48.9 per cent in 2010-11 to 53.7 per cent in 2011-12 before declining to 49 per cent in 2012-13. Consistent with the past trends, the States would, therefore, be expecting transfers from the Union Government, in addition to the Finance Commission transfers, over the award period in order to maintain the current level of aggregate transfers from the Union to the States. **Therefore, we expect that the Union Government will utilise its available fiscal space to continue to address the needs and expectations of the States and ensure the prevailing level of transfers to States of about 49 per cent of the gross revenue receipts during the award period.**

Recommendations

- i. We conclude that a compelling case has been made for reforming the existing system of fiscal transfers from the Union to the States in a comprehensive manner. We recommend that the existing system be reviewed and necessary institutional changes be considered. (para 12.23)
- ii. We believe that the existing arrangements for transfers between the Union and the States need to be reviewed with a view to minimising discretion, improving the design of transfers, avoiding duplication and promoting cooperative federalism, insofar as such transfers are required to be made outside of the recommendations of the Finance Commission. (para 12.27)
- iii. We recommend for consideration the evolution of a new institutional arrangement, consistent with the overarching objective of strengthening cooperative federalism, for: (i) identifying the sectors in the States that should be eligible for grants from the Union, (ii) indicating criteria for inter-state distribution, (iii) helping design schemes with appropriate flexibility being given to the States regarding implementation and (iv) identifying and providing area-specific grants. (para 12.28)
- iv. We urge that the suggested new institutional arrangement also consider taking up issues related to identifying and recommending resources for inter-state infrastructure schemes in the North-eastern States. (para 12.32)
- v. We urge that the new institutional arrangement should also become the forum for integrating economic and environmental concerns in decision making (para 12.35)
- vi. We suggest that the present role of the Inter-State Council be expanded to include the functions envisaged in paragraphs 12.28, 12.32 and 12.35. (para 12.46)
- vii. We expect that the Union Government will utilise its available fiscal space to continue to address the needs and expectations of the States and ensure the prevailing level of transfers to States of about 49 per cent of the gross revenue receipts during the award period. (para 12.49)

Chapter 13

Goods and Services Tax

13.1 Our TOR 6(xi) requires us to consider "the impact of the proposed Goods and Service Tax on the finances of Centre and States and the mechanism for compensation, in case of any revenue loss". After the introduction of value added tax (VAT) in the fiscal year 2005-06, further reform of indirect taxes for evolving a comprehensive and broad based goods and services tax (GST) has been under consideration since 2007.¹ Although the implementation of GST has been delayed, there has been a steady expansion of the base of service taxation over the years. A series of changes have taken place in the taxation of services since its introduction, both by bringing in more services under the tax net and by periodic revision of the rates of taxation.

13.2 In the fiscal year 2010-11, the Union Government was levying service tax on 104 selected services. The Union Budget 2012-13 introduced the concept of a negative list in service taxation, which implied that except for certain identified services, all other services would be subject to taxation. Seventeen services were placed in the negative list that year. The introduction of the negative list concept has, to a large extent, rendered the tax base comprehensive and eliminated selectivity and discretion in service taxation and has contributed to an increase in revenue growth. Revenue growth in 2012-13 over 2011-12 was 36.0 per cent and is projected to be 24.4 per cent and 31.0 per cent in 2013-14(RE) and 2014-15 (BE) respectively. The share of service tax in total tax revenue is expected to increase from 10.9 per cent in 2011-12 to 15.8 per cent in 2014-15 (BE). The Union Finance Minister, in his 2014-15 Budget speech, emphasised the need for early implementation of GST and assured that the Union Government would be fair when it comes to the question of the fiscal autonomy of States and compensation to them for any revenue loss.²

Views of Previous Finance Commissions

13.3 The FC-XIII appointed a task force on GST and recommended a single rate of 5 per cent for Central GST and 7 per cent for State GST, based on the report of this task force. It also recommended a uniform threshold of Rs 10 lakh for goods and services under both the levies and uniform treatment for both goods and services to avoid classification disputes. The GST design proposed by the FC-XIII limited the exemption from the tax to public services of the government, unprocessed food under the public distribution scheme, health and education services. The design also included motor spirit, alcohol and tobacco under GST as a creditable levy. It also recommended

¹The Union Finance Minister made an announcement that GST would be introduced from 1 April 2010 in his Budget speech of 2007-08

² "The debate whether to introduce a Goods and Services Tax (GST) must now come to an end. We have discussed the issue for the past many years. Some States have been apprehensive about surrendering their taxation jurisdiction; others want to be adequately compensated. I have discussed the matter with the States both individually and collectively. I do hope we are able to find a solution in the course of this year and approve the legislative scheme which enables the introduction of GST. This will streamline the tax administration, avoid harassment of the business and result in higher revenue collection both for the Centre and the States. I assure all States that government will be more than fair in dealing with them." (Budget Speech 2014-15, 10 July 2014, pp. 3-4).

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a compensation amount of Rs. 50,000 crore, in case of revenue loss to the States, for five years from 2010-11 to 2014-15.

Views of the Union Government

13.4 In its memorandum to the Commission, the Union Government mentioned that it had envisaged progress in the implementation of GST during the award period of the FC-XIII. It explained that this did not happen owing to the long process of building consensus between the Union and the States, along with the time required in undertaking the necessary Constitutional amendments.

13.5 The Union Government, in its subsequent submission on GST to the Commission, stated that key aspects like tax base and rate, exemption limit and place of supply rule for services, are still evolving. It said that in the absence of clarity on these issues, it is not possible to assess the likely impact of GST. The Union Government also emphasised that GST rates should be as close to the revenue neutral rate (RNR) as possible, so that revenue loss is minimised.

13.6 The Union Government has explained that the RNR of the States should take into account the revenue loss to the States due to abolition of Central sales tax (CST). It urged that since the CST rates has already been brought down from 4 per cent to 2 per cent, the revenue loss be estimated not on the basis of 4 per cent CST, as was done by the Empowered Committee of State Finance Ministers, but at the current rate of 2 per cent CST. According to the Union Government's estimates, with this adjustment alone, the revenue loss for the year 2012-13 would be only Rs. 46,500 crore as against Rs. 93,000 crore estimated by the Empowered Committee. It has also been highlighted by the Union Government that Empowered Committee of State Finance Ministers' estimate does not take into consideration the gains accruing due to GST, in terms of better tax compliance and higher economic growth.

13.7 On the question of an independent Constitutional mechanism for compensation of revenue loss, as demanded by the States, the Union Government argued that this was not necessary as compensation is a temporary feature. It has proposed the creation of a GST compensation fund through a Union legislation, in order to allay the fears of the States. It also proposed that an autonomous body may be constituted to study the impact of GST on Union and State finances and also to recommend the quantum of compensation to each State. This would be based on a common formula to be applied on each State for arriving at the actual revenue loss it would face. It also mooted the idea of working out an independent mechanism for directly transferring funds from the Union's resources to this proposed GST compensation fund in order to bridge the trust deficit between the Union and the States.

Views of the State Governments

13.8 States, in their submissions have generally favoured the implementation of GST and focussed their stand on five critical issues: (i) revenue compensation, including the issue of pending CST compensation; (ii) goods and services that should come under the purview of GST; (iii) state-specific issues with regard to inclusion/exclusion of specific taxes having implication on the GST design; (iv) issues related to RNR; and (v) capacity building.

Revenue Compensation

13.9 The main concern about compensation highlighted by the States are (a) proper estimation of revenue loss and corresponding compensation package, (b) a credible compensation mechanism

and (c) the period of compensation. A few States have suggested that a GST compensation fund may be created under the GST Council. States have also urged that all pending CST claims for the year 2010-11, 2011-12 and 2012-13 should be released by the Union Government.

State Taxes to be Subsumed Under GST

13.10 There are differing views across States regarding the list of goods to be subsumed under GST. States have argued that motor spirits and alcohol should remain outside GST and they should be allowed to levy higher rates of tax on these products. One State has raised an apprehension on the powers to be given to the GST Council, as it may come directly in conflict with the legislative powers of States.

Exemption of Specific Goods and Services

13.11 States have suggested that they should be allowed to exempt certain goods of local importance from the purview of GST. The States levying purchase tax are strongly in favour of retaining it outside GST. A few States are also of the view that that the GST design should provide flexibility for the levy of any separate entry tax/cess entertainment tax for the purpose of transferring it to local bodies. Further, some flexibility in the design of GST to enable levying a "Green Tax" on certain polluting goods has been suggested by some States.

Revenue Neutral Rate

13.12 Some States have suggested that the RNR should be determined on the basis of a robust study by the Union Government or the FC-XIV. A few States have argued that although a uniform GST rate is desirable, States should be given some flexibility in deciding the rates of GST within a band. One State has argued that GST with a uniform rate would erode the autonomy of States. A few States have suggested that the rate of CST may be increased to 4 per cent till GST is introduced.

Capacity Building

13.13 Many States have suggested that a one-time grant awarded by the FC-XIV for capacity building and strengthening the administration would be desirable. According to the States, capacity building for improving the accounting system, forms and procedures, assessment, auditing and computerisation of the administration would be a prerequisite for a successful outcome of GST. They accordingly suggested a special grant for upgradation of information systems and training of personnel for GST.

Meeting with the Empowered Committee

13.14 We had a meeting with the Empowered Committee of State Finance Ministers in September 2014. The meeting facilitated our interaction with individual States and the Ministry of Finance, Government of India on the progress of the implementation of GST.

13.15 In the meeting, Secretary of the Empowered Committee summarised the consensus on the following matters. It would be a dual GST model implemented through multiple statutes (one for the Central GST and the other for State GST) on a destination-based principle. The Central GST and the State GST would be applicable to all transactions of goods and services except those which were exempted and those goods outside the purview of the GST and transaction

below the threshold limits. The State taxes and levies to be subsumed under GST are VAT/sales tax, entertainment tax, luxury tax, taxes on lottery, betting and gambling, States' cesses and surcharges relating to the supply of goods and services and entry tax not in lieu of octroi. The State taxes proposed to be kept outside the purview of GST are those on petroleum products, alcohol for human consumption, tobacco and entry tax in lieu of octroi. However, States levying purchase tax wanted to retain this tax outside the purview of GST.

13.16 The Secretary, Empowered Committee, explained that the revenue gains from GST will come from the levy of State GST on services and on imports into States. However, according to him, the adverse revenue impact of the proposed GST on the finances of the States would arise mainly on account of the abolition of CST as well as the removal of cascading effect and the corresponding increase in input tax credit. The Secretary indicated that while some States may gain from this, many would suffer a revenue loss and would need to be compensated by the Union Government. He added that some States wanted a separate compensation to be given for any loss arising from subsuming the purchase tax on agricultural products if it is subsumed under the GST. He mentioned that the total GST loss, as estimated by the Empowered Committee taking into consideration these factors for the year 2012-13, worked out to be Rs, 96,500 crore.

13.17 The Secretary mentioned that the impact of the proposed GST would be different across States. He explained that as the GST is a destination-based tax, the respective RNR for individual State and Union Territories would vary substantially depending on whether it is a consuming State or a manufacturing State. It was also mentioned that it would be difficult to assess the gain from the inclusion of services in the base. He made it clear that RNR needs to be worked out for the entire country, after due consideration by the proposed GST Council and needs to be adopted by all States with consensus. He recognised that the introduction of GST may result in better tax compliance and may provide an impetus to higher growth in gross domestic product (GDP), but added that it would be difficult to make an assessment of such gains and take them into account while the RNR was being worked out by the Empowered Committee.

13.18 The Secretary, Empowered Committee, also highlighted the important issue of the need for adequate compensation and a compensation mechanism in case of revenue loss after the implementation of the GST. He said many States had pointed out the unsatisfactory experience in getting CST compensation from the Union Government, resulting in a trust deficit between the two levels of governments. Hence, the States wanted an independent mechanism through which the GST compensation should be paid to them. It was argued that since the loss on account of implementation of GST would be of permanent nature and that it would take nearly five years to reap the benefits of GST, full compensation for five years needs to be given to the States. **He added that the Parliamentary Standing Committee on Finance has also emphasised the need for an automatic compensation mechanism. He emphasised that States endorsed the recommendations of the Standing Committee to institute a well-defined automatic compensation mechanism. The suggestion was to create the GST compensation fund under the administrative control of GST Council to address the legitimate revenue concern of the States.**

13.19 The Secretary, Empowered Committee, pointed out that the FC-XIII gave its recommendations on GST and GST compensation at a time when the Union and the States were in the initial stages of implementing GST. He added that a final decision about the structure of GST would soon emerge since sufficient ground has since been covered and States are more or less in agreement with the basic design, exemptions and commodities to be kept in the lower rate

etc. He clarified that a final decision would include GST rates, threshold, composition scheme and exemptions.

13.20 We were requested by the Secretary, Empowered Committee, to take all the above issues into consideration while formulating our recommendations about the impact of the proposed GST on State revenues and GST compensation, based on the design of GST broadly agreed upon and also keeping in view the recommendations made by the Parliamentary Standing Committee on Finance.

13.21 In the meeting, a majority of the States stated that they were in broad agreement with the suggestions, views, opinions and recommendations of the Empowered Committee as placed before the Finance Commission. All of them reiterated their apprehensions on the revenue loss and raised the issue of some of the taxes to be subsumed under the proposed GST. They also raised the issue of keeping some of the goods like petroleum products, alcohol for human consumption, tobacco out of the purview of GST. State-specific concerns were raised on the issue of entry tax in lieu of octroi, compensation package, a separate and independent compensation fund under the administrative control of the GST Council, automatic compensation mechanism and the quantum of compensation.

13.22 The North-eastern States were in agreement with the issues raised by different States and mentioned that adequate compensation should be paid for the revenue loss. The representatives of Union Territories requested the Commission to consider the issue of amending Article 270 and 280 of the Constitution so as to enable the Union Territories to be treated equally with the States. The Union Territories welcomed the introduction of GST and agreed with the issues raised by various States on the impact of the proposed implementation of GST.

13.23 The representative from the Ministry of Finance conveyed the Union Government's view on the concerns of the States regarding the impact of the proposed implementation of GST and the revenue losses that were likely to result. It was clarified that the Union Government would compensate the States if the introduction of GST results in a revenue loss to them. The representative also highlighted the quantum of compensation already paid to the States on account of abolition of CST.

13.24 We gathered from the meeting that there is a significant trust deficit on the part of the States vis-à-vis the Union (whether warranted or not) on the issue of CST compensation. The States, therefore, insisted on an independent compensation mechanism outside the Ministry of Finance. The representative of the Ministry of Finance assured that an independent compensation mechanism will be put in place in the GST regime.

Revenue Implications of GST & Compensation

13.25 We recognise that while tax reform involving both Union and State Governments is not an easy task in a complex federal system like India, it is a process which would help in building a more harmonised tax structure and minimise distortions. We are of the view that a broad based tax like GST would help develop a common market and, in turn, would help increase economic growth and revenue outcome. We also hope that the application of technology in tax administration would result in higher revenue gain. **We expect that the final GST design would have all the**

characteristics of a good tax system such as broad base, low rate, minimum rate differentiation, low compliance cost and reduced distortions to the economy.

13.26 Our mandate is to examine the impact of the proposed GST on the finances of the Union and States and suggest a mechanism of compensation in case of any revenue loss. **There are several challenges and many unresolved issues. In the absence of clarity on the design of GST and the final rate structure, we are unable to estimate revenue implications and quantify the amount of compensation in case of revenue loss to the States due to the introduction of GST.**

13.27 In our assessment of Union finances, we were unable to explicitly factor in the quantum of compensation required in the event of introduction of GST during our award period for the reasons cited above. However, we recognise that States should be provided with the assurance of compensation by the Union. **The Union Government may have to initially bear an additional fiscal burden arising due to the GST compensation. This fiscal burden should be treated as an investment which is certain to yield substantial gains to the nation in the medium and long run. We also believe that GST compensation can be accommodated in the overall fiscal space available with the Union Government.** At the same time, States should keep broader public interest of the nation as a whole, and long-term interest of each of the States, and contribute to a consensus on this issue. In order to facilitate a speedy resolution of major issues in this subject of great national interest, we make the following suggestions for consideration of the Union and States relating to (a) period of GST compensation, (b) legal status of the compensation fund and (c) universal application of the GST regime.

Period of GST Compensation

13.28 **Introduction of GST in the country may lead to revenue losses for a few years to some States, as GST marks a shift from an origin-based system of indirect taxes to a destination-based system.** However, as GST will broaden the tax base, result in better tax compliance, and lead to higher growth in the economy, it is expected that the revenue earnings of the States will stabilise in a few years. Therefore, to ensure that the States do not face undue financial hardship in the initial years, the Union Government may compensate the States on a tapering basis for a period of five years for the revenue losses calculated as the difference between projected and actual revenues. We have, in this regard, the precedent of VAT. **In the case of VAT, compensation was provided to the States for three years, at 100 per cent in the first year, 75 per cent in the second year, and 50 per cent in the third year. In our view, it will be appropriate to keep this precedent as the basis for compensation for GST also. However, given the scale of reform and the apprehensions of revenue uncertainty raised by the States, the revenue compensation, in our view, should be for five years. It is suggested that 100 per cent compensation be paid to the States in the first, second and third years, 75 per cent compensation in the fourth year and 50 per cent compensation in the fifth and final year.**

Legal Status of GST Compensation Fund

13.29 The Commission recommends that a GST Compensation Fund be set up by the Union to compensate the States for their revenue losses. States have been demanding that the GST Compensation Fund must be created Constitutionally. As already mentioned, this insistence on an appropriate institutional arrangement arises from considerable doubts that States have about the Union discharging its obligations. However, the Union Government noted that since the

compensation would be a temporary feature, there appears to be no requirement of creating the Fund through a Constitutional provision. We believe that in the interest of a resolution of the issue, acceptable and appropriate institutional arrangements should be put in place to allay the fears of States. **We, therefore, recommend the creation of an autonomous and independent GST Compensation Fund through legislative actions in a manner that it gives reasonable comfort to States, while limiting the period of operation appropriately.**

Universal Application of GST Regime

13.30 There is merit in the universal application of GST in order to have a comprehensive base and, in the long run, all goods and services should be brought under the ambit of GST. In particular, exclusion of any goods from the ambit of GST through Constitutional guarantee is not desirable. This could lead to leakages of revenues due to disruption of tax credit chain and audit trails and would continue to have the problem of cascading. Further, the origin-based distortionary CST presently levied on inter-State sales of goods would have to be dispensed with once universalisation is achieved. **We, therefore, recommend that the Constitutional legislative and design aspects of the GST enable transition towards universal application of GST over the medium to long term, while making necessary provisions for smooth transition through temporary arrangements.**

Recommendations

- i. There are several challenges and many unresolved issues. In the absence of clarity on the design of GST and the final rate structure, we are unable to estimate revenue implications and quantify the amount of compensation in case of revenue loss to the States due to the introduction of GST. (para 13.26)
- ii. The Union may have to initially bear an additional fiscal burden arising due to the GST compensation. This fiscal burden should be treated as an investment which is certain to yield substantial gains to the nation in the medium and long run. We also believe that GST compensation can be accommodated in the overall fiscal space available with the Union Government. (para 13.27)
- iii. In the case of VAT, compensation was provided to the States for three years, at 100 per cent in the first year, 75 per cent in the second year and 50 per cent in the third year. In our view, it will be appropriate to keep this precedent as the basis for compensation for GST also. However, given the scale of reform and the apprehensions of revenue uncertainty raised by the States, the revenue compensation, in our view, should be for five years. It is suggested that 100 per cent compensation be paid to the States in the first, second and third years, 75 per cent compensation in the fourth year and 50 per cent compensation in the fifth and final year. (para 13.28)
- iv. We recommend creation of an autonomous and independent GST Compensation Fund through legislative actions in a manner that it gives reasonable comfort to States, while limiting the period of operation appropriately. (para 13.29)
- v. We, therefore, recommend that the Constitutional legislative and design aspects of the GST enable transition towards universal application of GST over the medium to long term, while making necessary provisions for smooth transition through temporary arrangements. (para 13.30)

Chapter 14

Fiscal Environment and Fiscal Consolidation Roadmap

14.1. 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".

14.2 While making its recommendations, the Commission is also required, under paragraph 6, to have regard, among other considerations, to:

- (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."

14.3 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 debt-stressed states.

Views of Previous Finance Commissions

14.4 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).

14.5 As regards future lending policy, the 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.

14.6 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.¹ 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.

14.7 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.

¹ The apparent mismatch between a 3 per cent of GSDP fiscal deficit target and a 2.4 per cent of GDP target, for all States, in relation to the consolidated fiscal deficit is due to differences in the methodology in calculating GSDP and GDP. This is also because all States do not include Union Territories.

² The FC-XIII had recommended a consolidated debt target of 68 per cent of GDP for 2014-15, which excluded loans from the Union to the States, amounting to 1.3 per cent of GDP, since these are in the nature of an inter-government transaction.

Review of Debt and Deficit

Review of Combined Finances³

14.8 The consolidated fiscal deficit of Union and State Governments declined from 7.2 per cent of GDP in 2004-05 to 4 per cent in 2007-08, its lowest level in our period of analysis which is 2004-05 to 2013-14 (BE). This was a period of high economic growth, revenue buoyancy and fiscal consolidation in line with the fiscal responsibility legislations at the Union and State levels. However, the combined fiscal deficit-GDP ratio increased sharply to 8.2 per cent in 2008-09 and reached a peak of 9.4 per cent in 2009-10 on account of the economic slowdown and the fiscal stimulus given to mitigate its effects, pay revision, debt relief measures, a high subsidy bill and increased welfare spending initiated largely by the Union Government. Subsequently, the fiscal deficit-GDP ratio declined to 7.6 per cent in 2011-12 and 6.9 per cent in 2013-14 (BE). Similarly, the combined revenue deficit-GDP ratio showed significant improvement from 3.5 per cent in 2004-05 to 0.1 per cent in 2007-08, before a sharp increase to 5.7 per cent in 2009-10. It later declined to 2.8 per cent in 2013-14 (BE).

14.9 The combined debt-GDP ratio declined from 79.5 per cent in 2004-05 to 66.4 per cent in 2013-14 (RE). The reduction was particularly significant - around 10 percentage points - in the period from 2004-05 to 2007-08 and came against the backdrop of high nominal GDP growth, moderate inflation and compressed fiscal deficit. The debt-GDP ratio deteriorated after 2007-08 primarily due to a higher fiscal deficit. It then declined to 66.5 per cent in 2010-11 and has since plateaued at that level. By the end of 2013-14 (BE), the combined fiscal deficit was 6.9 per cent, revenue deficit 2.8 per cent and adjusted outstanding liabilities (net of loans from the Union Government) was 66.4 per cent.

14.10 On a consolidated basis, the general government debt met the standard criteria of sustainability (that the nominal growth rate of the economy is higher than the nominal interest rate with no primary deficit) between 2004-05 and 2013-14 (RE). The shares of the Union and State Governments in the consolidated general government debt have largely been in the ratio of 70:30 in the same period. The proportion of loans from the Union Government to the States relative to GDP also declined from 5.9 per cent in 2004-05 to 1.4 per cent in 2013-14 (RE).

14.11 The consolidated debt-GDP ratio, at 66.4 per cent in 2013-14 (RE), was within the target of 70.8 for that year and the terminal year target of 67.8 per cent for 2014-15 prescribed by the FC-XIII. However, while the consolidated State debt on both net basis (19.8 per cent) and gross basis (21.0 per cent) for 2014-15 (BE) was within the recommended target of 24.3 per of GDP for 2014-15, the Union Government debt, at 45.4 per cent of GDP for 2014-15 (BE) marginally exceeded the recommended target of 44.8 per cent.

Review of the Fiscal Indicators of the Union

14.12 High growth in revenues from income tax and service tax from 2004-05 to 2007-08 enabled the Union Government to reduce its fiscal deficit to 2.5 per cent in 2007-08. However, the fiscal deficit increased sharply thereafter to 6.5 per cent in 2009-10 and although it later declined from 5.7 per cent in 2011-12 to 4.6 per cent in 2013-14 (RE), Union Government finances remained

³ Consolidated data on fiscal deficit and revenue deficit of the Union and States is only available till 2013-14 (BE) in Indian Public Finance Statistics.

under pressure. The revenue deficit declined to 1.1 per cent of GDP in 2007-08, but later increased. Except for two years - 2006-07 and 2007-08 - the Union Government had a primary deficit through the period from 2004-05 to 2013-14.

14.13 The total outstanding debt of the Union Government includes liabilities contracted in the Consolidated Fund and obligations secured under the Public Account. While the former consists of internal debt (dated securities and treasury bills) and external debt, the latter include liabilities on account of the NSSF and provident fund, among others. However, the outstanding debt as reported in the Union budget needs to be adjusted for certain liabilities that are not used to finance the Union Government's fiscal deficit such as Market Stabilisation Scheme (MSS) securities and borrowings by States under NSSF. In addition, this reported debt needs to be adjusted for external debt which is valued at historical book value in the Receipts Budget instead of current exchange (end of the financial year) rates.

14.14 The adjusted Union debt-GDP ratio⁴ declined from 54.3 per cent in 2004-05 to 46.3 per cent in 2013-14 (RE) and further to 45.4 per cent in 2014-15 (BE). However, the public debt component of this increased from 79.8 per cent in 2007-08 to 87.9 per cent in 2013-14 (RE), before marginally falling to 87.2 per cent in 2014-15 (BE). This decline was largely due to an increase in the share of internal debt in total liabilities, from 70.6 per cent in 2007-08 to 80.0 per cent in 2012-13. It later increased to 80.8 per cent in 2013-14 (RE) and to 81.3 per cent in 2014-15 (BE). Currency risk is relatively low, with the share of external debt in total liabilities declining from 9.1 per cent in 2007-08 to 7.1 per cent in 2012-13. It stood at 5.9 per cent in 2014-15 (BE). The proportion of public account liabilities in Union Government debt witnessed a continuous decline from 20.7 per cent in 2006-07 to 12.8 per cent in 2014-15 (BE), with provident funds and reserve funds and deposits each accounting for around 5.4 per cent.

14.15 The dated securities of the Union Government, as on 31 March 2014, accounted for 66.8 per cent of its total outstanding liabilities. The weighted average maturity of new issues declined from a high of 14.9 years in 2007-08 to 11.2 years in 2009-10, before rising to 14.3 years in 2013-14 (RE). Around 83 per cent of the stock of dated securities would be up for redemption over the next twenty years, including 33 per cent during our award period.

Review of the Fiscal Indicators of the States⁵

14.16 At an aggregate level, fiscal indicators of States improved in the period from 2004-05 to 2013-14 (RE). The fiscal deficit-GDP ratio for all States declined from 3.3 per cent in 2004-05 to 1.4 per cent in 2007-08. Although the aggregate fiscal deficit later increased to 3 per cent in 2009-10⁶, it declined to 1.9 per cent in 2012-13, before increasing again to 2.5 per cent in 2013-14 (RE). States, taken together, moved into a revenue surplus position in 2006-07 and have maintained this since then, except for 2009-10 when the implementation of Pay Commission awards and reduced revenue buoyancy on account of the economic slowdown resulted in a revenue deficit. However, there have been some exceptions. Kerala and West Bengal incurred revenue deficits between 2004-05 and 2012-13, while Punjab had revenue deficits during these years except in 2006-07. The 2013-14 (RE) figures show that Arunachal Pradesh, Assam, Bihar, Goa, Himachal Pradesh, Jammu & Kashmir, Karnataka, Kerala, Mizoram, Nagaland, Rajasthan, Tripura, and West Bengal incurred fiscal deficit in excess of 3 per cent of GSDP.

⁴ For the purpose of this chapter, outstanding debt of the Union Government refers to the resultant debt stock after undertaking the adjustment outlined in paragraph 14.13

⁵ The assessment of State finances is based on data from 2004-05 to 2013-14 (RE).

⁶ States remained within the relaxed FRBM fiscal deficit-GSDP target of 4 per cent permitted for 2009-10.

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14.17 The debt profile of States has undergone a significant change in the period from 2004-05 to 2013-14(RE). As a result of the debt write-off and interest relief offered under the DCRF by the FC-XII, along with the discontinuation of the practice of giving Central loans for State Plans from 2005-06, the share of loans from the Union in the total debt of the States witnessed a steady decline from 18.8 per cent in 2004-05 to 6.7 per cent in 2012-13 and further to 6.3 per cent in 2013-14 (RE).

14.18 Market borrowings have emerged as the major source of borrowings for State Governments, particularly after 2008, with their share in total debt rising from 23.2 per cent in 2007-08 to 42.6 per cent in 2013-14 (RE). Although NSSF securities are an important source of financing the fiscal deficit of States, their share in total debt has exhibited a secular decline from 32.8 per cent in 2006-07 to 19.2 per cent in 2013-14 (RE) because of policy changes by the Union Government. Other sources of financing for 2013-14 (RE) include liabilities in the public account like provident fund (12.6 per cent) and reserve funds and deposits (12.5 percent).

14.19 The share of State Government securities with interest rates above 10 per cent in the total outstanding liabilities of States declined from 10.1 per cent in 2008-09 to 1.5 per cent in 2010-11, and there were no such liabilities in 2011-12. A majority of the outstanding market loans (estimated at 82.6 per cent in 2012-13 RE) were contracted in the interest rate category of 7 per cent to 9 per cent; two-thirds of these were secured at annual interest rates in the range of 8 per cent to 9 per cent.

Extending the Definition of Debt

14.20 We believe that for any evaluation of public finances to be meaningful, it should consider the government's risk exposure to its public sector in the form of guarantees, off-budget borrowings and accumulated losses of financially weak public sector enterprises. In this context, we have explored the concept of extended debt, analysing different indicators, including the debt of public sector enterprises (PSEs), guarantees to PSEs, and a risk-weighted combination of guarantees. However, our analysis has been constrained by the non-availability of comprehensive audited recent data on State public sector debt.

14.21 A sizeable proportion of guarantees extended to State public sector entities is on account of short-term debt facilities which do not get reflected in the long term PSE debt. Thus, to get an approximation of the aggregate public sector borrowing of the States, we looked at the sum of public debt, State PSE debt and the ratio of guarantees to GDP as an indicative number.⁷

14.22 All long-term debt of State PSEs accounted for 4.6 per cent of GDP in 2011-12. When this was combined with the aggregate public debt of States, the extended debt of all States for that year ballooned to 26.4 per cent of GDP. Similarly, in the case of the Union Government, extended debt defined as the sum of Union public debt and the long term debt of Central public sector enterprises' (CPSEs) stood at 52.4 per cent of GDP in 2011-12.⁸

14.23 We find that the current and likely future stress on States' fiscal position could come from the exposure on account of guarantees provided to the power utilities and other PSEs,

⁷ This was done at the risk of double counting the portion of long-term debt that also has a guarantee.

⁸ CPSE Survey 2012.

including those in the transport sector. For the purpose of our analysis, we restricted the definition of extended debt to a sum total of public debt and a weighted sum of the guarantees of high risk public sector companies like those in the power and transport sectors as well as other PSEs. While analysing this extended debt, we assigned a weight of 90 percent to the power sector guarantees and 10 per cent to other guarantees, including transport sector guarantees. Under this definition, the aggregate extended debt of all States was 23.3 per cent of GDP in 2011-12. This approach cannot be used for the Union Government since there is hardly any devolvement of guarantee obligation on it, especially with regard to power and transport, unlike in the case of States.

14.24 Our analysis indicates that while the all-State aggregate extended debt for 2011-12 was below the debt target set by the FC-XIII for 2014-15, there were some States which were slipping from a position of relative comfort towards debt-stress due to significant exposure to guarantees of loss-making power sector companies. **Thus, we believe that it is important to keep such risks in mind when assessing the debt position of States while preparing fiscal management roadmaps for them, even though insufficient data prevents us from making firm policy inferences. In our view, it would be possible, and useful, to conduct a similar exercise with more contemporaneous data in the future. To this end, we recommend that both Union and State Governments adopt a template for collating, analysing and annually reporting the total extended public debt in their respective budgets as a supplement to the budget document.**

Stakeholders' Views

Views of State Governments

14.25 The States, in their memoranda, covered several issues and made suggestions regarding fiscal consolidation, fiscal sustainability, debt relief and the existing FRBM framework. One suggestion was to recommend a flexible model of fiscal consolidation that takes into account recent fiscal trends, the overall accumulated debt, and the requirements of counter-cyclical measures, with the revenue and fiscal deficit targets being adjusted in line with the growth expectations each year. Some States argued that in view of the uneven levels of economic growth and development across the country, the fiscal target-setting methodology should be modified to reflect the true fiscal situation of different States.

14.26 To overcome large deficits in social and physical infrastructure, States urged that the fiscal consolidation path be linked with the capital investment roadmap for each State separately and the current one-size-fits-all approach adopted while determining fiscal targets for States be discarded. In this context, they suggested an approach in which States would be given a medium term debt target, with the flexibility to roll over fiscal deficit and fiscal liabilities targets from year to year, provided the overall target is not breached.

14.27 Some States suggested an increase in the fiscal deficit target in the range of 3.5 per cent to 5 per cent of GSDP and raising the debt-GSDP ratio limit to 30 per cent. Andhra Pradesh (the successor State following the bifurcation of the State) urged that its fiscal deficit limit be enhanced to 7 per cent to allow it to meet its additional capital expenditure requirements following bifurcation.

14.28 The States gave several suggestions on the fiscal indicators that we should adopt in our recommendations. Some proposed the adoption of a single indicator, while others suggested a

multiple indicator approach. States argued that our recommendations could indicate alternative benchmarks in the fiscal consolidation roadmap and that their performance could be assessed on the basis of a combination of criteria. The suggestions made included dropping the revenue deficit target and anchoring the fiscal rules to a combination of ratios of fiscal deficit, debt to GSDP and interest payment to total revenue receipts ratios. Some States advocated that debt sustainability be determined by the ratio of interest payments to total revenue receipts, not exceeding 15 per cent, and the stock of debt not exceeding 200 per cent of revenue receipts. The States further urged that, as in the case of the Union Government, the use of the concept of effective revenue deficit should be extended to them and investments made in the sinking funds should be incorporated as part of the fiscal consolidation roadmap.

14.29 Punjab, Kerala and West Bengal, the three States which had been given a longer period by the FC-XIII to reach revenue balance as compared to other States, urged special consideration of their respective requirements. Punjab cited the historical legacy of accumulated debt and requested a one-time special purpose grant to restructure and retire high-cost loans, as well as waiver of the outstanding debt of the Union Government. Kerala argued that the bunching of maturity of about 60 per cent of its debt outstanding in five years beginning from 2015-16 would create enormous pressures on its finances, with little scope for raising resources for development. As the existing fiscal rules restrict borrowing beyond a limit, it urged that either all or 50 per cent of past Central loans may be waived, along with interest. West Bengal argued that its large interest burden constricted its development initiatives. It requested for a debt write-off of the outstanding loans from the Union Government, a three-year moratorium on interest obligations on open market borrowings, a special purpose grant for servicing current outstanding NSSF loans with a facility to replace NSSF loans in stages and enhanced access to Ways and Means Advance (WMA) from the Reserve Bank of India (RBI).

14.30 Some States pointed out that the high cost of NSSF loans, in comparison to market borrowings, adds to their debt-servicing burden. They also drew attention to the fact that in many States the collections under NSSF had fallen over the years and constituted an insignificant portion of their total current borrowings. In this connection, there were suggestions for write-off of these loans, granting debt waiver to the extent of 50 per cent of the annual repayment, resetting of all the outstanding NSSF loans at a common rate of interest of 7.25 per cent and giving the States an option to borrow from the NSSF fund.

14.31 Several States advocated write-off of debt and debt relief from one source or the other. The various suggestions included: (i) the grant of a one-time debt relief package by writing off all outstanding Central loans including interest; (ii) consolidation of the outstanding block loans of Ministry of Finance with interest reset at 7.5 per cent; (iii) debt waiver of 50 per cent of annual externally aided programmes (EAP) repayment obligation and (iv) transfer of exchange risk on EAP to the Union Government. As a measure to promote fiscal prudence, it was suggested that an interest subvention of 2 per cent on market borrowings be allowed for those States that adhered to revenue and fiscal deficit targets.

14.32 Most States were of the view that the rule-based fiscal framework has achieved its purpose and needs to be continued. However, they felt that the fiscal rules should apply equally to both the Union Government and State Governments. In view of the large fiscal and revenue deficits of

the Union Government, the States stressed the need for building disincentives in the FRBM Act to restrain it from breaching the numerical targets.

Views of Union Government

14.33 The Ministry of Finance pointed out that the process of fiscal consolidation had to be paused in 2008-09 in order to cushion the economy from the impact of the global economic slowdown. It said that a revised roadmap for consolidation has been adopted following the amendments to the FRBM Act in 2012 and that the Union Government is committed to abide by rule-based fiscal prudence.

14.34 The Ministry highlighted that the combined debt-GDP ratio of Union and States has shown a secular decline, barring the marginal increase in 2008-09 because of global factors, and was 65.6 per cent in 2013-14(RE). The trend in nominal growth rate in GDP, it pointed out, has been well above the average interest cost, reinforcing the sustainability of public debt. The Ministry drew attention to the fact that a bulk of Union Government debt is held domestically and denominated in domestic currency. A key feature of the country's debt profile is the declining proportion of external debt as a percentage of total borrowing and this insulates the debt portfolio from external sector shocks and currency risks.

14.35 The Ministry was of the view that the revenue surpluses of the States from 2006-07 onwards (except for 2009-10) was made possible, among other things, due to robust revenue transfers from the Union to the States, which amounted to about 40 percent of total revenue receipts of the States. On an aggregate basis, the States carried large cash balances.

14.36 The outstanding liabilities of State Governments indicate that there is a compositional shift in the outstanding debts component. The share of Central loans in the total outstanding debt of the States has declined from 57.4 percent in 1991 to 6.6 percent in 2013-14 (BE), thereby limiting any scope for restructuring or write-off of loans by the Union Government, except on outstanding non-Plan loans.

14.37 The Ministry stated that there was a need to improve the quality of fiscal consolidation at the state level by incentivising revenue generation, reducing committed liabilities and improving the quality of expenditures as measured against forward looking outcomes. To this end, it had approved multi-lateral funding through the Asian Development Bank in order to encourage West Bengal to pursue tax reforms measures, augment its resources and sustain development financing. A similar proposal is being considered for Punjab as well. The Ministry was also in favour of a uniform framework on the extent of guarantees that the States can extend to the borrowings made by PSEs, power distribution companies (discoms) and other utilities.

14.38 The Ministry categorically opposed the request by States for prepayment of NSSF, pointing out that any sudden change in the asset base of NSSF on account of draw down by the States would pose a threat to the viability of the fund. Small savings, it argued, serve a specific public policy purpose and should not be viewed as another source of debt financing by either the Union or the States.

14.39 Underlying the role of the Union Government in macro-stabilisation, the Ministry emphasised that the improvement in the finances of the States despite adverse global economic

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conditions demonstrates the effectiveness of the Union's interventions. It underlined that the year on year growth of grants from the Union to the States have been in the range of 11 per cent to 13 per cent except 2012-13.

14.40 The Ministry pointed out that the FRBM Act was amended to provide for a review by the Comptroller and Auditor General (C&AG) of the observance of fiscal rules by the Union Government. On the issue of conforming to the rules set in the Act, the Ministry explained that the Union Government is answerable to Parliament, which is the highest form of accountability in a democratic setup for a sovereign government.

14.41 The Planning Commission, in its written comments to the Commission, indicated that internationally, the preferred measure of fiscal performance is primary deficit (which excludes interest payments from fiscal deficits) rather than fiscal deficit. On the use of revenue deficit as an indicator, it highlighted the fact that including the Union Government's transfers to the States for financing capital expenditure in the former's revenue expenditures conveyed a misleading picture of its revenue deficit. The Planning Commission also suggested that fiscal deficit targets should be redefined in terms of "structurally adjusted deficit", that allows flexibility from the initial deficit target to be factored in on account of unexpected changes in GDP growth. Its proposals for modification in the approach to the fiscal consolidation roadmap included revised accounting norms for equity investment as well as disinvestment and capitalisation of public sector banks under Basel III norms. Implementing these suggested changes, it pointed out, would require amendments to the FRBM Act.

Views of the Comptroller and Auditor General

14.42 The C&AG proposed measures to deepen the elements of FRBM reporting in order to enhance fiscal marksmanship. It pointed out the need for improvements in budgetary forecasts, efficient tax mobilisation and the cost of compliance. The outcome indicators on each of these could be incorporated in the FRBM Acts so as to clearly define the fiscal numerators as committed disclosures in the medium term fiscal plan.

Issues and Approach

14.43 Our ToR mandates us to look at the impact of debt levels on resource availability in debt-stressed States with the objective of not only balancing the revenue receipts and revenue expenditure of all the States and the Union, but also generating surpluses for capital investment. We have accordingly assessed the burden of public debt of States during the 2015-20 period. The assessment was made on the basis of fiscal accounts and also by adopting the extended definition of public debt in order to ensure comparability of debt stress among states.

14.44 The FC-XII defined debt sustainability in terms of debt-GDP ratio and also in terms of interest payments relative to revenue receipts. This was considered an easier target to follow, as both revenue receipts and interest payments are part of budgetary data which is readily available, as compared to GSDP data, which comes with a lag. It recommended that States should target interest payments as a proportion of revenue receipts at 15 per cent for 2009-10.

14.45 By the end of 2012-13, five States had an interest payments-revenue receipts ratio more than 15 per cent, seventeen had debt-GSDP ratio of more than 25 per cent and twelve had interest

payments-revenue receipts ratio of less than 15 per cent but with debt-GSDP ratio of more than 25 per cent. However, the debt sustainability position of States changes on extending the definition of debt, with a few States moving from a position of relative comfort to vulnerability, largely because of the drag of power sector losses. We note that there were varying degrees of fiscal stress among States and it is difficult to draw a line and categorise some as seriously debt stressed.

14.46 We have also considered the scope and feasibility of debt relief, keeping in view the nature of outstanding debt obligations of States. It was noticed that a large part of the debt of States has been through open market borrowings. Since these are in the nature of tradable bonds, they cannot be rescheduled or renegotiated in the current dispensation of financial markets. The National Small Savings is a category which, by itself, is not strictly a part of the debt obligation of the States to the Union Government. While, the debt that is owed to the Union Government is amenable to traditional measures of debt relief through rescheduling and write-offs, it needs to be noted that the outstanding debt of the States to the Union is not a very large part of the debt portfolio of State Governments. In view of this, we find that the scope for rescheduling debt is very limited, compared to the past when previous Commissions undertook such exercises.

14.47 We have also noted the view that any debt relief to debt-stressed States could be construed as penalising the States that were prudent in their fiscal management. We are of the view that the assessment of the fiscal needs of all States, including those with significant debt stress, should fully provide for interest payments to discharge their debt. Accordingly, in our forecast for our award period, we have provided in full for the interest payments to the States.

Fiscal Consolidation: Assessment and Issues

14.48 Our review shows that, at an aggregate level, States made significant improvements in complying with the FRBM targets prescribed by the FC-XII and FC-XIII. In the pre-crisis period, fiscal consolidation at the State level was aided by a number of factors, including implementation of state-level fiscal responsibility acts, debt waiver and restructuring recommended by Finance Commissions, and improvement in revenues on account of buoyancy of Central taxes and introduction of value-added tax (VAT) at the state level. Despite States experiencing pressure on their fiscal balances in the post-crisis period due to lower buoyancy of Central taxes and increased expenditure commitment due to the implementation of the recommendations of Pay Commissions, they largely continued to comply with the FRBM targets.

14.49 The aggregate debt and deficit indicators of all States are well within the target thresholds suggested by the FC-XIII. We, however, note that there are variations among States in fiscal consolidation when the debt sustainability is measured on a multiple indicator approach like debt as percentage of GSDP and interest payments relative to revenue receipts.

14.50 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.

Quality of Fiscal Consolidation

14.51 Our ToR mandates us to recommend measures for "maintaining a stable and sustainable fiscal environment consistent with equitable growth", which makes it important to critically assess the fiscal adjustment process thus far, not just on the basis of achievement of quantitative fiscal targets, but also on the quality of consolidation. We note that the excessive focus on containing fiscal deficits by some States has resulted in constraining capital expenditures. In this context, we have considered the under-utilisation of borrowing headroom by most States and its impact on development spending, especially capital expenditure. At the same time, we are conscious that it is also important to consider the role of fiscal rules in ensuring fiscal stability and not encouraging over-borrowing given the challenging structural headwinds being faced by a few States.

14.52 An analysis of the budget documents of the Union and State Governments reveals imbalance between the budgetary allocations and the accumulated liabilities of incomplete and ongoing capital projects. Ministries at both the Union and State level routinely overreach themselves while making investment proposals. The delays in implementation and poor project management lead to cost and time overruns, impacting likely benefits accruing from capital investments in the form of higher per capita income and increased revenues to the governments. We are of the view that there is a need to curb the scope for perverse allocation of available funds among competing projects and to ensure that the economy benefits from investments in capital works by putting a statutory ceiling on the sanction of new capital works. This can be done by amending the FRBM Acts. We have noted that some States have already initiated action in this regard. **We recommend that the Union and the State Governments provide a statutory ceiling on the sanction of new capital works to an appropriate multiple of the annual budget provision.**

Approach to Fiscal Consolidation

14.53 The fiscal consolidation path drawn up by the FC-XIII envisaged a steady reduction in the augmented debt stock of the Union Government to 45 per cent of GDP by 2014-15 and that of the States to less than 25 per cent of GDP by the same period. The revenue deficit of the Union Government was to be progressively reduced and eliminated, followed by an emergence of revenue surplus by 2014-15. The State Governments were to bring down the fiscal deficit from 2.8 per cent in 2009-10 to 2.4 per cent of GDP in 2014-15 while the Union Government had to reduce its fiscal deficit from 6.8 per cent to 3 per cent. The consolidated fiscal deficit target was set at 5.4 per cent in 2014-15.

14.54 In our view, a uniform and rigid fiscal rule not only undermines the fiscal autonomy of the States, but also results in undesirable cuts in development expenditure in order to comply with numerical targets. The structural issues relating to fiscal imbalances in the Union Government as well as in some of the States do not get addressed through these rules alone. Acknowledging the asymmetry in the fiscal consolidation path at the Union and the State levels so far, we are proposing different rules and roadmaps and targets for the Union and State Governments. Keeping in view the fiscal position of the States and the need to provide headroom for the fiscally prudent ones, we have developed a multiple-indicator approach to fiscal consolidation.

14.55 We have also analysed the demand of the States for raising the limits on fiscal deficit by linking the fiscal consolidation path with the capital requirements and investment roadmap for each State. We recognise that there could be inter-state variations in the ability to utilise available resources due to a combination of a number of state-specific factors, including governance and administrative priorities, structural aspects of the implementation machinery and the characteristics of the intra-state resource transfer mechanisms. Investments for capital expenditure come through both borrowings and from revenue surpluses. Our tax devolution supplemented, where necessary, by grants-in-aid to cover any deficit, ensures that there will be no revenue deficit in any State while some will have surplus for investment so long as they follow a prudent fiscal policy. The States which have a revenue balance are well advised to make additional efforts to generate surpluses through better returns on investments made and through rationalising and reducing revenue expenditure. States which have a revenue surplus will, according to our assessment, have the additional headroom for investment along with the borrowing limit that is prescribed.

14.56 We have noted the suggestion of some States for a model which takes into consideration recent trends in fiscal consolidation and the overall accumulated debt and then adjust the fiscal deficit targets in line with the growth expectations each year. Keeping in view the parameters of debt sustainability and the medium term requirements of equitable and sustainable growth, we are of the opinion that the rigid application of uniform fiscal targets needs correction in our award period.

14.57 In our assessment, the basic parameters of fiscal consolidation adopted by the FC-XIII were reasonable and appropriate to our conditions. They have worked well as far as the States are concerned, though some operational flexibility has been desired by the States. They would have worked well for the Union Government also, but for the unforeseen external developments and, possibly, certain domestic policies. We, therefore, adopted an approach that is based on the parameters of the FC-XIII, but also builds on the experience gained.

14.58 We are aware that the FC-XIII had noted that macro-economic stabilisation and counter-recessionary actions are the primary responsibility of the Union Government, the core objective of which is 'the need to allow the fiscal system to adapt to exogenous shocks and/or changes in exogenous parameter values'. In this regard, the FC-XIII had made certain recommendations in respect of the FRBM Act and we note that some aspects were acted upon by the Union Government. We suggest that the Union Government take a comprehensive view on the above taking into account the global experience of legislation in this regard, Indian experience in the past, and the data and operational requirements for the purpose.

14.59 We consider the existing ceiling on the fiscal deficit of the Union Government at 3 per cent of GDP appropriate, but it may be able to achieve this by the end of 2016-17. The debt-GDP ratio of 45 per cent desired by the FC-XIII at the end of 2014-15 is also treated as an appropriate ceiling to start with. Given the FRBM target for the Union Government, the debt-GDP ratio should remain below this level. A realistic fiscal consolidation roadmap has to recognise that the desirable goal of eliminating the revenue deficit by 2019-20 may be difficult, but not impossible.

14.60 In respect of States, we have adopted the fiscal deficit threshold limit of 3 per cent of GSDP as fixed by the FC-XIII. We have treated the aggregate debt-GDP ratio of States and its

equivalent to GSDP, as determined by the FC-XIII, at 25⁹ per cent at the end of 2014-15 as a ceiling for all States in aggregate at end of 2019-20. Further, we are providing a year-to-year flexibility for additional borrowing to States. If the fiscal deficit of a State in a year falls short of the normal yearly limit of 3 per cent of GSDP, that State can borrow to the extent of the shortfall in the given year,¹⁰ provided it fulfils the eligibility conditions recommended. Similarly, if, for any reason, the fiscal deficit exceeds the normal 3 per cent in any given year, a downward adjustment needs to be done in the following year, except in cases where the State is otherwise eligible for the additional fiscal limit as per our recommendation. Finally, taking into account the development needs and the current macro- economic requirement, we are providing additional headroom to a maximum of 0.5 per cent over and above the normal limit of 3 per cent in any given year to the States that have a favourable debt-GSDP ratio and interest payments-revenue receipts ratio.

14.61 Thus, our approach to 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, we 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

14.62 In the light of our approach to fiscal consolidation and the fiscal roadmap as developed through our assessment of Union and State finances, we recommend the following rules for the Union and the States.

14.63 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.

14.64 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 year.**

⁹FC-XIII had recommended debt-GDP target of less than 25 per cent for the States by 2014-15.

¹⁰'given year' for the purpose of this Chapter is the year 't', for which the borrowing limits are to be fixed .

- iii. **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.**

If a State is not able to fully utilise its sanctioned borrowing limit of 3 per cent of GSDP in any particular year during the first four years of our award period (2015-16 to 2018-19), it will have the option of availing this un-utilised borrowing amount (calculated in rupees) only in the following year but within our award period.

14.65 In this regard, some States wanted the current methodology for fixing borrowing limits, relying on the Finance Commission's assessment of GSDP, to be modified, as these limits are fixed in advance and may be subject to either favourable or adverse correction due to macro-economic developments. According to these States, this practice of determination of borrowing limit by the Union Government denies the States their rightful share of annual borrowing. We have examined the matter. While there is merit in this argument, we also recognise that there are difficulties in obtaining up-to-date GSDP data at the time that the annual borrowing programme of States is being determined, which is done in the year preceding the given year. The Central Statistical Office (CSO) publishes GSDP data series on a bi-annual basis on 1 March and 1 August of each calendar year, which provides actual estimates of GSDP for the year, $t - 2$, where t is the given year for which the borrowing limit is going to be fixed and $t - 1$ is the year in which decision is taken for fixing the borrowing limits.

14.66 In our view, the difficulties in obtaining up-to-date GSDP data can be overcome by adopting a practical and reasonable methodology that factors in the trends of recent years to arrive at a close proximate of the likely GSDP for arriving at the borrowing limit. **We recommend that for the purpose of assigning state-specific borrowing limits as a percentage of GSDP for a given fiscal year (t), GSDP should be estimated on the basis of the annual average growth rate of the actual GSDP observed during the previous three years or the average growth rate of GSDP observed during the previous three years for which actual GSDP data are available. This growth should be applied on the GSDP of the year $t - 2$. Specifically, GSDP for the year ($t-1$) and the given fiscal year (t) should be estimated by applying the annual average growth rate of GSDP in $t - 2$, $t - 3$ and $t - 4$ years on the base GSDP (at current prices) of $t - 2$. We recommend that State estimates of GSDP published by the CSO should be used for this purpose.**

14.67 In the case of the interest payments-revenue receipts ratio required for determining additional borrowing limits, we recommend that figures for both should be based solely on the Finance Accounts data for the year $t - 2$. The same procedure should be followed in estimating the debt-GSDP ratio. The Ministry of Finance should adhere to the above rules and methodology while determining the annual borrowing ceiling for individual States.

(To clarify matters and to remove ambiguity, illustrative working of the Rules is given through hypothetical examples in Volume II) (Annex 14.2)

Fiscal Roadmap

14.68 Adopting the approach to fiscal consolidation laid out in the preceding paragraphs and the assessment of revenues and expenditure of the Union Government in Chapter 6, we restrict its fiscal deficit to 3 per cent of the GDP from 2016-17 onwards. The consolidation path conforms to the FRBM Act of the Union Government and the Medium Term Fiscal Policy (MTFP) statement of 2014-15. In terms of our roadmap (Table 14.1), the debt stock of the Union Government should decline from 43.6 per cent for 2015-16 to 36.3 per cent of GDP in 2019-20. Based on our projections, the roadmap leaves a revenue deficit of 0.9 per cent in 2019-20 for the Union Government. Thus, the revenue deficit of the Union Government will decline but will not be eliminated by the terminal year.

14.69 We have observed that States, at an aggregate level, have not fully utilised the fiscal space (corresponding to 3 percent of GSDP for each State) available to them in the past. If States maintain a fiscal deficit of this level in each year of our award period,¹¹ according to our projections their debt-GSDP ratio would decline from 25.6 per cent in 2015-16 to 25.4 per cent in 2019-20. As a percentage of GDP, the debt of all States would decline from 21.7 per cent in 2015-16 to 21.6 percent in 2019-20.

14.70 Based on our approach, we have projected the roadmap for the States after factoring in the additional fiscal space they could avail during the 2015-20 period. Under the fiscal roadmap we have drawn for the States (Annex 14.1), at the aggregate level, the State's debt-GSDP ratio would increase from 25.9 per cent in 2015-16 to 26.3 per cent in 2019-20. As a percentage of GDP, debt stock would increase marginally from 21.9 per cent in 2015-16 to 22.4 per cent in 2019-20. Nevertheless, this would still remain well below the debt-GDP target of 24.3 per cent for States recommended by the FC-XIII for 2014-15. The combined fiscal deficit of States in our roadmap would reduce from 2.76 per cent of GDP in 2015-16 to 2.74 per cent of GDP in 2019-20. Thus, the aggregate fiscal deficit in our road map is marginally higher than the target of 2.4 per cent that the FC-XIII recommended. However, keeping in view the needs of the States and the macro-economic situation, the additional fiscal space will not affect the sustainability of debt during our award period. The ceilings under the fiscal flexibility recommendations are unlikely to be reached, as many States have, in the past, kept well below the statutorily set fiscal deficit target of 3 per cent of GSDP.

Table 14.1: Consolidated fiscal roadmap (2015-16 to 2019-20)

	2015-16	2016-17	2017-18	2018-19	2019-20
Revenue Deficit - Union	2.56	2.25	1.79	1.36	0.93
Revenue Deficit -States	-1.07	-1.32	-1.60	-1.84	-1.88
Consolidated Revenue Deficit	1.49	0.92	0.19	-0.48	-0.95
Fiscal Deficit- Union	3.60	3.00	3.00	3.00	3.00
Fiscal Deficit -States	2.76	2.77	2.77	2.73	2.74
Consolidated Fiscal Deficit	6.36	5.77	5.77	5.73	5.74
Debt Stock -Union	43.60	41.41	39.49	37.79	36.30
Debt Stock - States	21.90	22.06	22.21	22.30	22.38
Outstanding Union Loan to States	0.97	0.81	0.66	0.54	0.44
Consolidated Outstanding Debt	64.53	62.67	61.03	59.55	58.24

¹¹Corresponding to an aggregate fiscal deficit-GDP ratio of 2.5 percent in each year.

14.71 As per the assessment of the Union and State finances discussed in Chapters 6 and 7 respectively, the consolidated revenue surplus in 2019-20 would be 0.95 per cent. The consolidated fiscal deficit would decline from 6.4 per cent in 2015-16 to 5.7 per cent in 2019-20. The total consolidated outstanding debt would decline from 64.5 per cent to 58.2 per cent in 2019-20.

Implicit Capital Outlay

14.72 Our ToR requires us to make recommendations for generating surpluses for capital investment. On the basis of the fiscal road map we 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.

14.73 All States taken together moved from a revenue deficit of 1.2 per cent in 2004-05 to a revenue surplus in 2013-14 (RE). Our assessment of State finances shows that eighteen states will have a revenue surplus from the start of our award period. Some States will get into revenue surplus during the award period and the remaining will be in revenue balance.

Table 14.2: Implicit Capital Outlay

(surplus (-) and deficit (+)
(per cent of GDP)

	2015-16	2016-17	2017-18	2018-19	2019-20
Union					
Revenue Deficit	2.56	2.25	1.79	1.36	0.93
Fiscal Deficit	3.60	3.00	3.00	3.00	3.00
Non-debt Capital Receipts	0.61	0.65	0.70	0.76	0.82
Implicit Capital Outlay	1.64	1.40	1.90	2.40	2.90
States					
Revenue Deficit	-1.07	-1.32	-1.60	-1.84	-1.88
Fiscal Deficit	2.76	2.77	2.77	2.73	2.74
Implicit Capital Outlay	3.83	4.09	4.37	4.57	4.61
Consolidated Implicit Capital Outlay	5.47	5.50	6.27	6.97	7.51

National Small Savings Fund

14.74 The FC-XIII recommended that loans to States from the NSSF contracted till 2006-07 and outstanding at the end of 2009-10 be reset at 9 per cent rate of interest and that the NSSF be reformed into a market-aligned scheme. However, the benefit of interest relief on NSSF to States was subject to necessary amendments/enactments carried out in the FRBM Acts, as recommended by the Commission. Consequent to the recommendations of the FC-XIII, the Union Government set up a "Committee on Comprehensive Review of National Small Savings Fund (NSSF)" in 2010. Based on the report of the Committee, the Union Government decided, among other things, that the mandatory component of investment of net small savings collections in State Government

securities be reduced from 80 per cent to 50 per cent and that the tenure of the loans be reduced from twenty-five years, including moratorium of five years, to ten years.

14.75 As we have noted earlier, States expressed concern regarding the rising liabilities on account of the NSSF and the involuntary nature of such borrowings. The suggestions they made in this regard included write-off of borrowings under NSSF or interest resetting. A study that we commissioned concluded that there is a serious mismatch between the income and expenses of the NSSF, with the interest earnings from the scheme being significantly lower than the liabilities.¹²

14.76 The study also observes that before the NSSF was constituted, the small savings receipts mobilised by the Union Government and on-lent to the States were treated as its capital expenditure and, accordingly, calculated in its gross fiscal deficit. Shortfalls in returns from loans to the Union Government out of small savings proceeds and the interest paid on small savings were calculated under its revenue deficit. After the constitution of the NSSF, however, the income deficit is not being reflected as a part of the Union Government's revenue deficit. This is because the NSSF operations are being accounted for within the Public Account, with outstanding balances under the NSSF being included under public account liabilities, instead of being accounted for as internal debt. The operational deficit, therefore, represents a defacto liability of the Union Government which remains unrecognised in the budget documents and for which the budget does not make any provision. This 'off-budget' nature of the NSSF operations renders them outside the regulatory framework of the FRBM Act, raising concerns of fiscal transparency and comprehensiveness.

14.77 It is note worthy that, according to the study, the NSSF operations combine several functions. These are: (a) sovereign debt management, involving financing through involuntary borrowings by States, (b) banking, outside the prudential norms applicable to commercial banking, (c) financial intermediation by the sovereign outside the fiscal accounts, (d) inter-governmental transfers, preventing full exposure of States to the market and (e) savings promotion. These operations are carried out in the absence of oversight by a financial sector regulator. Further, the study pointed out that direct public financing of public or private sector entities, such as lending to the India Infrastructure Finance Company Ltd. (IIFCL) from NSSF is also extraordinary. The study has also observed that the NSSF itself would need further review if post offices are allowed to function as payments banks, reducing the need for a separate NSSF outside the Consolidated Fund.

14.78 We note that the NSSF, in its present form, is characterised by several infirmities and has been under review by the Union Government. More recent developments in the financial sector, including licensing of payment banks in the private sector, make the future of the NSSF, in its present form, uncertain. The States have expressed several reservations about the scheme and are less than enthusiastic about their continued participation in it.

14.79 The FC-XII had recommended that the system of on-lending by the Union to the States should be phased out, thereby establishing the principle that it is normally not desirable for the Union Government to act as an intermediary for fulfilling any part of the borrowing requirements of the States. In substance, the NSSF model is essentially one in which the Union Government

¹² Liabilities include expenditure incurred on account of interest due to depositors; commissions due to the banks/agents; and remuneration due to the Department of Posts.

undertakes borrowings to further lend to the States. There is considerable merit in adopting the principle established by the FC-XII. We have, therefore, examined the future of NSSF in the light of concerns expressed by the States, the uncertain future of the NSSF and the implications of NSSF for sound federal fiscal relations.

14.80 We have noted the concerns expressed by the States and the suggestions they have made which amount to seeking either a virtual resetting of the existing debt obligations on this account or getting grants from the Union Government for offsetting a part of this burden. We, however, have not considered it appropriate to accept the suggestions made by some States for relief from the debt burden as any assessment of the burden, on account of this scheme, has to be viewed in the overall context of the debt burden of States with respect to all debtors.

14.81 We are, therefore, of the opinion that it would be appropriate to exclude the States from the operations of the scheme in future, even as they should honour the obligations already entered into insofar as servicing and repayment of outstanding debt is concerned. Accordingly, we recommend that State Governments be excluded from the operations of the NSSF, with effect from 1 April, 2015. This exclusion will not hamper the overall borrowing programme of the States in any manner, as they will continue to have access to open market borrowings. This arrangement would provide the Union Government greater flexibility in taking operational decisions on the future of the scheme, as well as freedom to manage it in the manner that it feels most appropriate. **As for the fiscal burden incurred in the course of the operations of the NSSF, prior to 1 April, 2015, since the scheme has been administered almost in its entirety by the Union Government, no part of this fiscal burden, incurred till that date, should be passed on to the States. We recommend that the involvement of the States in the NSSF scheme with effect from 1 April 2015, therefore, may be limited solely to discharging the debt obligations already incurred by them until that date.**

Consolidated Sinking Fund

14.82 The FC-X observed that the establishment of a sinking fund was desirable as a part of overall fiscal discipline and that the constitution of Consolidated Sinking Fund (CSF) for the amortisation of debt was relevant both for States and the Union. The logic of constituting a CSF for States was to enable them to tide over the roll-over risks due to their weak cash management practices and also State Development Loans being under-subscribed.

14.83 The CSF scheme was launched for State Governments in 1999-2000 to meet the redemption of market loans of States by contributing between 1 per cent and 3 per cent per annum of the outstanding open market loans as at the end of the previous financial year. A revised CSF scheme has come into effect since 2006-07. So far, twenty-one State Governments have constituted the CSF and the outstanding corpus stood at about Rs 60,000 crore in February 2014. The Union Government is yet to constitute a sinking fund.

14.84 In our view, CSF is an integral part of prudent fiscal management. The CSF creates a cushion to meet repayment obligations in times of fiscal/market stress, as it boosts investor confidence and thereby facilitates borrowing in the primary market at a reasonable cost even in normal times. Though there could be a trade-off between CSF investment and development expenditure in the very short-term, there is also a trade-off between roll-over risk and debt sustainability and development.

14.85 While the constitution of a CSF for the Union Government, as in the case of the States, could have a favourable impact on investor sentiments, we are conscious of the fact that it may not be viable when fiscal deficit is persisting, as the Union Government will have to borrow more to invest in the Fund, which would further push up fiscal deficit. **Keeping in view the experience of the States in this regard, we recommend the Union Government should examine the desirability of setting up of CSF at this stage.**

Fiscal Environment for Equitable Growth: A Shared Responsibility

14.86 We believe that fiscal management consistent with the fiscal roadmap we have set out would address the important issues relating to growth, equity and overall stability, particularly price stability and external sector stability. To discharge their obligations both the Union and the States should be fiscally empowered, separately and jointly. Such empowerment may warrant fiscal consolidation and improvement in the quality of fiscal management. Thus, the medium term framework for fiscal environment that we envisage is not mere consolidation, but prudent fiscal empowerment and the framework provides only quantitative, but binding, guidelines. The impact of growth equity and stability will depend significantly on the quality of fiscal transparency and fiscal management. **Recognising that the fiscal environment should be conducive to equitable growth, we recommend 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.**

14.87 Both the Union and the State Governments contribute to the country's fiscal environment, but the former has a greater role and responsibility in this area. The Union Government accounts for almost two-thirds of the consolidated revenues and debt. Its financial position is critical for external sector stability and the stability of the financial sector. Its fiscal management has significant implications for monetary and macroeconomic management. **We urge that all stakeholders recognise the predominant role of the Union in fiscal management, while considering our roadmap for the Union and the States that treats a conducive fiscal environment as the joint responsibility of both.**

14.88 We recognise that the FRBM framework at the Union and State level has brought about an improvement in the level of fiscal transparency, with a greater degree of publicly available information about government finances and budgetary processes. However, the measures taken thus far have to be further strengthened in order to ensure that the data available to the public is detailed, comprehensive, and accurate. In any case, we believe that it is critical to improve the quality, level and frequency of public data on the status of the debt of the Union and the States. At present, the Union Government publishes public debt management reports on different aspects of Union debt on a quarterly basis, and detailed reports on India's external debt thrice a year. Since 2010-11, it has also been bringing out an annual status paper on debt, covering different facets of debt of the Union and the States on a combined and disaggregated basis. More recently, the Union Government has started publishing an annual 'Handbook of Statistics on Central Government Debt'. We also note that the RBI puts out data on debt of State Governments and also reports on the debt of the Union Government, though there are some variations in the methodology of compilation between the Union government and the RBI. **To enable wider dissemination of the manner in which this shared responsibility for a conducive fiscal**

environment is being discharged by the Union and State Governments, we recommend that the Union Government and the RBI bring out a bi-annual report on the public debt of the Union and State Governments on a regular and comparable basis and place it in public domain.

A Review of FRBM Acts

14.89 Our review of Union and State finances in the period following the introduction of the FRBM framework indicates that rule-based fiscal legislation has been effective in enabling fiscal consolidation and improvement of fiscal management, particularly at the State level. However, as mentioned earlier, some challenges remain for the Union Government in adhering to the FRBM provisions.

14.90 We also see the point in the assertion by most States that the fiscal rules should apply equally to the Union Government and the States and the need for building disincentives in the FRBM Act for restraining the former from violating the fiscal rules. At the Union Government level, the challenges in achieving fiscal correction and adherence to rule-bound fiscal framework persist. The Union Government's FRBM Act came into effect in August 2003. It was amended in July 2004. Rules were modified twice over the years and were breached in practice. The conventional rule, as understood, of financing current expenditure by current revenue was discarded and an artificial concept of effective revenue deficit was introduced in the statute in 2012. We note that FRBM Rules in conducting the stated fiscal policy correction or fiscal adjustment path, as recommended by the FC-XIII, have not been effective, in the absence of hard budget constraints and any cost of non-compliance for the Union Government except for a threat of downgrade by sovereign rating agencies.

14.91 In the light of the experience gained so far, we conclude that the challenge is to design a basic incentive-compatible framework for the Union and State Governments to hold each other accountable over agreed fiscal targets. Accordingly, we stress the need for stronger mechanisms for ensuring compliance with fiscal targets and enhancing the quality of fiscal adjustment, particularly for the Union Government.

Effective Revenue Deficit

14.92 The ToR requires the Commission to consider the effect of receipts and expenditure in the form of grants for the creation of capital assets on the deficit, while making suggestions to amend the FRBM Acts currently in force. The Union Government amended the FRBM Act in 2012 by including the definition of an effective revenue deficit. The effective revenue deficit, as defined in the Act, is the difference between the revenue deficit and grants for the creation of capital assets. There is a further definition of grants for creation of capital assets to mean the grants-in-aid given by the Union Government to State Governments, Constitutional authorities or bodies, autonomous bodies, local bodies and other agencies implementing schemes for the creation of capital assets which are owned by the said entities. The amendment mandates the Union Government to take appropriate measures to reduce the fiscal deficit, revenue deficit and effective revenue deficit, in order to eliminate the effective revenue deficit by 31 March 2015 and thereafter build up adequate effective revenue surplus.

14.93 Under the Constitution, there are only two categories of expenditure- expenditure on the revenue account and other expenditure which is broadly expressed as capital expenditure. These

are shown separately in the budget for approval of legislatures. The artificial carving out of the revenue account deficit into effective revenue deficit to bring out that portion of grants which is intended to create capital asset at the recipient level leads to an accounting problem and raises the moral hazard issue of creative budgeting.

14.94 The FC-XIII examined in detail the existing classification of revenue and capital expenditure and, while recognising the revenue deficit as an approximation of current deficit, they considered it important to strictly follow the accepted definition of all the items that are to be treated as current (recurrent expenditure) in the economic classification of public expenditure. The Commission also stated that the existing classification of revenue and capital expenditure cannot be disturbed in an ad-hoc manner and has to be the result of a comprehensive study. Any disturbances of this classification, it was pointed out, would have wide-ranging implications for the finances of both the Union and the States.

14.95 In our view, the current definition of effective revenue deficit is unique and does not fit within international practices of classification of accounts/expenditure. A few State Governments, in their memorandum, argued that the States also be allowed to incorporate the concept of effective revenue deficit. We are not in favour of the continuance of the treatment of effective revenue deficit as a distinct concept. **We recommend 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. We also recommend that the objective of balancing revenues and expenditure on the revenue account enunciated in the FRBM Acts should be pursued.**

Independent Fiscal Institution

14.96 The FC-XIII had recommended that the Union Government should institute a process of independent review and monitoring of the implementation of its own FRBM process, initially by setting up a committee to conduct an annual independent and public review of FRBM compliance, including a review of the fiscal impact of policy decisions on the FRBM roadmap. It hoped that this committee would, over time, evolve into a full-fledged Fiscal Council and act as an autonomous body reporting to the Ministry of Finance, which would, in turn, report to Parliament on matters dealt with by the Council in accordance with current Constitutional provisions.

14.97 There is increasing recognition globally that the conduct of sustainable fiscal policy by governments and imparting greater realism to the forecasts (including testing their consistency with the fiscal rules) calls for the establishment of an independent fiscal institution which could undertake ex-ante assessment of the impact of fiscal policy and the fiscal implications of budget proposals. A number of countries have constituted fiscal councils to monitor fiscal policy calibration, particularly since 2005. These include the United States of America, Australia, Canada, the United Kingdom and Brazil. While the common agenda of these institutions is to promote sound fiscal policies as watchdogs, there is considerable diversity in their structure and the functions they are assigned to perform.

14.98 A common objective of these fiscal councils is to assist the national legislatures to monitor and evaluate the fiscal adjustment process and impart greater transparency to this process by objectively estimating the costs of various policies and programmes. The fiscal councils also enhance accountability to Parliament/Legislatures and the public at large in calibrating fiscal

policies. In addition, these institutions are also mandated to undertake objective and independent evaluation of budget forecasts in order to impart greater realism to budget formulation. Experience shows that such independent institutions may undertake ex-ante analysis and ex-post evaluation.

14.99 We have examined the status and potential usefulness of an independent fiscal council in India. While the Union Government has been generally able to enforce fiscal rules on the States, its own record of adherence to fiscal rules has not been impressive. Prima facie, recent experience invites our attention to the need for a fiscal council at the Union Government level. In an amendment to FRBM Act in 2012, a new Section 7A was inserted which requires the C&AG to conduct a periodic review of the compliance of the provisions of the FRBM Act by the Union Government. The Ministry of Finance, in its memoranda submitted to the Commission, has stated that the periodicity and scope of the C&AG review needs to be deliberated, keeping in mind the impact of fiscal policy on key macro-economic parameters as well as the efficacy of periodic review in the context of the economic growth cycle. The term 'review' appearing in Section 7A has not been defined. In this context, the 'review' that the C&AG can be entrusted with would only be an ex-post review.

14.100 We are of the view that it is important to have an ex-ante evaluation of the fiscal implications of the budget proposals and, therefore, believe that it is essential to establish an independent fiscal institution for this purpose. This could be done through the establishment of a fiscal council by an amendment to the FRBM Act, similar to the one that enables the ex-post assessment by the C&AG. The mission of the fiscal council would be to undertake ex-ante assessment of the fiscal policy implications of budget proposals and their consistency with fiscal policy and Rules. This institution should have the benefit of appropriate expertise, including getting its work done through outsourcing to reputed institutions. Similar to the provision under Section 7A of the FRBM Act, the newly-inserted section should provide that the assessment made by the fiscal council be tabled in both Houses of Parliament.

14.101 In the light of the above, we recommend an amendment to the FRBM Act inserting a new section mandating the establishment of an independent fiscal council on the lines indicated above to undertake ex-ante assessment of the fiscal policy implications of budget proposals and their consistency with fiscal policy and Rules. In addition, we urge that the Union Government take expeditious action to bring into effect Section 7A of the FRBM Act for the purposes of ex-post assessment.

Amendments to FRBM Acts and New Legislation

14.102 The fiscal roadmap we have drawn requires appropriate changes in the existing FRBM legislations in order to incorporate both flexibility and statutory binding commitments for the Union and the States, which have a shared responsibility for facilitating a fiscal environment for equitable growth, adherence to fiscal prudence and transparency in fiscal management for long term sustainability. **Our approach outlined and recommendations made warrant amendments to the FRBM Acts. To this end, we recommend that the State Governments may amend their FRBM Acts to provide for the statutory flexible limits on fiscal deficit. The Union Government may amend its FRBM Act to reflect the fiscal roadmap, omit the definition of effective revenue deficit and mandate the establishment of an independent 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.

14.103 We were alerted to the possibility that, in future, no State may have debt outstanding to the Union Government, due to discontinuance of intermediation of loans as recommended by FC-XII. It was further pointed out that, in such an event, the Union would be deprived of its ability to enforce fiscal rules on the States under Article 293 (3) of the Constitution. We examined the relevant facts and observed that, as of now, this contingency will not arise up to 2030, except in respect of two States where it will arise by 2025. It is, thus, clear that this issue will not become relevant during our award period.

14.104 In light of the above and the experience gained in recent years, we urge the Union Government to continue to exercise its powers under Article 293 (3), in an effective but transparent and fair manner, enforcing the fiscal rules consistent with the fiscal consolidation road map suggested by us for the award period.

14.105 We deliberated on the advisability of a new legislation being enacted by the Union to replace the existing FRBM Act. We noted that Article 292¹³ of the Constitution envisages¹⁴ such fiscal responsibility in the form of enactment of a legislation imposing a ceiling on debt. We also note that the C&AG¹⁵ referred to the suggestions made in several reports of the Public Accounts Committee and the Estimates Committee of the Parliament in this regard, and commented that the Union Government had not acted on the recommendations.

14.106 We further note that the FRBM Act currently in force is implicitly consistent with Article 292 of the Constitution. An explicit invoking of Article 292 may, in our view, accord greater sanctity and legitimacy to fiscal management legislation. **We, therefore, urge 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)¹⁶.**

¹³Art. 292 - The executive power of the Union extends to borrowing upon the security of the Consolidated Fund of India within such limits, if any, as may from time to time be fixed by Parliament by law and to the giving of guarantees within such limits, if any, as may be so fixed.

¹⁴ 'I therefore think that from all points of view this article 268 as it stands is sufficient to cover all contingencies and I have no doubt about it that, as my friend Mr. Ananthasayanam Ayyangar said, we hope that Parliament will take this matter seriously and keep on enacting laws so as to limit the borrowing authority of the Union. I go further and say that I not only hope but I expect that Parliament will discharge its duties under this article.' (Dr. Ambedkar in the Constituent Assembly - 10-8-1949). It may be noted that Article 268 in his remarks corresponds to Article 292 of the Constitution.

¹⁵ Report on Union Government accounts 2000-01, paragraph 5.5.

¹⁶Articles 293(1), 293(2) and 293(3) contain similar provisions in regard to the States, as below:

293. (1) Subject to the provisions of this article, the executive power of a State extends to borrowing within the territory of India upon the security of the Consolidated Fund of the State within such limits, if any, as may from time to time be fixed by the Legislature of such State by law and to the giving of guarantees within such limits, if any, as may be so fixed.

(2) The Government of India may, subject to such conditions as may be laid down by or under any law made by Parliament, make loans to any State or, so long as any limits fixed under article 292 are not exceeded, give guarantees in respect of loans raised by any State, and any sums required for the purpose of making such loans shall be charged on the Consolidated Fund of India.

(3) A State may not without the consent of the Government of India raise any loan if there is still outstanding any part of a loan which has been made to the State by the Government of India or by its predecessor Government, or in respect of which a guarantee has been given by the Government of India or by its predecessor Government.

Recommendations

- i. Keeping in mind the importance of risks arising from guarantees, off-budget borrowings and accumulated losses of financially weak public sector enterprises when assessing the debt position of States, we recommend that both Union and State Governments adopt a template for collating, analysing and annually reporting the total extended public debt in their respective budgets as a supplement to the budget document. (para 14.24)
- ii. To curb the scope for perverse allocation of available funds among competing projects and to ensure that the economy benefits from investments in capital works, we recommend that the Union and the State Governments provide a statutory ceiling on the sanction of new capital works to an appropriate multiple of the annual budget provision. (para 14.52)
- iii. In the light of our approach to fiscal consolidation and the fiscal roadmap as developed through our assessment of Union and State finances, we recommend a set of rules for the Union and the States. (para 14.62)
- iv. 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. (para 14.63)
- v. 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 year.
 - iii. 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.

If a State is not able to fully utilise its sanctioned borrowing limit of 3 per cent of GSDP in any particular year during the first four years of our award period (2015-16 to 2018-19), it will have the option of availing this un-utilised borrowing amount (calculated in rupees) only in the following year but within our award period. (para 14.64)

- vi. We recommend that for the purpose of assigning state-specific borrowing limits as a percentage of GSDP for a given fiscal year (t), GSDP should be estimated on the basis of the annual average growth rate of the actual GSDP observed during the previous three years or the average growth rate of GSDP observed during the previous three years for which actual GSDP data are available. This growth should be applied on the GSDP of the year $t - 2$. Specifically, GSDP for the year ($t - 1$) and the given fiscal year (t) should be estimated by applying the annual average growth rate of GSDP in $t - 2$, $t - 3$ and $t - 4$ years on the base GSDP (at current prices) of $t - 2$. We recommend that State estimates of GSDP published by the CSO should be used for this purpose. (para 14.66)
- vii. In the case of the interest payments-revenue receipts ratio required for determining additional borrowing limits, we recommend that figures for both should be based solely on the Finance Accounts data for the year $t - 2$. The same procedure should be followed in estimating the debt-GSDP ratio. The Ministry of Finance should adhere to the above rules and methodology while determining the annual borrowing ceiling for individual States. (para 14.67)
- viii. We are of the opinion that it would be appropriate to exclude the States from the operations of the NSSF scheme in future, even as they should honour the obligations already entered into insofar as servicing and repayment of outstanding debt is concerned. We recommend that State Governments be excluded from the operations of the NSSF, with effect from 1 April, 2015. As for the fiscal burden incurred in the course of the operations of the NSSF, prior to 1 April, 2015, since the scheme has been administered almost in its entirety by the Union Government, no part of this fiscal burden, incurred till that date, should be passed on to the States. We recommend that the involvement of the States in the NSSF scheme with effect from 1 April 2015, therefore, may be limited solely to discharging the debt obligations already incurred by them until that date. (para 14.81)
- ix. Keeping in view the experience of the States in this regard, we recommend the Union Government should examine the desirability of setting up of Consolidated Sinking Fund at this stage. (para 14.85)
- x. Recognising that the fiscal environment should be conducive to equitable growth, we recommend 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. (para 14.86)
- xi. We urge that all stakeholders recognise the predominant role of the Union in fiscal management, while considering our roadmap for the Union and the States that treats a conducive fiscal environment as the joint responsibility of both. (para 14.87)

Chapter 14 : Fiscal Environment and Fiscal Consolidation Roadmap

- xii. To enable wider dissemination of the manner in which this shared responsibility for a conducive fiscal environment is being discharged by the Union and State Governments, we recommend that the Union Government and the RBI bring out a bi-annual report on the public debt of the Union and State Governments on a regular and comparable basis and place it in public domain. (para 14.88)
- xiii. In the light of the experience gained so far and considering the challenge in designing a basic incentive-compatible framework for achieving fiscal correction and adherence to rule-bound fiscal framework for the Union and State Governments to hold each other accountable over agreed fiscal targets, we stress the need for stronger mechanisms for ensuring compliance with fiscal targets and enhancing the quality of fiscal adjustment, particularly for the Union Government. (para 14.91)
- xiv. We recommend 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. We also recommend that the objective of balancing revenues and expenditure on the revenue account enunciated in the FRBM Acts should be pursued. (para 14.95)
- xv. We recommend an amendment to the FRBM Act inserting a new section mandating the establishment of an independent fiscal council to undertake ex-ante assessment of the fiscal policy implications of budget proposals and their consistency with fiscal policy and Rules. In addition, we urge that the Union Government take expeditious action to bring into effect Section 7A of the FRBM Act for the purposes of ex-post assessment. (para 14.101)
- xvi. Our approach outlined and recommendations made warrant amendments to the FRBM Acts. To this end, we recommend that the State Governments may amend their FRBM Acts to provide for the statutory flexible limits on fiscal deficit. The Union Government may amend its FRBM Act to reflect the fiscal roadmap, omit the definition of effective revenue deficit and mandate the establishment of an independent 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. (para 14.102)
- xvii. We urge the Union Government to continue to exercise its powers under Article 293 (3), in an effective but transparent and fair manner, enforcing the fiscal rules consistent with the fiscal consolidation roadmap suggested by us for the award period. (para 14.104)
- xviii. In order to accord greater sanctity and legitimacy to fiscal management legislation, we urge 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). (para 14.106)

Chapter 15

Pricing of Public Utilities

15.1 Our terms of reference (ToR) require us to take into consideration, among other things, "the need for insulating the pricing of public utility services like drinking water, irrigation, power and public transport from policy fluctuations through statutory provisions. "The ToR recognises that the provision of public utility services entails a cost which needs to be recovered essentially through stable policies relating to user charges. We note that, for the first time, the Finance Commission has been asked to consider statutory provisions relating to the pricing of public utilities. The ToR of previous Commissions emphasised commercial viability of public utilities, mainly at the State level, by requiring reasonable returns on investments, in areas such as irrigation, power and public transport. States are the main providers of a large range of public utility services like drinking water, power and public transport. However, the Union Government also makes investments in these areas, in addition to operating the railways. Our ToR does not distinguish between the Union and State Governments.

Approaches Followed by Previous Commissions

15.2 Both the FC-IX and the FC-X noted the need for State Road Transport Undertakings (SRTUs) to carry out their activities on the basis of "business principles". They identified numerical targets to be achieved as minimum returns on government investments in the SRTUs. The FC-XII further observed that State Electricity Boards (SEBs) and SRTUs routinely defaulted on interest payments and loan repayments. The FC-XII also found that the effective rate of interest received on all outstanding loans by all States was extremely low at around 2 per cent in 2002-03. In the case of dividends, the average rate of return was even lower at 0.6 per cent in 2002-03.

15.3 Apart from making recommendations on the required rate of return on investments in public utilities, the earlier Commissions also determined normative returns on investments while projecting the revenues of States. For example, in the case of irrigation, while projecting receipts both the FC-XII and the FC-XIII adopted the principle that the current costs must be recovered. Accordingly, in the assessment of state finances, the FC-XIII normatively calibrated receipts from irrigation to increase from 25 per cent of non-Plan revenue expenditure on irrigation in 2010-11 to 75 per cent in 2014-15.

15.4 The FC-XIII incentivised States to set up a regulator to deal with the pricing and management of water resources. It recommended a grant-in-aid of Rs. 5,000 crore to States for the maintenance of irrigation networks, with the release of grants being subject to certain conditions like the setting up of a Water Regulatory Authority (WRA) by 2011-12 and achievement of state-specific recovery rates, as normatively projected by it for the period 2011-12 to 2014-15. The WRAs were required to have the mandate to fix and regulate water tariffs and charges for surface and sub-surface water used for domestic, agricultural, industrial and other purposes and to regulate the distribution of entitlements for different categories of uses, as well as within each category of use.

15.5 In the case of the power sector, the FC-XIII observed that some States had not raised tariffs for eight or nine years in spite of increasing deficits, and that the absence of timely tariff increases had adversely affected the operations of the utilities. Further, it noted that in several States, where tariff revisions had taken place, financial gaps had been reduced. Nevertheless, large financial deficits continued to persist since the true costs were not taken account of. The FC-XIII also observed that regulatory institutions, in general, lacked sufficient capabilities and urged the expediting of tariff reforms, including a multi-year tariff implementation, as required by the Electricity Act, 2003.

Views of the State Governments

15.6 Some States were not in favour of referring the matter of pricing of public utilities to the Finance Commission, contending that the issue was outside its core mandate. They argued that the Commission should be circumspect in recommending any across-the-board statutory measures on the pricing of public utility services, as State-specific conditions vary widely and need to be carefully factored into any decisions related to the sensitive issue of delivery of public services.

15.7 Most States argued for continuing with subsidy on public utility services, as full cost recovery from users would restrict the use of these public goods by those who cannot afford the price. Insulating public utility pricing through regulation would further restrict access to public utilities by the vulnerable sections of society. Further, these States maintained that even when pricing is determined by independent regulatory bodies, State Governments should reserve the right to provide basic services at subsidised prices to the poor. They argued that it was neither desirable nor practical to prescribe a uniform pricing policy across the State through statutory mechanisms as the cost of providing public utilities like drinking water varies widely across regions and districts within a State, as well as between rural and urban areas within a district. In their view, the large positive externalities resulting from the use of public utilities strengthens the case for leaving their pricing to State Governments, which are better placed to assess the capacity of their citizens to pay for them.

15.8 A few States, however, were in favour of tariff setting by independent regulators over direct control of tariffs of public utilities by government. Their main argument was that an independent regulatory mechanism allows a check on cost inefficiencies and ensures recovery of the economic cost of service delivery. This helps to maintain a level playing field between public and private players and also ensures an independent and transparent mechanism for balancing the interests of government, service providers and consumers. The pricing regulator also provides a platform for achieving sector objectives. In the water sector, for instance, the cross-subsidisation of tariffs for different income groups and tariff structures that promote water conservation illustrate how pricing can be a potent tool for achieving policy objectives. These States favoured legislative backing for the regulator, whose processes and decisions must be marked by demonstrable transparency, rationality and responsiveness in processes and decisions, reinforced by a grievance redressal mechanism as part of institutional design.

15.9 Some States stated that pricing public utilities on the principle of full cost recovery may not be possible where the cost of providing public services is high, for example, in the case of States with hilly terrains and small, dispersed populations. Since electricity and transport services are often managed by regular government departments in such cases, the States urged the

Commission not to prescribe uniform pricing policies for public utilities based on commercial principles. One State even suggested that the matter of deciding on revisions in the user charges of the concerned public utility should be left to the State Finance Commissions (SFCs).

15.10 There was a broad agreement among the States that pricing in the power sector is already substantially regulated by the Electricity Act. They said that the issue of non-revision of tariffs has also been addressed through an order of the Appellate Tribunal for Electricity (APTEL) dated 11 November 2011. This order directed all State Electricity Regulatory Commissions (SERCs) to revise tariffs based on prescribed norms, even if power utilities did not seek a tariff revision. Thus, they reasoned that pricing of electricity is already statutorily insulated from policy fluctuations. On irrigation and drinking water, the dominant view was that these are subjects under the State List, and the broad policy consensus, over time and across States, has been to not fully charge users for the cost of supply. Overall, States suggested that policy decisions based on welfare considerations were best taken in the evolving context of each State. Therefore, they stated that no recommendations by the Commission on this ToR, especially on cost recovery, were warranted. As an alternative, some States indicated that the Commission could suggest guiding principles for the benefit of States.

Views of the Union Government

15.11 The Union Ministry of Power concurred with the views of the States that compliance with the directions of APTEL by SERCs would bring about discipline and simplify procedures in the distribution sector as well as lead to improvements in the revenue and liquidity position of distribution utilities. It pointed out that the Financial Restructuring Plan of state-owned distribution companies contained a condition for mandatory tariff revisions.

15.12 The Union Ministry of Drinking Water and Sanitation stated that although some States are levying user charges in some form, there is no pricing policy for drinking water and sanitation either in the Union or in the States. The Ministry also emphasised that it would be necessary for each State to have a pricing policy as the country moves towards piped water supply systems. It suggested that, given the vast variation in conditions across States, the Union Government should provide a broad policy framework for such a pricing policy. Each State may decide on an appropriate pricing method, based on the cost of production of water and may also legitimately decide on the extent of subsidisation of various sections.

15.13 The Ministry further observed that financing of water supply systems would increasingly require private capital, particularly in the urban sector. In addition, new arrangements like public-private partnerships reinforce the need to set up regulatory commissions to control pricing mechanisms and to regulate monopolistic practices. The Ministry also suggested that the terms of reference of the regulatory commissions include measurement of productivity of public utilities.

15.14 The Ministry of Water Resources, for its part, stressed the need for setting up WRAs in all States. It also advocated the need to empower Water Users Association, through statutory provisions, to collect and retain a portion of water charges, manage the volumetric quantum of water allotted to them and maintain the distribution system in their jurisdiction. The Ministry emphasised that the over-exploitation of ground water is a direct result of the full subsidisation of electricity. Unless there are strong disincentives for subsidising electricity in agriculture, it

pointed out, ground water resources in many parts of India will be in peril, and this, in turn, would affect not only food security, but also water quality. The Ministry also suggested the setting up of dedicated feeders for the supply of electricity to farmers for a fixed period during the day.

15.15 The Ministry of Road Transport and Highways pointed out that the share of SRTUs in public transport operations has been declining. Competition from private players and other transport modes, adverse bus-staff ratios, poor fuel efficiency and absence of a fare revision mechanism are the reasons the Ministry cited for the poor performance of SRTUs. It recommended the creation of a Rural Public Transport Fund at the national level, funded by a cess on both fuel and taxes. It also suggested a similar fund at the State level to be funded by state-level cesses.

15.16 The Ministry of Railways spelt out the tariff policy of the Indian Railways, which has traditionally been one of restraint in increasing passenger fares, even as freight rates have been periodically increased in order to cross-subsidise losses from passenger services. After remaining unchanged for ten years, passenger fares were moderately increased for all classes in 2013 and again in 2014. The Ministry added that it is in the process of setting up a statutory Rail Tariff Authority (RTA) to address issues related to the pricing of railway passenger and freight services and that the RTA would be vested with the task of developing an integrated, transparent and dynamic pricing mechanism to help generate surpluses.

Views of the Forum of Regulators for the Power Sector

15.17 The Forum of Regulators is a body constituted under the Electricity Act and consists of the Chairperson of the Central Electricity Regulatory Commission (CERC) and Chairpersons of the SERCs. The Forum made three broad points. One, retail consumer tariffs are determined on a cost-plus basis in accordance with tariff regulations specified by the Regulatory Commissions under Section 61 of the Act. Two, the Act provides that no tariff or part of any tariff may ordinarily be amended more than once in any financial year, except for changes expressly permitted under the terms of a fuel surcharge formula that may be specified. Three, State Governments do not have a direct role in the tariff-setting process, but they can provide a subsidy to any consumer or class of consumers. Given these statutory provisions, the Forum has affirmed that the determination of electricity tariffs is fairly insulated from policy shifts, and re-emphasised that the matter of subsidies is within the exclusive purview of State governments.

Studies Commissioned

15.18 We commissioned two studies on public utilities. The study on "Insulating Public Utility Pricing from Policy Fluctuations for Sustainable Growth: Power and State Road Transport" examined the power and road transport sectors. In the case of the power sector, the report concluded that state-owned distribution utilities are unlikely to become financially viable unless statutory changes are made to redefine the roles of the government, regulators and distribution companies. For the passenger road sector, the study recommended that 100 per cent subsidies (free services) must be phased out in three years and that concessions in other cases should not exceed 50 per cent of the cost of services. The second study, "Power Sector Operations and Impact on State Finances", made several recommendations for improving power sector operations, under the broad headings of structural, regulatory, system/process and human resources.

Issues and Approach

15.19 We acknowledge that the pricing of public utilities raises several policy issues and that insulating pricing from policy fluctuations need not exclude targeted subsidies. We see merit in the common view expressed by the Union Government, State Governments and Forum of Regulators for the power sector that the Commission should desist from making recommendations on this ToR. Hence, we confine our approach to some principles and a few suggestions, as relevant to fiscal management.

15.20 From a purely economic perspective, the price of any commodity or service should cover the long-term marginal cost of its production or provision. This implies that the capital cost and operation and maintenance costs should be recovered. However, to the extent that public utilities also have externalities and redistributive objectives, both private and social rates of return also need to be considered. With the above principles in mind, our approach rests on four pillars: measurement, pricing, subsidies and regulation.

15.21 Measurement of consumption is the starting point for any meaningful discussion on the operations of public utilities. In addition, metering is also an important method of identifying leakages and inefficiencies. What cannot be measured cannot be priced. In our analysis, we have stressed the need for measurement as a *sine qua non* for addressing challenges in the functioning of public utilities, especially those related to subsidies.

15.22 The second pillar, pricing, has two critical dimensions: the links between the pricing structure and the dictates of economic efficiency, and the imperative for periodic revisions. Price rationalisation has been a key component of almost every reform programme for public utilities and remains one of the most important and challenging tasks facing policymakers. Clearly, pricing policies that have led to fiscal drain, under-investment and inadequate maintenance have not served the public well in the long run. Statutory provisions and their effective implementation are relevant in this context, along with public policies.

15.23 The third pillar, subsidies, raises the key question of the process by which some utilities are subsidised and whether this is independent of political economy considerations and whether the outcome is efficient. International experience, particularly in developing countries, has shown that social causes are best served by the assured provision of these services. If a provision needs to be subsidised for some deserving sections of the population, the government should compute the cost of the subsidy and pay it upfront to the utility. In practice, the issue of subsidies needs to be resolved by sound public policies.

15.24 The final pillar is the regulatory framework. Regulation of public utilities needs to be designed to encourage competition where it is feasible, minimise the costs of information asymmetries, prevent utilities from passing the costs of inefficiencies to customers and provide operators with incentives to improve their performance. To achieve these, regulatory systems should have independence, predictability, legitimacy and credibility. In practice, the effectiveness of regulations is compromised when the government exercises ownership over the public utilities under regulation. In such situations, complications arise in terms of the independence of the regulator and compliance by the regulated entity.

15.25 In brief, we believe that full information and effective independent regulation are crucial to ensuring the insulation of pricing of public utility services from avoidable policy fluctuations.

15.26 The ToR has identified four key public utility services and we have restricted our analysis to these, though other public services could, arguably, also be included in the broad categorisation of public utilities. Within public transport, we have looked at the pricing of services in both rail and road transport sectors. While examining each of these public utilities, we have been mindful, that except for the Railways, all of them fall within the domain of the States, and there are significant differences across States in the institutional mechanisms for the provision of these services.

Power

15.27 Between 2005 and 2011, there were few hikes in power tariff in the States. The consolidated financial position of all the state utilities deteriorated considerably and, in 2011-12, they incurred a combined loss of Rs. 92,845 crore (without taking into account the subsidy). Four states, which had not raised tariffs for six to eight years, accounted for 61 per cent of the combined loss. The distribution utilities of only two states showed profits in 2011-12.

15.28 Since State Governments are the sole owners of the overwhelming majority of power distribution entities, the financial health of these entities directly affects the fiscal position of the States. In this regard, it is noteworthy that the financial gap (the excess of the average cost of supply [ACS] over the average revenue realised [ARR]) at the national level has consistently increased over the last few years. This is partly due to the increase in the ACS, without a commensurate increase in tariffs. The financial gap can be segregated into two parts: one related to inadequate tariff increases and the other related to inefficiencies on the part of the distribution utilities, i.e., collection inefficiencies and technical losses. An analysis of the data for 2011-12 suggests that inefficiencies account for 59 per cent of the total financial gap at the national level, and inadequate increases in tariffs account for the rest. These inefficiencies can be addressed through a combination of full information and policies.

15.29 Metering is necessary for deriving the consumption details of the various consumer categories, as also for determining the subsidy element, estimating actual aggregate technical and commercial (AT&C) losses and, ultimately, for financial management. In the absence of metering, losses are sometimes determined based on the estimated consumption of the unmetered category, mainly in agriculture. The Electricity Act provides that no licensee shall supply electricity except through the installation of a correct meter in accordance with regulations. However, even eleven years after the enactment of the legislation, full metering has still not been achieved in most states. None of the States has been able to meter all their agricultural consumers.

15.30 Metering is also necessary as a basis for informed pricing decisions by the regulator. Unless there is universal metering, measuring losses becomes a notional exercise lacking credibility. **We, therefore, recommend that 100 per cent metering be achieved in a time-bound manner for all consumers as already prescribed statutorily.**

15.31 The Electricity Act provides for some insulation of pricing from the vagaries of policy fluctuations through Multi-Year Tariffs (MYTs). The MYT regulation provides an element of certainty on costs to all stakeholders, for which utilities can legitimately be held accountable. It also seeks to reduce the cost of regulation and regulatory intervention in routine utility matters. The MYT framework has been implemented in most States.

15.32 On the provision of subsidies by State Governments, Section 65 of the Electricity Act mandates that these need to be paid in advance to the utilities. The Section also stresses that no

direction of the State Government to subsidise a certain section of consumers will be operative, if payment is not made in accordance with tariffs fixed by the SERC. At present, the subsidy is not being paid in advance. The timely payment of subsidies is extremely important from the point of view of fiscal transparency perspective. **The Electricity Act, 2003, currently does not have any provision of penalties for delays in the payment of subsidies by State Governments. We, therefore, recommend that the Act be suitably amended to facilitate levy of such penalties.**

15.33 Though statutory provisions are in place, the experience of the last eleven years suggests that the mere enactment of the Electricity Act and the appointment of regulators have not necessarily led to the intended outcomes. In practice, it appears that SERCs have tended to be influenced to keep tariffs low, despite legitimate increases in expenses of the distribution companies. In some SERCs, this is done by classifying approved expenditures as "regulatory assets" and not factoring them into the tariff increase. These regulatory assets continue to remain on the books of the utilities even after the mandated three-year period. This suggests that SERCs need to be strengthened in order to effectively carry out their statutory responsibilities.

15.34 A key issue in the functioning of the SERCs is their financial independence and autonomy. The SERCs' primary sources of income include grant from State Governments and their own revenue generated through fees for annual licenses and the filing of applications. **In order to provide financial autonomy to the SERCs, Section 103 of the Electricity Act, 2003, provides for the establishment of a State Electricity Regulatory Commission Fund by State governments, to enable the SERCs to perform their responsibilities, as envisaged under the Act. We reiterate the importance of financial independence of the SERCs and urge all States to constitute a SERC Fund, as statutorily provided for.**

Railways

15.35 The tariff structure in the Railways is characterised by very low passenger fares and high freight charges. Indian passenger tariffs are one-fourth of those in China, one-ninth of those in Russia, and nearly one-twentieth of tariffs in Japan. In purchasing power parity terms, too, the tariffs reflect similar gaps. To remedy this, a regulatory framework for tariff setting is urgently required. This will enable costing of services and timely rate revisions along commercial principles for both passenger and freight traffic.

15.36 We note that the Union Government has recognised this need and recently approved the setting up of a RTA. Though this requires an amendment of the Railways Act, 1989, an interim RTA has been set up as an advisory body, pending the enactment of a comprehensive legislation. The primary function of the RTA would be to develop an integrated, transparent and dynamic pricing mechanism for the determination of tariffs for the Indian Railways.

15.37 The RTA is expected to advise the Ministry of Railways on matters related to the fixation of tariffs, that is, rates for passenger and freight services (including freight traffic carried in privately owned wagons using the railway system) and track access charges. Apart from focussing on the requirements of the Railways, the Authority will engage with all stakeholders to usher in a new pricing regime through a transparent process. This is expected to lead to the rationalisation of fares and freight structures, improvements in the fare-freight ratio and gradual reduction in the cross-subsidisation across different segments.

15.38 **We endorse the initiative to set up a RTA and urge expeditious replacement of the advisory body with a statutory body, through necessary amendments to the Railways Act, 1989.**

Road Transport

15.39 Passenger road services in most States are run by SRTUs. In addition, companies, government departmental undertakings and municipal undertakings also provide public transport services. According to the "Review of the Performance of SRTUs, 2012-13" brought out by the Ministry of Road Transport and Highways, of the thirty-eight SRTUs, only two reported net profits in that year. The aggregate losses of the SRTUs amounted to Rs. 7,269 crore, 56 per cent of which was accounted for by three SRTUs. Departmental undertakings provide road passenger services in a few states, mainly in the North-east, and their performance is no different from the SRTUs. However, in comparison with the power sector, the fiscal impact of the SRTUs on state finances is limited.

15.40 Section 22 of the Road Transportation Corporations Act, 1950, which deals with corporation finances, states that "it shall be the general principle of a Corporation that in carrying on its undertaking it shall act on business principles". In terms of pricing, the first step would then be to separate the social obligations of providing bus connectivity to all villages as well as concessional fares to socially deserving target groups from the rest of the pricing formula. Both these require government financial support, and it is axiomatic that such fiscal support should be contingent on the reliable and timely supply of relevant information. However, we observe that the accounting information system is incomplete and lacks transparency and that annual reports are not released in time. **Accordingly, we recommend that accounting systems in the SRTUs make explicit all forms of subsidy, the basis for determining the extent of the subsidies and also the extent of reimbursement by State Governments.**

15.41 At present, there is no independent regulatory authority for the road transportation sector. Current arrangements, both at the Union and State level, give rise to a potential conflict, as the rule-making body is also the implementing body. Consequently, there is no independent assessment of the performance of the SRTUs across various parameters. **We, therefore, recommend the setting up of independent regulators for the passenger road sector, whose key functions should include tariff setting, regulation of service quality, assessment of concessionaire claims, collection and dissemination of sector information, service-level benchmarks and monitoring compliance of concession agreements.**

Irrigation

15.42 Water fees/charges for irrigation are collected from farmers for two main reasons. The first is to cover operations and maintenance (O&M) costs, so that a project is financially sustainable. In many cases, fees include a charge for the cost of capital required to construct the project. This cost recovery is important for future investments in irrigation. The second objective is to encourage farmers to use less water per unit of output, or generate higher net economic returns per unit of water, or both. Historically, the first objective has been paramount, but as water scarcity increases, the water-use efficiency objective is likely to grow in importance and be accorded higher priority.

15.43 At present, there is no uniform set of principles for fixing water rates. Water charges vary from State to State, project to project and crop to crop. Rates vary widely for the same crop in the

same State, depending upon the agricultural season and type of irrigation system, among other factors. Water rates are levied on a 'crop/area basis', except for irrigation from tube wells. The use of tube well water is charged indirectly on the basis of electricity required by the tube well.

15.44 The fixation of water rates is a complex task. From the irrigator's point of view, water rates must be considered in the light of the benefit irrigation confers, rather than from the angle of the cost of irrigation projects. However, irrigation is only one of the inputs used by a farmer and it is difficult to evaluate the precise contribution it makes to the farmer's net gain. The fixation and rationalisation of water charges should be guided by the basic consideration of generating sufficient revenue to recover recurring O&M costs essential for the maintenance of the system initially, and a fixed percentage of the capital cost subsequently. Nevertheless, a balance needs to be maintained, keeping in view the paying capacity of farmers.

15.45 Appropriate fixation and rationalisation of water charges demands basic information, which requires measurement of water consumption through meters. The advantage of metering is that it encourages farmers to limit their water use, adopt the cropping pattern best suited to the area and avoid over-irrigation, as well as wasteful use of water. For this purpose, meters are required, which have to be honestly read and reported. **We recommend that all States, irrespective of whether WRAs are in place or not, consider full volumetric measurement of the use of irrigation water. Any investment that may be required to meet this goal should be borne by the States, as the future cumulative benefits, both in environmental and economic terms, will far exceed the initial costs.**

15.46 Maharashtra was the first State to set up an independent regulatory authority under the Maharashtra Water Resources Regulatory Authority Act, 2005, and, as required by the Act, it has been able to meet the O&M expenditure on its irrigation projects through water charges. According to the Ministry of Water Resources, based on the recommendations of the FC-XIII, Arunachal Pradesh, Andhra Pradesh, Gujarat, Jammu and Kashmir, Kerala, Madhya Pradesh and Uttar Pradesh have also set up WRAs on the basis of their respective State Acts. However, it is too early to analyse the performance of these newly established WRAs, as many of them are not yet fully functional.

15.47 The National Water Policy (2012) also recommended that equitable access to water for all be ensured and its fair pricing for drinking and other uses like sanitation, agricultural and industrial purposes should be arrived at through an independent statutory WRA set up by each State, after wide-ranging consultations with all stakeholders. We concur with the view that all states should set up WRAs.

15.48 There is a strong case for setting up WRAs in States that have still not done so. **We reiterate the recommendations of the FC-XIII and urge States which have not set up WRAs to consider setting up a statutory WRA so that pricing of water for domestic, irrigation and other uses can be determined independently and in a judicious manner. However, this may not be practical for the North-eastern states, due to the small size of their irrigation sectors, with Assam being the exception. Further, we recommend that WRAs already established be made fully functional at the earliest.**

Drinking Water

15.49 Sustainable drinking water supply systems are defined as those being operated under a formal management model, have 100 percent household meters installed and whose net revenues from water tariffs and subsidies are sufficient to cover at least the O&M costs of the system. The biggest challenge to drinking water utilities is measurement of consumption. The benefits of metering are that, in conjunction with volumetric pricing, it provides an incentive for water conservation. Further, it helps to detect water leaks in the distribution network, thus providing a basis for reducing the amount of non-revenue water. Finally, it is a precondition for quantity-targeting of water subsidies to the poor.

15.50 Considering all these factors, we recommend that States (and urban and rural bodies) should progressively move towards 100 per cent metering of individual drinking water connections to households, commercial establishments as well as institutions. All existing individual connections in urban and rural areas should be metered by March 2017 and the cost of this should be borne by the consumers. All new connections should be given only when the functioning meters are installed. While providing protected water supply through community taps is unavoidable for poorer sections of population, metering of water consumed in such cases also would ensure efficient supply.

Recommendations

- i. We recommend that 100 per cent metering be achieved in a time-bound manner for all electricity consumers as already prescribed statutorily. (para 15.30)
- ii. The Electricity Act, 2003, currently does not have any provision of penalties for delays in the payment of subsidies by State Governments. We, therefore, recommend that the Act be suitably amended to facilitate levy of such penalties. (para 15.32)
- iii. In order to provide financial autonomy to the SERCs, Section 103 of the Electricity Act provides for the establishment of a State Electricity Regulatory Commission Fund by State Governments, to enable the SERCs to perform their responsibilities, as envisaged under the Act. We reiterate the importance of financial independence of the SERCs and urge all States to constitute a SERC Fund, as statutorily provided for. (para 15.34)
- iv. We endorse the initiative to set up a Rail Tariff Authority (RTA) and urge expeditious replacement of the advisory body with a statutory body, through necessary amendments to the Railways Act, 1989. (para 15.38)
- v. We recommend that accounting systems in the SRTUs make explicit all forms of subsidy, the basis for determining the extent of subsidies, and also the extent of reimbursement by State Governments. (para 15.40)
- vi. We recommend the setting up of independent regulators for the passenger road sector, whose key functions should include tariff setting, regulation of service quality, assessment of concessionaire claims, collection and dissemination of sector information, service-level benchmarks and monitoring compliance of concession agreements. (para 15.41)

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- vii. We recommend that all States, irrespective of whether Water Regulatory Authorities (WRAs) are in place or not, consider full volumetric measurement of the use of irrigation water. Any investment that may be required to meet this goal should be borne by the States, as the future cumulative benefits, both in environmental and economic terms, will far exceed the initial costs. (para 15.45)
- viii. We reiterate the recommendations of the FC-XIII and urge States which have not set up WRAs to consider setting up a statutory WRA, so that the pricing of water for domestic, irrigation and other uses can be determined independently and in a judicious manner. However, this may not be practical for the North-eastern states, due to the small size of their irrigation sectors, with Assam being the exception. Further, we recommend that WRAs already established be made fully functional at the earliest. (para 15.48)
- ix. We recommend that States (and urban and rural bodies) should progressively move towards 100 per cent metering of individual drinking water connections to households, commercial establishments as well as institutions. All existing individual connections in urban and rural areas should be metered by March 2017 and the cost of this should be borne by the consumers. All new connections should be given only when the functioning meters are installed. While providing protected water supply through community taps is unavoidable for poorer sections of population, metering of water consumed in such cases also would ensure efficient supply. (para 15.50)

Chapter 16

Public Sector Enterprises

16.1 Para 6 (ix) of our terms of reference (ToR) requires us to take into consideration "the need for making the public sector enterprises competitive and market oriented; listing and disinvestment; and relinquishing of non-priority enterprises" in making our recommendations. Our ToR does not distinguish between public sector enterprises of the States and the Union; and it is our understanding that our consideration may extend to both.

16.2 Implicit in the ToR is the idea that the government could raise resources through making the enterprises competitive as well as listing and disinvesting them. It is also acknowledged that there are non-priority enterprises that no longer need to be in the government's portfolio, either fully or partially. The scope of our task is, thus, expansive and, therefore, we need to analyse the structure, composition and current status of public sector enterprises under both the Union and State Governments in a comprehensive manner. Consistent with our primary mandate, our analysis focusses on the impact of policies relating to public sector enterprises on Union and State finances.

16.3 While the total number of State Government public sector enterprises is large, the value of their investments is not high except in the power and transport sectors, which are in the nature of public utilities. In the case of the Union Government's public sector enterprises, there are fewer companies, but the portfolio base is large and they operate in diverse segments. The Public Enterprises Survey 2012-13, brought out by the Department of Public Enterprises (DPE), has reported on 277 government-run companies, their subsidiaries and the statutory corporations with investment of Rs. 8.51 lakh crore, but excludes public sector banking and financial institutions. The Comptroller & Auditor General (C&AG), audits about 1,300 public sector commercial enterprises controlled by the Union and State Governments. It is evident that policies relating to public enterprises have significant fiscal implications, both at the Union and State levels.

Views of Previous Finance Commissions

16.4 Up to FC-XII, the focus of successive Finance Commissions was on assessing the returns on investments for state-level enterprises to the extent that they had a bearing on state finances. The assessments factored in what the Finance Commissions considered reasonable rates of return on irrigation works, power projects, transport undertakings etc. and made projections on the resources that such enterprises would contribute to States' own revenues. The ToR of the FC-XII for the first time explicitly referred to relinquishing non-priority enterprises and disinvestment by State Governments. Disinvestment was omitted in the ToR of the FC-XIII and instead, the policy focus reverted to restructuring and revival of public sector enterprises. The focus on disinvestment and efficiency has been renewed in our mandate with the efficiency aspect expressed differently as 'competitive' and 'market oriented'. Our mandate also brings back to the table the need for 'relinquishing of non-priority enterprises'.

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16.5 Taking note of the shift in policy regarding the public sector enterprises following the 1991 reforms, the FC-X suggested a ban on adding new public sector enterprises and devising a disinvestment strategy based on considerations of certain performance parameters. The FC-XI and FC-XII suggested gradual reduction of government intermediation in public sector enterprises and further strengthening of steps for closure and disinvestment of these respectively. The FC-XIII, while focusing on restructuring and disinvestment of public sector enterprises, suggested a comprehensive roadmap and operational arrangements for initiating this process.

Views of Union Government

16.6 The Union Ministry of Finance, in its Memorandum to the Commission, has mentioned that there is an urgent need to look into the structure, purpose and performance of public sector enterprises. It has suggested that these should be made competitive and market oriented. In this context, the need for an assessment of their role and significance in the current market scenario was highlighted. The Ministry also referred to the need for projecting the capital expenditure requirements of public sector enterprises, particularly for those in the energy and power sectors, as also the need to identify those enterprises that can be listed and disinvested. It categorically suggested that the non-priority areas of government should be identified in order to recover and realise the public investments made in such enterprises through disinvestment or relinquishment.

16.7 The DPE has informed us that over the years, norms for the purpose of categorisation and re-categorisation of Central public sector enterprises have been evolved based on both quantitative and qualitative criteria. The quantitative factors broadly include investment, capital employed, profitability, number of employees and number of units. The qualitative indicators are factors such as national importance, problems faced by the company, prospects for expansion and diversification and competition from other sectors. However, the DPE mentioned that there has been no categorisation of public sector enterprises into priority and non-priority.

16.8 The DPE has pointed out that policies and measures relating to need for making public sector enterprises competitive and market oriented, include restructuring of the board of directors by limiting the number of Government Directors, inclusion of independent directors, grant of enhanced autonomy through schemes of 'Ratnas', autonomy in terms of salaries within broad public sector pay scales, introduction of performance related pay, corporate governance system and setting of targets with performance evaluation through memorandum of understanding (MoU). The DPE has further suggested that Central public sector enterprises which have been given control over extraction and marketing of mineral resources be benchmarked to global standards or those of private sector companies operating in the sector. The Department further informed us that as of June 2014 the Union Government has approved forty-eight proposals for revival of Central public sector enterprises and four for closure and winding up. These decisions have been made on the recommendations of the Board for Reconstruction of Public Sector Enterprises (BRPSE). The DPE has also highlighted the changes in the process of assessment of sick Central public sector enterprises through the National Company Law Tribunal.

Views of State Governments

16.9 In our consultations with State Governments, it has emerged that in a majority of the States, power companies set up after the unbundling of State Electricity Boards were the largest

enterprises in terms of capital invested and sales turnover. Road transport corporations were the next largest. In some States listing of state-level enterprises had been done successfully but, by and large, the experience has not been encouraging. Most States argued that the power companies and road transport corporations are public utilities providing basic essential public services, while the remaining functional companies cater to welfare functions. In the opinion of these States, it would, therefore, not be prudent and expedient to measure the performance of such enterprises on commercial considerations alone. They have, accordingly, urged us to reckon lower returns on such investments and not insist on their disinvestment. Some States also pointed out that the small size of most of their enterprises does not severely impact their fiscal balances. Others urged that a share of the disinvestment proceeds of the Central public sector enterprises should be provided to them since they provided land, supporting infrastructure and other assistance for setting up such public sector enterprises.

Approach

16.10 We have viewed the three important components of our ToR namely, 'the need for making public enterprises competitive and market oriented', 'listing and disinvestment' and 'relinquishing non-priority enterprises' as inter-related. Making them competitive and market oriented will have relevance as long as they continue to be public enterprises. Even assuming that relinquishing is planned or partial disinvestment is expected, making a public enterprise competitive and market oriented would help obtain higher yields from the process and hence, be beneficial from the fiscal point of view.

16.11 According to the policy of the Union Government¹ laid down in 1998-99, government shareholding in public sector enterprises was to be brought down to 26 per cent, except in enterprises with strategic considerations where majority holding by government was to be retained. A 'case by case' criterion was prescribed² which presumably implied a targeted investment portfolio view for each Central public sector enterprise. Reduction of government stake to 26 per cent was subject to the twin considerations of preventing concentration of power in the private sector and setting regulatory mechanisms in place before privatisation. Over the years, there has been some progress in disinvestment in several enterprises, mainly to raise budgetary resources, but a detailed and longer term framework for operationalising the stated policy is not in place.

16.12 We noted that the Planning Commission had appointed a Panel of Experts on Reforms in Central public sector enterprises in August 2010, which gave a detailed report in November 2011. The report made several recommendations relating to corporate governance, human resource strategy, memorandum of understanding system, joint ventures, public-private partnership, procurement and technology mapping. In this context, the Panel briefly reviewed the history of Central public sector enterprises and concluded: "There is, therefore, a need for initiating a nation-wide debate as to what the new avatar of CPSEs ought to be, and how it should be structured". In this regard, we also note that the Ministry of Finance, in its memorandum, has also highlighted the need for assessment of the role and significance of public sector enterprises in the current market scenario. We do recognise the need for initiating a nation-wide debate on the future of public sector enterprises in India.

16.13 Central public sector enterprises have varying origins. Some were investments in new enterprises, while some were nationalised private companies and others were a result of taking

¹ Budget Speech of Union Finance Minister, 1 June, 1998.

² Cabinet Decision dated 16 March, 1999.

over of sick units. In any case, most of them came into existence decades ago in different contexts and several developments have taken place since then. These developments have to be factored in determining the continued appropriateness of public investments in each public enterprise. We should also be forward looking in assessing the role of public enterprises in our strategies for inclusive development. Further, the fiscal implications of public ownership at the present juncture of the fiscal environment should also be considered in such a review, while not ignoring the interests of employees. **Accordingly, we have approached the assessment of the priority of Central public sector enterprises based on certain new realities (including strategic perspectives), fiscal implications and the interests of employees.**

New Realities

16.14 In our view, the new realities relevant for the prioritisation of Central public sector enterprises may be summarised as follows:

- a) Some public enterprises were established at a time when private capital was not forthcoming. However, the private sector has, in recent years, developed the capacity to invest and operate in a globally competitive manner.
- b) The private sector is now permitted in many sectors, including those which were once the exclusive preserve of the public enterprises.
- c) With global integration of the Indian economy, many commodities and even services are imported and exported liberally and the regime is bound by obligations to the World Trade Organisation. Thus, the strategic role of public enterprises in the national economy has to be considered in the context of a relatively open economy.
- d) With a liberalised environment of global trade, India is importing goods and services manufactured by the private sector from other countries. These include defence equipment as well. In such a situation, the private sector in India can legitimately expect to occupy the same space without any detriment to public interest.
- e) Technological developments have changed the range and contours of natural monopolies. Erstwhile natural monopolies have been unbundled and several areas have since been opened for the private sector and competition.
- f) In terms of public policy, both in theory and in terms of global practice, ensuring effective regulation, competition and protection of consumers' interests have been generally accepted as better instruments of public policy relative to public ownership of enterprises. The concept of public provision must be differentiated from public ownership and production.
- g) There have been several downsides in regard to global experiences with emphasis on market orientation and private ownership, in particular, in the financial sector. However, the dominant correctives have been in terms of changes in regulation and governance, and seldom in favour of shift towards public ownership.
- h) It is true that China provides an example of a dynamic and profitable public enterprise sector, particularly since it did not have a legacy of private sector. However, foreign

private investment took the lead for growth there and currently the private sector is expanding rapidly. The dynamism of the Indian private sector has been globally acknowledged and hence its comparative advantage relative to India's public sector should be recognised.

- i) It needs to be seen if the objectives of public sector enterprises have been achieved, and, if not, whether the original objectives have been re-defined. Public enterprises were started with the objective of leveraging resources for development and there is no continued justification for public investments unless the enterprises are generating assured resources for the government.
- j) There may be a compelling need for the presence of public enterprises in specific activities from a strategic perspective, but what constitutes strategic perspective demanding the presence of public enterprises does vary from time to time. What was once a strategic activity may cease to be so now and new areas of strategic importance may be opened up for public sector enterprises. Serious market imperfections may warrant, at times, entry of public sector enterprises.
- k) Finally, in terms of institutional innovations, it has been possible to ensure elements of public sector character of public enterprises with a varying mix of public and private ownership. In other words, it is possible to have elements of management control by the government through ownership, combined with market discipline inculcated by a measure of private ownership through listing and trading. Hence, the choices are not restricted to either total public or total private ownership but differing mixes of public and private ownership, in a dynamic context.

16.15 We recommend that these new realities be recognised in order to shape and develop a comprehensive public sector enterprise policy with adequate focus on the fiscal costs and benefits. We further recommend that the new realities described above be considered in evaluating the future of each public enterprise in the entire portfolio of Central public sector enterprises.

Fiscal Implications

16.16 The fiscal costs of public ownership in public enterprises, for analytical purposes, may be reckoned as the opportunity costs of retaining the current level of investments in public enterprises. An obvious reference point for assessing it in the case of Central public sector enterprises is the cost of borrowing by the government. Thus, any public enterprise which gives a return on equity of, say, less than 8 per cent is prima facie a candidate for relinquishing, unless there are other benefits which are best obtained only through public ownership of an enterprise. A second approach is to insist on a return on equity consistent with market expectations, say, 16 per cent in India, in view of the risks associated with equity holding. A third approach to compute opportunity cost is assessing the market value of equity held by the government relative to fiscal returns to it. If the realisable market value of equity is more than the capitalised value of expected returns, it is better to relinquish the ownership. Often, the private sector expects to make more profitable use of assets of a public sector unit and is thus willing to pay a premium. A fourth approach could be to consider the alternative use of resources obtained through disinvestment. In particular, there are certain goods and services, especially public goods, which could be provided only by the

government. If the private sector is in a position to provide the goods currently being provided by public enterprises, there is a case for unlocking the investments in public enterprises to utilise them to provide basic public goods and services. The resources freed can be used for goods that only the government can provide, and services that are critical to growth and equity. A fifth approach could be to consider the benefits of the 'crowding-in' effects of public investment in infrastructure through a shift in investments away from those in public enterprises producing tradable goods and into building economic infrastructure in the interest of growth. Similarly, shifting away from public investments in tradable goods may enable increased provision of public or social goods and could add to re-distribution.

16.17 It is equally necessary to recognise that there are also indirect fiscal costs of continuing with public ownership, such as liability for debts incurred by public enterprises, fiscal costs of other risks associated with the enterprise concerned and costs of administrating and overseeing the enterprise. **In our view, the evaluation of the fiscal implications of the current level of investments in, and operations of, the existing public enterprises, in terms of opportunity costs, is an essential ingredient of credible fiscal consolidation. Hence, we recommend that the fiscal implications in terms of opportunity costs be factored in while evaluating the desirable level of government ownership for each public enterprise in the entire portfolio of Central public sector enterprises.**

Employees' Interests

16.18 The total employee strength in Central public sector enterprises stood at 14.04 lakh (excluding contractual workers) in 2012-13 as compared to 14.50 lakh in 2011-12. The number of employees in the sixty-four sick Central public sector enterprises as on 31 March 2012 was estimated at 2.26 lakh. Several steps have been taken in the past for the welfare of the workers. One such initiative was the National Renewal Fund which has now been replaced by the scheme for Counselling, Retraining and Redeployment.

16.19 In the process of restructuring and relinquishment, taking both the fiscal impact and interests of workers into consideration are important, but a balance is necessary between safeguarding workers' interests and the interests of all stakeholders. In our view, the government should ideally have a comprehensive and transparent public sector workers' policy, while considering employees' issues in the context of the disinvestment/relinquishment process. Such a policy should address the workers' interests and allay their fears and misgivings. We notice that consideration of the employees' issues at the time of relinquishment or disinvestment so far has resulted in disproportionate fiscal costs, without necessarily guaranteeing commensurate protection of workers' interests. **We recommend that the basic interests of workers of Central public sector enterprises should be protected at a reasonable fiscal cost, while ensuring a smooth process of disinvestment or relinquishing of individual enterprises. We further recommend that employment objectives should be considered in evaluating the portfolio of public enterprises, not only in the narrow context of the enterprises' employees, but also in terms of creating new employment opportunities.**

Principles of Prioritisation

16.20 In our view, several approaches are possible for prioritising of public enterprises in terms of the desired extent of the public sector character appropriate to each enterprise. One approach

is to identify those enterprises in "high priority" activities where public ownership should be predominant or in "priority" activities where a majority of public ownership would suffice. Illustratively, the criteria for high priority or priority could be: (a) activity assessed as strategic in terms of public interest; (b) the enterprises having earmarked or assigned natural resources with sovereign or quasi-sovereign functions; (c) the enterprises required to cater to market imperfections; (d) enterprises where returns on investments are higher than any alternative investment by the government; and (e) public utilities, where some presence of public enterprises may be desirable as a reference point for getting more reliable information for the regulators. The rest of the enterprises could be categorised as 'low-priority' and 'non-priority' based on some inter-related and non-exclusionary indicative criteria of market conditions and socio-economic considerations. These would include the following: (i) where private sector presence has been allowed and the enterprises are functioning well; (ii) activities where un-restricted imports are permitted; (iii) where the public enterprise is not a public utility or it is a public utility, but regulated; (iv) where the enterprise is not a statutory monopoly; and (v) where enterprises are loss making and sick, unless there are other compelling reasons of broad public interest to retain them in public sector, commensurate with fiscal costs.

16.21 As already mentioned, we believe that relinquishing non-priority enterprises or expanding investment in the existing enterprise or disinvestment has to be considered within the framework of a long-term view of the priority for public ownership in the enterprises considered. In case of non-priority enterprises, 100 per cent disinvestment would be in order while in case of others a view needs to be taken on whether the medium to long term goal is dominant control, majority control or some presence. In enterprises that are high priority and hence require dominant control, disinvestment may not take place at all or, if it takes place, it should not exceed 25 per cent so that the government has predominant position. In cases of priority industries, warranting the presence of the public sector with a majority control of the government, disinvestment should not exceed 49 per cent. In cases categorised as low priority, where only some presence is needed, disinvestment could be up to 74 per cent. However, in the case of statutory corporations, a more nuanced view of ownership, management control and governance needs to be taken.

16.22 We have identified eighty-eight Central public sector enterprises³ with a total turnover ranging from less than Rs.1 crore to Rs.100 crore and with the total market share of each entity in its respective area being less than 1 percent. The output of these eighty-eight enterprises is insignificant, while the Union Government has to devote attention to supervising them. These enterprises would, thus, qualify to be non-priority and deserving of relinquishment.

16.23 For purposes of illustration, we have also analysed the profile of the largest twenty-five Central public sector enterprises. These account for 87.7 per cent of total turnover, 71.6 percent of capital employed, 71.9 percent of profit before interest and tax (PBIT), 64.1 percent of profit after tax (PAT) and 57.1 percent of employees of the units covered by DPE (see Annex-16.1). An attempt has been made to categorise them into high-priority, priority, low-priority and non-priority. It may be seen that such categorisation helps not only in indicating the scope for disinvestment but also suggests the importance of fresh investments in a few public enterprises. A similar exercise has been attempted for the top ten profit and loss making companies which do not fall in the category of the top twenty-five companies mentioned (see Annex-16.2).

³Public Enterprises Survey, 2012-13 (Annual Report on the performance of Central Public Sector Enterprises).

16.24 The illustrations mentioned above point to the desirability of setting out principles of prioritisation to enable the assessment of the existing portfolio of Central public sector enterprises for the benefit of all stakeholders. The principles will help each public enterprise to plan its future path of existence based on the expected extent of public ownership in it. The principles will also provide a medium-term framework for disinvestments and fresh investment by the government along with associated fiscal impact. In brief, the policy built around these principles could outline the specific strategic and macro-economic goals that govern continued public investment, along with a disinvestment/investment roadmap wherever continuance of government shareholding is not warranted or is required to be reduced or increased through fresh investments. **We, therefore, recommend that the enterprises be categorised into 'high priority', 'priority', 'low priority' and 'non-priority' keeping in view the illustrations given by us to : (i) facilitate co-ordinated follow-up action by policy makers and (ii) provide clarity to public enterprises themselves on their future and to the financial markets about the opportunities ahead for them.**

Sick Industries Policy

16.25 Under the existing policy, a company is defined to be 'sick' if it has accumulated losses in any financial year equal to 50 percent or more of its average net worth during the four years immediately preceding the financial year. The now repealed Sick Industrial Companies (Special Provisions) Act, 1985, provided for companies to be declared sick when accumulated losses equalled or exceeded the net worth. With the promulgation of the Companies Act, 2013 a company can now be declared sick on application by secured creditors. If creditors do not agree for revival or to a revival package prepared by the Company Administrator of the sick company, a winding up order will have to be passed by the National Company Law Tribunal.

16.26 We have noted that the process of revival or relinquishing of sick companies has been tardy and time-consuming. The Public Enterprises Survey 2012-13 reports that out of forty-seven Central public sector enterprises approved for revival till date, only nineteen sick enterprises have actually managed to turnaround, meaning that the long-drawn process of restructuring at additional costs to the government has not proved beneficial in a majority of the cases. The experience shows that the non-revival of these enterprises has not materially impacted the industrial sector or the economy of the country. However, the delayed decisions on closures have consequent fiscal costs. The existing sick companies would, thus, qualify to be non-priority and deserving of relinquishment.

16.27 Even though various alternatives are available for relinquishment of unlisted non-priority public enterprises, we are of the view that the mode of auction through an open and transparent mechanism of bidding should be the preferred option. The auction of a public enterprise may be done along with all the assets and liabilities of the company for which a detailed and transparent inventory could be prepared and put in the public domain to elicit sufficient interest and response through bidding. Further, in our view, the auction of public enterprises should be carried out without making any attempt at re-structuring of the enterprise, as this itself can lead to non-transparent and subjective decisions and become a potential cause of disputes and delays in the relinquishment process. The interests of the workers could be built into the terms and conditions of auction or they could be delinked from the auction and attended to separately with transparent fiscal costs. It can be reasonably presumed that the auction of non-priority unlisted public sector

enterprises should be able to generate sufficient private sector interest and it should be possible to retrieve some value in most of the cases, in order to maximise the fiscal benefits. However, in exceptional cases, the option of offering transparent fiscal support for making the enterprise viable for the private buyer can be considered, in order to limit the recurring fiscal costs of keeping it in the public sector. **We, therefore, recommend that the route of transparent auctions be adopted, keeping in view the observations made above, for the relinquishment of unlisted sick enterprises in the category of non-priority public sector enterprises.**

Listing

16.28 We have noted the inherent advantages of listing the Central public sector enterprises as recognised by the DPE in the Public Enterprises Survey of 2012-13. Listing of profitable Central public sector enterprises on the stock exchanges with a mandatory public ownership of at least 10 per cent shareholding, revised upward to 25 per cent in line with recent regulatory guidelines, has been observed to significantly increase the value of the enterprises, the government's residual shareholdings as well as that held by the public post-listing. It is also recognised that listing widens the ownership base amongst retail investors who can participate and share in the prosperity of the enterprises.

16.29 As of May 2014, the listed Central public sector enterprises had a total market cap of Rs.13.71 lakh crore. The Department of Disinvestment has informed us that in addition to the fifty-one Central public sector enterprises listed at present, fifty more can be listed on the basis of the existing listing criteria. These developments have, in our opinion, substantially enhanced the scope for disinvestments and non-debt capital revenues for the Union Government.

Disinvestment and Investment

16.30 The disinvestment policy has evolved over the years. The current policy envisages developing "people's ownership" of Central public sector enterprises in order to share in their wealth, while ensuring that government equity does not fall below 51 per cent and the government retains management control. The approach to disinvestment is based on making the listed profitable Central public sector enterprises compliant with regulatory guidelines through measures such as 'offer for sale', issue of fresh shares, addition of eligible Central public sector enterprises, follow-on public offers and permitting use of surplus cash to buy back shares. However, the process of disinvestment over the years has been generally ad-hoc, based on the limited approach of short-term fiscal gains to cover the budgetary revenue gaps to the extent feasible, depending on market circumstances.

16.31 We note the existing policies and procedures of listing and disinvestment, and urge that such policies be considered in future only within the parameters set by the approach to prioritisation for each enterprise in the entire portfolio of Central public sector enterprises. We consider that the level of disinvestment should be relatable to desired level of public ownership in each category. **We recommend that the level of disinvestment should be derived from the level of investment that the government decides to hold over the medium to long term in each enterprise, based on principles of prioritisation advised by us, while the process of disinvestment should take into account the market conditions and budgetary requirements, on a year to year basis.**

16.32 While there are a number of industrial sectors where government presence is not required or can be reduced, there may be certain other areas where public enterprises need to step in and have an increased presence. The disinvestment policy of the government should, therefore, also be complemented with a public sector investment policy with a long-term perspective. The government should identify new areas of strategic interests and sectors from the view point of enhancing the global competitiveness of the Indian industrial sector.

16.33 Indicatively, new public sector investments can be in the fields of advanced engineering and special-capital equipment, areas of strategic economic interests or to promote infrastructure investments for enhancing last mile access for improved services and facilities. Fresh investments can also be focused on leveraging the inherent strengths of the country's industrial sector to maintain its competitive edge or in critical areas having high import dependency. The fresh investment policy of the government can potentially consider all the available options, including partnerships and joint ventures with the private sector, to leverage the existing areas of strength, maintain the competitive edge and to cover the existing investment gaps. **We recommend that the government devise a policy relating to the new areas of public sector investments. We also recommend the purchase of shares where the existing portfolio holding in the 'high priority' and 'priority' public sector enterprises is less than the desired level of government ownership.**

National Investment Fund

16.34 On the issue of utilisation of proceeds from the disinvestment and relinquishing of Central public sector enterprises, we have noted that guidelines of the National Investment Fund (NIF), into which these proceeds go, have been modified to enable their utilisation for select items of capital expenditure. We agree with this approach, as it would be fiscally unwise to borrow from markets and maintain this corpus at much lower rates of returns. The NIF, at present, serves no purpose except for routing the disinvestment receipts through the public account for limited accounting needs. These accounting needs can be met by other means and the operation of public accounts only for this limited purpose is undesirable. **We, therefore, reiterate the recommendations made by the FC-XIII to maintain all disinvestment receipts in the Consolidated Fund for utilisation on capital expenditure. The National Investment Fund in the Public Account should, therefore, be wound up in consultation with Controller General of Accounts (CGA) and C&AG.**

Sharing with States

16.35 During our consultations, the States had raised the issue of getting a share in the proceeds of disinvestment of Central public sector enterprises. We sought the views of the Union Government on this, as the existing arrangement does not require such sharing. We have been informed that such proceeds may not form part of the divisible pool, in view of the Union Government's decisions to credit disinvestment receipts in NIF for spending on specified purposes. We have noted that the State Governments have also played decisive roles in the setting up of Central public sector enterprises in different ways. Many of them have provided land, power and water at concessional rates as well as other incentives such as tax concessions. The operation of these units is, to a great extent, critically dependent on effective coordination with local state authorities. The labour and employees in many Central public sector enterprises also belong to the particular state in which the unit is located. This contribution of the States, though

acknowledged, is yet to be rewarded in the process of disinvestment. We are also aware of the complications of designing an appropriate system of rewards in this regard.

16.36 In our view, the sharing of the proceeds of disinvestment, even marginal, will, in addition to rewards, also ensure a more active interest in State Governments in the process of disinvestment. **We, therefore, find considerable merit in the Union Government dispensing a small share of proceeds of disinvestment to the States. In the case of Central public sector enterprises with multiple units located in different states, the distribution of this share could be uniform across all the States where units are located. In cases where only vertical unit-wise disinvestment is done, the share could go to the State/States where the units being disinvested are located.**

Making Central Public Sector Enterprises Competitive

16.37 The structure of public sector enterprises has inherent limiting factors that reduce their capacity to be competitive, compared to the private sector. The monitoring and multi-layered oversight mechanisms as well as the assigned monopoly and protected status, by their very nature, restrict the development of a competitive culture. The constraints of public accountability limit managerial and operational flexibility, leading to a culture of conservatism and slow decision making. These, in turn, impact investment decisions and thereby, competitiveness of the public sector enterprises. Further, some Central public sector enterprises operate in an environment of soft-budget constraint, which promotes inefficiency, low levels of productivity and financial losses.

16.38 In addition to the above systemic limitations, public sector enterprises in India have inherited the burden of a large and redundant work force with a relatively rigid compensation structure based broadly on the government pay structure. The recruitment procedures also provide limited flexibility. The delays in board-level appointments add to uncertainties at the enterprise level. **In view of the above factors, we recognise the importance of making Central public sector enterprises effective and competitive, but suggest that the monitoring and evaluation of these enterprises take into account the institutional constraints within which their managements operate.**

16.39 The competitiveness and market orientation of the Central public sector enterprises are impacted also by the burden of implementing certain non-commercial social objectives of the government, generally in a non-transparent manner. This affects their profitability and competitiveness vis-à-vis the private sector. There is, therefore, a clear divergence between the government's role as a public service provider and running enterprises for profit. **In our view, if the Central public sector enterprises are burdened with implementing the social objectives of the government, it should compensate them in a timely manner and adequately through a transparent budgetary subvention. Similarly, losses on account of administered price mechanisms (APM) should also be calculated and fully compensated for.**

16.40 The report of the Panel of Experts on Reforms in Central public sector enterprises noted that the composition and functioning of the board of directors is vital in determining governance at all levels within these enterprises. The strengthening of vigilance as a function, developing a manpower planning strategy, succession planning, listing of every Central public sector enterprise and maintenance of proper land banks, among other things, are other suggestions made in the Report for improving corporate governance practices. **We recommend that governance**

arrangements be reviewed, especially in regard to separation of regulatory functions from ownership, role of the nominee as well as independent Directors, and, above all, the framework of governance conducive to efficiency.

Dividends, Reserves and Subsidiary Policy

16.41 The operational decisions of a public sector enterprise should lie with the concerned entity, but final decisions relating to dividends and reserves should remain with the government, as the owners. The policy of the Union Government mandates a standard and minimum rate of dividend from Central public sector enterprises. In view of our framework and approach, the dividends policy should cater to the requirements of the government also, as it would in the case of any prudent investor / owner. The current policy of insisting on a minimum and standard rate of dividend is a narrow view, though it has the advantages of simplicity in ensuring compliance. Many of the Central public sector enterprises are not paying dividends even after earning profits and the C&AG has pointed out a shortfall of Rs.3, 588 crore for the year 2012-13, due to non-compliance of the dividend guidelines. An across-the-board policy dispensation on dividends/reserves does not result in optimisation, whether from a unit level or from the fiscal point of view.

16.42 As observed in the Public Enterprises Survey 2012-13, a number of Central public sector enterprises carry substantial reserves. In March 2013, the surplus cash holding of Central public sector enterprises stood at Rs. 2,66,560 crore. Further, according to the information provided by the DPE, the excess and free reserves required to be capitalised by the issue of bonus shares, in terms of the existing government guidelines, is pending in the case of eighty-six Central public sector enterprises, thereby flouting the existing norms. However, it is necessary to recognise that the transfer of profits to reserves should take account of the requirements of the enterprise concerned for its genuine needs. In our view, there should be a correct assessment of the requirements for reserves of each enterprise by the government and the remaining surplus should be transferred to the owners, including the government, as dividends. Hence, Central public sector enterprises which do not have investment requirements that cannot be met by borrowings ought to pay higher dividends rather than building reserves. Dividends should be paid out of excess/free reserves built out of previous years' profits also.

16.43 It has been observed from the data provided by DPE that most of the Central public sector enterprises are under-leveraged (not taking debt) and the enterprises have interest in seeking recourse to reserves than borrowing. The debt to equity ratio of the top twenty profit-making Central public sector enterprises averaged 0.63 in March 2013. Therefore, from the fiscal point of view, the scope for borrowing for fresh investments by each Central public sector enterprise should be fully explored by applying greater scrutiny to the gaps in leveraging and the capabilities for borrowing from the market. This will also preclude the need for building reserves without future investment plans and will enable release of funds for dividends to the government at a time when it faces a fiscal crunch. It must be recognised that unlike operational matters in which the board and management should have autonomy, transfer to reserves and payment of dividends is a policy matter. The temptation of enterprises to retain cash surplus is understandable, but the government's interest in fiscal prudence should reconcile the broader public interest with that of the enterprise concerned. The transfer to reserves, therefore, may be permitted only after the

entity has exhausted the options and limits for raising additional resources through debt, in terms of a defined enterprise limit on the optimum debt to equity ratio. **We therefore, recommend that as part of the comprehensive review of the public sector enterprises proposed by us, policies and procedures relating to borrowing by the enterprises, payment of dividends and transfer of excess reserves be enunciated and enforced.**

16.44 In respect of creation of subsidiaries by a Central public sector enterprise, it is essential to have a clear government policy, delineating the conditions and purposes for which subsidiaries can be created and with specific systems of prior guidance to the nominee director by the government as a dominant owner. The purpose of subsidiaries in the public sector may not be entirely similar to those of the private sector, where they are often created for the purposes of tax planning or as measures of mitigation against litigation or controlling the risks of damage spill-over to the entire company. Ideally, proposals for the formation of new subsidiaries should be evaluated and appraised broadly in the same manner as a fresh investment by the government. **We recommend that, in view of the significant fiscal implications, a clear-cut and effective policy on investments of Central public sector enterprises in their subsidiaries be adopted.**

Financial Sector Public Enterprises

16.45 The public sector financial institutions occupy a special position, by virtue of their critical role in the financial system and the economy. These can be broadly classified into three categories: public sector banks, public sector insurance companies and the developmental finance institutions (DFIs). We have briefly considered each category of public sector financial enterprises from the fiscal point of view.

16.46 The Commission was apprised of the fact that, based on BASEL-III guidelines, public sector banks have a huge capital requirement of Rs. 2.84 lakh crore. We note that the Union Government's policy initiative of considering reduction of the minimum government holding in these banks to 52 percent is designed to provide additional scope for financing the minimum capital requirement needs. We were informed that even after this, government contribution of Rs.1.02 lakh crore will be required during the period 2015-16 to 2019-20. We also understand that there is a proposal to create a holding company, but we believe that such a mechanism will result in indirect and non-transparent fiscal obligations for the Union Government. In our view, there is scope and need to further lower the fiscal costs of re-capitalisation by restricting it to select and better performing public sector banks, instead of an across-the-board policy of covering all of them, in view of the competing demands on available budgetary resources. The non-performing public sector banks may be advised to manage their asset portfolio and growth in tune with the available capital. This will promote competitiveness amongst these banks and act as a hard budget constraint on them. This approach requires a view to be taken on, as well as an assessment of, the number of public sector banks that can cater to the desirable share of the public sector banking system in India, in order to serve the social objectives.

16.47 In the insurance sector, substantial reforms have already been carried out through privatisation, and the public sector insurance companies are working in a market-based competitive environment. The policy of insurance companies buying substantial shares of Central public sector enterprise disinvestments at the instance of the Union Government is another issue that

needs to be weighed in terms of returns on investments and the implications of simply shifting of public asset holdings from one public entity to another.

16.48 Development finance institutions have been established to serve specified objectives, such as promoting the development of agriculture, rural areas, small industries, and housing, among others. They have made tangible contributions, though the overall impact is unclear. Undoubtedly, budgetary support is appropriate for such institutions. However, the budgetary support to the DFIs should be linked with efficiency in achieving government objectives and the alternative means of achieving such objectives.

16.49 We could not examine the fiscal implications of the functioning of financial sector public enterprises due to a variety of reasons, but have been made aware of the large demands on the resources of the budget, in particular from the banking sector. **We, therefore, recommend that a Financial Sector Public Enterprises Committee be appointed to examine and recommend parameters for appropriate future fiscal support to financial sector public enterprises, recognising the regulatory needs, the multiplicity of units in each activity and the performance and functioning of the DFIs.**

State Level Public Sector Enterprises

16.50 The State public sector enterprises have been historically set up by State Governments for achieving certain welfare goals or for promotional activities or as commercial enterprises. There are limits to the commercial viability of welfare-oriented State public sector enterprises in areas like public distribution, handicrafts and handloom etc. There are promotional activities such as those in the tourism sector or in small industries, which also may warrant fiscal support on occasion. There is a large presence of State public enterprises in public utilities, such as power and road transport, because of government policy and these entail a significant fiscal burden. On the other hand, a few enterprises such as those in land-based infrastructure and trading in beverages have been yielding apparently huge fiscal gains, though their profits mostly arise out of the government patronage to them rather than as a result of operational efficiency. There were 1,321 State public sector enterprises at the close of financial year 2012-13, with 298 of them in the non-working category. The largest enterprises are in the power and transport sectors and they dominate the portfolio. The poor financial performance of most of these enterprises over the years has impacted state finances and the recommendations of earlier Finance Commissions on prescriptive rates of return have also not led to any perceptible change on the ground.

16.51 The FC-XIII had recommended to the States to draw up, by March 2011, a roadmap for closure of non-working companies. It had suggested a detailed operational and administrative framework for closure/winding up of loss-making and non-working public sector enterprises. A holding company comprising of technical experts was also suggested for ease of liquidation as well as prompt settlement of all pending commercial and other disputes. Most of the States have not reported on the action taken on these recommendations.

16.52 Further, relevant, reliable and audited financial statements are a key aspect of good governance and accountability. However, despite statutory requirements of finalising and laying the audited accounts before the Annual General Meetings (AGMs) within six months of the close of financial year, huge arrears in audit are observed in the case of the State public sector enterprises.

FC-XIII had observed that more than 70 per cent of State public sector enterprises had their accounts in arrears. It had recommended proactive clearance in consultation with, and through the flexibility provided by C&AG to clear the backlog in accounts. During our review also the position has remained very similar. C&AG reports of State public sector enterprises show that as on 31 March 2013, out of 1,023 working public sector enterprises, the accounts of 696 (68 per cent) are in arrears. We reiterate the concerns expressed by the FC-XIII on the significance of finalisation of accounts in a timely manner, and to review the policy of continued investments in them without any assurance on their proper utilisation.

16.53 The desired levels of return on equity and interest on outstanding loans suggested by the previous Finance Commissions have not been achieved. The FC-XIII had noted that State public sector enterprises remain a drag on the finances of State Governments. We reiterate the views of the FC-XIII on the necessity for all working enterprises, except those in the welfare and utility sectors, to become financially viable. The FC-XIII recommendations, for the relinquishment of sick and non-working public sector enterprises were, in our view, comprehensive and adequate.

16.54 The approach we have suggested for Central public sector enterprises related to prioritisation, disinvestment and relinquishment are equally relevant to the State public sector enterprises. Our suggestions on assessment of each entity for categorisation as per their levels of 'priority' and 'non-priority' can be used for operationalising the recommendations of the FC-XIII, with appropriate changes as required in the particular State/entity's context. **We recommend that, in addition to acting upon the recommendations of the FC-XIII on state-level enterprises, the logic of our recommendations on public sector enterprises in general be adopted, to the extent appropriate, by State Governments.**

Recommendations

- i. We recommend that the new realities outlined in para 16.14 be recognised in order to shape and develop a comprehensive public sector enterprise policy with adequate focus on the fiscal costs and benefits. We further recommend that the new realities be considered in evaluating the future of each public enterprise in the entire portfolio of Central public sector enterprises.(para 16.15)
- ii. The evaluation of the fiscal implications of the current level of investments in, and operations of, the existing public sector enterprises, in terms of opportunity costs, is an essential ingredient of a credible fiscal consolidation. Hence, we recommend that the fiscal implications in terms of opportunity costs be factored in while evaluating the desirable level of government ownership for each public enterprise in the entire portfolio of Central public sector enterprise. (para 16.17)
- iii. We recommend that the basic interests of workers of Central public sector enterprises should be protected at a reasonable fiscal cost, while ensuring a smooth process of disinvestment or relinquishing of individual enterprises. We further recommend that employment objectives should be considered in evaluating the portfolio of public sector enterprises, not only in the narrow context of the enterprises' employees, but also in terms of creating new employment opportunities.(para 16.19)

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- iv. We recommend that the enterprises be categorised into 'high priority', 'priority', 'low priority' and 'non-priority' in order to: (i) facilitate co-ordinated follow up action by policy makers and (ii) provide clarity to public sector enterprises themselves on their future and to the financial markets about the opportunities ahead for them.(para 16.24)
- v. We recommend that the route of transparent auctions be adopted for the relinquishment of unlisted sick enterprises in the category of non-priority public sector enterprises. (para 16.27)
- vi. We recommend that the level of disinvestment should be derived from the level of investment that the government decides to hold, over the medium to long term, in each enterprise, based on principles of prioritisation advised by us, while the process of disinvestment should take into account the market conditions and budgetary requirements, on a year to year basis. (para 16.31)
- vii. We recommend that the government devise a policy relating to the new areas of public sector investments. We also recommend the purchase of shares where the existing portfolio holding in the 'high priority' and 'priority' public sector enterprises is less than the desired level of government ownership.(para 16.33)
- viii. We reiterate the recommendations made by the FC-XIII to maintain all disinvestment receipts in the Consolidated Fund for utilisation on capital expenditure. The National Investment Fund in the Public Account should, therefore, be wound up in consultation with the Controller General of Accounts (CGA) and Comptroller & Auditor General (C&AG). (para 16.34)
- ix. There is considerable merit in the Union Government dispensing a small share of proceeds of disinvestment to the States. In the case of Central public sector enterprises with multiple units located in different States, the distribution of this share could be uniform across all the States where units are located. In cases where only vertical unit-wise disinvestment is done, the share could go to the State/States where the units being disinvested are located. (para 16.36)
- x. We recognise the importance of making Central public sector enterprises effective and competitive, but suggest that the monitoring and evaluation of these enterprises take into account the institutional constraints within which their managements operate. (para 16.38)
- xi. If the Central public sector enterprises are burdened with implementing social objectives of the government, it should compensate them in a timely manner and adequately through a transparent budgetary subvention. Similarly, losses on account of administered price mechanisms should also be calculated and fully compensated for. (para 16.39)
- xii. We recommend that governance arrangements be reviewed, especially in regard to separation of regulatory functions from ownership, role of the nominee as well as independent directors, and, above all, the framework of governance conducive to efficiency. (para 16.40)

- xiii. We recommend that as part of the comprehensive review of the public sector enterprises proposed by us, policies and procedures relating to borrowing by the enterprises, payment of dividends and transfer of excess reserves be enunciated and enforced. (para 16.43)
- xiv. We recommend that, in view of the significant fiscal implications, a clear cut and effective policy on investments of Central public sector enterprises in their subsidiaries be adopted. (para 16.44)
- xv. We recommend that a Financial Sector Public Enterprises Committee be appointed to examine and recommend parameters for appropriate future fiscal support to financial sector public enterprises, recognising the regulatory needs, the multiplicity of units in each activity and the performance and functioning of the DFIs.(para 16.49)
- xvi. We recommend that, in addition to acting upon the recommendations of the FC-XIII on state-level enterprises, the logic of our recommendations on public sector enterprises in general be adopted, to the extent appropriate, by State Governments.(para 16.54)

Chapter 17

Public Expenditure Management

17.1 Our terms of reference (ToR) require us to "review the present Public Expenditure Management systems in place including the budgeting and accounting standards and practices; the existing system of classification of receipts and expenditure; linking outlays to outputs and outcomes; best practices within the country and internationally, and make appropriate recommendations thereon" (paragraph 8). The focus is on three inter-related aspects of public expenditure management (PEM), namely, budgeting and accounting standards, classification of receipts and expenditures and linking outlays to outcomes.

17.2 Previous Finance Commissions have considered some aspects of PEM and recommended measures for improving allocative and technical efficiency in public spending, at both the Union and State Government levels. The FC-XII emphasised the need to move towards an accrual based accounting system, to adopt improved budgetary procedures and introduce better evaluation and monitoring of public expenditure programmes. The FC-XIII recommended the adoption of uniformity in the budgetary classification code and a standardised list of appendices to the Finance Accounts. It also discouraged the incurring of public expenditure by creating funds outside the Consolidated Funds of the States and encouraged improvements in reporting systems.

17.3 We have been given a wider mandate than the previous Commissions in so far as reviewing the existing PEM systems at Union and State levels is concerned. Accordingly, we assessed the status of the existing systems as well as the attempts made to improve them. We noted that efforts have been made from time to time to introduce budgetary innovations including performance budget, zero-based budgeting and outcome budget. There is currently an ongoing process of consideration and implementation of accounting standards, so as to improve governmental accounting and financial reporting. The system of classification of receipts and expenditures, based on the broad functions and major programmes of the government, is also under review. An attempt is being made to link outlays, outputs and outcomes through the outcome budgets, supported by an ongoing computerisation of accounts, real-time management information systems (MIS) and performance monitoring and evaluation systems (PMES). The Union Government introduced a few budgetary and accounting reforms initially, which were subsequently adopted by State Governments, and a few States have initiated reforms on their own.

Views of State Governments

17.4 States recognised the need to improve PEM systems and mentioned the various expenditure reforms which they have undertaken. A majority of the States supported the key recommendations of the High Level Expert Committee (HLEC) on Efficient Management of Public Expenditure made in 2011. One view was that there was no need for another review by the Finance Commission and that the focus should be on implementing the recommendations of the HLEC. Some States questioned the need for the Finance Commission to examine PEM issues, given that the Comptroller and Auditor General (C&AG) of India is vested with this responsibility under the Constitution.

17.5 States favoured doing away with the Plan and non-Plan classification, as this would avoid distortions, improve the focus on asset maintenance, enable better expenditure management and eventually lead to better outcomes. They were also unanimous in the view that all Centrally sponsored schemes (CSS) should be routed through State treasuries.¹ In their view, this would bring CSS funds under the State budget, allow States to devise proper procedures, minimise parking of funds by implementing agencies in banks and make State Governments fully responsible for the proper utilisation of funds. States also mentioned that the existing Central Plan Scheme Monitoring System (CPSMS), implemented by the office of the Controller General of Accounts (CGA), enables the Union Government to track expenditure on different Plan schemes.

17.6 On the proposed accounting classification system, the report of the Committee constituted in 2010 to review the List of Major and Minor Heads of Accounts of Union and States (henceforth, the LMMHA Committee) had been shared with the States. This was followed by a consultation meeting with States and their suggestions are under consideration by the CGA. States also provided details on their use of information technology (IT) to increase efficiency in PEM and urged that such forward-looking efforts be incentivised.

17.7 States highlighted their efforts to rationalise revenue expenditure. They stated that capital expenditure was constrained by the ceilings on the fiscal deficit and borrowings imposed by the Fiscal Responsibility and Budget Management (FRBM) Act. They suggested that State targets under the FRBM Act should be more flexible. They were critical of some aspects of the CSS and the uncertainty about the quantum of funds flowing through these schemes. They observed that substantial funds were often released in the last month of the financial year, resulting in the bunching of sanctions and incurring of expenditure at the end of the financial year. As a result, it was difficult to economise on expenditures as well as ensure efficiency and effectiveness in implementation. In addition, they pointed out that there was the likelihood of future allocations being reduced if allocations were not spent. The general view was that States should be given a lump-sum grant, with the flexibility to choose from a bouquet of schemes.

Views of the Union Government

17.8 The Union Ministry of Finance emphasised the need for a comprehensive Public Expenditure and Financial Management (PEFM) system at both the Union and State levels. The Ministry pointed out that in the long run, fiscal consolidation has to be buoyed by greater resources and improved targeting of government expenditure. As a step towards improved efficiency of government expenditure, the Ministry referred to a recent relevant initiative, namely, the constitution of an Expenditure Management Commission (in September 2014) by the Union Government.

17.9 The Ministry stressed that States need to incentivise revenue generation, reduce committed liabilities and have the ability to measure the quality of expenditure against forward-looking predetermined and prescribed outcomes. It also pointed out that States need to introduce effective cash management by building the capacity to record, monitor and project inflows and outflows and to realistically forecast cash balances.

¹In the budget of the Union Government in 2014-15, all transfers to States under CSS, including funds meant for pass-through to implementing agencies, are routed through the Consolidated Fund of the State.

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17.10 The office of the CGA, we were informed, would finalise the roadmap for transition to an accrual-based accounting system, in consultation with the Ministry of Finance and Comptroller & Auditor General of India (C&AG). We were also informed that the Ministry and the CGA are examining the recommendations of the LMMHA Committee, made in 2012. The Ministry pointed out that the multi-dimensional accounting classification system proposed by the LMMHA Committee would require large-scale changes in the payment and accounting software, financial disclosures and reporting formats, and budgetary statements of the Union and State Governments. Further, the Ministry of Finance envisaged an Integrated Financial Management Information System (IFMIS), of which the Chart of Accounts would be an integral part. Accordingly, revision of the accounting classification is expected to become a part of the proposed IFMIS. In this context, the CGA advocated a uniform Chart of Accounts for Civil, Railways, Defence, and Posts and Telecommunications, and integration of the CPSMS, now renamed the Public Fund Management System (PFMS), with State treasury systems. It also emphasised the need to strengthen internal audit in the Union civil ministries and departments and enhance their capability to perform risk based functions.

Views of the Comptroller & Auditor General of India

17.11 The C&AG supported doing away with the distinction between Plan and non-Plan. It underlined the usefulness of an accrual based accounting system to capture information on committed liabilities, arrears of revenue, other receivables and payables, depreciation, provision for losses and impairment of assets. The major challenges in implementing the LMMHA Committee Report, according to the C&AG, were to ensure robust computing infrastructure, to evolve a strategy for linking legacy data and capacity building. The importance of a uniform accounting code for Civil, Railways, Defence, and Posts and Telecommunications was emphasised. The C&AG also raised concern over the funds placed outside the Consolidated Fund, by both the Union Government and State Governments. Attention was drawn to weaknesses in the existing budgeting practices, as reflected in the excess expenditure over grants and appropriations, unrealistic budgeting leading to large supplementary grants, large amounts of savings, and the rush of expenditure at the end of the financial year. The C&AG emphasised the need for a uniform Object Head classification for both the Union and State Governments and the creation of a separate Object Head for annuity payments under public-private partnerships (PPPs). The importance of setting up internal control systems in State Governments to protect public resources and ensure compliance with applicable statutes and regulations was also stressed. For this, it was suggested that a strong internal audit system, preferably backed by legislation, would be a source of confidence to the external auditors.

Our Approach

17.12 We recognise that the Union Government has appointed several commissions and committees to review the PEM system and make suggestions for improvement. Prominent among these are: the Expenditure Reforms Commission (2000), the Second Administrative Reforms Commission (2005), HLEC Committee (2010) and LMMHA Committee (2010). These have covered a wide range of subjects in their reports and while many of their recommendations are still relevant, they have yet to be decided on. For instance, the decision to transfer CSS funds through State treasuries has been implemented but a view has not been taken on other key recommendations of the HLEC report submitted in 2011. In September 2014, the Union Government constituted the Expenditure Management Commission to review the major areas of

its expenditure management and the institutional arrangements, including the budgeting process and FRBM rules. The Expenditure Management Commission is required to suggest measures to improve allocative and operational efficiencies, the cash management system and financial reporting systems, and to promote greater use of IT tools for expenditure management. It is against this background that we addressed the three interrelated aspects referred to us for consideration, namely, budgeting and accounting standards, classification of receipts and expenditures and linking outlays to outcomes. In addition, we considered related issues, namely, pay and productivity, pensions and the interdependence of Union-State finances in the context of expenditure management.

Budgeting and Accounting Systems

17.13 We note that budget documents, periodic information on public finances and annual accounts are placed in the Parliament and State Legislatures, as well as in the public domain. The FRBM Act and FRBM Rules, and similar initiatives by the States, have also enhanced fiscal transparency. However, it is important to assess whether the budget and accounts are credible, predictable, comprehensive and transparent. The challenge is to reconcile the objective of comprehensiveness with the need to reduce the voluminous information in these documents in order to make them informative and easily understood by the general public.

17.14 The FC-XII had pointed out several shortcomings in the cash-based accounting system followed by the Union and State Governments and underlined the need to make the transition to the accrual-based accounting system. However, it noted that the transition would require considerable preparatory work and capacity building. Therefore, it recommended that both the Union and State Governments should, in the medium term, append a list of additional statements to the prevailing system of cash accounting. The list included statements on explicit and implicit subsidies, salaries of various departments, information on pensioners, committed liabilities in future, debt and other liabilities, accretion to and erosion of financial assets, fiscal implications of major policy decisions and maintenance expenditures segregated into salary and non-salary segments. While the ultimate objective was to enable a transition to accrual-based accounting, these measures were intended to facilitate more informed decision-making in the interim. Considering the demands on the accounting personnel needed to make the transition to the accrual-based accounting system, the FC-XII recommended that the Union Government set up a National Institute of Public Financial Accountants. **We endorse the view that the transition to accrual-based accounting by both the Union and State Governments is desirable. We also recognise that this transition can only be made in stages, as it requires considerable preparatory work and capacity building of accounting personnel. We, therefore, reiterate the recommendation of the FC-XII that the building blocks for making a transition to the accrual-based accounting system in terms of various statements, including those listed by the Commission, should be appended in the finance accounts by the Union and State Governments. We also reiterate its recommendation that action should be taken to build capacity among accounting professionals in accrual-based accounting systems.**

17.15 Our analysis of the C&AG reports revealed shortcomings in the Union and State Finance Accounts. A common observation in these reports is the misclassification between revenue and capital expenditure. For example, expenditures under 'grants-in-aid' and 'minor works' are, at

times, classified as capital expenditure, which results in the overstating of the revenue surplus of the State. Another issue flagged in the reports is the booking of expenditure by the Union and State Governments under the Minor Head 800-Other Receipts /Other Expenditures. Based on the reports, we estimate that, in 2012-13 State Governments classified about 15 percent of total expenditure under 'Minor Head 800-Other expenditure' in their accounts. The reports also adversely commented on the practice of State Governments to transfer funds from the Consolidated Fund into personal deposit accounts. The reports referred to States' tendency to somehow spend at the end of the financial year to avoid lapse of funds under the cash-based accounting system, and suggested that this practice should be minimised. In the light of the above, **we reiterate the importance of prompt and effective follow-up on the observations of the C&AG while preparing accounts and adherence to the timeline prescribed for the laying of accounts before the Parliament and State Legislatures.**

Classification of Receipts and Expenditure

17.16 The Union Government constituted the LMMHA Committee in 2010 to conduct a comprehensive review of the existing system of expenditure and receipt classification and to suggest a new list of accounting heads. The Committee's objectives included ensuring simplification, rationalisation and standardisation across the Union and State Governments, and improving the reporting of transfer payments from one level of government to another. In its report submitted in 2012, which is under consideration by the Ministry of Finance and the office of the CGA, the LMMHA Committee proposed a multi-dimensional accounting classification system. **We recommend that a view may be taken expeditiously on all the recommendations of the LMMHA Committee.**

17.17 The accounting classification of receipts and expenditures has been made uniform across the Union and State Governments up to the Minor Head level. Thus, the objective of comparability has largely been served by ensuring uniformity up to this level. Beyond this level, State Governments have the power to open Object Heads, which gives them the flexibility to meet local information and control requirements. Both the FC-XII and FC-XIII had recommended a uniform classification code for all States up to the Object Head level to facilitate comparison across States while ensuring consistency. We recognise, in principle, the importance of comparability as enunciated by the FC-XII and FC-XIII. However, **at the Object Head level, we believe it is sufficient to have a few uniform Object Heads, such as salary, maintenance, subsidies and grants-in-aid, across both the Union and States. Regarding the other Object Heads, we recommend that States retain their existing flexibility to open new Object Heads, according to their functional requirements.**

Linking Outlays to Outcomes

17.18 Conventional budget exercises have focused on the allocation of resources to different heads, without taking into account how these expenditures are translated into outputs and outcomes. Outputs refer to the physical and quantitative aspects of goods and services that are expected to result from programmes proposed to be implemented, while outcomes refer to their impact in terms of achieving specific goals. Since the introduction of the Outcome Budget in 2005-06 by the Union Government, ministries and departments are required to link their outlays to outputs

and outcomes. Since outputs and outcomes vary across ministries and departments, their specifications have been left to individual ministries and departments. We understand that the experience in this regard has been mixed and that there is a variation across ministries and departments in the coverage and quality of outcome budgets. While outputs can generally be measured in quantifiable terms, measuring outcomes has proved to be a difficult exercise and physical outputs are reported as outcomes in many instances. In the light of available experience, **we reiterate the importance of linking outlays with outcomes. However, we emphasise that it is essential to spell out key indicators for outputs and to monitor these within an already defined accountability framework.**

17.19 Often, it may not be possible to relate expenditures to outcomes, either because information on outcomes is difficult to obtain, or because outcomes are determined by factors other than expenditures. In such cases, it may be necessary to relate expenditures to outputs rather than outcomes. In our view, standards are needed for the objective specification of deliverables (outputs) and unit costs, if necessary by reputed external institutions. The accountability framework needs to be enhanced to include programme managers, and to make organisations and individual managers responsible for the delivery of intended outputs. **As a step towards improving the system, we recommend the formulation of appropriate indicators for measurement of outputs, specification of standards and costs, and establishing a suitable accountability framework.**

17.20 In this regard, it may be useful to make a distinction between expenditures incurred directly by the Union Government and transfers to State Governments. Undoubtedly, it is meaningful to prepare an outcome budget for direct expenditures incurred by the Union Government. However, the exercise of linking outlays to outcomes would be done more meaningfully by States and implementing agencies in the case of transfers made to them. This data could be collated by the Union Government to present a complete picture. Similarly, State Governments could prepare outcome budgets in respect of the expenditures directly incurred by them. For transfers made below the State level, implementing agencies could be required to prepare outcome budgets. Data in this regard could then be collated by States to prepare outcome budgets on the expenditures incurred by them. **We, therefore, suggest serious consideration of the issue of assigning primary responsibility for preparing outcome budgets at the level of actual spending and its consolidation at the relevant level of government.**

Monitoring of Expenditure and Internal Control Systems

17.21 The Public Fund Management System (PFMS) was developed by the office of the CGA to enable the tracking of all Plan releases to the Consolidated Fund of States and state implementing agencies, and further till the ultimate beneficiary. The system, however, did not have an interface with the State Governments' treasuries. The decision to transfer all CSS funds through treasuries, from 2014-15 onwards, strengthens the need for an interface between the Union system and the State systems. The States have computerised their treasuries and some States are already moving towards an IFMIS. The Union Government has also indicated its intention to develop an IFMIS. We believe that a proper interface of the IFMIS of the Union and of the States would ensure sharing of data and integration with other stakeholders, such as the office of the Accountant General, the Reserve Bank of India and agency banks. This will ensure that the transfer of funds is seamless and captured at every stage. It would also provide a meaningful management

information system to the Union Government, State Governments and implementing agencies at every level. To this end, **we recommend synergising the efforts of the Union Government and State Governments towards building a technology platform in which their systems can interface and information can be shared, leading to end-to-end linkages, particularly in respect of sector-specific grants from the Union Government to States.**

17.22 The C&AG and CGA, in their presentations, highlighted the importance of internal control systems and internal audits. Many developed countries have made 'risk management' an integral part of their internal audit functioning. The Second Administrative Reforms Commission (2005), in its fourteenth report, recommended setting up an office of Chief Internal Auditor in select ministries and departments, which would report directly to the Secretary of the department, establishing standards for internal audit, and constituting an audit committee in each ministry and department. As these are standard tools for safeguarding government assets and checking the misuse and inefficient use of resources, **we recommend that the Union and State Governments consider the recommendations of the Second Administrative Reforms Commission (submitted in 2009) on internal audit and internal control systems and take a decision on each recommendation expeditiously.**

Pay and Productivity

17.23 Wages and salaries constitute a significant portion of the committed liabilities of both the Union and States. Periodic revisions based on the recommendations of the Pay Commissions of the Union, with States following suit, have contributed to rising revenue expenditure. For States in particular, the fiscal impact of a pay revision is severe, as the share of salary expenditure in their total revenue expenditure is substantially larger than in the case of the Union. Arrears in pay and bi-annual releases of Dearness Allowance compound the burden.

17.24 Technically, the recommendations of a Central Pay Commission are only for Central Government employees and States are not bound to follow suit. Indeed, up to the 1980s, States constituted their own Pay Commissions and prescribed their own pay scales, based upon their fiscal capacity. However, since the Fifth Central Pay Commission, salaries and allowances in States have tended to converge with those in the Union Government and since the Sixth Central Pay Commission, almost all States have adopted the Union pattern of pay scales, albeit with modifications.

17.25 An internal study by the Commission brought out the fact that the Union Government's expenditure on pay and allowances² (including expenditure for the Union Territories) more than doubled for the period 2007-08 to 2012-13, from Rs. 46,230 crore to Rs. 1,08,071 crore.³ This increase can be largely attributed to the implementation of the Sixth Central Pay Commission recommendations, evident from the per employee annual salary (excluding defence salary) increasing from Rs. 1,45,722 to Rs. 3,25,820 over this period. Moreover, the share of expenditure on pay and allowances in revenue expenditure (net of interest payment, pensions and grants-in-aid) increased from 11.8 per cent in 2007-08 to 13.1 per cent in 2012-13. The incidence of salary expenditure is much higher in the States than in the Union. In 2012-13, the share of expenditure on pays and allowances of all employees in the revenue expenditure (net of interest payments

²Excluding productivity linked bonus/ad-hoc bonus, honorarium and encashment of earned leave, and travel allowances.

³If salary of defence services is included, the corresponding figures will be Rs. 73,073 crore and Rs. 1, 84,711 crore.

and pensions) among the States ranged from 28.9 per cent to 79.1 per cent. Per employee (for regular employees) salary in 2012-13 across States ranged between Rs. 2,12,854 and Rs. 5,49,345. Thus, the impact of revisions in pay scales on fiscal positions is uniformly significant, though it varies widely across States.

17.26 Given the variations across States and the lack of knowledge about the probable design and quantum of award of the Seventh Central Pay Commission, we believe that it is neither feasible, nor practicable, to arrive at any reasonable forecast of the impact of the pay revision on the Union Government or the States. Further, any attempt to fix a number in this regard, within the ambit of our recommendations, carries the unavoidable risk of raising undue expectations.

17.27 Our concern is the likely impact on overall budgetary resources, particularly of the States, once the recommendations of the Seventh Central Pay Commission are announced and adopted by the Union Government. All States have asked us to provide a cushion for the pay revision likely during our award period. The Union Government's memorandum has built, in its forecast, the implications of a pay increase from 2016-17 onwards. The recommendations of the Seventh Central Pay Commission are likely to be made only by August 2015, and unlike the previous Finance Commissions, we would not have the benefit of having any material to base our assessments and projections and to specifically take the impact into account. We have, therefore, adopted the principle of overall sustainability based on past trends, which should realistically capture the overall fiscal needs of the States.

17.28 In our view, on matters that impact the finances of both the Union and States, policies ought to evolve through consultations between the States and the Union. This is especially relevant in the determination of pay and allowances, where a part of the government itself, in the form of the employees, is a stakeholder and influential in policy making. A national view, arrived at through this process, will open avenues for the Union and States to make collective efforts to raise the extra resources required by their commitment to a pay revision. More importantly, it would enable the Union and States to ensure that there is a viable and justifiable relationship between the demands on fiscal resources on account of salaries and contributions to output by employees commensurate with expenditure incurred. In this regard, **we reiterate the views of the FC-XI for a consultative mechanism between the Union and States, through a forum such as the Inter-State Council, to evolve a national policy for salaries and emoluments.**

17.29 Further, we would like to draw attention to the importance of increasing the productivity of government employees as a part of improving outputs, outcomes and overall quality of services relating to public expenditures. The Seventh Central Pay Commission, has, *inter alia*, been tasked with making recommendations on this aspect. Earlier Pay Commissions had also made several recommendations to enhance productivity and improve public administration. Productivity per employee can be raised through the application of technology in public service delivery and in public assets created. Raising the skills of employees through training and capacity building also has a positive impact on productivity. The use of appropriate technology and associated skill development require incentives for employees to raise their individual productivities. A Pay Commission's first task, therefore, would be to identify the right mix of technology and skills for different categories of employees. The next step would be to design suitable financial incentives linked to measurable performance. **We recommend the linking of pay with productivity, with**

a simultaneous focus on technology, skills and incentives. Further, we recommend that Pay Commissions be designated as 'Pay and Productivity Commissions', with a clear mandate to recommend measures to improve 'productivity of an employee', in conjunction with pay revisions. We urge that, in future, additional remuneration be linked to increase in productivity.

Pensions

17.30 Pensions have been growing steadily, and the liability for pension payments is likely to cast a very heavy burden on budgets in the coming years. Some of the factors contributing to this growth are: (i) the rise in pensions recommended by successive Pay Commissions; (ii) removal of the distinction between people retiring at different points of time, so that all pensioners are treated alike in their pension rights; (iii) taking over the liability for pensions of retired employees of aided institutions and local bodies; and (iv) increasing longevity. The New Pension Scheme (NPS), a contribution-based scheme introduced by the Union Government in 2004 for all new recruits after the cut-off date, has now been adopted by all States, with the exception of West Bengal and Tripura. This scheme has the merit of transferring future liabilities to the New Pension Fund and factoring the current liability on a State's contribution from its current revenues. **We urge States which have not adopted the New Pension Scheme so far to immediately consider doing so for their new recruits in order to reduce their future burden.**

Inter-dependence of Union and State Finances

17.31 States made several observations on the links between Union and State expenditure management systems. They noted that the Union Government's budgetary practices and expenditure management impact the finances of individual States. States said they receive Union grants as close-ended matching transfers and have to commit a certain percentage of their budget as matching contributions as a precondition for the release of CSS grants. This arrangement enhances the dependence of States on Union finances and affects State Governments' own priorities on public spending in three ways. First, it ties substantial portions of a State's budget to Union Government programmes and alters States' own priorities in allocating funds. Second, States are dependent on the release of the Union Government's share before they can utilise their own share. At times, the Union share is released only in the month of March, which has resulted in State Governments having to divert funds to personal deposit accounts to avoid a lapse of funds. Third, a reduction in CSS allocation to suit Union Government fiscal targets impacts States in terms of commitments and the planned achievement of targets. Further, when a CSS is discontinued or altered, it leaves additional liability on the states. States also pointed out that this hinders long-term planning by States to address state-specific needs.

17.32 In this regard, we note that the dependence of State Governments on the Union budget subjects them to considerable uncertainties, particularly when Union finances are under stress. In the absence of structural reforms to raise revenue productivity or compress unproductive expenditures, States often try to achieve fiscal deficit targets by compressing capital and maintenance expenditures and this has adverse consequences on economic growth. Further, the fiscal targets set in the Medium Term Fiscal Policy (MTFP) statements are translated into annual targets in the budget, and the budget estimates are set as targets rather than projections. The

failure to realise these ambitious revenue targets, and pressure to conform to fiscal deficit targets, results in an unplanned compression of expenditures. This violates the basic budget discipline, as spending departments and State Governments are unable to implement the approved budget and appropriations. Spending departments have to carry out these unplanned expenditure cuts, which result in postponements and often cancellation of contractual obligations, time and cost overrun of projects and other adverse consequences on the productivity of public expenditures.

17.33 Prudent cash management is an important component of efficient PEM. This issue is important at both the Union and State levels. Considering the magnitude, poor cash management, by the Union Government in particular, has a significant adverse impact on monetary management as well as on the macro economy. At the State level, the holding of idle cash balances from borrowed funds involves interest costs. While States have to hold cash to manage the risks associated with shortfalls in revenues or to meet unforeseen expenditures, there is considerable scope for improvement in cash management by both the Union and State Governments.

17.34 There is considerable scope for improving expenditure management at both the Union and State levels. **We recommend that both the Union and State Governments improve their forecasts, by adopting a more scientific approach for this process. Similarly, the fiscal responsibility legislations and estimates in the MTFPs should be backed by well-calibrated reasoning to justify the forecasts. When forecasts are out of line with past trends, it is important to make a detailed statement on the intended reforms necessary to enhance revenue productivity and to rationalise expenditures. We also recommend that the Union and State Governments undertake measures to improve their cash management practices.**

Recommendations

- i. We endorse the view that the transition to accrual-based accounting by both the Union and State Governments is desirable. We also recognise that this transition can only be made in stages, as it requires considerable preparatory work and capacity building of accounting personnel. We reiterate the recommendation of the FC-XII that the building blocks for making a transition to the accrual-based accounting system in terms of various statements, including those listed by the Commission, should be appended in the finance accounts by the Union and State Governments. We also reiterate its recommendation that action should be taken to build capacity among accounting professionals in accrual-based accounting systems. (para 17.14)
- ii. We reiterate the importance of prompt and effective follow-up on the observations of the C&AG while preparing accounts, and adherence to the time line prescribed for the laying of accounts before the Parliament and State Legislatures. (para 17.15)
- iii. We recommend that a view be taken expeditiously on all the recommendations of the LMMHA Committee made in 2012. (para 17.16)
- iv. At the Object Head level, we believe it is sufficient to have a few uniform Object Heads, such as salary, maintenance, subsidies and grants-in aid, across both the Union and States. Regarding the other Object Heads, we recommend that States retain their existing flexibility to open new Object Heads, according to their functional requirements. (para 17.17)

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- v. We reiterate the importance of linking outlays with outcomes. However, we emphasise that it is essential to spell out key indicators for outputs and to monitor these within an already defined accountability framework. (para 17.18)
- vi. We recommend the formulation of appropriate indicators for the measurement of outputs, specification of standards and costs, and establishing a suitable accountability framework. (para 17.19)
- vii. We, suggest serious consideration of the issue of assigning primary responsibility for preparing outcome budgets at the level of actual spending and its consolidation at the relevant level of government. (para 17.20)
- viii. We recommend synergising the efforts of the Union Government and State Governments towards building a technological platform in which their systems can interface and information can be shared, leading to end-to-end linkages, particularly in respect of sector-specific grants from the Union Government to the States. (para 17.21)
- ix. We recommend that the Union and State Governments consider the recommendations of the Second Administrative Reforms Commission (submitted in 2009) on internal audit and internal control systems, and take a decision on each recommendation expeditiously. (para 17.22)
- x. We reiterate the views of the FC-XI for a consultative mechanism between the Union and States, through a forum such as the Inter-State Council, to evolve a national policy for salaries and emoluments. (para 17.28)
- xi. We recommend the linking of pay with productivity, with a simultaneous focus on technology, skill and incentives. We recommend that Pay Commissions be designated as 'Pay and Productivity Commissions', with a clear mandate to recommend measures to improve 'productivity of an employee', in conjunction with pay revisions. We urge that, in future, additional remuneration be linked to increase in productivity. (para 17.29)
- xii. We urge States which have not adopted the New Pension Scheme so far to immediately consider doing so for their new recruits in order to reduce their future burden. (para 17.30)
- xiii. We recommend that both the Union and State Governments improve their forecasts, by adopting a more scientific approach for this process. Similarly, the fiscal responsibility legislations and estimates in the MTFPs should be backed by well-calibrated reasoning to justify the forecasts. When forecasts are out of line with past trends, it is important to make a detailed statement on the intended reforms necessary to enhance revenue productivity and rationalise expenditures. We also recommend that the Union and State Governments undertake measures to improve their cash management practices. (para 17.34)

Chapter 18

Summary of Recommendations

Sharing of Union Taxes

1. Considering all factors, in our view, increasing the share of tax devolution to 42 per cent of the divisible pool would serve the twin objectives of increasing the flow of unconditional transfers to the States and yet leave appropriate fiscal space for the Union to carry out specific-purpose transfers to the States.

(para 8.13)

2. We have not consented to the submission of States on minimum guaranteed devolution.

(para 8.14)

3. Though we are of the view that use of dated population data is unfair, we are bound by our ToR and have assigned a 17.5 per cent weight to the 1971 population. On the basis of the exercises conducted, we concluded that a weight to the 2011 population would capture the demographic changes since 1971, both in terms of migration and age structure. We, therefore, assigned a 10 per cent weight to the 2011 population.

(para 8.25)

4. For area we have followed the method adopted by the FC-XII and put the floor limit at 2 per cent for smaller States and assigned 15 per cent weight.

(para 8.26)

5. We believe that large forest cover provides huge ecological benefits, but there is also an opportunity cost in terms of area not available for other economic activities and this also serves as an important indicator of fiscal disability. We have assigned 7.5 per cent weight to the forest cover.

(para 8.27)

6. We have decided to revert to the method of representing fiscal capacity in terms of income distance and assigned it 50 per cent weight. We have calculated the income distance following the method adopted by FC-XII.

(para 8.28 and 8.29)

7. Table 8.1 shows the criteria and weights assigned for inter-se determination of the shares of taxes to the States. State-specific share of taxes is presented in Table 8.2.

(para 8.30)

8. As service tax is not levied in the State of Jammu & Kashmir, proceeds cannot be assigned to this State. We have worked out the share of each of the remaining twenty-eight States in the net proceeds of service taxes and presented this in Table 8.3.

(para 8.31)

Local Governments

9. We recommend that the local bodies should be required to spend the grants only on the basic services within the functions assigned to them under relevant legislations.

(para 9.56)

10. We recommend that the books of accounts prepared by the local bodies should distinctly capture income on account of own taxes and non-taxes, assigned taxes, devolution and grants from the State, grants from the Finance Commission and grants for any agency functions assigned by the Union and State Governments. In addition to the above, we also recommend that the technical guidance and support arrangements by the C&AG should be continued and the States should take action to facilitate local bodies to compile accounts and have them audited in time.

(para 9.61)

11. We recommend distribution of grants to the States using 2011 population data with weight of 90 per cent and area with weight of 10 per cent. The grant to each state will be divided into two, a grant to duly constituted gram panchayats and a grant to duly constituted municipalities, on the basis of urban and rural population of that state using the data of census 2011.

(para 9.64)

12. We have worked out the total size of the grant to be Rs.2,87,436 crore for the period 2015-20, constituting an assistance of Rs. 488 per capita per annum at an aggregate level. Of this, the grant recommended to panchayats is Rs.2,00,292.20 crore and that to municipalities is Rs.87,143.80 crore. The grant assessed by us for each state for each year is fixed.

(para 9.69)

13. We have recommended grants in two parts - a basic grant and a performance grant for duly constituted gram panchayats and municipalities. In the case of gram panchayats, 90 per cent of the grant will be the basic grant and 10 per cent will be the performance grant. In the case of municipalities, the division between basic and performance grant will be on a 80:20 basis. The shares of the States for these grants are set out in Annex 9.1.

(para 9.70)

14. The grants that we recommend should go to gram panchayats, which are directly responsible for the delivery of basic services, without any share for other levels. We expect that the State Governments will take care of the needs of the other levels. The earmarked basic grants for gram panchayats will be distributed among them, using the formula prescribed by the respective SFCs for the distribution of resources. Similarly, the basic grant for urban local bodies will be

divided into tier-wise shares and distributed across each tier, namely the municipal corporations, municipalities (the tier II urban local bodies) and the nagar panchayats (the tier III local bodies) using the formula given by the respective SFCs. The State Government should apply the distribution formula of the most recent SFC, whose recommendations have been accepted.

(para 9.72)

15. In case the SFC formula is not available, then the share of each gram panchayat as specified above should be distributed across the entities using 2011 population with a weight of 90 per cent and area with a weight of 10 percent. In the case of urban local bodies, the share of each of the three tiers will be determined on the basis of population of 2011 with a weight of 90 per cent and area with a weight of 10 per cent and then distributed among the entities in each tier in proportion to the population of 2011 and area in the ratio of 90:10.

(para 9.73)

16. We are providing performance grants to address the following issues: (i) making available reliable data on local bodies' receipt and expenditure through audited accounts; and (ii) improvement in own revenues. In addition, the urban local bodies will have to measure and publish service level benchmarks for basic services. These performance grants will be disbursed from the second year of our award period, that is, 2016-17 onwards so as to enable sufficient time to State Governments and the local bodies to put in place a scheme and mechanism for implementation.

(para 9.75)

17. To be eligible for performance grants, the gram panchayats will have to submit audited annual accounts that relate to a year not earlier than two years preceding the year in which the gram panchayat seeks to claim the performance grant. It will also have to show an increase in the own revenues of the local body over the preceding year, as reflected in the audited accounts. To illustrate, the audited accounts required for performance grants in 2016-17 will be for the year 2014-15; for performance grants in 2017-18, the audited accounts will be for the year 2015-16; for performance grants in 2018-19, the audited accounts will be for 2016-17; and for performance grants in 2019-20, the audited accounts will be for 2017-18.

(para 9.76)

18. We are of the opinion that it may be better that the detailed procedure for disbursement of the performance grant to gram panchayats based on revenue improvement be designed by the State Government concerned, keeping in view the two conditions given above. The operational criteria, including the quantum of incentive to be given, is left to the discretion of the State Governments. In case some amount of the performance grant remains after disbursement to the eligible gram panchayats, this undisbursed amount should be distributed on an equitable basis among all the eligible gram panchayats. The scheme for disbursement of the performance grant will be notified by the State Governments latest by March 2016, in order to enable the preparation of the eligibility list of local bodies entitled to them. The concerned Ministries of the Union Government will also be informed in order to facilitate release of the instalment of performance grants.

(para 9.77)

19. A detailed procedure for the disbursement of the performance grant to urban local bodies would have to be designed by the State Government concerned, subject to certain eligibility criteria. To be eligible, the urban local body will have to submit audited annual accounts that relate to a year not earlier than two years preceding the year in which it seeks to claim the performance grant. It will also have to show an increase in the own revenues over the preceding year, as reflected in these audited accounts. In addition, it must publish the service level benchmarks relating to basic urban services each year for the period of the award and make it publically available. The service level benchmarks of the Ministry of Urban Development may be used for this purpose. The improvement in revenues will be determined on the basis of these audited accounts and on no other basis. For computing the increase in own revenues in a particular year, the proceeds from octroi and entry tax must be excluded. In case some amount of the performance grant remains after disbursement to the eligible urban local bodies, the undisbursed amount should be distributed on an equitable basis among all the eligible urban local bodies that had fulfilled the conditions for getting the performance grant.

(para 9.78)

20. These guidelines for the disbursement of the rural and urban performance grants will remain in force for the period of our award. We recommend that the Union Government accept the detailed procedure prepared by the State which incorporates our broad guidelines without imposing any further conditions.

(para 9.79)

21. We recommend that no further conditions or directions other than those indicated by us should be imposed either by the Union or the State Government for the release of funds.

(para 9.80)

22. The grants recommended by us shall be released in two instalments each year in June and October. This will enable timely flows to local bodies during the year, enabling them to plan and execute the works better. We recommend that 50 per cent of the basic grant for the year be released to the State as the first instalment of the year. The remaining basic grant and the full performance grant for the year may be released as the second instalment for the year. The States should release the grants to the gram panchayats and municipalities within fifteen days of it being credited to their account by the Union Government. In case of delay, the State Government must release the instalment with interest paid from its own funds.

(para 9.81)

23. We recommend that stern action should be ensured if irregularities in the application of funds are noticed or pointed out.

(para 9.82)

24. We recommend that the State Governments should strengthen SFCs. This would involve timely constitution, proper administrative support and adequate resources for smooth functioning and timely placement of the SFC report before State legislature, with action taken notes.

(para 9.84)

25. We suggest that the existing rules be reviewed and amplified to facilitate the levy of property tax and the granting of exemptions be minimised. The assessment of properties may be done every four or five years and the urban local bodies should introduce the system of self-assessment. We recommend that action be taken by the States to share information regarding property tax among the municipalities, State and Union Governments.

(para 9.90)

26. We suggest that the levy of vacant land tax by peri-urban panchayats be considered. In addition, a part of land conversion charges can be shared by State Governments with municipalities and panchayats.

(para 9.91)

27. We recommend that the States should review the position and prepare a clear framework of rules for the levy of betterment tax.

(para 9.92)

28. We suggest that States may like to consider steps to empower local bodies to impose advertisement tax and improve own revenues from this source.

(para 9.93)

29. We recommend that States review the structure of entertainment tax and take action to increase its scope to cover more and newer forms of entertainment.

(para 9.94)

30. We recommend raising the ceiling of professions tax from Rs. 2500 per annum to Rs. 12,000 per annum. We further recommend that Article 276(2) of the Constitution may be amended to increase the limits on the imposition of professions tax by States. The amendment may also vest the power to impose limits on the Parliament with the caveat that the limits should adhere to the Finance Commission's recommendations and the Union Government should prescribe a uniform limit for all states.

(para 9.97)

31. We recommend that State Governments take action to assign productive local assets to the panchayats, put in place enabling rules for collection and institute systems so that they can obtain the best returns while leasing or renting common resources.

(para 9.98)

32. We recommend that the urban local bodies rationalise their service charges in a way that they are able to at least recover the operation and maintenance costs from the beneficiaries.

(para 9.99)

33. We are of the view that mining puts a burden on the local environment and infrastructure, and, therefore, it is appropriate that some of the income from royalties be shared with the local

body in whose jurisdiction the mining is done. This would help the local body ameliorate the effects of mining on the local population.

(para 9.101)

34. We recommend that the Union and State Governments examine in depth the issue of properly compensating local bodies for the civic services provided by them to government properties and take necessary action, including enacting suitable legislation, in this regard.

(para 9.102)

35. We recommend that local bodies and States explore the issuance of municipal bonds as a source of finance with suitable support from the Union Government. The States may allow the larger municipal corporations to directly approach the markets while an intermediary could be set up to assist medium and small municipalities who may not have the capacity to access the markets directly.

(9.107)

36. We urge the Union Government to consider a larger, sustained and more effective direct intervention for the up-gradation of administration as well as development of the areas covered under the proviso to Article 275(1) and excluded from the consideration of Finance Commissions in the ToR, in order to bring such areas on par with other areas.

(para 9.110)

Disaster Management

37. The financing of the NDRF has so far been almost wholly through the levy of cess on selected items, but if the cesses are discontinued or when they are subsumed under the GST in future, we recommend that the Union Government consider ensuring an assured source of funding for the NDRF.

(para 10.26)

38. While making appropriations into the NDRF, we recommend that past trends of outflows from it should be taken into account by the Union Government to ensure adequacy of the Fund in order to assure timely availability and release of funds to the States.

(para 10.27)

39. Recognizing that contributions from the public and institutions could be another source of financing the NDRF, we recommend that a decision on granting tax exemption to private contributions to the NDRF be expedited and that the Union Government consider invoking the use of Schedule VII of the Companies (Corporate Social Responsibility Policy) Rules 2014 as an enabling provision for financing the NDRF.

(paras 10.28 and 10.29)

40. We recommend a review of the current arrangements for the reimbursement of expenditure incurred by the defence forces on disaster relief, since we are convinced that these could have an adverse impact on their operational efficiency.

(para 10.30)

41. Considering the usefulness of a scientifically validated risk vulnerability indicator to measure the type, frequency and intensity of disasters, and also in view of the very wide responsibility cast on governments at different levels by the statute, we recommend that the Union Government should expedite the development and scientific validation of the Hazard Vulnerability Risk Profiles of States.

(para 10.34)

42. We adopted the practice of the previous Commissions and used past expenditure on disaster relief for the period 2006-07 to 2012-13 to determine the SDRF corpus for each State. Further, we followed the methodology of the FC-XIII to arrive at an aggregate corpus for all States of Rs. 61,219 crore for the award period.

(para 10.36)

43. We recommend that all States contribute 10 per cent to SDRF during our award period, with the remaining 90 per cent coming from the Union Government.

(para 10.40)

44. We are in agreement with the views of the FC-XIII that the decision of constituting DDRFs is best left to the wisdom of the State Governments, and hence, separate grant for the financing of DDRFs are not recommended.

(para 10.42)

45. We note with satisfaction that the norms for expenditure have undergone periodic revisions and that the States are being consulted in the process of reviewing the norms. We urge the Union Government to take account of the genuine concerns of the States in the consultative mechanism already in place.

(para 10.46)

46. Considering the need for flexibility in regard to state-specific disasters, we recommend that up to 10 per cent of the funds available under the SDRF can be used by State Governments for natural disasters that they consider to be 'disasters' within the local context in the State and which are not included in the notified list of disasters of the Ministry of Home Affairs.

(para 10.52)

47. While calculating the requirement for funds from the NDRF during severe calamities, the existing practice of adjusting the contribution made by the Union Government to the SDRF should continue.

(para 10.55)

Grants-in-Aid

48. A total revenue deficit grant of Rs. 1, 94,821 crore is recommended during the award period for eleven States (Table 11.3).

(para 11.37)

49. There is a case for transfers from the Union Government to the States to augment expenditure in specific sectors with high degree of externalities in order to ensure desired minimum level of expenditures in every State. However, past experience shows that achieving this through the mechanism of Finance Commission grants may not be appropriate. Further, we are informed that Finance Commission grants on this account often operate in parallel with other transfers. We, therefore, conclude that all such transfers, in whichever sectors are considered necessary, should be addressed through a different institutional arrangement described in Chapter 12.

(para 11.42)

50. We endorse the proposal made by the Department of Justice to strengthen the judicial systems in the States and urge State Governments to use the additional fiscal space provided by us in the tax devolution to meet such requirements.

(para 11.44)

51. Our projection of the expenditure needs of the States has taken into account the high base of expenditure for both general administration and police. Therefore, in our view, the States have the appropriate fiscal space to provide for the additional expenditure needs as per their requirements. This should help them address the problems and facilitate them to build capacity and bridge the existing gaps in regard to general administration and police.

(para 11.45)

52. We have provided appropriate fiscal space for maintenance expenditures and this should enable the States to meet the additional expenditure needs according to their requirements. We also urge the States to enhance expenditure on maintenance of capital assets to the appropriate levels.

(para 11.48)

53. 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, States and domain expertise. Therefore, we have desisted from recommending specific purpose grants and have suggested that a separate institutional arrangement be introduced for the purpose.

(para 11.59)

Towards Cooperative Federalism

54. We conclude that a compelling case has been made for reforming the existing system of fiscal transfers from the Union to the States, in a comprehensive manner. We recommend that the existing system be reviewed and necessary institutional changes be considered.

(para 12.23)

55. We believe the existing arrangements for transfers between the Union and the States need to be reviewed with a view to minimizing discretion, improving the design of transfers, avoiding duplication and promoting cooperative federalism, insofar as such transfers are required to be made outside of the recommendations of the Finance Commission.

(para 12.27)

56. We recommend for consideration that a new institutional arrangement consistent with the overarching objective of strengthening cooperative federalism be evolved for: (i) identifying the sectors in the States that should be eligible for grants from the Union, (ii) indicating criteria for inter-state distribution, (iii) helping design schemes with appropriate flexibility being given to the States regarding implementation and (iv) identifying and providing area-specific grants.

(para 12.28)

57. We urge that the suggested new institutional arrangement also consider taking up issues related to identifying and recommending resources for inter-state infrastructure schemes in the North-eastern States.

(para 12.32)

58. We urge that the new institutional arrangement should also become the forum for integrating economic and environmental concerns in decision making.

(para 12.35)

59. We suggest that the present role of the Inter-State Council be expanded to include the functions envisaged in paragraphs 12.28, 12.32 and 12.35.

(para 12.46)

60. We expect that the Union Government will utilise its available fiscal space to continue to address the needs and expectations of the States and ensure the prevailing level of transfers to States of about 49 per cent of the gross revenue receipts during the award period.

(para 12.49)

Goods and Services Tax

61. There are several challenges and many unresolved issues. In the absence of clarity on the design of GST and the final rate structure, we are unable to estimate revenue implications and quantify the amount of compensation in case of revenue loss to the States due to the introduction of GST.

(para 13.26)

62. The Union may have to initially bear an additional fiscal burden arising due to the GST compensation. This fiscal burden should be treated as an investment which is certain to yield substantial gains to the nation in the medium and long run. We also believe that GST compensation can be accommodated in the overall fiscal space available with the Union Government.

(para 13.27)

63. In the case of VAT, compensation was provided to the States for three years, at 100 per cent in the first year, 75 per cent in the second year, and 50 per cent in the third year. In our view, it will be appropriate to keep this precedent as the basis for compensation for GST also. However, given the scale of reform and the apprehensions of revenue uncertainty raised by the States, the revenue compensation, in our view, should be for five years. It is suggested that 100 per cent compensation be paid to the States in the first, second and third years, 75 per cent compensation in the fourth year and 50 per cent compensation in the fifth and final year.

(para 13.28)

64. We recommend creation of an autonomous and independent GST Compensation Fund through legislative actions in a manner that it gives reasonable comfort to States, while limiting the period of operation appropriately.

(para 13.29)

65. We recommend that the Constitutional legislative and design aspects of the GST enable transition towards universal application of GST over the medium to long term, while making necessary provisions for smooth transition through temporary arrangements.

(para 13.30)

Fiscal Environment and Fiscal Consolidation Roadmap

66. Keeping in mind the importance of risks arising from guarantees, off-budget borrowings and accumulated losses of financially weak public sector enterprises when assessing the debt position of States, we recommend that both Union and State Governments adopt a template for collating, analysing and annually reporting the total extended public debt in their respective budgets as a supplement to the budget document.

(para 14.24)

67. To curb the scope for perverse allocation of available funds among competing projects and to ensure that the economy benefits from investments in capital works, we recommend that the Union and the State Governments provide a statutory ceiling on the sanction of new capital works to an appropriate multiple of the annual budget provision.

(para 14.52)

68. In the light of our approach to fiscal consolidation and the fiscal roadmap as developed through our assessment of Union and State finances, we recommend a set of rules for the Union and the States.

(para 14.62)

69. 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 (rationalization 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.

(para 14.63)

70. 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 year.
- iii. 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.

If a State is not able to fully utilise its sanctioned borrowing limit of 3 per cent of GSDP in any particular year during the first four years of our award period (2015-16 to 2018-19), it will have the option of availing this un-utilised borrowing amount (calculated in rupees) only in the following year but within our award period.

(para 14.64)

71. We recommend that for the purpose of assigning State-specific borrowing limits as a percentage of GSDP for a given fiscal year (t), GSDP should be estimated on the basis of the annual average growth rate of the actual GSDP observed during the previous three years or the average growth rate of GSDP observed during the previous three years for which actual GSDP data are available. This growth should be applied on the GSDP of the year $t-2$. Specifically, GSDP for the year ($t-1$) and the given fiscal year (t) should be estimated by applying the annual average growth rate of GSDP in $t-2$, $t-3$ and $t-4$ years on the base GSDP (at current prices) of $t-2$. We recommend that State estimates of GSDP published by the CSO should be used for this purpose.

(para 14.66)

72. In the case of the interest payments-revenue receipts ratio required for determining additional borrowing limits, we recommend that figures for both should be based solely on the Finance Accounts data for the year $t-2$. The same procedure should be followed in estimating the debt-GSDP ratio. The Ministry of Finance should adhere to the above rules and methodology while determining the annual borrowing ceiling for individual States.

(para 14.67)

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73. We are of the opinion that it would be appropriate to exclude the States from the operations of the NSSF scheme in future, even as they should honour the obligations already entered into insofar as servicing and repayment of outstanding debt is concerned. We recommend that State Governments be excluded from the operations of the NSSF, with effect from 1 April, 2015. As for the fiscal burden incurred in the course of the operations of the NSSF, prior to 1 April, 2015, since the scheme has been administered almost in its entirety by the Union Government, no part of this fiscal burden, incurred till that date, should be passed on to the States. We recommend that the involvement of the States in the NSSF scheme with effect from 1 April 2015, therefore, may be limited solely to discharging the debt obligations already incurred by them until that date.

(para 14.81)

74. Keeping in view the experience of the States in this regard, we recommend the Union Government should examine the desirability of setting up of Consolidated Sinking Fund at this stage.

(para 14.85)

75. Recognising that the fiscal environment should be conducive to equitable growth, we recommend 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.

(para 14.86)

76. We urge that all stakeholders recognise the predominant role of the Union in fiscal management, while considering our roadmap for the Union and the States that treats a conducive fiscal environment as the joint responsibility of both.

(para 14.87)

77. To enable wider dissemination of the manner in which this shared responsibility for a conducive fiscal environment is being discharged by the Union and State Governments, we recommend that the Union Government and the RBI bring out a bi-annual report on the public debt of the Union and State Governments on a regular and comparable basis and place it in public domain.

(para 14.88)

78. In the light of the experience gained so far and considering the challenge in designing a basic incentive-compatible framework for achieving fiscal correction and adherence to rule-bound fiscal framework for the Union and State Governments to hold each other accountable over agreed fiscal targets, we stress the need for stronger mechanisms for ensuring compliance with fiscal targets and enhancing the quality of fiscal adjustment, particularly for the Union Government.

(para 14.91)

79. We recommend 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. We also

recommend that the objective of balancing revenues and expenditure on the revenue account enunciated in the FRBM Acts should be pursued.

(para 14.95)

80. We recommend an amendment to the FRBM Act inserting a new section mandating the establishment of an independent fiscal council to undertake ex-ante assessment of the fiscal policy implications of budget proposals and their consistency with fiscal policy and Rules. In addition, we urge that the Union Government take expeditious action to bring into effect Section 7A of the FRBM Act for the purposes of ex-post assessment.

(para 14.101)

81. Our approach outlined and recommendations made warrant amendments to the FRBM Acts. To this end, we recommend that the State Governments may amend their FRBM Acts to provide for the statutory flexible limits on fiscal deficit. The Union Government may amend its FRBM Act to reflect the fiscal roadmap, omit the definition of effective revenue deficit and mandate the establishment of an independent 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.

(para 14.102)

82. We urge the Union Government to continue to exercise its powers under Article 293 (3), in an effective but transparent and fair manner, enforcing the fiscal rules consistent with the fiscal consolidation roadmap suggested by us for the award period.

(para 14.104)

83. In order to accord greater sanctity and legitimacy to fiscal management legislation, we urge 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).

(para 14.106)

Pricing of Public Utilities

84. We recommend that 100 per cent metering be achieved in a time-bound manner for all electricity consumers as already prescribed statutorily.

(para 15.30)

85. The Electricity Act, 2003, currently does not have any provision of penalties for delays in the payment of subsidies by State Governments. We, therefore, recommend that the Act be suitably amended to facilitate levy of such penalties.

(para 15.32)

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86. In order to provide financial autonomy to the SERCs, Section 103 of the Electricity Act, 2003, provides for the establishment of a State Electricity Regulatory Commission Fund by State Governments, to enable the SERCs to perform their responsibilities, as envisaged under the Act. We reiterate the importance of financial independence of the SERCs and urge all States to constitute a SERC Fund, as statutorily provided for.

(para 15.34)

87. We endorse the initiative to set up a Rail Tariff Authority (RTA) and urge expeditious replacement of the advisory body with a statutory body, through necessary amendments to the Railways Act, 1989.

(para 15.38)

88. We recommend that accounting systems in the State Road Transport Undertakings make explicit the types of subsidies, the basis for determining the extent of subsidies, and also the extent of reimbursement by State Governments.

(para 15.40)

89. We recommend the setting up of independent regulators for the passenger road sector, whose key functions should include tariff setting, regulation of service quality, assessment of concessionaire claims, collection and dissemination of sector information, service-level benchmarks and monitoring compliance of concession agreements.

(para 15.41)

90. We recommend that all States, irrespective of whether Water Regulatory Authorities (WRAs) are in place or not, consider full volumetric measurement of the use of irrigation water. Any investment that may be required to meet this goal should be borne by the States, as the future cumulative benefits, both in environmental and economic terms, will far exceed the initial costs.

(para 15.45)

91. We reiterate the recommendations of the FC-XIII and urge States which have not set up WRAs to consider setting up a statutory WRA, so that the pricing of water for domestic, irrigation and other uses can be determined independently and in a judicious manner. However, this may not be practical for the North-eastern states, due to the small size of their irrigation sectors, with Assam being the exception. Further, we recommend that WRAs already established be made fully functional at the earliest.

(para 15.48)

92. We recommend that States (and urban and rural bodies) should progressively move towards 100 per cent metering of individual drinking water connections to households, commercial establishments as well as institutions. All existing individual connections in urban and rural areas should be metered by March 2017 and the cost of this should be borne by the consumers. All new connections should be given only when the functioning meters are installed. While

providing protected water supply through community taps is unavoidable for poorer sections of population, metering of water consumed in such cases also would ensure efficient supply.

(para 15.50)

Public Sector Enterprises

93. We recommend that the new realities outlined in para 16.14 be recognized in order to shape and develop a comprehensive public sector enterprise policy with adequate focus on the fiscal costs and benefits. We further recommend that the new realities be considered in evaluating the future of each public enterprise in the entire portfolio of Central public sector enterprises.

(para 16.15)

94. The evaluation of the fiscal implications of the current level of investments in, and operations of, the existing public enterprises, in terms of opportunity costs, is an essential ingredient of credible fiscal consolidation. Hence, we recommend that the fiscal implications in terms of opportunity costs be factored in while evaluating the desirable level of government ownership for each public enterprise in the entire portfolio of Central public sector enterprises.

(para 16.17)

95. We recommend that the basic interests of workers of Central public sector enterprises should be protected at a reasonable fiscal cost, while ensuring a smooth process of disinvestment or relinquishing of individual enterprises. We further recommend that employment objectives should be considered in evaluating the portfolio of public enterprises, not only in the narrow context of the enterprises' employees, but also in terms of creating new employment opportunities.

(para 16.19)

96. We recommend that the enterprises be categorized into 'high priority', 'priority', 'low priority' and 'non-priority' in order to: (i) facilitate co-ordinated follow-up action by policy makers and (ii) provide clarity to public enterprises themselves on their future and to the financial markets about the opportunities ahead for them.

(para 16.24)

97. We recommend that the route of transparent auctions be adopted for the relinquishment of unlisted sick enterprises in the category of non-priority public sector enterprises.

(para 16.27)

98. We recommend that the level of disinvestment should be derived from the level of investment that the government decides to hold over the medium to long term in each enterprise, based on principles of prioritization advised by us, while the process of disinvestment should take into account the market conditions and budgetary requirements, on a year to year basis.

(para 16.31)

99. We recommend that the government devise a policy relating to the new areas of public sector investments. We also recommend the purchase of shares where the existing portfolio holding

in the 'high priority' and 'priority' public sector enterprises is less than the desired level of government ownership.

(para 16.33)

100. We reiterate the recommendations made by the FC-XIII to maintain all disinvestment receipts in the Consolidated Fund for utilisation on capital expenditure. The National Investment Fund in the Public Account should, therefore, be wound up in consultation with the Controller General of Accounts (CGA) and Comptroller & Auditor General (C&AG).

(para 16.34)

101. There is considerable merit in the Union Government dispensing a small share of proceeds of disinvestment to the States. In the case of Central public sector enterprises with multiple units located in different states, the distribution of this share could be uniform across all the States where units are located. In cases where only vertical unit-wise disinvestment is done, the share could go to the State/States where the units being disinvested are located.

(para 16.36)

102. We recognize the importance of making Central public sector enterprises effective and competitive, but suggest that the monitoring and evaluation of these enterprises take into account the institutional constraints within which their managements operate.

(para 16.38)

103. If the Central public sector enterprises are burdened with implementing social objectives of the government, it should compensate them in a timely manner and adequately through a transparent budgetary subvention. Similarly, losses on account of administered price mechanisms should also be calculated and fully compensated for.

(para 16.39)

104. We recommend that governance arrangements be reviewed, especially in regard to separation of regulatory functions from ownership, role of the nominee as well as independent Directors, and, above all, the framework of governance conducive to efficiency.

(para 16.40)

105. We recommend that as part of the comprehensive review of the public sector enterprises proposed by us, policies and procedures relating to borrowing by the enterprises, payment of dividends and transfer of excess reserves be enunciated and enforced.

(para 16.43)

106. We recommend that, in view of the significant fiscal implications, a clear-cut and effective policy on investments of Central public sector enterprises in their subsidiaries be adopted.

(para 16.44)

107. We recommend that a Financial Sector Public Enterprises Committee be appointed to examine and recommend parameters for appropriate future fiscal support to financial sector public enterprises, recognizing the regulatory needs, the multiplicity of units in each activity and the performance and functioning of the DFIs.

(para 16.49)

108. We recommend that, in addition to acting upon the recommendations of the FC-XIII on state-level enterprises, the logic of our recommendations on public sector enterprises in general be adopted, to the extent appropriate, by State Governments.

(para 16.54)

Public Expenditure Management

109. We endorse the view that the transition to accrual-based accounting by both the Union and State Governments is desirable. We also recognise that this transition can only be made in stages, as it requires considerable preparatory work and capacity-building of accounting personnel. We reiterate the recommendation of the FC-XII that the building blocks for making a transition to the accrual-based accounting system in terms of various statements, including those listed by the Commission, should be appended in the finance accounts by the Union and State governments. We also reiterate its recommendation that action should be taken to build capacity among accounting professionals in accrual-based accounting systems.

(para 17.14)

110. We reiterate the importance of prompt and effective follow-up on the observations of the C&AG while preparing accounts, and adherence to the timeline prescribed for the laying of accounts before the Parliament and State Legislatures.

(para 17.15)

111. We recommend that a view be taken expeditiously on all the recommendations of the LMMHA Committee made in 2012.

(para 17.16)

112. At the Object Head level, we believe it is sufficient to have a few uniform Object Heads, such as salary, maintenance, subsidies and grants-in aid, across both the Union and States. Regarding the other Object Heads, we recommend that States retain their existing flexibility to open new Object Heads according to their functional requirements.

(para 17.17)

113. We reiterate the importance of linking outlays with outcomes. However, we emphasise that it is essential to spell out key indicators for outputs and to monitor these within an already defined accountability framework.

(para 17.18).

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114. We recommend the formulation of appropriate indicators for the measurement of outputs, specification of standards and costs and establishing a suitable accountability framework.

(para 17.19)

115. We suggest serious consideration of the issue of assigning primary responsibility for preparing outcome budgets at the level of actual spending and its consolidation at the relevant level of government.

(para 17.20)

116. We recommend synergising the efforts of the Union Government and State Governments towards building a technological platform, in which their systems can interface and information can be shared, leading to end-to-end linkages, particularly in respect of sector-specific grants from the Union Government to the States.

(para 17.21)

117. We recommend that the Union and State Governments consider the recommendations of the Second Administrative Reforms Commission (submitted in 2009) on internal audit and internal control systems, and take a decision on each recommendation expeditiously.

(para 17.22)

118. We reiterate the views of the FC-XI for a consultative mechanism between the Union and States, through a forum such as the Inter-State Council, to evolve a national policy for salaries and emoluments.

(para 17.28)

119. We recommend the linking of pay with productivity, with a simultaneous focus on technology, skill and incentives. We recommend that Pay Commissions be designated as 'Pay and Productivity Commissions', with a clear mandate to recommend measures to improve 'productivity of an employee', in conjunction with pay revisions. We urge that, in future, additional remuneration be linked to increase in productivity.

(para 17.29)

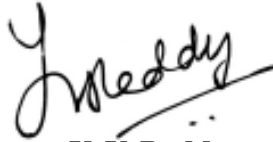
120. We urge States which have not adopted the New Pension Scheme so far to immediately consider doing so for their new recruits in order to reduce their future burden.

(para 17.30)

121. We recommend that both the Union and State Governments improve their forecasts, by adopting a more scientific approach for this process. Similarly, the fiscal responsibility legislations and estimates in the MTFPs should be backed by well-calibrated reasoning to justify the forecasts. When forecasts are out of line with past trends, it is important to make a detailed statement on the intended reforms necessary to enhance revenue productivity and rationalise expenditures. We

also recommend that the Union and State Governments undertake measures to improve their cash management practices.

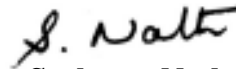
(para 17.34)



Y. V. Reddy
Chairman



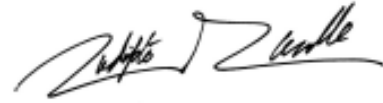
Abhijit Sen**
Member(Part-time)



Sushama Nath
Member



M. Govinda Rao
Member



Sudipto Mundle
Member

New Delhi
5 December, 2014

I wish to record my deep appreciation of the camaraderie, commitment and contribution of all the Members of the Commission. This report is a product of intense deliberations and determined effort to address the issues referred to the Commission and in the process profound knowledge and mutual trust were in ample evidence. Members, drawn from different backgrounds, have assigned differing weights to the relevant considerations and varying priorities to the possible solutions. But the report represents their best collective judgement on critical issues.

I also want to put on record my appreciation of the immense contribution made by Shri Ajay Narayan Jha in facilitating and guiding the Commission in every aspect of its work apart from actively participating in its deliberations. He has been an inspiring leader of a committed team of professionals and other staff which enabled the Commission to complete the work to its satisfaction. Dr. Pinaki Chakraborty, Shri V.S. Senthil and Shri Mukhmeet Singh Bhatia have been valuable members of the professional team and they actively participated in all the meetings of the Commission.



Y.V. Reddy
Chairman

New Delhi
5 December, 2014

** Subject to the appended Note of Dissent.

A Note of Dissent by Prof. Abhijit Sen, Member (Part-time)

The 14th FC has made at least five major shifts from the past. First, to award a very sizeable increase in quantum of tax devolution. Second, to take into account plan revenue expenditures while assessing revenue deficit grants. Third, to discontinue the distinction between special category and other States. Fourth, to desist from awarding sector/state specific grants or to subject grants to conditionality. And, fifth, to suggest institutional mechanisms for better monitoring of fiscal rules and to achieve "co-operative federalism". I am in full agreement with the direction of all these shifts which address many concerns and could meet States' demand for larger untied transfers as against discretionary grants tied to centrally designed schemes. But, with the Centre's net tax resources shrinking by nearly 1% of GDP as result of the higher devolution, implementing these shifts will require fairly drastic alteration to present arrangements. I am also constrained to note that, although the Commission had very detailed and lively discussions on most subjects, there was reluctance on part of the Chairman and other Members to analyse the transition from the present situation to that likely after our award. I am, therefore, unable to agree fully with the recommendations in the main report.

My concerns are the following:

- (a) The recommendations regarding devolution and revenue deficit grants are bound to disrupt existing plan transfers, with likely very serious effects in the first year of the award period. The increased devolution is about a third of all current plan transfers from Centre to states and the cut will have to be allocated across the various plan schemes and block grants at very short notice. Quite apart from affected Central Ministries, there will be knock-on effects on line departments at the State level. Since states generally assume that FC awards will leave plan flows from the Centre relatively unaffected, large cuts in any of these flows will test states' capacities to re-allocate.
- (b) The manner in which present plan expenditures have been incorporated in the assessment carried out in the main report could be rather confusing. This may suggest that the Commission's award has fully absorbed transfers that were classified as Central Assistance to State Plans (i.e. items in Statement 16 of Volume 1 of the Union's Expenditure Budget) till the list was expanded to include Centrally Sponsored Schemes in Budget 2014-15. Such a conclusion would be erroneous since the Commission's assessment was limited to States' plan revenue expenditures only, and did not involve assessment of their plan capital expenditure. Consequently, it would be misreading the Commission's intent if cuts in plan transfers were concentrated on the block grants and schemes that were classified as Central Assistance to State Plans (CASP) till 2013-14 rather than on what were till then classified as Centrally Sponsored Schemes (CSS).
- (c) The Normal Central Assistance (NCA), based on the Gadgil-Mukherjee formula, comprised 29% of all CASP in 2013-14 RE. Since this is untied and formula-based, with the formula (including its original grant-loan break-up) endorsed by the National Development Council(NDC), I had suggested that that we recommend specifically that NCA be continued as at present until NDC (or its successor, if any) decides

otherwise. The view of the Chairman and other members was that this was unnecessary since our remit is on the revenue side whereas NCA also finances capital expenditure. I would like my view on this to be recorded because discontinuance of NCA may cause some small deserving States to receive less (even unadjusted for inflation) by way of untied transfers in 2015-16 after our award than the actual that they are likely to receive in 2014-15.

- (d) Some states, and especially some backward districts, could be similarly hit if the Backward Region Grant Fund (BRGF) is wound up as part of pruning plan transfers consequent to our award. This comprises about 10% of CASP, and again this is relatively untied and its district component is formula-driven. The view of the Commission in its main report is that, although many States have represented that backward areas in their jurisdiction be given special consideration, the remit of the Finance Commission is limited to assessing needs at the State level and responsibility for area-specific needs below this level is that of the States. While I generally agree with this view, we have not assessed the implications of a possible winding-up of BRGF. I have two concerns here. First, that Seventh Schedule areas (to which we were unable to award Local Body grants given our terms of reference) may be particularly affected, especially if grants under proviso to Article 275(1), that are also classified as CASP, are not adequately expanded. Second, about Bihar which gets about 30% of all BRGF grants, in part as an obligation under Statement of Objects and Reasons for the Bihar Reorganisation Act 2000, but receives a lower devolution share by our formula than by that of 13th FC and also no revenue deficit grant in our award.
- (e) Another CASP, the Rashtriya Krishi Vikas Yojana (RKVY) was adopted as a result of a resolution by the NDC in its 53rd meeting in May 2007. This meeting of the NDC was exclusively on Agriculture and discussed, along with other inputs, the Report of an NDC sub-committee on Agriculture that was the result of eight working groups, each headed by a Chief Minister. The RKVY is again completely formula-driven and in my opinion has contributed significantly to the improved growth performance of Indian agriculture (from about 2.5% during 1997-98 to 2006-07 to nearly 4% subsequently). Although this matter was not discussed by the Commission, I, as an ex-Member (Agriculture), Planning Commission, feel strongly that the country will be ill-served if RKVY is pruned excessively as part of reallocations following the award of the 14th Finance Commission.

I am fully aware that the specific concerns above are mine alone and not shared by the Chairman and other members who, quite correctly, think that the Finance Commission should not intrude too much into what the Union government (or for that matter each State government) does with the fiscal space available to it. I am also aware that grants under NCA, BRGF and RKVY taken together constitute about 16% of all plan transfers to States (or about 4% of the divisible pool of Central taxes) in 2014-15 BE and, if fully preserved, would require much higher cuts in other existing plan transfers. Further, I fully agree with the main report that health, education, drinking water and sanitation are public services with significant inter-state externalities and that grants in these sectors may need to be expanded under the institutional mechanism suggested for co-operative federalism. Given the above, the need for fiscal consolidation and also the requirement to provide for legal entitlements as in the Right to Education and the Mahatma Gandhi National

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Rural Employment Guarantee Acts, I strongly feel that the space available to continue existing plan grants needs to be widened, at least in the first year of the award period.

Consequently, I recommend that the share of tax devolution be set at 38 per cent of the divisible pool in the first year of the award period and maintained at that level unless there is agreement in the new institutional mechanism to revert to the 42 per cent share of tax devolution as in recommendation No. 1 of the main report. I accept with all the other recommendations in the main report, including criteria and weights for inter-se determination of the share of taxes to the States (recommendations 7 & 8) and that the prevailing level of transfers to States be maintained at about 49 per cent of the gross revenue receipts of the Union government during the award period (recommendation 61). However, to be consistent with the assessment of State finances, the revenue deficit grants in recommendation 49 would need to be increased if devolution share is 38 per cent. The state-wise, year-wise details of this are as follows:

(Rs. Crore)

States	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Andhra Pradesh	8989	7677	7604	7316	6752	38338
Arunachal Pradesh	0	0	0	0	0	0
Assam	4025	3305	2236	877	0	10443
Bihar	0	0	0	0	8723	8723
Chattisgarh	0	0	0	0	0	0
Goa	0	0	0	0	0	0
Gujarat	0	0	0	0	0	0
Haryana	0	0	0	0	0	0
Himachal Pradesh	8408	8693	8844	8822	8580	43347
Jammu & Kashmir	10725	11786	12946	14213	15594	65264
Jharkhand	0	0	0	0	0	0
Karnataka	0	0	0	0	0	0
Kerala	6019	4941	3368	1158	0	15486
Madhya Pradesh	0	0	0	0	0	0
Maharashtra	0	0	0	0	0	0
Manipur	2411	2494	2551	2575	2549	12580
Meghalaya	979	952	886	771	592	4181
Mizoram	2397	2592	2790	2987	3178	13944
Nagaland	3482	3773	4072	4376	4676	20379
Odisha	0	0	0	0	0	0
Punjab	0	0	0	0	0	0
Rajasthan	0	0	0	0	0	0
Sikkim	0	0	0	0	0	0
Tamil Nadu	0	0	0	0	0	0
Telangana	0	0	0	0	0	0
Tripura	1446	1501	1536	1543	1514	7540
Uttar Pradesh	0	0	0	0	0	0
Uttarakhand	319	0	0	0	0	319
West Bengal	12484	7966	1933	0	0	22383
Total	61685	55681	48766	44638	52158	262928

I deeply thank the Chairman, members and staff of the 14th Finance Commission for the forbearance that they have showed towards me.

A handwritten signature in black ink, appearing to read 'Abhijit Sen', written in a cursive style.

Abhijit Sen

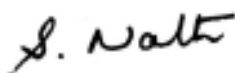
New Delhi
4 December, 2014

Reply to the Note of Dissent

Our esteemed colleague, Prof. Abhijit Sen, has expressed agreement with the Commission in regard to general direction of our recommendations, but has mentioned that, "*there was reluctance on the part of the Chairman and other Members to analyse the transition from the present situation to that likely after our award.*" We admit that there has been reluctance in taking a view about the transition because we believe that it is necessary for the authorities to determine the transition path and make arrangements as are appropriate. As regards the alternate recommendations made by him in this context, we have reconsidered and examined the matter. After a careful analysis, and without going into the details of the rationale of our stand at this stage, we conclude that the concerns raised by Prof. Abhijit Sen have been adequately addressed in the Report itself. In particular, we do not accept his recommendation relating to reduction in the share of tax devolution to 38 percent and arrangement proposed for the remaining award period, particularly since it injects avoidable uncertainties to the stakeholders.



Y. V. Reddy
Chairman



Sushama Nath
Member



M. Govinda Rao
Member



Sudipto Mundle
Member

New Delhi
5 December, 2014