सत्यमेव जयते

FINANCE COMMISSION IN COVID TIMES

Report For 2021-26

UNION

STATES

XV FINANCE COMMISSION

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CONTENTS

Pages

Chapter 1: Introduction **1**

The Unusual Context 1
Constitutional Mandate and Consultative Approach 3
The Debt and Fiscal Paradigm 8
Towards Cooperative Federalism: Balancing Needs and Performance 11
Reforms of Fiscal Architecture 18
Conclusions 19

Chapter 2: Intergovernmental Fiscal Relations: Lessons from International Experience **21**

Trends in Fiscal Federalism 22
Resource Availability 25
Vertical Fiscal Gap 27
Horizontal Fiscal Gap and the Equalisation Transfer System 28
Conditional or Incentive-based Fiscal Transfers 32
The Third Tier 36
Conclusions 40

Chapter 3: Setting the Context: Analysis of the Past **43**

Under the Shadow of the Pandemic 46
Review of Goods and Services Tax 50
Review of Union Finances 55
Review of State Finances 76
Trends in Inter-Governmental Transfers 89
Summary of Union Finances 94
Summary of State Finances 96

Chapter 4: Pandemic Times: Analysis for the Future 2021-26 **99**

Introduction and Context 99
Finances of the Union Government 100
Assessment of State Finances 114
Summary and Recommendations 122

Pages

Chapter 5: Resource Mobilisation **125**

Revenues of the Union 128
Non-GST Taxes at the State Level 129
The Third Tier – Property Tax and Professions Tax 142
Summary of Recommendations 145

Chapter 6: Towards Cooperative Federalism: Balancing Equity and Efficiency **149**

Vertical Fiscal Imbalance 150
Vertical Sharing 150
Horizontal Sharing 156
Summary of Recommendations 165

Chapter 7: Empowering Local Governments **169**

The Evolution of Local Self Government 170
Approach of Previous Finance Commissions 171
Status and Effectiveness of State Finance Commissions 177
Views of Stakeholders 178
Studies Commissioned by FC-XV 183
Immediate Challenges 184
Nine Guiding Principles 187
Grants to Local Governments 188
Grants to Rural Local Bodies 189
Grants to Urban Local Bodies 199
Grants for Health to be Channelised through Local Governments 212
Competition-based Grants for Incubation of New Cities 216
Shared Municipal Services – Grants for National Data Centre 217
Tax on Professions 218
Summary of Recommendations 219

Chapter 8: Disaster Risk Management **223**

Background 224
The Evolving Context of Finance Commission's Recommendations 225
States' Priorities 227

Pages

	Views from Union Agencies and Ministries	228
	Evolution of Disaster Risk Financing	230
	Key Features of Disaster Risk Financing	230
	Aggregate Expenditure on Disasters	231
	Conceptual Framework for Disaster Risk Financing	232
	Guiding Principles for the FC-XV	233
	National and State Disaster Mitigation Funds	234
	Size and Allocation of Disaster Risk Management Funds for States	235
	Allocation of Funds for National Disaster Risk Management Fund	238
	Diversifying Funding Windows	240
	Feasibility of District Disaster Response and Mitigation Funds	248
	Empowering Panchayati Raj Institutions for Disaster Preparedness and Management	249
	Reimbursement to Ministry of Defence for Expenditure on Disaster Rescue and Response	250
	Strengthening Institutional Capacities and Improving Guidelines	251
	Alternative Sources of Funding	253
	List of Calamities	257
	Accounting Norms and Standards	258
	Summary of Recommendations	259
Chapter 9:	**Pandemic and Beyond: Building Resilience in Health Sector**	**263**
	Health Outcomes: Performance Over Time	264
	Health Infrastructure: An Assessment of Vulnerabilities	266
	Low Public Health Spending	268
	Other Challenges in India's Healthcare System	272
	Views of Previous Finance Commissions	273
	Views of Union Government	273
	Views of State Governments	274
	Views of FC-XV in Report for the Year 2020-21	274
	Stakeholder Consultations	275
	India Fights the Pandemic	275
	Recommendations/Way Forward	278
	Summary of Recommendations	286

Pages

Chapter 10:	**Performance-based Incentives and Grants**	**289**
	Revenue Deficit Grants	292
	Performance-based Incentives and Grants	297
	Our Approach	299
	Social Sector	299
	Agriculture Sector and Rural Infrastructure	303
	Governance and Administrative Reforms	309
	Power Sector Reforms	316
	State-specific Grants	323
	Monitoring of Grants	326
	Summary of Recommendations	329
Chapter 11:	**Defence and Internal Security**	**333**
	Constitutional Provisions	334
	Analysis of Defence Expenditure	334
	Analysis of Expenditure on Internal Security	338
	Views of the Union Government	339
	Views of the States	343
	Deliberations of the Group Constituted on Defence and Internal Security	344
	Approach	347
	Specific Recommendations	350
	General Recommendations	352
	Summary of Recommendations	353
Chapter 12:	**Fiscal Consolidation Roadmap**	**357**
	Background	357
	Review of the Current Position	362
	Path of Fiscal Consolidation for the Union Government	368
	Path of Fiscal Consolidation for the State Governments	371
	Incentive-based Extra Borrowing Space for the States	373
	General Government Deficit and Debt	374
	Off-budget and Contingent Liabilities and Fiscal Rules	376
	Summary of Recommendations	377

Pages

Chapter 13:	**Fiscal Architecture for Twenty-First Century India: Fiscal Rules, Financial Management and Institutions**	**379**
	Fiscal Rules	381
	India's Fiscal Rule: Challenges in Implementation	382
	Public Financial Management Reforms	386
	Fiscal Institutions	386
	Moving Ahead	394
	Summary of Recommendations	396
Chapter 14:	**Summary of Recommendations**	**399**

LIST OF TABLES

			Pages
Chapter 1:	**Introduction**		
	Table 1.1	Range of Union Government's Fiscal Deficit (% of GDP)	9
	Table 1.2	Range of all-State Fiscal Deficit under the Recommended Space for Borrowing (% of GSDP)	10
	Table 1.3	Horizontal Devolution Criteria and Weights	13
Chapter 3:	**Setting the Context: Analysis of the Past**		
	Table 3.1:	Taxes Subsumed in GST and Their Rates (in June 2017)	50
	Table 3.2:	Profile of Fiscal Indicators of the Union Government	52
	Table 3.3:	Fiscal Performance of the Union	58
	Table 3.4:	Outstanding Liabilities of the Union Government	59
	Table 3.5:	Performance of Major Taxes of the Union	62
	Table 3.6:	Persons Filing Returns and Taxpayers	64
	Table 3.7:	Trends of Revenue Foregone	66
	Table 3.8:	Cesses and Surcharges	67
	Table 3.9:	Trends in Non-Tax Revenues	69
	Table 3.10:	Non-Debt Capital Receipts	71
	Table 3.11	Trends of Union Government Expenditure	72
	Table 3.12:	Subsidies Relative to Union Government's Net Revenue Receipts	73
	Table 3.13:	Trends in Aggregate Fiscal Indicators of States – Deficits and Debt	78
	Table 3.14:	Trends in Aggregate Revenue Receipts of the States	81
	Table 3.15:	Trends in Aggregate State Expenditure	82
	Table 3.16:	States Spending Less than Average Per Capita Revenue Expenditure on Health /Education (2018-19)	83
	Table 3.17:	Per Capita Expenditure	88
	Table 3.18:	Transfers from the Union to States as Proportion of Gross Revenue Receipts	90
	Table: 3.19:	Trends and Structure of Union Transfers, Including Direct Transfers	91
	Table 3.20:	Relative Share of Union and States in Combined Revenue Receipts	93

Pages

Table 3.21: Relative Share of Union and States in Combined Revenue Expenditure 94

Chapter 4: Pandemic Times: Analysis for the Future 2021-26

Table 4.1: Key Fiscal Variables of the Union Government as per cent of GDP 113

Chapter 5: Resource Mobilisation

Table 5.1: General Government Revenue (tax plus non-tax) and Expenditure (as % of GDP) 126
Table 5.2: Business Income of the Non-Corporate Sector 134
Table 5.3: Comparison of Tax Regimes Across Countries 135
Table: 5.4: Increase in Direct Tax Demand Under Dispute 139

Chapter 6: Towards Cooperative Federalism: Balancing Equity and Efficiency

Table 6.1: States' Share in Divisible Pool 151
Table 6.2: Central Transfers to States as Percentage of Gross Revenue Receipts 154
Table 6.3: Criteria and Weights (%) in Previous Finance Commissions 157
Table 6.4: Criteria and Weights Assigned for Horizontal Devolution 163
Table 6.5: Inter se Shares of States 164

Chapter 7: Empowering Local Governments

Table 7.1: Grants Recommended Versus Actual Releases 172
Table 7.2: Criteria for Distribution of Grants to States for Local Governments by Finance Commissions 173
Table 7.3: Areas where Provisions of Parts IX and IX-A of the Constitution Do Not Apply 176
Table 7.4: Status of Constitution of SFCs 177
Table 7.5: Grants to Local Governments 189
Table 7.6: Range for Distribution of Funds to the Three Tiers 191

Pages

Table 7.7: States Using Chartered Accountants for Auditing of Accounts 193

Table 7.8: Eligibility Criteria for Rural Local Bodies to Avail Grants 195

Table 7.9: Detailed Year-Wise Grants for Rural Local Bodies 197

Table 7.10: Urbanisation Trends 197

Table 7.11: Urban Agglomerates Distribution (Census 2011) 198

Table 7.12: Eligibility Criteria for Urban Local Bodies To Avail Grants 202

Table 7.13: MCF for Million-Plus Agglomerations /Cities 203

Table 7.14: Relative Weightage for City Performance Assessment 206

Table 7.15: Grants for Non-Million-Plus Cities/Category-II Cities/Towns 209

Table 7.16: Features of Cantonment Boards and Municipalities 211

Table 7.17: Sector-wise Break Up of Health Grants 214

Chapter 8: Disaster Risk Management

Table 8.1: Aggregate Expenditure of 28 States on Disasters 231

Table 8.2: Annual Allocation for States for Disaster Management 237

Table 8.3: Distribution of Total States Allocation 237

Table 8.4: Proposed Annual National Allocation for Disaster Management 239

Table 8.5: Distribution of Total National Allocation 239

Table 8.6: Windows of NDRF 240

Table 8.7: Allocation to Drought-prone States for Drought Mitigation 244

Table 8.8: Allocation for Managing Seismic and Landslide Risks in Hill States 245

Table 8.9: Allocation to Cities for Reducing the Risk of Urban Flooding 246

Table 8.10: Summary of Earmarked Allocations 248

Chapter 9: Pandemic and Beyond: Building Resilience in Health Sector

Table 9.1: Comparison of India with Other Countries in Key Health Outcomes 265

Table 9.2: Public Health Expenditure 268

Pages

Table 9.3:	Memorandum Received from Ministry of Health and Family Welfare (only State share)	273
Table 9.4:	Health Grants Through Local Governments	283
Table 9.5:	Sectoral Grants for Health	286

Chapter 10: Performance-based Incentives and Grants

Table 10.1:	Share of Grants-In-Aid and Tax Devolution in Total Transfers Recommended by Finance Commissions	291
Table 10.2:	Pre-Devolution Revenue Deficit/Surplus	295
Table 10.3:	Post-Devolution Revenue Deficit/Surplus	296
Table 10.4:	Grants-in-aid for Revenue Deficit	297
Table 10.5:	Component-wise Disaggregation of Grants for Higher Education	302
Table 10.6:	Parameters, Targets and Weights for Performance-Based Grants for Agricultural Reforms	304
Table 10.7:	Categories of States for Variable Grants for Statistics	311
Table 10.8:	List of Milestones for Variable Component of Statistics Grants	312
Table 10.9:	Requirement of Funds for Aspirational Districts and Blocks	315
Table 10.10:	Matrix for Evaluation of Performance of States	321
Table 10.11:	State-wise and Year-Wise Distribution of State-specific Grants	325
Table 10.12:	Year–wise Total Grants and Incentives	327
Table 10.13:	Total Transfers Recommended by FC-XV	328

Chapter 11: Defence and Internal Security

Table 11.1:	Analysis of Total Defence Expenditure (Revenue and Capital)	335
Table 11.2:	Capital Outlay of Defence Services	336
Table 11.3:	Defence Pension Expenditure	337
Table 11.4:	Total Police and CAPFs Expenditure	339
Table 11.5:	Estimated Shortfall in Allocations for Defence Services	340

Pages

Table: 11.6: Projections for Police (Union Government) (Grant 48-Police) 342

Table.11.7: Projection and Allocation of Funds for Capital Investments in Defence Services 345

Table 11.8 Annual Incremental Accrual of Resources 346

Table 11.9: Indicative Transfer Limits from Gross Revenue Receipts (in percentage) 348

Table 11.10: Transfers as Percentage of Gross Revenue Receipts 349

Table 11.11: Indicative Amount for Investment in Defence and Internal Security Capital Fund 349

Table 11.12: Annual Targets for the Proposed MFDIS 351

Table 11.13: Amount Earmarked for Internal Security from the Proposed MFDIS During the Award Period of FC-XV 352

Chapter 12: Fiscal Consolidation Roadmap

Table 12.1: Revenue Deficit (+)/Surplus (-) of the States 365

Table 12.2: Indicative Deficit and Debt Path for the Union Government (% of GDP) 370

Table 12.3: Range of Union Government's Fiscal Deficit (% of GDP) 371

Table 12.4: Indicative Deficit and Debt Path for State Governments (% of GSDP) 373

Table 12.5: Range of all-State Fiscal Deficit under the Recommended Space for Borrowing (% of GSDP) 374

Table 12.6: Indicative Deficit and Debt Path for the General Government (% of GDP) 375

Note: Sum of components may not match with corresponding totals in some tables/annexes of all volumes of this report, because of rounding off.

LIST OF FIGURES

			Pages
Chapter-1	**Introduction**		
	Figure 1.1	Fiscal Deficit as % of GDP	10
	Figure 1.2	Debt Trajectory during 2020-26 (% of GDP)	11
Chapter 2:	**Intergovernmental Fiscal Relations: Lessons from International Experience**		
	Figure 2.1:	Soaring Global Public Debt	24
	Figure 2.2:	G20: General Government Total Revenue	26
	Figure 2.3:	Vertical Fiscal Imbalances	28
	Figure 2.4:	Comparison of Equalisation Systems	29
	Figure 2.5:	Inter-governmental Transfers	32
	Figure 2.6:	Institutional Structure for Inter-governmental Transfers in India	35
	Figure 2.7:	Central Transfers to States in India	35
	Figure 2.8:	OECD Expenditure Composition	37
	Figure 2.9:	OECD Public Investment	37
Chapter 3	**Setting the Context: Analysis of the Past**		
	Figure 3.1:	Decelerating Quarterly GDP Growth (Annual, constant prices, in per cent)	47
	Figure 3.2	Net in-migration, 2011 Census	48
	Figure 3.3	Per capita NSDP,2011 (2004-05 constant prices)	48
	Figure 3.4:	GST Rate Structure	51
	Figure 3.5:	Union Taxes (percentage of GDP)	52
	Figure 3.6:	GST Compensation as Percentage of Protected Revenue	53
	Figure 3.7 :	Revenue Deficit, Fiscal Deficit and Primary Deficit of the Union Government as Percentage of GDP	58
	Figure 3.8:	Union Tax GDP Ratio: Direct Tax, Indirect Tax and Gross Tax Revenue	65
	Figure 3.9:	Relative Percentage Share of Revenue and Capital Expenditure	76
	Figure 3.10:	Trends in Aggregate Fiscal Indicators of States	77
	Figure 3.11:	Impact of UDAY(as percentage of GDP)	79

Pages

Figure 3.12:	Increase (+) in Revenue Deficit in General States: (2018-19 over 2011-12)	86
Figure 3.13:	Increase (+) in Revenue Deficit in NEH States: (2018-19 over 2011-12)	86
Figure 3.14:	Debt/GSDP and its Difference (+Increase/-Decrease) in General States (2018-19 over 2011-12) (in percentage points)	86
Figure 3.15:	Debt/GSDP and its Difference (+Increase/-Decrease) in NEH States (2018-19 over 2011-12) (in percentage points)	86
Figure 3.16	Own Tax Revenue/GSDP Ratio in 2018-19 and Difference in the Ratio in 2018-19 over 2011-12 (in percentage points) (+ Increase/- Decrease)	87

Chapter 4: Pandemic Times: Analysis for the Future 2021-26

Figure 4.1:	Nominal GDP: Levels and Growth (Actuals till 2019-20 and projections thereafter)	102
Figure 4.2:	Buoyancy of the Union Government's Taxes during 2021-22 to 2025-26	106

Chapter 5: Resource Mobilisation

Figure 5.1:	General Government Revenue (tax plus non-tax) as % of GDP	125
Figure 5.2:	Budget Marksmanship of the Union Government in Revenues during 2010-2020 (average, in per cent)	127
Figure 5.3:	GST Returns Filing as Per cent of Total Eligible Tax Payers	129
Figure 5.4:	GST Collections vis-à-vis Collection from Taxes Subsumed Under GST	130
Figure 5.5:	Basic Custom Duty as % of Merchandise Import and GDP	133
Figure 5.6	A&B: Rates of Corporate Tax Across Countries in 2020 and Change From 2010	136
Figure 5.7:	Stock of Disputed Tax Demand Versus Direct Tax Collections	138

Pages

	Figure 5.8:	Percentage Share of Taxes in States' Own Tax Revenue: 2018-19	140
	Figure 5.9:	Stamp Duties and Registration Fee Collections of All States As Percentage of GDP and Total Own Tax Revenue	141
	Figure 5.10:	Stamp Duties and Registration Fee Collections of General States as Percentage of GSDP and Own Tax Revenue	142
Chapter 6:	**Towards Cooperative Federalism: Balancing Equity and Efficiency**		
	Figure 6.1:	India's Vertical Fiscal Gap (2018-19)	150
	Figure 6.2:	Divisible Pool as Percentage of GTR and GRR	152
	Figure 6.3:	Total Fertility Rates of States	162
Chapter 7:	**Empowering Local Governments**		
	Figure 7.1:	Grants to Local Governments by Various Commissions	172
Chapter 8:	**Disaster Risk Management**		
	Figure 8.1:	Evolution of Disaster Risk Financing in India	230
	Figure 8.2:	Earmarked Funds for SDRMF	238
	Figure 8.3:	Earmarked Funds for NDRMF	242
Chapter 9:	**Pandemic and Beyond: Building Resilience in Health Sector**		
	Figure 9.1:	Human Resource for Health and Hospital Beds per 1000 Persons	268
	Figure 9.2:	Expenditure on Health as Percentage of GDP	269
	Figure 9.3:	Share of Expenditure by Ministry of Health and Family Welfare and States on Health	269
	Figure 9.4:	Public Spending on Health as Percentage of GDP	270
	Figure 9.5:	Per Capita Health Expenditure (2018-19)	271
	Figure 9.6:	Health Expenditure of States as Percentage of Total Expenditure (2018-19)	271

Pages

Chapter 12: Fiscal Consolidation Roadmap

Figure 12.1: Union Government Fiscal Indicators as % of GDP 363
Figure 12.2: Financing of Fiscal Deficit of the Union 364
Figure 12.3: Financing of the States' Fiscal Deficit 366
Figure 12.4: General Government Debt and Deficit 367

Chapter 13: Fiscal Architecture for Twenty-First Century India: Fiscal Rules, Financial Management and Institutions

Figure 13.1: Indian States' Aggregate Fiscal Positions (in per cent) 384
Figure 13.2: Challenges of Market Discipline in the States (2018-19) 386
Figure 13.3: Objectives of Public Financial Management 387

List of Box Items

Pages

Chapter 2: Intergovernmental Fiscal Relations: Lessons from International Experience

Box 2.1:	Countries with Output/Process-based Conditional Transfers	33

Chapter 3 Setting the Context: Analysis of the Past

Box 3.1:	Farm Loan Waivers	84

Chapter 5: Resource Mobilisation

Box 5.1:	Revenue Gap in GST – an approximation	131

Chapter 6: Towards Cooperative Federalism: Balancing Equity and Efficiency

Box 6.1	Phases in Horizontal Devolution	156
Box 6.2:	Progressivity of horizontal distribution	161

Chapter 7 Empowering Local Governments

Box 7.1:	Partnerships, Convergence and Community Cadre	179
Box 7.2:	Best Practices in Property Taxation in States	185
Box 7.3:	Initiatives by MoPR for Auditing and Integration of Accounts	192
Box 7.4:	Kerala Reforms for Effective Delivery of Healthcare Services	213

Chapter 9 Pandemic and Beyond: Building Resilience in Health Sector

Box 9.1:	Inter-State variations in Spending on Health	271

Chapter 11 Defence and Internal Security

Box 11.1:	Opinion of Shri. K. Parasaran	344

Chapter 13: Fiscal Architecture for Twenty-First Century India: Fiscal Rules, Financial Management and Institutions

Box 13.1:	Recent Amendments to FRBM Act, 2003	383
Box 13.2:	Key Elements of Public Finance Management Reforms in India	393

LIST OF ABBREVIATIONS

ACA	additional Central assistance
ACS-ARR gap	average cost of supply and average revenue realized gap
ADCs	Autonomous District Council
ADB	Asian Development Bank
ANMs	auxiliary nurse midwife
ASHA	accredited social health activists
ATBs	auction treasury bills
AT&C	aggregate technical and commercial
ATR	action taken report
AYUSH	ayurveda, yoga and naturopathy, unani, siddha and homeopathy
BE	budget estimate
BPL	below poverty line
BRICS	Brazil, Russia, India, China, South Africa
CAG	Comptroller and Auditor General
CAPFs	Central armed police forces
CBDT	Central Board of Direct Taxes
CBIC	Central Board of Indirect Taxes and Customs
CENVAT	Central value added tax
CGA	Controller General of Accounts
CGST	Central GST
CHC	community health centre
CRF	Calamity Relief Fund
CSS	Centrally sponsored schemes
CPCB	Central Pollution Control Board
CPSEs	central public sector enterprises
DBT	direct benefit transfer
DCRF	Debt Consolidation and Relief Facility
DDMA	District Disaster Management Authority
DDMF	District Disaster Mitigation Fund

DDRF	District Disaster Response Fund
DDW&S	Department of Drinking Water and Sanitation
DNB	Diplomate of National Board
DISCOM	distribution companies
DPSEs	defence public sector enterprises
DRI	Disaster Risk Index
DTH	direct to home
EAP	externally aided projects
EBR	extra budgetary resources
e-POS	electronic point of sale
ETF	exchange traded funds
ECF	Economic Capital Framework
FCI	Food Corporation of India
FRBM Act	Fiscal Responsibility and Budget Management Act
FTAs	free trade agreements
GDP	gross domestic product
GNP	gross national product
GPDP	Gram Panchayat Development Programme
GSDP	gross state domestic product
GST	goods and services tax
G-Sec	Government Security
GVA	gross value added
HLEG	High Level Expert Group
HPC	High Powered Committee
HPCL	Hindustan Petroleum Corporation Ltd
HWC	health and wellness centres
ICDS	Integrated Child Development Scheme
ICMR	Indian Council of Medical Research
ICU	intensive care units
IDA	International Development Association
IEBR	internal and extra budgetary resources
IFMS	Integrated Financial Management System

IGST	Integrated GST
IIFCL	India Infrastructure Finance Company Ltd.
IMF	International Monetary Fund
IMR	infant mortality rate
IRFC	Indian Railway Finance Corporation
ITBs	intermediate treasury bills
KPI	key performance indicators
LPG	liquefied petroleum gas
MCF	Million-Plus Cities Challenge Fund
MCI	Medical Council of India
MoAFW	Ministry of Agriculture and Farmers' Welfare
MoD	Ministry of Defence
MoHUA	Ministry of Housing and Urban Affairs
MoPR	Ministry of Panchayati Raj
MDG	Millennium Development Goal
MFDIS	Modernisation Fund for Defence and Internal Security
MFN	Most Favoured Nation
MHA	Ministry of Home Affairs
MMR	maternal mortality ratio
MoEF&CC	Ministry of Environment & Forest and Climate Change
MOOC	massive open online courses
MoSPI	Ministry of Statistics and Programme Implementation
MoU	memorandum of understanding
MTEF	Medium Term Expenditure Framework
MTFP	Medium Term Fiscal Policy
NABARD	National Bank for Agriculture and Rural Development
NAFCC	National Adaptation Fund for Climate Change
NAMP	National Air Monitoring Programme
NAPCC	National Action Plan on Climate Change
NBE	National Board of Education
NCA	normal Central assistance
NCAP	National Clean Air Programme

NCCD	National Calamity Contingent Duty
NCCF	National Calamity Contingency Fund
NDHM	National Digital Health Mission
NDMA	National Disaster Management Authority
NDMF	National Disaster Mitigation Fund
NDRF	National Disaster Response Fund
NDRMF	National Disaster Risk Management Funds
NEH	North-Eastern and Himalayan
NEP	National Education Policy
NFCR	National Fund for Calamity Relief
NFSA	National Food Security Act
NGO	non government organisation
NHM	National Health Mission
NIDM	National Institute for Disaster Management
NIF	National Investment Fund
NIPFP	National Institute of Public Finance and Policy
NMAM	National Municipal Accounting Manual
NMC	National Medical Council
NPA	non-performing assets
NRDWP	National Rural Drinking Water Programme
NRHM	National Rural Health Mission
NSSF	National Small Savings Fund
NSSO	National Sample Survey Organisation
NSO	National Statistical Office
OECD	Organisation for Economic Cooperation and Development
ONGC	Oil and Natural Gas Corporation
OROP	one rank one pension
PA	provisional accounts
PDNA	Post-Disaster Needs Assessment
PEFA	Public Expenditure And Financial Accountability
PFC	Power Finance Corporation
PFMS	Public Finance Management System

PGI	Performance Grading Index
PHC	primary health centre
PM-ASBY	Prime Minister's Atmanirbhar Swasth Bharath Yojana
PMFBY	Pradhan Mantri Fasal Bima Yojana
PMGSY	Pradhan Mantri Gram Sadak Yojana
PMJAY	Pradhan Mantri Jan Arogya Yojana
PMSSY	Pradhan Mantri Swasthya Suraksha Yojana
PMUY	Pradhan Mantri Ujjwala Yojana
PM-KISAN	Pradhan Mantri Kisan Samman Nidhi
POCSO	Protection of Children from Sexual Offences
POL	petrol, oil, lubricants
PPE	personal protective equipment
PSE	public sector enterprise
RBI	Reserve Bank of India
RE	revised estimates
REC	Rural Electrification Corporation
RNR	revenue neutral rate
RRB	Regional Rural Bank
RTS	Representative Tax System
SAPCC	State Action Plans on Climate Change
SBA	Special Banking Arrangement
SBM-G	Swachh Bharat Mission (Grameen)
SCA	special Central assistance
SDG	Sustainable Development Goal
SDL	State Development Loan
SDMA	State Disaster Management Authority
SDMF	State Disaster Mitigation Fund
SDRF	State Disaster Response Funds
SDRMF	State Disaster Risk Management Funds
SEZ	special economic zone
SFC	State Finance Commission
SFDRR	Sendai Framework for Disaster Risk Reduction

SGST	State GST
SHG	self-help group
SIDM	State Institute for Disaster Management
SPA	special Plan assistance
SRS	Sample Registration System
TARC	Tax Administration Reform Commission
TCS	tax collection at source
TDS	tax deduction at source
TFR	total fertility rate
ToR	terms of reference
TPDS	targeted public distribution system
U5MR	under five mortality rate
UDAY	Ujjwal DISCOM Assurance Yojana
UIP	Universal Immunisation Programme
UNDP	United Nations Development Programme
UPSC	Union Public Service Commission
VAT	value-added tax
WACR	weighted average coupon rate
WEO	World Economic Outlook
WHO	World Health Organization
WRI	World Resource Institute

Chapter 1

Introduction

“The future depends on what we do in the present.” – Mahatma Gandhi

The Unusual Context

“Never let the future disturb you. You will meet it, if you have to, with the same weapons of reason which today arm you against the present.”

— *Marcus Aurelius, Meditations*

1.1 The title of this Finance Commission's report is Finance Commission in Covid Times. The title itself brings out the exceptional context in which this report is being submitted.

1.2 The global economy is facing the most unprecedented shock in post-war history. Some compare it with the Global Financial Crisis or the 1918 Spanish flu pandemic, but, in some sense, it is actually like both and more. The shock is different than anything we have previously experienced in generations. It moved fast – our world, after all, has never been more deeply interconnected. And so did we – the speed of scientific understanding of the virus and collaboration in finding a solution has also been unprecedented. Nonetheless, Covid-19 is changing our economies and societies perhaps permanently.

1.3 This crisis has real and psychological dimensions that feed on and amplify each other. The fear of such a virulent virus and the elemental uncertainty about social contact were not prevalent during any previous recession. The Covid-19 shock also has the unique feature that the response – virus control and social distancing measures – itself constrains economic activity in ways that are unprecedented, at least in post-war history. Illness and the fear of illness have created both demand and supply-side shocks. These disruptions are unevenly distributed across the physical and digitally mediated sectors, and have created cascades of longer-run impacts on education, inequalities, economic geography, business structure, employment, social capital and more that we will be undoubtedly managing for years to come. However, we are seeing, in the process, both new opportunities and challenges – distributed economic geography, for example – along with visible fault lines such as security of livelihoods. The logic of biology, with exponential growth rates, little respect for status, hierarchy and socially created attitudes, as well as a duration far beyond any flood, earthquake or other similarly sized shock, stretches our understanding and overrides our traditional methods of disaster response.

1.4 The International Monetary Fund projects global gross domestic product (GDP) to

contract by 4.4 per cent in 2020.[1] This is certainly the deepest recession since at least World War II and, in some ways, the most complex with both short- and long-term effects that differ across economic sectors. Massive policy support has helped sow the seeds for global recovery, but we can certainly expect further surprises. And we are also still in the stabilisation phase – the key risk to global recovery is the continued rise in globally confirmed cases of Covid, with new surges in outbreaks in several parts of the world. Sustained virus control and economic recovery will remain a daunting challenge until a vaccine is approved and becomes widely available. Researchers around the world, including in India, are developing more than 150 vaccines and several of them are in advanced stages for trials of safety and effectiveness. Our nation is a global leader in the scale and speed of vaccine production. While uncertainties are high, it is likely that a vaccine will be developed in the finite future.

1.5 Our choices in how to invest for the growth phase will come next. And, with these, we must not only remedy the damage but think ahead to the future. We do not expect the world to return to the way it was before. The new normal will not be the old normal. The psychological effects of seeing a known, but abstract, risk becoming real will last and manifest itself in how we travel, socialise and invest. The economic and social effects of gaps in education, health, closure of businesses, and dramatic acceleration of the digital, the remote and the automated world will remain with us. But we do expect new opportunities to emerge in the rebound, whether it be through digital leadership and analytical innovation for smarter human development, health-protecting biotechnology and pharmaceutical advances informed by both traditional wisdom and cutting edge, clean technology for thriving in a zero-carbon future or, simply, the inevitable post-Covid shuffling of supply chains and locations. We may not see these changes clearly, and the post-Covid horizon may appear too distant for comfort, but we must prepare now and be ready.

1.6 It certainly makes our task more difficult. In this spirit, and in this time, we seek not only to fulfil the traditional mandate of the Finance Commission to allocate revenues across levels of government, but also to put in place and reinforce the structures, habits and building blocks to increase our adaptability as a nation, a Union of States, and a partner in a more sustainable global trajectory for human development.

1.7 The initial and ongoing response to the virus focused, and must continue to emphasise, on containment and control. Like several countries, the virus situation has continued to dramatically escalate in India as well. The Government of India took strong measures to combat the spread of the virus very swiftly, and imposed among the most stringent lockdowns across the world. Lockdown management was decentralised significantly through classified containment zones, and strict enforcement measures controlled the spread of the virus in these zones. Not surprisingly, amid one of the world's toughest lockdowns and rising public anxiety about the virus, India saw a sharp deterioration in economic activity. The National Statistical Office reported a staggering 23.9 per cent year-on-year drop in real output for the April-June quarter of 2020, with probably a sharper decline in the informal sector. It must be pointed out that

[1] *World Economic Outlook, October 2020*

considering the severity of our lockdown, in many ways, this compares somewhat favourably to many other countries which did not have such a severe lockdown, but equally experienced a sharp contraction during this period such as the United Kingdom, the United States and Brazil.

1.8 Looking back, this crisis came just as the Indian economy was beginning to stabilise after a prolonged slowdown – attributable to global factors and credit stresses in the domestic financial sector, but also to a painful transition from challenges in the implementation of a succession of major policy changes, including the introduction of the 2017 national goods and services tax (GST). Indeed, the possible economic recovery gave way to the Covid shock.

1.9 However, we must not dwell only on the present. We must look ahead. From that perspective, it is clear that we must invest now in building greater agility – greater ability to move and think quickly and easily, in a world that is characterised by increasingly rapid change. It is against this truly unprecedented global context, and its domestic macroeconomic and fiscal backdrop, and with these goals in mind, that the Fifteenth Finance Commission of India submits its report to the President of India.

1.10 In a departure from past practices, it does so in four volumes. Volume I and II, as in the past, contain the main report and the accompanying annexes. Volume III is devoted to the Union Government and examines key departments in greater depth, with the medium-term challenges and the roadmap ahead. Volume IV is entirely devoted to the States. We have analysed the finances of each State in great depth and have come up with State-specific considerations to address the key challenges that individual States face.

Constitutional Mandate and Consultative Approach

The Commission's Mandate

1.11 The Fifteenth Finance Commission (FC-XV) was constituted by the President under Article 280 of the Constitution on 27 November 2017 to make recommendations for the period 2020-25. Shri N.K. Singh, former Member of Parliament and former Secretary to the Government of India was appointed as the Chairman of the Commission. Shri Shaktikanta Das, former Secretary to the Government of India and Prof. Anoop Singh, Adjunct Professor, Georgetown University were appointed full time Members. Dr. Ashok Lahiri, Chairman (non-executive, part time) Bandhan Bank and Dr. Ramesh Chand, Member, NITI Aayog were appointed as a part-time Members. Shri Arvind Mehta was appointed as Secretary to the Commission. Shri Ajay Narayan Jha, former Finance Secretary, Government of India, was later appointed as Member with effect from 1 March 2019 in place of Shri Shaktikanta Das. Over the course of the Commission's tenure, this and other changes in membership were subsequently notified by President's Order (Annex 1.1 to 1.5).

1.12 The Commission's terms of reference (ToR) are noted in Annex 1.1, but it is worth mentioning several points that constitute wider terms of reference compared to previous

Commissions. The Commission was tasked not only with determining the distribution between Union and States of the net proceeds of taxes, but also reviewing and commenting on the design of fiscal principles for various grants that are typically provided alongside revenue shares. We were, in particular, asked to consider performance-based incentives to support and motivate the efforts of State and/or local governments – the "appropriate level of government"– in a variety of policy areas.

1.13 Paragraphs 4 (ii), 5, and 7 of the ToR, on the terms of grants to be considered provided us with an opportunity to shift the incentive structure underlying fiscal transfers in order to reward – and motivate – self-reliance, innovation and the full exercise of capabilities across all levels of government for credible, collaborative federalism. It is worth noting that several of the items mentioned in Paragraph 7 (i-ix) are among the most complex challenges that India faces, like other nations facing accelerating environmental, social and technological change. These must be addressed.

1.14 After the distribution of the net proceeds of taxes, the second core function entrusted to the Finance Commission is to determine the principles which should govern grants-in-aid, assess the needs of States in relation to such norms developed and applied to both revenue effort and desirable levels of expenditure and thereafter recommend grants in specific sums. Thus, tax devolution and grants-in-aid are the two constitutional instruments in the hands of the Commission for transfer of funds from Union to States. The sharing of revenue has, since the inception of the Finance Commission, provided States with sufficient stability of unconditional revenue to pursue their diverse development objectives. Within the second, we welcome the opportunity to shift to a new paradigm of performance – and innovation – in achieving these prerequisites for advancing India's development.

1.15 We note that though performance incentives may not have been explicitly mentioned in the ToRs of past Commissions, many of them have used performance as a criterion for both devolution and in allocation of some of the grants-in-aid. We have deliberated on the aforementioned ToRs in detail, learnt from analysis of their experience and tried to address them in Chapter 10.

1.16 One lesson from the past is that publicly available measurement and data, which are essential foundations for performance incentives, remain critical. We must see and recognise performance to measure it in transparent ways. Continued investment in accurate, credible, authoritative and publicly available data on the state of the outcomes we seek will expand our nation's ability to discuss and use such mechanisms.

1.17 A number of additional notifications were issued. The Commission was originally asked to make its report covering a period of five years commencing from 1 April 2020. However, based on notification No.S.O.2691(E) dated 29 July 2019 (Annex 1.6) the date for submission of the report was extended by one month, that is 30 November 2019, and also a paragraph was inserted in the original ToR after paragraph 9. "9A. The Commission shall also examine whether a

separate mechanism for funding of defence and internal security ought to be set up, and if so, how such a mechanism could be operationalised."

1.18 Later, the Commission, vide order No.S.O.4308(E) dated 29 November 2019 (Annex 1.7), was intimated about the following changes:

(i) The Commission shall submit two reports, namely a first report for financial year 2020-21 and a final report for an extended period of 2021-22 to 2025-26."

(ii) Date of submission for first report is 30 November 2019.

(iii) Date of submission of final report by 30 October 2020 covering a period of five years commencing from 1 April 2021.

1.19 The Commission submitted its first report covering the financial year 2020-21 to the President on 5 December 2019. The Report of the Commission covering the financial year 2020-21, commencing from April 1, 2020, together with an Explanatory Memorandum on the action taken on the recommendations of the Commission, was then laid on the Table of the House, in pursuance of Article 281 of the Constitution (Annex 1.40).

1.20 During its full tenure, the Commission held 151 meetings on dates indicated in Annex 1.23.

The Consultation Process

1.21 The Commission, while formulating its work plan, undertook extensive consultations with multiple stakeholders to address the ToR. In seeking international best practice, extensive interactions were held with multilateral institutions (Annex 1.27) including the International Monetary Fund, World Bank, Asian Development Bank, the Organisation for Economic Cooperation and Development (OECD) and UNDP. List of presentations made and study submitted by them, which are also available on our website, is available at Annex 1.22A.

1.22 In keeping with earlier practice, the Commission had extensive consultations with State Governments, Ministries and Departments of the Union Government and other stakeholders and opinion makers. In order to obtain detailed inputs on the ToR, six committees were also constituted under the directions of the Commission.

1.23 We constituted an Advisory Council to assist the Commission in enhancing its understanding of the complexities involved, on broader issues as well as those specified in the ToR, and enabling it to make appropriate recommendations. We also constituted some other committees of experts in specific subjects like agriculture, health, defence. The details of the committees constituted by us and a list of their meetings are outlined in Annex 1.15 to 1.20.

1.24 Also, the practice of structured interactions of the Commission with economists and economic administrators was widened to include key policy makers as well as experts from a range of other social sciences. Consultations with experts continued throughout our tenure

(Annex 1.27). Select 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. The Commission invited suggestions and comments on its ToR from the general public (Annex 1.13 and 1.14). The Commission 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 of the Chairman's meetings with eminent personalities/organisations is placed in Annex 1.24 and the list of the Commission's meeting with individuals/organisations is in Annex 1.25B. The list of the Commission's meeting held with Ministries/Department of the Union Government is in Annex 1.26.

1.25 Before undertaking visits to the States, meetings were held with the respective Accountants General of each of the States, including erstwhile State of Jammu and Kashmir (Annex1.28). 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, efficiency in resource mobilisation and expenditure. They also provided insights into the performance of various sectors, financial health of public sector enterprises and, importantly, of the local governments in these States. This was followed by a detailed presentation by the Commission's Secretariat on the fiscal issues of the State concerned. These, as mentioned earlier, are fully reflected in Volume IV of this Commission's report.

1.26 We place on record our deep appreciation for the support and inputs provided by the Comptroller and Auditor General (CAG) 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 CAG over multiple meetings.

1.27 The Commission visited the headquarters of the Reserve Bank of India (RBI) in Mumbai on 8 May 2019 to discuss issues related to macroeconomics, financial stability and the cost of borrowing of the Union and States. The other issues pertaining to market-driven borrowing cost, debt trajectories of States and recapitalisation of banks were also discussed during the meeting. We are thankful to the Governor, RBI, for all the cooperation and support extended.

Consultations with the States

1.28 Consultations with the State Governments and other stakeholders in the States have been an essential and enduring feature for all previous Finance Commissions. We covered all twenty-eight States and held at least four meetings in each of them. The meeting with the Chief Minister, Ministers and officers of the State Government was an important feature of the State visits. Separate meetings were held with elected representatives of panchayats and municipalities, representatives of research institutes, 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-seven States before October 2019. Our visit to the twenty-eighth State was concluded in January 2020.

1.29 Due to meticulous planning we had 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 for submission of both our reports to the President. The itineraries of the State visits are placed in Annex 1.30. A list of meeting with nodal officers of the State is placed in Annex 1.29. We extend our deep appreciation and gratitude to the State Governments for making extensive arrangements to ensure fruitful discussions and for their warm hospitality during our visits.

Consultation with the Union Government

1.30 The meetings with the Ministries and Departments of the Union Government were generally held between January 2018 and July 2020 (Annex 1.26). As the ToRs given to us is unique in many ways, and the Commission was tasked with handling diverse issues, several rounds of ministerial-level discussions were held with more than thirty Ministries/ Departments. We tried to leave no stone unturned in fully understanding and deliberating upon the many issues involved. We therefore decided to include many of the results of our work with key Ministries/Departments in a separate volume. Thus, Volume III of the Report covers the essence of our work on the key Ministries/ Departments which may be insightful for the readers.

1.31 The Commission made a courtesy call on the Prime Minister on 6 March 2018 and the Union Finance Minister on 4 December, 2017. We again met Union Finance Minister on 13 January 2018 for a detailed discussion. This provided us with an opportunity to exchange views on several issues before us (Annex 1.25A).

Studies

1.32 The Commission undertook a robust analytical approach to the issues and subjects and had assigned studies to research organisations and institutions, both national and regional. In order to obtain an overview of State finances from local experts, we commissioned studies for every State, generally through universities and institutions located in those States. Thus, we could obtain studies on the economy of each State. The reviews focused on the revenue capacities of the States, along with measures taken for improving their tax ratios, analysis of the States' own non-tax revenues, review of their expenditure patterns and analysis of their deficits, manner of financing and debt. In particular, these studies covered the performance of the States on several parameters, including fiscal consolidation efforts, potential for additional resource mobilisation, performance of public sector enterprises, and performance of the power sector, among the issues covered in the ToR. Further, these studies gave us a better understanding of the unique

characteristics of individual States. A list of State studies is at Annex 1.21.

1.33 Studies commissioned on various issues related to fiscal federalism and inter-governmental transfers were examined by the Economic Adviser's team under the supervision of the Commission (Annex 1.22). All studies are available on our website for public access.

The Debt and Fiscal Paradigm

1.34 Based on extensive internal and external consultations, cross country experience, and several rounds of discussions and deliberations, the Commission believes that the ratio of public debt to GDP should continue to serve as the medium-term anchor for fiscal policy in India, with fiscal deficit as the operational target, as recommended by the Fiscal Responsibility and Budget Management (FRBM) Review Committee in 2017, and accepted by the Parliament in 2018.

1.35 A credible and transparently measured fiscal policy framework is one that is rule-based, with clearly delineated affordances to ensure resilience in the face of change. We must be firm, but flexibly so, to avoid fragility.

1.36 Central to a credible framework is the concept of an anchor, which ties down the final goal of policy and helps the expectations of economic agents adjust accordingly. By acting as a constraint on policy discretion, an anchor dis-incentivises time inconsistencies, including pressures from diverse special interest groups. Central to resilience, however, is the ability to adjust that anchor in specific ways in exceptional circumstances. As we have often seen, many a ship has been set entirely adrift and dashed on the rocks by storms that snapped their anchor ropes; thus, bounded flexibility, a bit more play than required in normal times, is needed and is an important buffer against this outcome.

1.37 Fiscal uncertainty is now at an all-time high amid the pandemic. Nominal GDP and government revenues are already contracting in 2020-21, and placing distinct upward pressure on Union and State fiscal and debt positions. This upward pressure is unavoidable, at a time when growth destruction must be mitigated and income support extended. This is reason to consider flexibility. These are extraordinary times.

1.38 Yet, we believe that in the medium term, fiscal policies must be embedded in caution rather than exuberance, in restraint rather than profligacy. Therefore, while positive interest-growth differentials and adverse debt dynamics would be inevitable over the next two-three years, we recommend a declining trajectory for total public debt in ratio of GDP towards the later part of the award period. Importantly, what would also reassure markets is to build such a credible fiscal plan once the recovery firmly takes hold, which would entail return to a path of debt and fiscal consolidation over the medium-term.

1.39 It is also essential to ensure that the needed additional expenditure at this time is invested

well in strengthening the fundamentals for an economy and society to rebuild in any of the post-Covid scenarios. We must also ensure that the recovery efforts do not just build back the past, but seize new opportunities; these include the likely relocation of global production to India and the potential for greater familiarity with remote work to drive a more distributed economic geography, rather than continued growth of the largest cities alone. For this reason, we have prioritised investments in that most fundamental form of capital: human capital, through health and education, especially to the children who form the most vulnerable sub-set of the population, as well as additional attention to climate change and environmental risks, such as air pollution. We have also, as we discuss further below, adopted a new stance of rewarding outcomes, while maintaining the level of fiscal support for States and local governments, and to innovate in achieving them. Throughout the report, we have emphasised outcomes, with States free to choose inputs suited to local context. This is an important re-orientation that opens up lots of possibilities for innovation but also creates new demands on the systems for measuring and attributing outcomes.

1.40 Our forecast assumes a gradual return to a trend real GDP growth of around 7 per cent; we do assume scarring effects for workers and businesses to look less severe than feared. At the same time, the Commission was cognisant of the need to account for the uncertainties and risks in both directions following the unprecedented global shock. Therefore, the Commission preferred to work with three scenarios, and accordingly a range for both debt and headline deficit, instead of fixed numbers. The three scenarios are given in Table 1.1.

Table 1.1: Range of Union Government's Fiscal Deficit (% of GDP)

	2021-22	2022-23	2023-24	2024-25	2025-26
In case economic recovery is slower than assessed	6.5	6.0	5.5	5.0	4.5
If our macro-economic assessment holds	6.0	5.5	5.0	4.5	4.0
In case economic recovery is faster than assessed	6.0	5.5	5.0	4.0	3.5

1.41 The Commission is fully aware that in the context of parliamentary democracies, providing a range for, say, fiscal deficit would get operationalised at the upper end of the range; yet, there was consensus to provide flexibility in the proposed framework, to allow the Union and State Governments (Table 1.2) to navigate through the crisis, and its consequences for balance sheets of households, businesses and governments. The Commission recommends three windows to allow greater flexibility to the States: (a) additional unconditional borrowing space in the first two years of the award period to compensate for the loss of tax revenues; (b) an additional borrowing of 0.5 percentage of GSDP to be allowed to the States in case they meet the criteria for

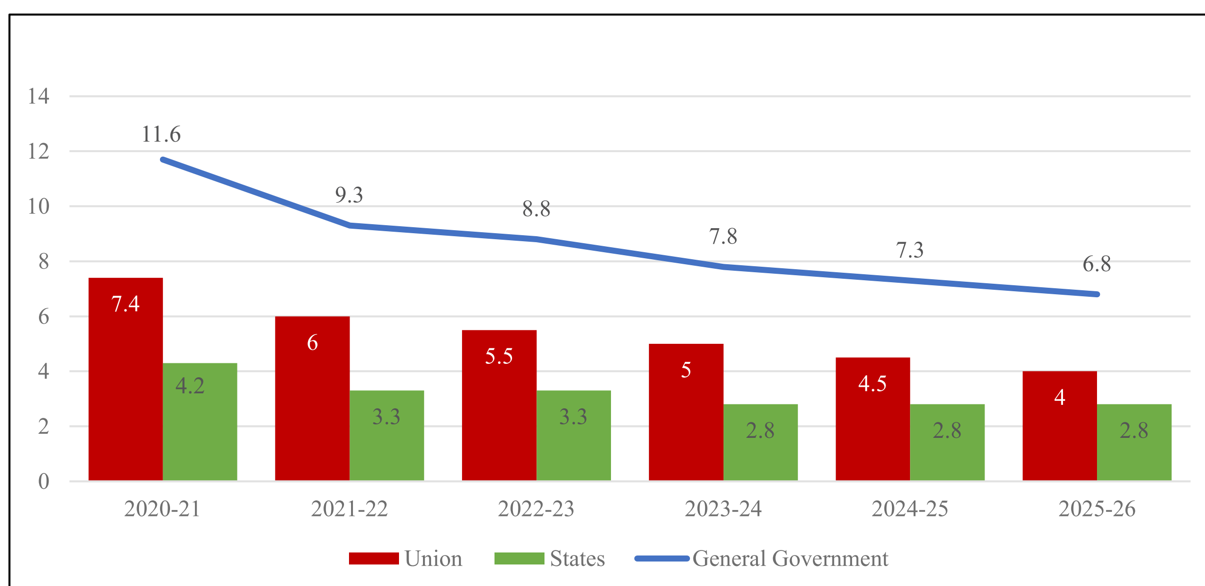
power sector reforms; (c) building on the FC-XIV recommendation, we are also allowing the States to utilise any unutilised borrowing space in the subsequent years within our award period.

Table 1.2: Range of all-State Fiscal Deficit under the Recommended Space for Borrowing

(% of GSDP)

	2021-22	2022-23	2023-24	2024-25	2025-26
Upper limit (if all States use the full borrowing space available)	4.5	4.0	3.5	3.5	3.0
Lower limit (States, on an average, reach the current FRBM limit)	3.0	3.0	3.0	3.0	3.0

Figure 1.1 Fiscal Deficit as % of GDP



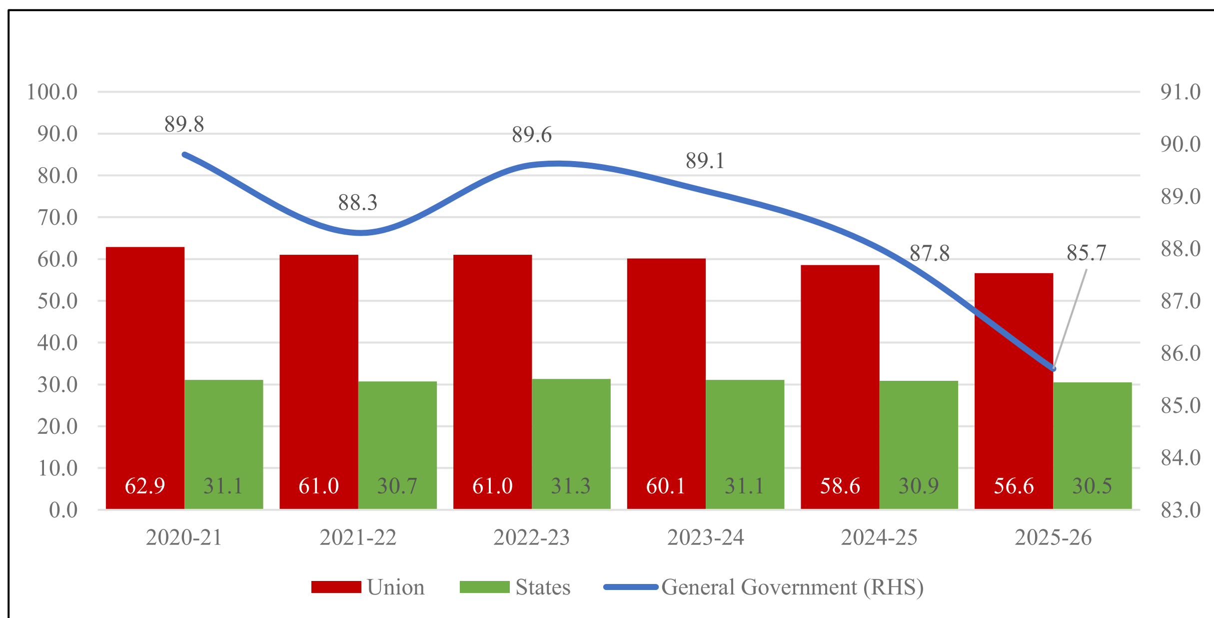
1.42 We have provided higher fiscal room to both the Union and the States to deal with the current pandemic and economic recovery in later years. Accordingly, general government fiscal deficit which is expected to be around 11.6 per cent of GDP in 2020-21 has been given a glide path reaching 6.8 per cent of GDP in the terminal year (Figure 1.1).

1.43 To sum up this part, the indicative consolidated debt trajectory of the general government which allows room for manoeuvre can be seen in Figure 1.2.

Towards Co-operative Federalism: Balancing Needs and Performance

1.44 Given India's vibrant federal structure, increased devolution of resources from the Union to the States under the previous Finance Commissions, and the fact that total State expenditures as a percent of GDP are greater than that of the Union, State finances have become a crucial lynchpin of India's fiscal framework. Overall, as stipulated by the FRBM Act, 2003 (as amended in 2018), we believe that the States must partner with the Union Government in pursuit of medium-term consolidation of debt and firmly place India's sovereign debt to GDP ratio on a sustainable footing in the medium term. They must partner with the Union Government in developing new ways to support their residents, the economy as a whole and India's global engagements. Hence, the debt and fiscal trajectory of the general government in Figure 1.2 envisages this partnership of both the Union and the States to achieve the key features of macroeconomic stabilisation by way of sustainable levels of debt and fiscal deficit.

Figure 1.2 Debt Trajectory during 2020-26 (% of GDP)



For general government debt, inter-governmental transactions have been adjusted. These include the stock of Union Government loans to the States, the stock of NSSF securities and Treasury Bills held by the State Governments.

1.45 When India gained independence, active state intervention was envisaged to reduce disparities across regions. Transfer of resources from the Union to States was the main mechanism to achieve these goals. In order to maintain predictability and stability of resources, especially during the pandemic, we recommend maintaining the vertical devolution at 41 per cent – the same as in our report for 2020-21. Our vertical devolution is in line with the recommended share in devolution of the FC-XIV. We have only made the required adjustment of about 1 per cent due to the changed status of the erstwhile State of Jammu and Kashmir into the new Union Territories of Ladakh and Jammu and Kashmir.

1.46 We believe, as outlined in the concerned chapter, that "stability and predictability of resources is the most essential component of good long-term budgeting and fiscal marksmanship for both the Union and the States. Certainly, this requires the Union and the States raising their resource availability through a number of sources, especially through the higher tax-GDP ratio, which is low relative to comparable countries. It is, therefore, our considered view that there should be broad continuity in the availability of resources through the divisible pool." We also believe that "this level of vertical transfers will allow appropriate fiscal space for the Union as well to meet its demands as well as maintain an adequate level of unconditional resources to the States."

Horizontal Sharing

1.47 The level of development of a state is a function of complex factors, which include historical, cultural and sociological characteristics. Additional financial resources are certainly needed to help a state develop, but the ability to effectively use those resources is undoubtedly more crucial, and is a distinctive feature visible across states. Poor administration and weak institutions in a state, for example, clearly under optimise allocated resources. This Commission seeks to harmonise the principles of expenditure needs, equity and performance in determining the criteria for horizontal sharing by broadly assigning appropriate weightages. The need-based principles would clearly include the criteria of population, area, forest and ecology. The equity-based principles envisage income distance which, as in the past, continues to be assigned high weightage. In respect of the performance criteria, we have assigned weightages to demographic performance as well as tax and fiscal efforts. The logic of this broad classification has been explained in the concerned chapter.

1.48 We have, therefore, proposed a scheme of allocation of resources across States, that takes into account both their development needs as well as past performance, where the latter aims to incentivise better performance, and to allocate resources where they can be used most effectively. Specifically, our newly introduced parameter of 'demographic performance' is designed to be an umbrella performance reward in areas relating to population control, as well as better outcomes in the sectors of education and health – including better nutrition outcomes. A significant body of health literature suggests that lower birth rates are related to reductions in the infant mortality rates too.

1.49 Taking into account a number of factors, and extensive consultations, the Commission recommends giving weight of 12.5 per cent to the criterion of 'demographic performance'.

Table 1.3: Horizontal Devolution Criteria and Weights

Criteria	Weight (%)
Population	15.0
Area	15.0
Forest & ecology	10.0
Income distance	45.0
Tax & fiscal efforts	2.5
Demographic performance	12.5
	100

Grants-in-aid

Revenue deficit grant

1.50 Several discussions within the Commission, and with outside experts, including policy makers, suggested "revenue deficit" (defined as the difference between revenue or current expenditure and revenue receipts, that includes tax and non-tax) to be an important goal post in the day-to-day policy making process. The distinction between revenue and capital accounts is, in fact, rooted in the history of budget making process, and in the Constitution of India. Revenue deficit grants emanate from the requirement to meet the fiscal needs of the States on their revenue accounts that remain to be met, even after considering their own tax and non-tax resources and tax devolution to them. There can be no formula-based horizontal devolution which can meet the needs of each of the twenty-eight States whose cost disabilities and fiscal capabilities are so vastly different from each other. Therefore, we recommend an allocation of 1.92 per cent of the gross revenue receipts of the Union as revenue deficit grants to specific States. The revenue deficit grants aggregate to Rs 2,94,514 crore, with gradual tapering off during the award period.

1.51 The composition of our award reflects the intention of laying relatively significant emphasis on grants in aid and, within that, on performance-linked grants. Besides revenue deficit grants, we have recommended grants and incentives for various sectors. These grants revolve around four main themes. The first is social sector, where we have focused on health and education critical to a large and particularly vulnerable subset of the population. Both these sectors face unprecedented challenges with the pandemic and are both public goods with huge multiplier benefits for human capital and growth. Second is the rural economy, where we have focused on agriculture and the maintenance of rural roads. The rural economy plays a significant role in the country as it encompasses two-thirds of the country's population, 70 per cent of the total workforce and 46 per cent of national income. Third, governance and administrative reforms under which we have recommended grants for judiciary, statistics and aspirational districts and blocks. Fourth, we have developed a performance-based incentive system for the power sector, which is not linked to grants but provides an important, additional borrowing

window for States. Undoubtedly, the economic and social returns from having a well-functioning, financially stable and environmentally sustainable power distribution sector are more important than ever before.

1.52 To put this in historical perspective, we note that the type and size of grants-in-aid have varied over a period of time. There have been five different types of grants: (a) revenue deficit grants, (b) grants for local governments, (c) grants for disaster management, (d) sector-specific grants and (e) State-specific grants. Except for the revenue deficit grants, these were often conditional and performance based. The size of the grants varied from 26.1 per cent of total transfers under the FC-VI to 7.7 per cent of total transfers under the FC-VII. While the FC-XIII recommended grants amounting to 15.15 per cent of total transfers, the FC-XIV recommended 11.97 per cent of total transfers as grants-in-aid.

1.53 In practice, except for the revenue deficit grants, the actual flow of funds remained generally less than recommended amounts by the end of the award period, which indicates that the revenue deficit grants were predictable and assured while others were not. Some conditional grants for local governments faced challenges of conditionalities and timely release. Apart from the original conditions prescribed by Commissions, additional conditions were prescribed by the Union, and even by some States, thereby diluting the original intent of the recommendations of past Commissions. We have tried to avoid these complications by keeping our recommendations simple, yet focused on the most fundamental of capacities: timely audited accounts and effective use of property taxes to boost self-reliance and long-term sustainability.

1.54 During our deliberations, we observed that grants-in-aid can make corrections for cost disabilities and other redistributive requirements which are possible to address only to a limited extent in any devolution formula. Besides, grants-in-aid are pre-determined in absolute terms and remain fixed. They are better targeted and may be used to equalise the standards of basic social services. We have also tried to link many of our grants with performance-based criteria that may catalyse public services of primary importance in the national interest. Some of these public services sometimes receive low priority from States in spite of their wider benefits for the economy as a whole. These grants have also helped us to address our wide-ranging items in our ToR. We have accordingly recommended several categories of grants-in-aid amounting in aggregate to Rs 10,33,062 crore.

Collaboration

Social Sector

1.55 The outbreak of the Covid-19 pandemic has brought to fore the multiple challenges being faced by the health sector, including low investment, inter-regional disparities especially in undernourishment and hunger, supply side problems of doctors, paramedics, hospitals, and inadequate numbers of primary healthcare centres like sub centres, primary health centres and

community health centres. Hence, the second most important grant after revenue deficit grants recommended by us relates to the health sector, aggregating more than Rs. 1 lakh crore spread over three components. The details of health grants amounting to Rs. 31,755 crore are discussed in Chapter 9. Health grants to the local governments, amounting to Rs. 70,051 crore, which are discussed in Chapter 7 is a part of the overall thrust towards cooperative federalism by involving and motivating all levels of government. In this spirit, we have noted that several proposals sent by State Governments in respect of State-specific grants also assign high weightages to improving the health infrastructure. We have also recommended State-specific grants for health amounting to Rs. 4,800 crore. These grants will also help to build resilience against future pandemics by building critical care hospitals and public health labs. In this, we have made clear the important role that the third tier of government must play in primary health care. We have also tried to address the gap in shortfalls of specialists and paramedics through these grants.

1.56 For addressing the pandemic situation, and building further resilience to shocks, the FC-XV, for the first time, took a deep dive into the health sector. Overall, we envisage enhanced public outlays for the health sector, and also propose the creation of an All India Health Service. Recognising the urgency to address the ongoing pandemic, we have also sought to frontload the financial resources assigned for the health sector. The flexible and somewhat enlarged fiscal space both for the Union and the States in the initial years of our award, hopefully, will also enable them to incur additional expenditure on the health sector.

1.57 The pandemic has also created new challenges in the field of education for our young learners. State Governments across the country shut down schools and colleges as an immediate measure to slow the spread of the pandemic. The closure of schools and universities will not only have a short-term impact on the continuity of learning for students but will also have far-reaching economic and social consequences. Hence, this has prompted us to provide a grant for technology related solutions especially for higher education to promote learning through direct to home channels and online modules. There is also a dearth of professional courses in regional languages, thus creating hindrances for many coming from rural areas. Thus, we have also recommended grants for this purpose. Another prime area of concern in the field of education is the poor learning outcomes of school children which exist even after 100 per cent gross enrolment at primary levels. Also, there are issues relating to equity and access outcomes. We have therefore, recommended incentive grants for States to improve these outcomes of school education using the Performance Grading Index (PGI) of the Ministry of Education. Undoubtedly, creativity and innovation can only come when curriculum can be imparted in their regional language (matribhasha) and, therefore, we have sought to embed this in our proposals on higher education.

Rural Economy

1.58 Under our second theme, we have recommended grants pertaining to incentivising agriculture reforms and enhancing agri-exports. This grant targets some of the most daunting

challenges of the agricultural sector where cooperation is needed with the States. This includes land reforms, sustainable and efficient use of water in agriculture, export promotion and providing a push to more remunerative crops like oilseeds, pulses and wood products. We have also recommended grants for the Pradhan Mantri Gram Sadak Yojana (PMGSY) roads, considering their inadequate maintenance after the end of the post-construction five-year maintenance period. At the same time, studies have proved several advantages of last mile connectivity like improved prices for agricultural products and better access and learning outcomes of school education. Thus, improvement in the condition of PMGSY roads complements the other grants recommended by us by providing access to various important social and economic services.

Governance and Administrative Reforms

1.59 Under the third theme, we have focused on administrative and governance reforms that often do not get due priority from State Governments. We have recommended grants to strengthen the judiciary that is the foundation of any peaceful and progressive nation. These grants will expedite the judicial process by operationalising fast track courts for speedier justice delivery in cases of heinous crimes, civil cases of marginalised people, five-year-old property cases, and economic offences, as well as special fast track courts for cases under the Protection of Children from Sexual Offences Act, 2012.

1.60 Most emerging and developing nations are embracing decentralisation as the form of governance to achieve higher economic efficiency, better accountability and higher satisfaction of local population. As local officials have better knowledge of local conditions and are more accessible, closer and accountable to their constituents, they have the means and the incentives to be more responsive.

1.61 In order to further empower local governments, the Commission recommends substantially enhanced resources available to them, compared to any earlier periods. In line with the overall spirit of this report to create a balance between needs and performance, the allocation of funds to local governments is generally linked to certain performance criteria. For instance, online submission of annual accounts for the previous year, and audited accounts for the year before, is an entry level criterion for grants (except health grants) to all local governments; similarly, the notification of minimum floor rates for property taxes is an additional condition for grants to urban local bodies. Further, we propose to earmark significant portion of resources to local governments with the goal of improving primary health care services, water and sanitation, rainwater harvesting, air quality and, importantly, a “challenge fund” for developing the fifty cities with population of over a million (Million-Plus cities). We also lay emphasis on disposal of waste - also critical for better air quality in more efficient ways, extracting value addition as well as seeking partnership from private entities.

1.62 Also, considering the importance of data and statistics in today's world, we have

recommended grants for improvements in statistics. The role of quality statistics and data is very crucial for any policy making, its implementation and subsequent monitoring. Besides these, we also believe that incentivising, in a transparent manner, administrative units like districts or blocks, which are below the national average in critical parameters, on the basis of performance can be an effective tool of improvement in governance. Hence, we have recommended grants for aspirational districts and blocks that will be entirely performance-based.

Power Sector

1.63 Under our fourth theme, we have focused on power sector reforms by providing additional borrowing limits for States based upon a performance matrix targeted at improving the functioning of distribution companies (DISCOMs). The DISCOMs have remained a persistent strain on State finances and the overall performance of the power sector. In most States, the improvements in the distribution segment are incomplete and this segment has been the weakest link in the entire value chain. The DISCOMs have long faced questions of financial sustainability on account of below-cost tariffs to different consumer groups, supply of un-metered, free electricity to agriculture, States not providing the promised subsidies to the utilities, high aggregate technical and commercial (AT&C) losses, and poor regulatory governance. We expect that this access to additional financing will incentivise States to undertake policies towards efficient working of the power DISCOMs. A viable and well-functioning distribution sector is a pre-requisite for attracting investment to expand capacity and provide reliable, sufficient power to avoid bottlenecks for growth. It is a pre-requisite for being able to attract the partners required to move quickly to newer, cleaner, more cost-effective forms of energy.

National Considerations

1.64 Given the geopolitical uncertainties, we also addressed the ToR on defence and internal security. There can be no two opinions that defence is a national priority of highest importance for the integrity and sovereignty of the country. It is the inescapable obligation of every citizen and stakeholder to contribute towards strengthening the bulwark of security, both internal and external. Moreover, law and order, national security and peace are pre-requisites for economic prosperity and sustainable growth. In order to address the specific ToR, we propose to create a non-lapsable pool for the defence and internal security sector under the Public Accounts of India with standard reporting and audit requirements, with the goal to ensure that committed capital expenditure of the sector can be met in a predictable way. The non-lapsable fund would undoubtedly give greater predictability for enabling critical defence capital expenditure.

1.65 Lastly, we have recommended State-specific grants to help States meet special burdens or obligations of national concern. These span across six broad areas: (a) social needs, (b) administrative governance and infrastructure, (c) conservation and sustainable use of water,

drainage and sanitation, (d) preserving culture and historical monuments, (e) high cost capital infrastructure and (f) tourism.

Reforms of Fiscal Architecture

1.66 In terms of medium-term fiscal reforms, we analysed in depth the structural "tax gap" for India. In line with literature on the topic, we estimate a large gap in India's tax collections of more than 5 per cent of GDP, compared to its potential. We recommend a series of urgent operational and policy changes to bridge this gap which include, among other steps, correcting the inverted duty structure in GST, addressing defects in the IT system for GST and facilitating complete invoice matching and reviewing exemptions, thresholds and concessions in income tax.

1.67 The thinking on fiscal architecture has changed globally. Most countries have multiple fiscal rules and, in many cases, with provisions to allow fiscal space for exogenous shocks. These are complemented with independent fiscal councils, escape clauses and automatic correction mechanisms to impart transparency, flexibility and credibility to the framework. Building on the recommendations of the FRBM Review Committee, the Commission highlights the fact that India's twenty-first century fiscal architecture would need to have three pillars that reinforce each other: fiscal rules across the levels of government which set the institutional and budgetary framework for fiscal sustainability; an overarching public financial management system which provides complete, consistent, reliable and timely reporting of the fiscal indicators that are part of the first pillar; and fiscal institutions - in particular, an independent assessment mechanism so as to provide assurance and advice on the working of the other two pillars.

1.68 We recognise that the FRBM Act needs a major restructuring, given the current challenges both in relation to debt and fiscal deficit. Given continuing uncertainties, the architecture of the FRBM Act needs to be fundamentally restructured keeping in mind contemporary realities, the uncertainties and challenges and based on evolving international practice. Towards this objective, we have recommended the constitution of a High-powered Inter Governmental Group for a new fiscal consolidation framework. It needs to be inter-governmental for reasons explained in the chapter. Both the Union and the States need to be active partners and collaborators to achieve macroeconomic stability. While the FRBM Review Committee made a number of far-reaching suggestions for the Union Government, the issue of a similar enabling framework for States was left to the Finance Commission. In the current context, given these uncertainties, an inter-governmental group would need to revisit this issue with an open mind.

Organisation of the Rest of the Report

1.69 The rest of the report is organised as follows. Chapter 2 ("Inter-governmental Fiscal Relations: Lessons from International Experience") discusses inter-governmental fiscal relations across the global landscape, with lessons for India. Chapter 3 ("Setting the Context: Analysis of

the Past") reviews the Union and State finances as well as inter-governmental transfers during 2011-12 to 2020-21. Chapter 4 ("Pandemic Times: Analysis for the Future 2021-26") lays out the projection of the finances of the Union and State Governments for 2021-2026. Chapter 5 ("Resource Mobilisation") discusses operational and urgent policy changes needed to fill India's tax gap. Chapter 6 ("Towards Co-operative Federalism: Balancing Needs and Performance") presents the underlying principles, and the Commission's key recommendations on vertical and horizontal devolution. Chapter 7 ("Empowering the Local Governments") proposes steps to enhance the resource envelope and further empower urban and local bodies. Chapter 8 ("Disaster Risk Management") recommends State-wise allocation of funds for disaster management. Chapter 9 ("Pandemic and Beyond: Building Resilience in the Health Sector") discusses proposed grants for the health sector. Chapter 10 ("Performance-based Incentives and Grants") prescribes revenue-deficit grants as well as performance-linked grants for other sectors. Chapter 11 ("Defence and Internal Security") focuses on the resource pool for the defence sector. Chapter 12 ("Fiscal Consolidation Roadmap") presents the recommended fiscal roadmap of the Union, the States and general government for the next five years. Finally, Chapter 13 ("Fiscal Architecture for Twenty-first Century India: Fiscal Rules, Financial Management and Institutions") lays out the details of the three pillars needed to bring India's fiscal architecture to twenty-first century international standards - fiscal rules, public financial management, and the need for an independent assessment mechanism.

Conclusions

1.70 We have done our utmost to gather the advice and perspectives of world-class experts within India and abroad, State Governments, sector leaders and other stakeholders in India's success during times that have been more turbulent than any Finance Commission has faced. We have addressed our ToR with a series of recommendations on adjusting the nation's fiscal architecture to meet the needs of unprecedented times, over the course of these reports.

1.71 To summarise, we have allowed for some flexibility in the previously set debt and borrowing ceilings, but we have argued that such flexibility must be strictly bound and additional borrowings be invested with a clear eye to future growth. We have proposed a system of grants that helps to support and motivate such investments, while meeting the needs of States in the present crisis. We have laid out the core pillars for a fiscal architecture that can better harness India's resources, raise the quality of public spending and deliver broad-based, resilient growth.

1.72 While the title of the report of this Commission is Finance Commission in Covid Times, the graphic on the cover page shows the two sides of the Scale, namely the Union and the States, as being equitably balanced. In doing so, we recognise that, "through the combination of the Finance Commission's recommended transfers and the Union's voluntary transfers to various schemes the States are already receiving about half of the gross-revenue receipts." In this broader sense, the States' expectation of financial transfers from the Union are being significantly met. It

has been the endeavour of this Commission to ensure that in terms of our approach, the consultative process and the financial allocation, as well as the flexibility in observing the fiscal trajectory, its recommendations aptly meet this desirable objective of evenly balancing the Union and the States.

1.73 Overall, this report seeks to achieve responsible, efficient, equitable, and inclusive growth for India, amid an unparalleled global and domestic macroeconomic backdrop. As Einstein said "In the midst of every crisis lies an opportunity." This Commission envisions a next generation fiscal architecture and a system of inter-governmental transfers to enable India to utilise this opportunity to be ready, agile, and to thrive in what lies ahead.

1.74 Last, but not least, the philosophy of federalism transcends the relationship bound in mere fiduciary obligations. Federal partnership must embrace the broader context and seek wider ways in which the Union and the States can act in concert to address national priorities – social, economic, attitudinal – addressing emerging challenges and never allowing the broader vision to be masked by just the sharing of financial resources. Einstein, in a different context, had said that, "Not everything that can be counted counts and not everything that counts can be counted." A working federation counts.

Chapter 2

Intergovernmental Fiscal Relations: Lessons from International Experience

This chapter reviews intergovernmental fiscal relations across the global landscape, thereby providing a context in which to assess how India's fiscal federalism has developed. The recent Covid-19 crisis risks bringing about changes in fiscal federalism given its magnitude, the inability of sub-national governments to absorb the fiscal costs on their own and the asymmetric regional impact of the crisis.

Globally, resource availability has long been a critical challenge for meeting equalisation needs, and this is now accentuated by the shock on government revenues from the sharp drops in gross domestic output resulting from the Covid crisis. The chapter compares India's relatively low revenue ratio and the need to bring this closer to that of other emerging markets, thereby better meeting rising developmental needs.

India's vertical fiscal gap has been high relative to other federations, reflecting the mismatch between revenue and expenditure decentralisation, and this has risen over time. This makes the horizontal fiscal imbalance at the sub-national level a critical determinant of devolution, given India's relatively high heterogeneity across States, as is now becoming more evident in their very differentiated health capacities to address the immediate consequences of the Covid crisis.

Although there is much diversity in the approaches that federations have used in horizontal devolution, most have used cost or revenue equalisation systems to identify per capita equalisation determinants. In contrast, India's equalisation system has used a macro-indicator approach. This approach, which is necessitated by data limitations, has some unique factors that seek to combine elements of revenue capacity and expenditure need or cost, including population levels, among the macro indicators in the devolution formula.

In addition to the formula-based transfers, countries have also used discretionary, specific-purpose transfers to meet infrastructure needs, as India also has done. International experience suggests that these transfers are more effective and progressive if they are based on well-designed output or outcome-based indicators, rather than input- or process-based transfers, and this is also becoming more evident in assessing how sub-national governments are meeting the Covid health crisis. These are areas where this Finance Commission has made recommendations to improve the output impact of specific transfers.

The need for accountability and efficient public financial management becomes more critical during public finance crises as that currently being faced across the global landscape. To limit these tensions, many countries have quickly put in place new and innovative coordination

mechanisms, involving governance and fiscal tools, to tailor support to the different regional impacts of the current crisis and ensure continuity of fiscal federalism governance.

The chapter then looks at the third tier of government in other federations and a key lesson that emerges is to build more resilient and locally-sourced revenues of local governments to meet rising urbanisation needs, especially on account of health and education, anchor local government finances on a sound footing and limit moral hazard. At the same time, in order to be leveraged through market borrowing, such a framework needs reliable and transparent market information about local government finances, areas where this Finance Commission has made a set of new recommendations.

Trends in Fiscal Federalism

2.1 The design of inter-governmental fiscal relations across the global landscape has typically depended on political and economic considerations. Hence, its complexity has been driven by resource availability and the broader decentralisation framework governing taxation, spending assignments and institutional arrangements – in many cases (including in India) depending on the constitutions of individual countries. Over time, inter-governmental relations have demonstrated institutional continuity, although exogenous shocks (such as now being experienced with the Covid-19 crisis) have been a trigger for institutional and policy change. Nevertheless, common principles and lessons can be drawn from international experience, providing useful context in assessing how India's fiscal federalism has developed and equalisation objectives met, given much-needed investment in its health, education, and physical infrastructure, and the catalytic effects on growth and regional inequality. In doing this, much support was provided by this Commission's meetings with, and presentations by, the International Monetary Fund (IMF), the World Bank, the Organisation for Economic Cooperation and Development (OECD), and the Asian Development Bank (ADB).

2.2 Recent history has witnessed a gradual process of fiscal decentralisation, with a trend shift in the distribution of expenditures and revenue toward sub-national governments. This shows up in the rising vertical devolution of shared taxes to States and other sub-national bodies. However, large scale crises such as economic depressions, financial shocks and global pandemics constitute critical junctures during which transformative changes in inter-governmental relations can follow, resulting in greater centralisation in fiscal relations, such as during the Great Depression. The 2008 Global Financial Crisis also witnessed a centralising effect on federal relations with the implementation of large stimulus packages financed predominantly by the centre (although generally executed by sub-national governments).[1] This centre-led policy response to the Global Financial Crisis was generally accompanied by increased conditionality in

[1] However, the stimulus packages have generally fallen short of making up for the revenue shortfalls faced by states and municipalities during critical junctures. In the United States, during the recession of 2008-09, the federal government disbursed aid to states through the American Recovery and Reinvestment Act, but this was not enough to make up for the shortfall. This is likely to happen again during the current pandemic, resulting in contractionary policy by the states and affecting areas of social support.

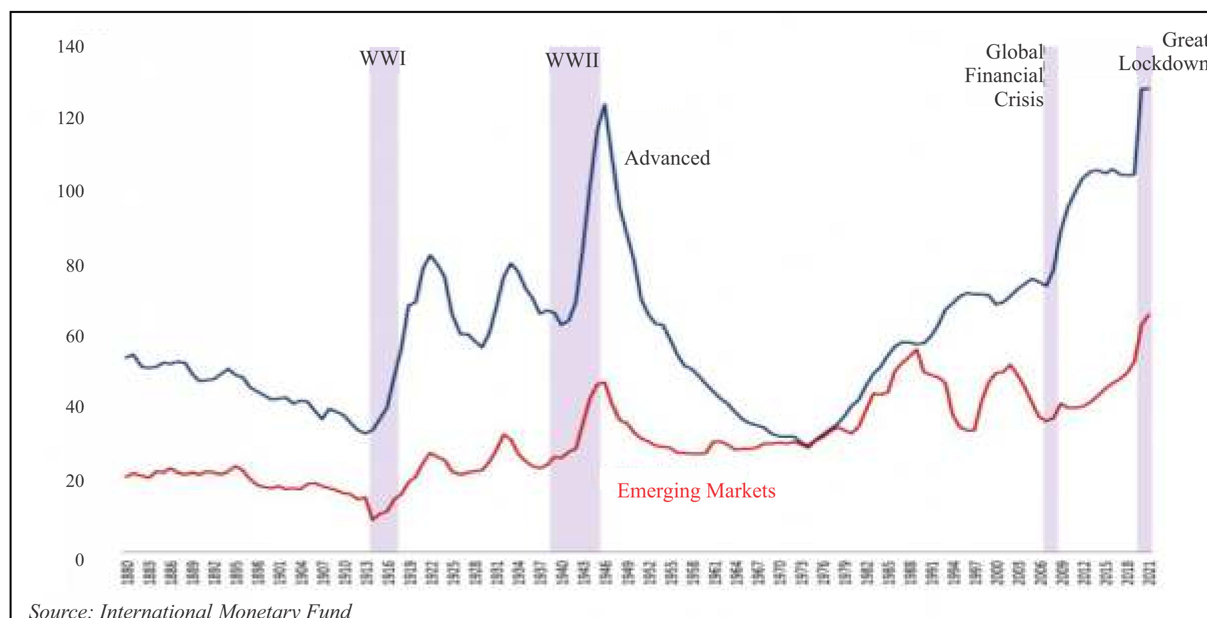
inter-governmental grants and transfers, followed by the tightening of regulations on sub-national borrowing and spending in order to deliver fiscal consolidation. This consequently reduced sub-national policy making and fiscal-financial management autonomy.

2.3 The Covid-19 crisis is different from the economic and financial crises the global economy has previously faced. However, the scope and speed of the resulting downturn, and the marked different impact across regions and municipalities, are without modern precedent and are significantly worse than any recession since World War II. In its early stages, the primary objectives of the health crisis have been to boost resources for health care and provide emergency lifelines to people and firms affected by social distancing. As the health crisis and social distancing measures recede, the objective is shifting to providing stimulus and support for economic recovery, carefully balanced with securing the additional revenues needed to restore fiscal sustainability once growth is put on an upward path. Given that regional and local governments are at the front lines of the current crisis, and are principally responsible for social protection and other public order services highly impacted by the crisis, the shock on sub-national government finances has magnified the economic consequences.

2.4 Thus, sub-national governments have faced a "scissors" effect, with significantly declining revenues (from tax bases linked to the economic cycle as well as tax policy decisions to contain the impact on businesses and individuals) and rising spending pressures in critical areas of their responsibility, especially health, education and social security. These effects have been compounded by borrowing constraints and fiscal rules applicable to sub-national governments. As federal fiscal capacity and sustainability vastly exceed those of other levels of government, it has triggered unprecedented centre-led fiscal and monetary support programmes globally.

2.5 Central fiscal tools have taken the primary role, in differentiated forms across countries, with different budgetary and debt-related implications. From a representative sample of over fifty countries, total global fiscal support has been split almost evenly between above-the-line measures, with a direct effect on revenue and expenditure such as deferral of taxes and cash transfers, and below-the-line support, which includes public sector loans, equity injections and government guarantees. Overall, these have stopped short of making up for the rising revenue shortfalls being faced by sub-national governments. Generally, emerging markets have deployed much smaller fiscal support than advanced countries, constrained to some extent by limited fiscal space. Global public debt is reaching its highest level in recorded history, at over 100 per cent of global gross domestic product (GDP), in excess of post-World War II peaks (Figure 2.1).

Figure 2.1: Soaring Global Public Debt



Source: International Monetary Fund

2.6 The fiscal tools have been accompanied by central banks generally using the fiscal side of their balance sheets to expand their monetary policy, lending, liquidity support and regulatory roles beyond their responses during the global financial crisis – trying to provide liquidity support to state and local governments and backstop their debt, buying corporate debt from the secondary (and junk-bond) market and easing bank regulatory restrictions on liquidity and loan classification. As a result, monetary policy has become accommodative across the board, with unprecedented support from major central banks and monetary easing in emerging markets including, in many cases, their first time use of unconventional policies.

2.7 This raises the tension between the need to centralise responses during the pandemic and dealing with the highly asymmetric regional impact of the crisis that could widen regional inequalities. Specifically, are there risks that the crisis will trigger institutional changes in fiscal federalism that lead to lasting greater centralisation in inter-governmental fiscal relations in the post-Covid period, when fiscal consolidation will likely again become the priority, as it did after the global financial crisis? The tension is that greater centralisation might work against the need for increased spending at the sub-national levels on healthcare, education and infrastructure to tackle inequalities. As such, there is the risk that premature, pro-cyclical fiscal tightening by sub-national governments during the current Covid crisis could create important headwinds to growth and be particularly disruptive for low-income households and the unemployed, thereby also widening income inequalities.

2.8 To limit these tensions, many countries have quickly put in place new and innovative coordination mechanisms, involving governance and fiscal tools, to tailor support to the different regional impacts of the current crisis – especially in meeting varying regional health infrastructure needs, supporting small and medium enterprises and avoiding disjointed responses

across different levels of government. Efforts are also being made to address pre-existing weaknesses and bottlenecks in public financial management systems and set up improved reporting mechanisms to ensure financial transparency and accountability that would help reprogramme budget allocations and accelerate the reallocation of funds to the front lines of the Covid crisis. Without improving the adaptability and responsiveness of public financial management systems, the costs to the economy from misdirected resources and inefficient resource use will compound the effects of the Covid crisis.

2.9 All these measures have generally involved setting up inter-territorial commissions, with exchange platforms, to support cooperation among different levels of government. In many G-20 countries, these are in addition to the permanent institutional features that already exist in their inter-governmental fiscal relations.[2] For example, in Australia, an inter-governmental body has been formed (the "National Cabinet"), including the Prime Minister and state Premiers, which meets weekly to coordinate nationally consistent health and fiscal policy responses to the crisis. In Europe, countries have generally formed task forces to manage the crisis between national and regional governments. Many countries have also adopted "emergency bills" to suspend fiscal rules, enhance flexibility in sub-national regulatory frameworks, and support local finance through grants to states and municipalities (in some case by front loading policy funding).

2.10 However, it is already apparent that these steps will generally fall short of meeting the immediate needs of sub-national governments. Much depends on the resilience of resource availability at different levels of government, that is driving the scissors effect of the Covid crisis on sub-national governments that could significantly affect their long-term fiscal sustainability. It is important to note that countries are likely to see a significant decline in their average tax to GDP ratio in 2020, as happened during the global financial crisis, accentuated at state and local governments. Estimates on tax buoyancy suggest that tax revenues could contract more strongly than economic output. This will have lasting implications – after the 2008-09 financial crisis, for many countries it took an average of eight years for revenues to recover to their pre-crisis level. All of this also makes progress towards the Sustainable Development Goals (SDGs) even more challenging.

Resource Availability

2.11 Well before Covid-19, resource availability had been a persistent challenge for many federations to devolve funds to meet the spending needs at the sub-national levels. Although tax revenue has been rising over time in many emerging markets and low-income countries, India's general government revenue as a percentage of GDP is among the lowest of the BRICS countries[3], much below the OECD average, and has little redistributive impact, given the much smaller proportion of the population that pays income and property taxes. (Figure 2.2)

[2] Unlike India, a number of countries have had permanent bodies in the structure of their institutional fiscal arrangements. Among these, Australia's Commonwealth Grants Commission has always had permanent staff, and similarly so in South Africa and Mexico.

[3] Brazil, Russia, India, China, South Africa

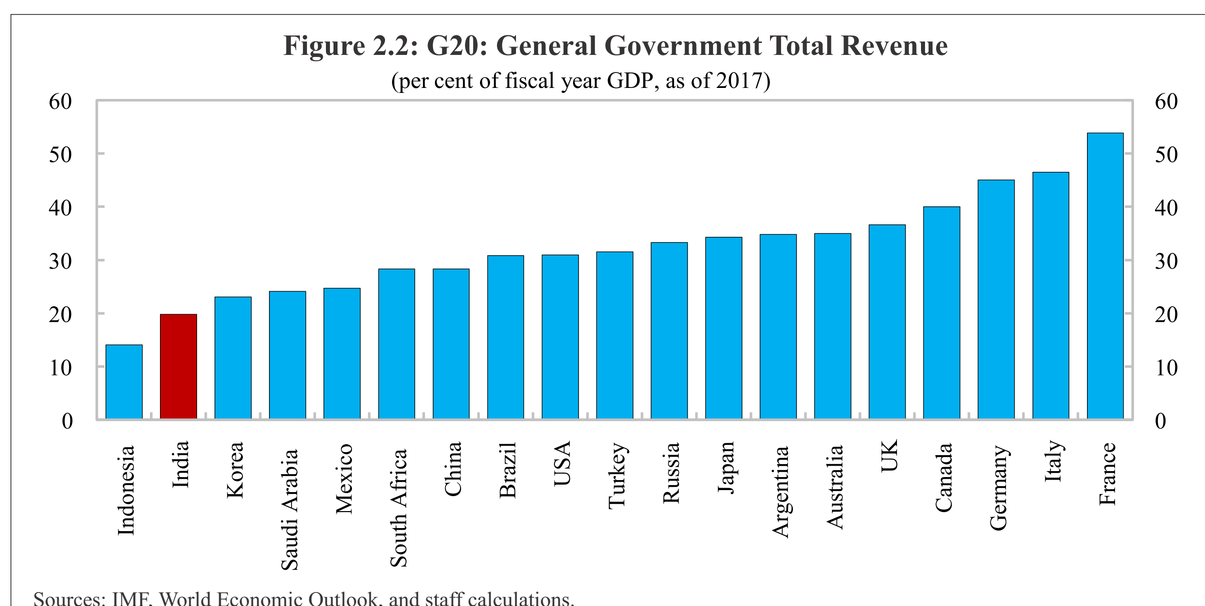


Figure 2.2: G20: General Government Total Revenue

(per cent of fiscal year GDP, as of 2017)

Sources: IMF, World Economic Outlook, and staff calculations.

2.12 The tax revenue of the Union and States in India stood at about 17 per cent of GDP in 2018-19 and has remained broadly constant since the early 1990s, but is now coming under pressure during the Covid-19 crisis. At the same time, cesses and surcharges earmarked by the Union Government have grown over time, amounting to about 15 per cent of its gross revenues, reducing the proportion of Union revenues eligible for transfers to States from the divisible pool. Given international trends, there is a compelling case for raising India's tax ratio from both macroeconomic and redistributive perspectives, especially at the sub-national level. This is essential for building fiscal space, meeting social protection and infrastructure needs and driving inclusive growth.

2.13 In contrast to India, tax revenue has been rising in other emerging markets and low-income countries by narrowing the untapped revenue potential, or the tax gap relative to tax capacity. International experience confirms that significant increases in tax revenues (0.5 per cent of GDP per year) in emerging markets are achievable over relatively short periods of time - about three years. However, it is important this is done through less distortive and more efficient taxes that allow for progressivity and improved market certainty. In particular, the effects of the current pandemic heighten the imperative to support longer-term tax capacity building, and the importance of mobilising revenues in the aftermath of the current crisis.

2.14 Based on the experience of fifty-five episodes of large tax revenue increases, the following are the main lessons from the reform patterns that have sparked and sustained such increases in other emerging market economies:[4]

[4] These experiences are summarised in Revenue Mobilisation Episodes in Emerging Markets and Low-Income Countries: Lessons from a new Dataset, IMF, Working Paper, WP/18/234, November 2018

(i) Undertake revenue administration reforms in parallel with tax policy changes.

(ii) Broaden the base for both direct and indirect taxes by reducing exemptions and improving compliance.

(iii) Shift focus to indirect taxation, through the value-added tax, with simplification and greater efficiency being the key drivers of significant revenue gains, without imposing a higher burden on the poor.

(iv) Sustain the revenue increase episodes through administration reforms in key compliance areas, including risk-based audits, filing and reporting.

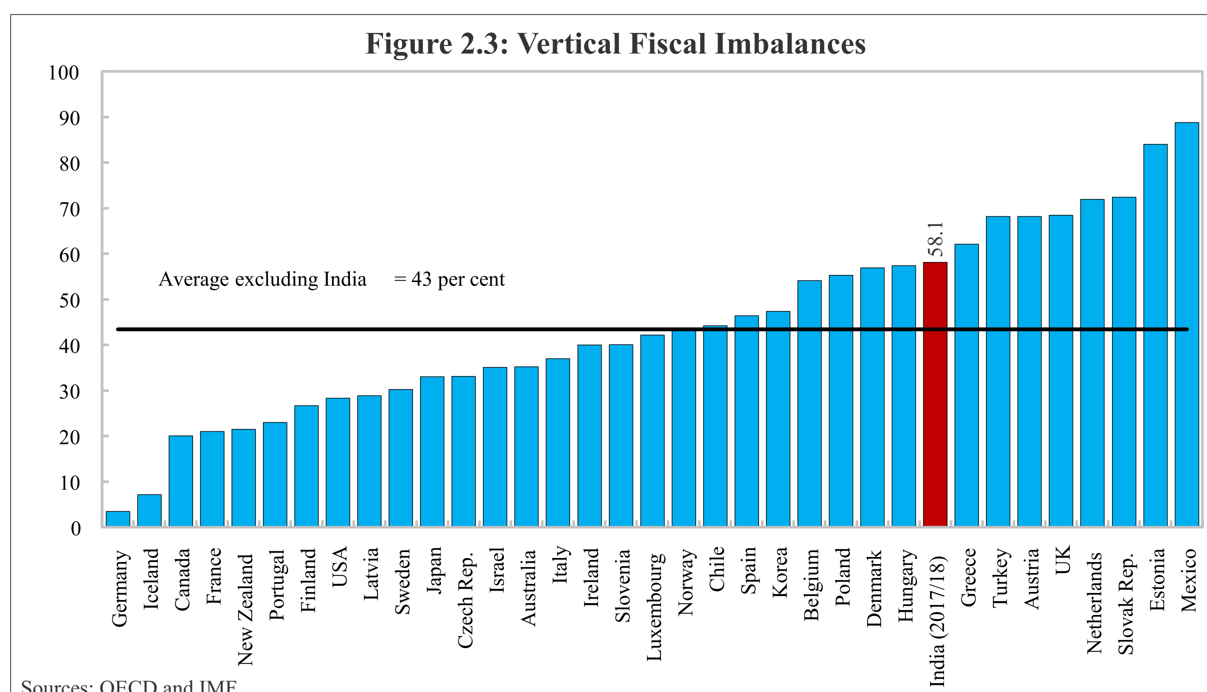
(v) Build revenue from local government property taxes, that is steadily increasing in emerging markets, with better definition of property rights and more empowered municipalities.

2.15 International experience confirms that comprehensive tax reforms can be implemented without imposing higher, and politically sensitive, burdens on the poor, provided this is done with greater progressivity in the tax structure. The move to the landmark goods and services tax (GST) in India is an important step in this direction, following the general global shift to value-added taxes. Experience also points to the room to build its progressivity and yield by continuing efforts to simplify its structure and rationalise its exemptions, without burdening the poor. International experience also points to the need for a broad reform of property, personal income and corporate taxes that would complement the GST reform in a way that supports economic growth and empowers sub-national governments to better respond to local needs. The recent move to bring India's corporate tax rate more in line with international standards should help remove obstacles for business development and attract foreign investment. Most importantly, the driver of these reforms must be base-broadening and rate-reducing measures, with parallel steps to increase the capacity and expertise of the tax administration at all three tiers of government.

Vertical Fiscal Gap

2.16 The vertical fiscal gap sums up the shortfall of sub-national own-revenue relative to their expenditure (Figure 2.3). This mismatch between expenditure and revenue decentralisation varies significantly across countries and is strongly related to the degree of revenue decentralisation that has generally increased over time, partly reflecting the rising revenue capacity of sub-national governments in many countries. While the average vertical gap has been around 40 per cent in the OECD, there has been significant diversion around the average, ranging from 6 per cent to 82 per cent. On average, the vertical gap is lower in federations than in unitary countries, reflecting the usually greater revenue-raising ability of state-level governments in federations.

Figure 2.3: Vertical Fiscal Imbalances



Sources: OECD and IMF

2.17 However, India has a larger (and rising) vertical gap than most federations, reflecting the reality that many States have relied heavily on transfers from the Union rather than on own tax revenues to finance their expenditures. This reflects the large vertical imbalances stemming from the effective assignment of expenditure and revenue powers between the Union and the States. Typically, inefficiency in meeting the vertical gap (resulting in vertical imbalance) shows up in unfunded spending mandates, inadequate provision of public services (both at the sub-national level) or excessive sub-national government borrowing. Such imbalances are magnified during crises that drive a larger wedge between sub-national revenues and expenditure responsibilities, as we are seeing during the Covid crisis. In recent years, rising fiscal deficits in many States has been a key indicator of growing vertical imbalances, despite higher tax devolution from the Union, reflecting inadequate transfers to the States relative to their expenditure needs and revenue raising capacity.

Horizontal Fiscal Gap and the Equalisation Transfer System

2.18 The horizontal gap at the sub-national level reflects the heterogeneity across States. Differences between States in their revenue capacities and public service spending needs yield horizontal fiscal gaps across jurisdictions that need to be filled by the equalisation transfer system which typically tries to minimise horizontal fiscal imbalances.

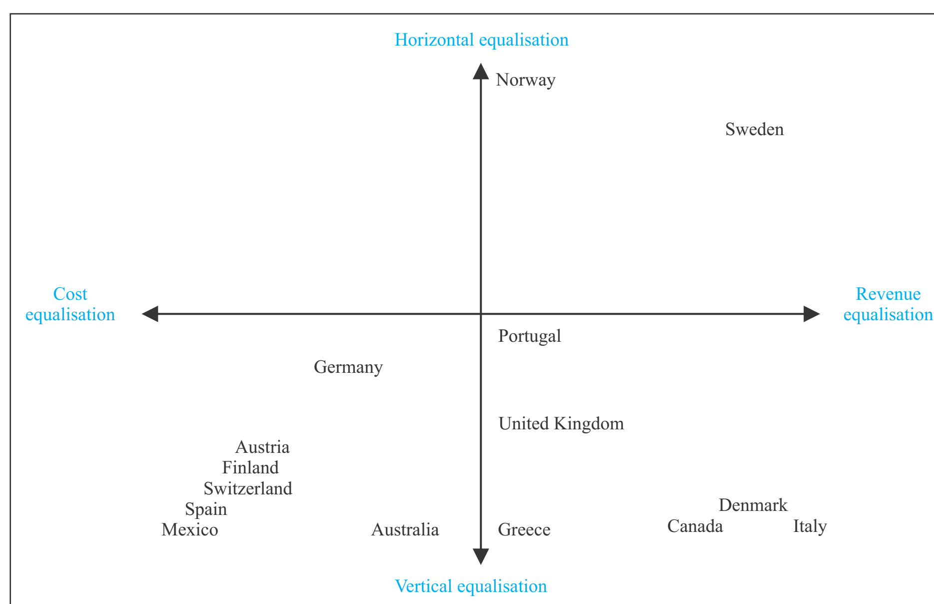
2.19 International experience confirms the diversity of approaches to defining the equalisation transfer system.[5] The common underlying principle is to provide unconditional transfers from the

[5] Forman, K., S. Dougherty and H. Blöchliger (2020), "Synthesising good practices in fiscal federalism: Key recommendations from 15 years of country surveys", OECD Economic Policy Papers, No. 28, OECD Publishing, Paris, https://doi.org/10.1787/89cd0319-en.

federal government to the states, differentiated according to their measured fiscal capacity, thereby insuring also against long-term regional fiscal shocks. Well-designed equalisation systems limit, as much as possible, moral hazard implications that would arise if the system creates incentives for states to influence transfers. International best practice is for equalisation transfers to be formula-based, avoiding discretionary changes that could respond to short-run political purposes, with infrastructure transfers being generally handled separately by discretionary and generally conditional payments. India's equalisation systems have followed this approach, with Finance Commission transfers largely being unconditional, formula-based and predictable for five years.

2.20 There are three broad approaches to measuring fiscal capacity for formula-based transfers: (a) expenditure equalisation based on needs/costs of public services; (b) revenue equalisation measured by the ability of the state to raise revenue from one or more sources; and (c) macro-indicators covering broader economic or non-economic indicators that approximate fiscal capacity where data constraints make it difficult to apply the other approaches. The systems adopted by federations have been influenced to a large extent by measurement problems and the extent of diversity of conditions and policies of individual states. For example, revenue equalisation may be difficult to implement if state tax bases are very heterogeneous and full expenditure equalisation would depend on a host of relative state-wise factors and be difficult to estimate. Revenue or expenditure equalisation practices have been the most common, although there is much diversity in the approaches that federations have used as well as in the assessment of their effectiveness. Key lessons from experience suggest that complexity in the approach adopted could raise moral hazard risks, reduce transparency and erode public support.

Figure 2.4: Comparison of Equalisation Systems



Source: OECD Fiscal Network Estimates

2.21 Figure 2.4 shows the pattern of equalisation arrangements that have developed within and across countries.[6] Fiscal equalisation systems can be divided into vertical and horizontal systems, and systems that equalise revenue differences and those that equalise cost differences. The horizontal axis depicts the cost versus revenue equalisation dimensions (the more to the left, the more `cost-oriented' the system, to reduce differences in the cost of providing public services) and the vertical axis depicts the percentage of horizontal equalisation to total equalisation (the higher the value, the more horizontal the system). Most systems are a mix of horizontal and vertical, and revenue and cost equalisation systems:

(i) In most OECD countries, equalisation systems are established in law and are periodically reviewed. For example, in Canada and Germany, equalisation is put in the Constitution.

(ii) Some systems (like Spain and Mexico) are mainly vertical and cost-equalising, while Sweden leans towards horizontal and revenue equalisation, but most find themselves along the middle of both axes.

(iii) Canada's equalisation principle measures fiscal capacity solely by the ability of a state to raise revenues using the Representative Tax System (RTS) approach.[7] Equalisation payments are made only to provinces with below-average revenue raising capacity.

(iv) Australia and Switzerland equalise both revenues and expenditures. In Australia, all GST revenues are collected by the central government and transferred to states according to each state's equalisation entitlement based on both revenue and expenditure equalisation. Revenue equalisation uses the RTS approach, and expenditure equalisation uses both needs and costs as estimated by the Australian Grants Commission.

(v) Germany partially equalises revenue capacities and supplements it by using macro indicators of special needs.

(vi) In South Africa, the Financial and Fiscal Commission (an advisory body mandated by the Constitution) measures the standard costs of selected public services as the basis for determining expenditure needs and recommends their use, but the country's Ministry of Finance still mainly uses a macro-based approach.

2.22 India's equalisation has used a macro-indicator approach with some unique factors that seek to combine elements of revenue capacity and expenditure need or cost:

(i) Equalisation applies to Union-State transfers from a shareable pool of predetermined size. This divisible pool is smaller than gross revenues and does not include defined cesses, surcharges and non-tax revenues. Nor does it include conditional transfers by the Finance Commission (or other Union sources) in support of State

[6] The data in figure 2.4 reflect country responses to questionnaires sent by the OECD and summarised in OECD: Fiscal Federalism 2014: Making Decentralisation Work.

[7] Under this approach, states' equalisation entitlements are based on the amount of revenue that would be raised by applying common tax rates to a given set of tax bases used in the states.

expenditure programmes. For example, in 2015-16, about 32.6 per cent of State revenues were from Union transfers, subject to equalisation[8]. The remaining 67.4 per cent consisted of own revenues and specific transfers, neither of which are equalised.

(ii) Although it is simpler to implement than the revenue and expenditure equalisation systems used in some OECD federations, India's equalisation methodology does not directly reflect State fiscal capacities. It has generally been based on five macro-indicators, each with its own weight in the formula, reflecting approximations to States' needs and revenue-raising capacity. Among the indicators used, per capita State income is a proxy for revenue capacity, while population approximates needs, and area and forest cover approximate expenditure costs.

(iii) Since GST revenues are not equalised, they are bound to lead to differences in the revenue-raising capacity among States. Instead, GST revenues have been guaranteed for the first five years, as a transition measure, and the approach does not involve their equalisation using the RTS approach. This is in contrast with the Australian example, where all GST revenues are allocated among states according to a combined revenue and expenditure equalisation approach. Instead, in India, State GST revenues are allocated based on the principle of destination or consumption.

(iv) Equalisation transfers have generally been far from proportional to population in the Indian system (reflecting the use of a macro-based approach in which population comprises only about one-third of the weight). This is anomalous to the extent that the cost of public services increases proportionately with population. It is also in contrast with the way in which revenue-capacity and expenditure-needs equalisation are implemented in federations elsewhere, where entitlements are typically calculated on a per capita basis, so that total entitlements are strictly proportional to population.

(v) The second concern is the co-existence, for some time, of the 1971 and 2011 population levels as macro-indicators in the equalisation formula, with a much higher weight being given to the former. The motivation for doing so was to reward States which have been more successful in containing their population growth rates, but it risks making equalisation transfers less responsive to existing population levels. This was changed in the first report of this Commission, with the 2011 population level being adopted as the relevant macro-indicator with a separate factor for population control.

(vi) In the longer run, moving to a system of revenue and/or expenditure equalisation has many advantages, given that these are better measures of State fiscal capacity than macro-based measures, and would thereby help achieve fuller equalisation. Using these to calculate per capita equalisation entitlement would take population fully into account. Data limitations remain a constraint, and such a major change would have to be subject to a reasonable transition. In any event, a key challenge is to use factors that cannot be easily

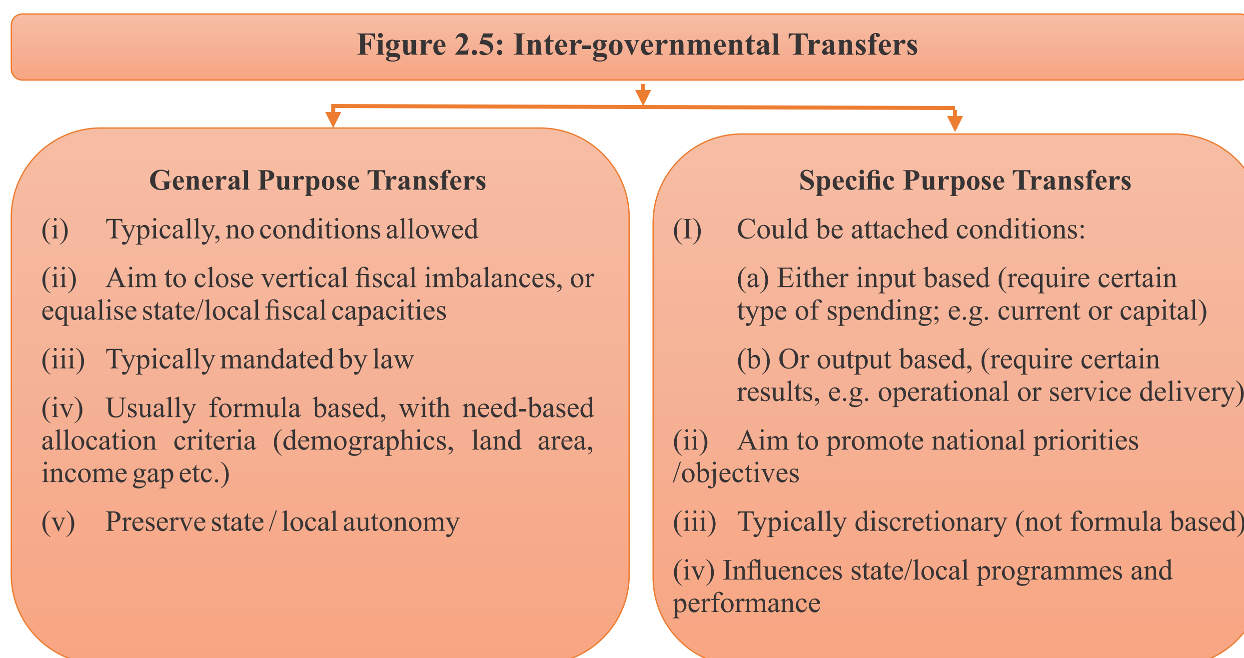
[8] Rao, M Govinda (2017), "The effect of Intergovernmental Transfers on Public Services in India," National Institute of Public Finance and Policy, Working Paper no. 218, New Delhi.

influenced by State policies, to help avoid moral hazard risks.

Conditional or Incentive-based Fiscal Transfers

2.23 While equalisation transfers are a key tool to meet deficiencies in the fiscal capacity of States to provide public services and to address horizontal fiscal imbalances, they are not the appropriate instrument for regional development or policies relating to education, health and poverty reduction, or indeed for meeting special social protection needs, as is being witnessed during the current Covid crisis. As such, countries have used discretionary, specific-purpose central government transfers with attached conditions to address varying state infrastructure needs, for broader regional development and social policy, and also to drive fiscal performance and administrative changes (Figure 2.5). Many countries have already voted on additional (temporary) budgetary transfers to support sub-national governments that will face large additional spending pressures due to Covid-19. However, judging from past experience, such as during the Global Financial Crisis, central fiscal transfers in many federations fell short of meeting shortfalls in tax revenue at sub-national levels.

Figure 2.5: Inter-governmental Transfers



2.24 International experience has clear lessons about the kind of conditions that better ensure the effective use of discretionary transfers, while also addressing concerns of political influence and softening budget constraints.

2.25 Input or process-based conditions have traditionally been more common in such transfers. These have focused on the intended use of funds, such as the type of education spending, or on the service process involved, such as on school enrolment. Countries have also

often used input-based matching transfers to subsidise benefit spill overs. One example is South Africa, which provides matching transfers to teaching hospitals to compensate for state under-spending on tertiary education and health care services that benefit non-residents. Another example is the United States, which provides matching capital grants to states for highway construction, with matching rates varying by state fiscal capacity.

2.26 However, given issues of fungibility and related factors, there is growing consensus that rigid and excessive input-and process-based controls have not been effective in delivering efficient service delivery and outcomes. In the current Covid crisis, such weaknesses in fiscal transfers risk the ability to manage and meet changing health service needs.

2.27 Rather, international experience conveys that output-based conditions are more efficient in ensuring the use of funds to achieve the desired results. For instance, in service delivery, the output could be increasing high school graduation rates to achieve the outcome of increased supply of skilled professionals, without tying the funds to required inputs like the number of teachers. Thus, output-based grants have conditions on outputs, as opposed to outcomes, because outcomes can be influenced by factors other than state performance, and states should be held accountable only for factors under their control. For instance, supply of skilled professionals could be influenced by external factors such as emigration. Canada's health transfer programme (CHT) is viewed as a simple and effective output-based conditional federal transfer.

Box 2.1: Countries with Output/Process-based Conditional Transfers

Education:

(I) Brazil: Grants based on school enrolment to top-up the share of state/local revenue earmarked for primary education, if the earmarked amount per student is less than the national standard.

(ii) Chile: Per-student grant to all schools is topped up by a 25 per cent additional grant for giving salary bonus to teachers in best performing schools based on national achievements scores.

(iii) Indonesia: Operating grants for schools based on school age population are supplemented by a matching capital grant for constructing school buildings to improve access to primary education nationally.

(iv) Uganda: Grants are given for increased school facilities (desks, classrooms) to targeted levels and for school enrolment.

Health Care:

(i) Brazil: Per-capita grant for basic benefits is topped up by grants for hospital admissions and ambulatory care.

(ii) Rwanda: Grants for hospital cases admitted, staff bonuses and facility improvement.

2.28 As a result, reforms are taking place in many countries to shift to output-based transfers that measure service delivery performance. Countries have given priority to developing output-based conditions on education and health care transfers (including to set minimum standards in health care and education service delivery). The methods adopted, at least initially, have involved topping up other specific-purpose transfers and block grants with output-based transfers (Box 2.1).

2.29 Such reforms to adopt output-based conditions have generally been accompanied by steps to give states greater flexibility to deliver services, alongside greater accountability and clearer specification of roles and responsibilities, as well as reforms to improve transparency and the governance and implementation capacity of states.

2.30 However, shifting to output-based conditions does pose operational challenges, especially in low-income countries and states. These challenges range from the availability of institutional capacity to timely measurement of results to the ability of enforcement. As conditionality moves from inputs to process to outputs, it gets increasingly harder for states to achieve them. If some states have lower institutional capacity, perhaps the conditionality should differ by state capacity. Relatedly, in many African as well as South-East Asian developing countries, performance-based grants are increasingly being used to improve local institutional capacity. For instance, Tanzania and the Philippines adjust capital grants by good public financial management practices.

2.31 Achieving compliance is largely a function of transfer design — setting the right conditions, performance targets and incentives. In case of non-compliance with grant conditions even after taking effective design into account, various methods of penalties may be adopted, including the reduction, withholding, repayment, return or refund, reallocation of funds, or instituting financial corrections. Alternatively, rather than penalising weak performance ex-post, conditional transfers could be designed to reward good performance such as by topping up unconditional grants for high performing states.

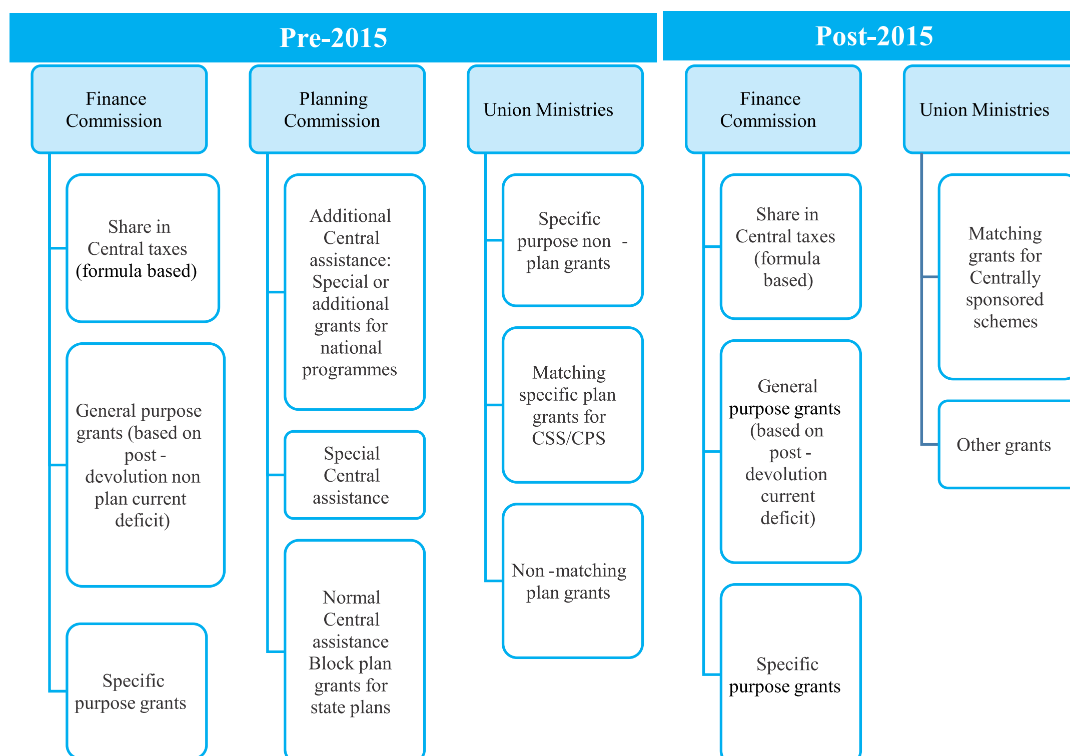
2.32 Many of these issues and concerns arise in the Indian experience as well, although they need to be assessed against the recent changes in the transfer architecture (Figure 2.6).

2.33 Reflecting the wide disparity of Indian States (especially those that were classified as `special category'[9]), as well as the growing importance of local governments in public service delivery, specific-purpose transfers (outside the unconditional general-purpose transfers linked to tax devolution) have been large – recognising constraints on the equalisation that could be achieved through tax devolution. Seven out of fourteen Finance Commissions recommended State-specific grants, but the share given by the Union ministries has remained much larger. The use of fiscal responsibility and fiscal governance as conditionalities in the specific-purpose transfers by recent Finance Commissions has been growing. The Twelfth Finance Commission (FC-XII) made the enactment of fiscal responsibility and budget management legislations a

[9] The special category states were mainly in the North East, with very small revenue bases, and high government spending mostly financed by government transfers.

condition for State Governments to receive debt relief, and subsequent Commissions stipulated conditions on local body transfers linked to building financial management and auditing. [10]

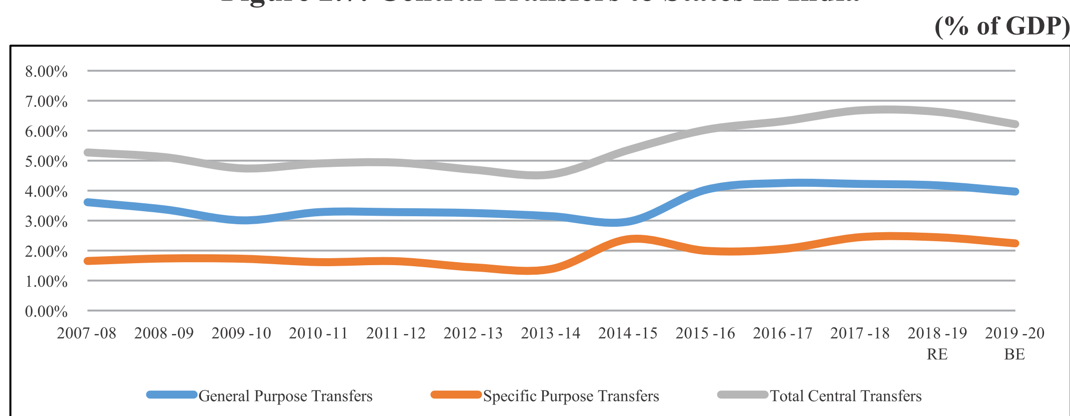
Figure 2.6: Institutional Structure for Inter-governmental Transfer in India



2.34 However, the share of these specific-purpose transfers is declining, following the recommendations of the FC-XIV and the abolition of Plan transfers following the dissolution of the Planning Commission (Figure 2.7). Nevertheless, they still account for about 30 per cent of total transfers, equivalent close to 2 per cent of India's GDP.

Figure 2.7: Central Transfers to States in India

(% of GDP)



Source: Union budget documents and Finance Accounts for various years

[10] FC-XII recommended that state legislations should, among other things, provide for the elimination of revenue deficit by a given deadline, and reducing fiscal deficit to or below a target level

2.35 Concerns arise because, even after some recent consolidation, India's specific-purpose transfers have been channelled through a large number of discretionary cost-sharing Centrally sponsored schemes (CSS) and non-matching Central sector schemes. They are not generally linked to outcomes, and are input- or process-based, and give rise to the usual concerns associated with such conditionalities. The concerns result, in part, from the large number of schemes, their concurrence with State responsibilities and their burdensome matching requirements, especially for States with lower fiscal and institutional capacity.

2.36 Significantly, recent studies conclude that India's specific-purpose transfers, especially those given by the Union ministries, detract from the equalising focus of the transfers extended by the Finance Commissions, and are probably regressive, in the sense that they are positively correlated with per capita incomes of the states.[11] This is of particular concern in the case of education and health care, which are crucial to build convergence in human capital standards across States. Thus, there is a strong need to build institutional capacity in the States and shift to well-designed output-based transfers, while rationalising the multiplicity of Union schemes. This could be done by moving in the direction of equal per capita transfers with general output-based conditions attached to them that reflect the need to build institutions.

The Third Tier

2.37 International cross-sectional studies point to a sharp contrast in the degree of decentralisation to the third tier between the developed and developing countries, with significant correlation with population and per capita GDP.[12] Developing countries are typically characterised by a higher degree of fiscal centralisation. One critical aspect of centralisation is the disparity between state and local level governments in their expenditure commitments and access to revenues - closely related with the devolution of functions - and their administrative capacity. This reflects the reality that local governments in federations have typically derived their power from intermediate (that is, state-level) governments, rather than the Constitution. As a result, state governments have a high degree of discretion in determining sub-provincial fiscal management. India's experience mirrors these characteristics.

2.38 However, there is a clear trend in emerging markets to strengthen local government finances. This trend has also been driven by the global rise of urbanisation, as in India, in line with per capita GDP. Urbanisation has added to the challenges faced by local governments, especially municipalities, to finance public infrastructure and services, as well as for the devolution of functions and finance.[13,14] For example, even in China, where vertical fiscal imbalances have been

[11] Rao, M Govinda (2017) and "Strengthening Indian Center-State Fiscal Frameworks,' IMF Country Report No. 17/55, February 2017.

[12] These issues are reviewed in Roy Bahl and Richard M. Bird (2018), Fiscal Decentralisation and Local Finance in Developing Countries, Edward Elgar Publishing, Inc, ISBN 978 1 78643 529 3

[13] In OECD countries, 80 per cent of national populations are urbanised on average, and in developing countries, urbanisation has risen close to 60 per cent.

[14] International evidence (including recent reports in India) point to the infrastructure needs of urbanisation in developing countries rising annually to 1-2 per cent of GDP. Bahl, Roy, "Metropolitan City Finances in India: Options for A New Fiscal Architecture," International Center for Public Policy Working Paper 12-33, 2012

high, the budget law was revised in 2015 to reduce the structural shortfall of revenue relative to rising spending obligations of provinces, overcome mis-alignments in inter-governmental financing and develop a more sustainable regulatory framework on oversight and disclosure. Countries, such as Brazil, Colombia and South Africa already have national legislation on cities with specified revenue instruments.

2.39 There is, therefore, a strong case for providing adequate and effective tax sources to local governments. Although international experience suggests a trend in this direction, continuing disparities have clearly been magnified in the Covid crisis, especially for municipalities, whose revenues (taxes, user fees) have significantly declined, while their expenditures (health and other social support measures) have sharply risen. An examination of the main characteristics and best practices in meeting these challenges in local governments in federations is, therefore, in order.

Local Government Expenditure

2.40 With rising incomes, federations have generally assigned a higher portion of education and health spending to local governments. These items can be over half of local government expenditure in some OECD federations (Figure 2.8). In many countries, local governments have also become key players of investment-led growth. Local government investment spending is around a third of the total investment by the general government sector in several OECD federations (Figure 2.9). Both factors explain the emergence of large vertical imbalances in several countries, in many cases resulting in soft budget constraints. Typically, local governments that receive transfers to carry out spending on behalf of higher levels of government spend less efficiently than if they were responsible for raising revenue locally from taxation. This raises problems related to the multiplicity of expenditure responsibilities with higher levels of government and the need for periodic performance evaluation at all levels of public expenditure.

Figure 2.8: OECD Expenditure Composition
(per cent of local government expenditure)

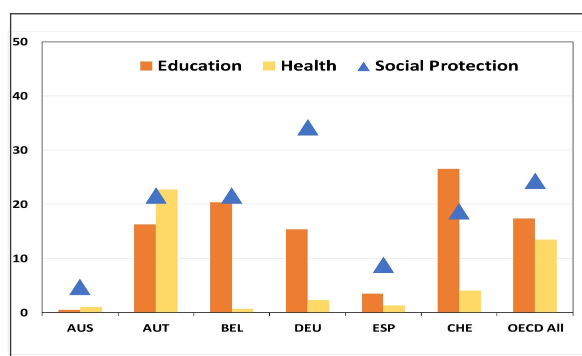
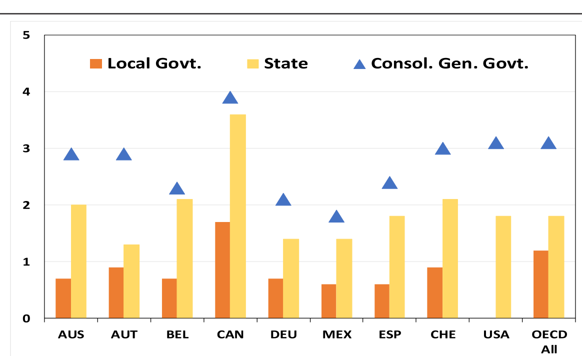


Figure 2.9: OECD Public Investment
(per cent of GDP)



Source: OECD Database

Local Government Revenue

2.41 Building locally-sourced revenues has become essential to anchor local government finances on a sound footing, limit moral hazard and pre-empt financing risks. While some countries, like Australia and Mexico, give local governments full authority to set certain tax rates without consulting upper-level governments, this is not the case in many others. In China and in India, for example, local governments have inadequate capacity and control over revenue instruments and their local government revenues (generally from user fees and property value) have been less than 5 per cent of GDP.[15] The experience of the United States, where each state can decide what tax instruments it will authorise to local governments, has clear lessons for India, where the Seventy-Fourth Amendment to the Constitution follows a similar model. In India, however, there is the added institutional challenge of building consensus across State Governments to drive the process forward consistently. In the United States and Canada, some provinces and large cities may `piggyback' an income tax on top of a state/provincial tax, using the same base and potentially the same administration.

2.42 Growing urbanisation is now changing the parameters for local government revenue, especially for municipalities, given that their infrastructure needs have risen well beyond the capacities of traditional central government revenue and transfers. Unlike rural local bodies, urban areas, especially the cities, typically have the economic power to be financially self-sufficient, with the right legal framework and supportive policies. In India, the State Finance Commissions (SFCs) need to play a much more critical role in recommending taxes assigned to municipalities and other local governments and related financial relations between the States and their municipalities.

2.43 International experience points to property taxation being among the best tax options for local governments, together with tariffs for services such as water and electricity.[16] By global standards, property tax revenues in Indian cities are a fraction of the developing country average of about 0.7 per cent of GDP, and well below the level in China. This is a reflection of the large inter-state disparities in the devolution of functional and financial powers, including the effective limitations in many States on local governments levying property taxes. In many OECD as well as emerging market countries, recurrent taxes on immovable properties has become the most important tax revenue for state and local governments. Thus, there is considerable potential in moving in this direction, and the lessons point to the need to build a framework for property taxation with universal coverage, limited exemptions, transparent and updated valuations and rates that are broadly in line with global norms.

2.44 Overall, significant revenue-raising discretion for local governments is necessary as part of the process of building local capacity to meet infrastructure needs efficiently and with fiscal discipline. Meanwhile, fiscal transfers to local governments help address their fiscal imbalances

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[15] Slack, Enid and Richard Bird (2015); "How to reform the Property Tax: Lessons from Around the World, "IMFG Papers on Municipal Finance and Governance, No 21, Toronto.

[16] Many local governments impose other selective taxes on certain services and license fees on businesses; these seldom produce much revenue and experience suggests they serve little regulatory purpose too. In contrast, property taxes are less distortionary and more progressive

but there is need to incentivise building their revenue potential.

Local Government Fiscal Sustainability

2.45 Among the lessons from international experience is the importance of imposing hard budget constraints on local governments in order to contain financing risks from their large vertical imbalances, which should be covered by transfers from higher levels of government. These budget constraints have generally aimed at balancing current spending with current revenue and limiting capital expenditures to designated financing sources. However, in order to be effective, they require tight definitions, oversight and disclosure of their balance sheets to be consistent with general government fiscal targets and to avoid building up contingent liabilities. In many countries, limited oversight and expectations of bailouts has given rise to the rapid build-up of vulnerabilities in local government finances.

2.46 China is a clear example of the inherent risks of local governments dealing with structural misalignments of their revenues and expenditure obligations. After the global financial crisis, China's local governments implemented large scale fiscal stimulus by setting up unregulated financing vehicles to borrow from prohibited sources in unreported ways. China's new budget law in 2015 aimed at reforms to contain risks from local government finance, develop the bond market for local governments and better align inter-governmental revenue and spending.

2.47 In more developed countries, local governments clearly borrow from commercial banks as well as by issuing bonds, depending on the strength of their fiscal institutions and fiscal rules that helps improve credit rating and reduce credit costs. Loans and commercial debt have accounted for over half of sub-national government borrowing in twenty-nine OECD countries.[17] In Europe, these loans are mostly provided by commercial banks, whereas in the United States and Canada, there are well developed markets for local government bonds.

2.48 These considerations are especially important for large municipalities. South Africa stands out among emerging markets in its adoption of a policy framework for municipal borrowing. It has built a predictable legal framework for own-source revenue instruments in urban areas (mainly through property tax, electricity tariffs and water tariffs), while deploying equalising transfers in poor rural areas with little tax base.

2.49 At the same time, in order to be leveraged through market borrowing, such a framework also needs reliable and transparent market information about local government finances and accountability of managers. Examples include guidelines for reporting and publishing of fiscal accounts and the use of multi-year budgeting to improve fiscal policy coordination and response to shocks and alternative scenarios, consistent with best practice public financial management standards. Independent auditing of sub-national financial accounts is also an important component used in many countries. Several countries, such as Mexico, require sub-national governments to subscribe to a credit rating system in order to access financial markets.

[17] OECD, 2016

2.50 Consistent with these lessons, India has been progressively updating the 2003 Fiscal Responsibility and Budget Management (FRBM) legislation with a rule-based fiscal policy that limits government debt, fiscal deficits and revenue deficits to prescribed targets. Although borrowing by States from the market has grown over time, there are still conflicts with building fiscal sustainability, given the continuing expectations of implicit guarantees by the Union, and now under the scissors pressures from the Covid crisis.[18] As discussed later in Chapter 13, the last four Finance Commissions (and the present Commission) have made specific recommendations and set performance criteria for bringing the accounts of local governments, and their audit and disclosure, to international standards. However, India is still lagging in this respect. In particular, consistent and consolidated data on States' accounts are still not available, making India among the set of countries that does not report general government (inclusive of State accounts) fiscal aggregates.[19] In contrast, Brazil and South Africa, among other emerging market countries, provide comprehensive general government reports complying with international standards.

Conclusions

2.51 The Covid crisis risks bringing about changes in fiscal federalism given its magnitude, the inability of sub-national governments to absorb the fiscal costs on their own and the asymmetric regional impact of the crisis. In dealing with these issues, which have significant and manifold social implications, the crisis magnifies the importance of collaboration between the Union and State Finance Commissions, and building independent fiscal institutions. International experiences give India an important opportunity to benchmark its own experiences and trends to its peers and build best practices in inter-governmental fiscal relations.

2.52 Among the international challenges accentuated during the pandemic is the critical importance of resource availability for meeting equalisation needs. Resource availability and distribution during this crisis will generally shape the fiscal federal relationship during the next decade. In this context, India's revenue ratio has persisted at relatively low levels, with rising pressure to bring this closer to that of other emerging markets, thereby better meeting rising social and developmental needs.

2.53 India's vertical fiscal gap has been high relative to other federations, reflecting the mismatch between revenue and expenditure decentralisation at sub-national levels, and this has risen over time. This makes the horizontal fiscal imbalance at the sub-national level a critical determinant of devolution, given India's relatively high heterogeneity across States, as is now becoming more evident in their very differentiated health capacity to address the immediate consequences of the Covid crisis.

2.54 In addition to the formula-based transfers, countries have used discretionary, specific-

[18] A recent study assesses that bond spreads have remained relatively narrow across States despite their varying fundamentals. “Fiscal Discipline in Indian States: Market-Based and other Options” (IMF Selected Issues, July 2, 2018)

[19] Sarma, Atul and Debabani Chakravarty, Integrating the Third Tier Government in the Indian Federal System, Palgrave Macmillan, 2018, ISBN 978-981-10-5624-6

purpose transfers to meet infrastructure needs. International experience is clear that these transfers are more effective and progressive if they are based on well-designed output or outcome-based indicators, and this is becoming more evident in assessing how sub-national governments are meeting the Covid health crisis.

2.55 A key lesson from the third tier of government in other federations is to build resilient and locally-sourced revenues to meet rising urbanisation needs (especially on account of health and education), anchor local government finances on a sound footing and limit moral hazard. Consistent with these lessons, and among other steps, this Commission has recommended multiple performance criteria on transfers to the third tier to grow the property tax and institutionalise the public availability of their audited balance sheets.

2.56 Indeed, the need for accountability and efficient public financial management becomes more critical during public finance crises as that currently being faced across the global landscape. To limit these tensions, many countries have quickly put in place new and innovative coordination mechanisms, involving governance and fiscal tools, to tailor support to the different regional impacts of the current crisis. There are clear lessons for India, including to ensure consistency in the operation of the State Finance Commissions and to ensure their continuing collaboration with the Finance Commission. Overall, international experience makes clear the many advantages of continuity at the political and institutional levels between the Union and the States, so that fiscal equalisation can be closely monitored, new shocks to fiscal federalism examined and performance criteria on grants followed.

Chapter 3

Setting the Context: Analysis of the Past

The Fifteenth Finance Commission (FC-XV) reviewed the Union and State finances as well as inter-governmental transfers during the period 2011-12 to 2020-21 (BE). The period from 2015-16 onwards has witnessed fundamental changes in the architecture of fiscal federalism and the working of the fiscal system in the country. The abolition of the Planning Commission, removal of the distinction between Plan and non-Plan expendture, transformation of the indirect taxation system through the introduction of goods and services tax were accompanied by substantial enhancement of the share of the States in the divisible pool of taxes to 42 per cent by the FC-XIV.

Fiscal consolidation with a progressive glide path was substantially achieved with the fiscal deficit of the Union Government falling from 5.9 per cent of gross domestic product (GDP) in 2011-12 to 3.4 per cent in 2018-19, along with a corresponding drop in the revenue deficit from 4.5 per cent to 2.4 per cent. This consolidation has been achieved with a marginal improvement of the the tax-GDP ratio from 10.2 per cent to 11 per cent, enhancement of disinvestment receipts and reduction in revenue expenditure, largely on account of a reduction in the petroleum subsidy. The expenditure on defence services as a proportion of GDP declined from 2 per cent in 2011-12 to 1.5 per cent in 2018-19. The debt to GDP ratio improved from 51.8 per cent to 47.9 per cent over the same period. The introduction of the goods and service tax on 1 July 2017, with an assured revenue growth of 14 per cent for the States for five years, injected an element of uncertainty in the financial flows of the Union Government. The above indicators do not take into account increasing resort to deferred liabilities and off-budget borrowings to cover the Union Government's food and fertilizer subsidy commitments. Unpaid liabilities and extra-budgetary resources (EBR) affect the integrity of fiscal accounts. In a welcome move, the Union Government has started including details of EBR in its Medium-term Fiscal Policy Statement from 2019-20.

For the States, the period 2011-12 to 2018-19 saw a deterioration in the aggregate fiscal indicators for States, with the gross fiscal deficit increasing from 1.9 per cent to 2.5 per cent of GDP. The Ujjwal DISCOM Assurance Yojana (UDAY) scheme for the financial and operational improvement and revival of power distribution companies had a negative impact on the aggregate indicators of State Governments both in 2015-16 and 2016-17. The impact of UDAY was also reflected in the total debt-GDP ratio of the States, which increased from 22.6 per cent in 2011-12 to 24.3 per cent in 2016-17. The implementation of the FC-XIV recommendations saw the aggregate tax devolution to States as a proportion of GDP jump from 2.7 per cent in 2014-15 to 4 per cent in 2018-19. Despite the enhanced devolution, again as a proportion of their respective gross state domestic product (GSDP), seven of the North-Eastern and Himalayan States (including erstwhile State of Jammu and Kashmir) saw a reduction in their aggregate

transfers from the Union between 2014-15 and 2015-16, primarily on account of the reduction in grants-in-aid in the form of normal Central assistance, special Central assistance and special Plan assistance.

In inter-governmental transfers, the share of devolution in the Union Government's gross revenue receipts went up from 23.8 per cent in the FC-XIII period to 31.37 per cent in the first four years of the FC-XIV period. A compositonal shift from grants to devolution in the Union's transfers gave the States greater flexibility in their choice of expenditures.

3.1 The terms of reference (ToR) of this Commission requires us to "review the current status of the finance, deficit, debt levels, cash balances and fiscal discipline efforts of the Union and the States, and recommend a fiscal consolidation roadmap for sound fiscal management, taking into account the responsibility of the Union Government and State Governments to adhere to appropriate levels of general and consolidated government debt and deficit levels, while fostering higher inclusive growth in the country, guided by the principles of equity, efficiency and transparency. The Commission may also examine whether revenue deficit grants be provided at all" (paragraph 5). Accordingly, we reviewed the major trends in Union and State finances with a focus on the trends between 2011-12 and 2020-21 (BE).

3.2 The past five years have seen major changes in the country's fiscal landscape. The Planning Commission was abolished and replaced by NITI (National Institution for Transforming India) Aayog on 1 January 2015. The closing down of the Planning Commission effectively brought to an end a sixty-five years long era of central planning and ushered in a fundamental change in the mechanism of transfers to States. NITI Aayog, unlike its predecessor, does not play a role in determining the allocation of resources. Instead, it is designed to foster "cooperative federalism, promotion of citizen engagement, egalitarian access to opportunity, participative and adaptive governance and increasing use of technology." [1] Designed to evolve a shared vision of national development priorities with active involvement of States, "NITI Aayog (will) seek(s) to provide a critical directional and stategic input into the development process."[2] A corollary to this was the removal of the distinction between Plan and non-Plan expenditure in the Union Budget of 2017-18, on the culmination of the Twelfth Five-Year Plan in March 2017. This has been replaced by the Constitutionally mandated as well as universally accepted standard practice of classifying expenditure as revenue and capital.

3.3 The award of the Fourteenth Finance Commisison (FC-XIV) itself had been a departure from the past. It took a comprehensive view of both non-Plan and Plan revenue expenditures and increased the devolution to the States from 32 per cent to 42 per cent of the divisible pool from 2015-16 onwards. Not only did the quantum of general purpose transfers go up substantially, but there has also been a major compositional shift in the total transfers from the Union to States. As a consequence, various Plan expenditures that were earlier steered by the Planning Commission,

[1] Cabinet Secretariat Resolution, no.511/2/1/2015 dated 1st January, 2015
[2] Ibid.

such as normal Central assistance (NCA), special Central assistance (SCA) and special Plan assistance (SPA), were discontinued. On the basis of a recommendation made by a sub group of Chief Ministers constituted by NITI Aayog, the Union Government in 2016-17 also rationalised the Centrally sponsored schemes (CSS) into twenty-eight umbrella schemes, consisting of six core of the core schemes, twenty core schemes and two optional schemes.[3] Further, the medium term framework for CSS and their sunset dates have been made co-terminus with Finance Commission cycles. A major initiative relating to public finance management has been the roll out of direct benefit transfers (DBT) through the Public Finance Management System (PFMS). The other two reforms were the merger of the railway budget with general budget and advancement of the budget presentation to 1 February beginning with the budget of 2017-18.

3.4 This period has also seen a significant shift in the contours of inter-governmental fiscal relations, both with the acceptance of the recommendations of the FC-XIV and the implementation of the nation-wide goods and services tax (GST) from 1 July 2017. The sharp increase in tax devolution has resulted in the share of general-purpose transfers going up. On the other hand, steps taken by the Union Government have also altered the composition of transfers in two ways: (a) the assistance to the States through the Planning Commission route have been discontinued and (b) the States' share in CSS has been enhanced to reduce the support of the Union.

3.5 The introduction of GST is unarguably the most important structural reform in the field of indirect taxation in the country. By amalgamating a large number of Union and State taxes into a single tax, GST is expected to remove the ill effects of cascading of taxes or 'tax on tax' and pave the way for a common national market. From the consumer's point of view, the biggest advantage would be in terms of an estimated reduction in the overall tax burden. The assignment of concurrent jurisdiction to the Union and the States for the levy of GST required a unique institutional mechanism that would ensure that decisions about the structure, design and operation of the tax are taken jointly by both. The institutional development of the GST Council as one of the pillars of fiscal federalism has been a major positive in this regard.

3.6 However, unique challenges have emerged in the implementation of GST. The less-than-expected buoyancy in revenues and the difficulties in the settlement process have affected both the Union's and the States' finances. Lower GST revenues than what was expected in the initial phase could be attributed to several changes in rates, returns, shifting timelines for filing of returns, delayed introduction of anti-evasion measures such as invoice matching, reverse charge, technical glitches and cumbersome compliance processes.

3.7 This chapter has been divided into five sections. We first review the current situation prevailing due to the Covid-19 pandemic followed by a review of GST for which we have data available for the the financial years 2017-18 (nine months), 2018-19 and 2019-20. We have

[3] Report of The Sub-Group Of Chief Ministers On Rationalisation Of Centrally Sponsored Schemes, October 2015, https://www.niti.gov.in/sites/default/files/2019-08/Final%20Report%20of%20the%20Sub-Group%20submitter%20to%20PM.pdf

reviewed GST separately as it has a significant impact on both Union and State finances, and the final shape that it take will have a criticial bearing on finances during our award period. In the third section we have undertaken a review of the Union finances, followed by a review of State finances in the fourth section. We finally look at the trends of inter-governmental transfers in the last section.

Under the Shadow of the Pandemic

3.8 The world economy, already decelerating since 2017, was and continues to be severely affected by Covid-19, a novel coronavirus causing acute respiratory syndrome first reported by China in end-December 2019 as a cluster of cases of pneumonia in Wuhan in Hubei Province. Highly infectious through human-to-human transmission, it travelled widely across countries and soon acquired the status of a pandemic. By 22 October 2020, Covid-19 had affected more than 40 million people and resulted in over 1.2 million deaths in more than 210 countries. Apart from the tragic loss of life, the heavy and sudden burden of the pandemic has overwhelmed the health care system across countries and resulted in a shortage of doctor and paramedics, hospital beds, intensive care units (ICUs) and quarantine facilities. Non-Covid-19 patients have also suffered.

3.9 To contain the virus and save lives, most countries announced what the International Monetary Fund (IMF) has termed as the Great Lockdown, through quarantines and social distancing practices. The Great Lockdown has triggered, the IMF warned in June 2020, the 'worst recession since the Great Depression.' According to WEO October 2020, the world economy is likely to contract by 4.4 per cent in 2020. With no cure through medical treatment, or vaccine and prophylactic discovered so far, the future of the pandemic in terms of virulence and duration remains uncertain. The IMF expected the world economy to grow by 5.2 per cent in 2021; the level of global gross domestic product (GDP)[4] in 2021 is expected to be a modest 0.6 per cent above that of 2019 . The prognosis for the world economy is equally gloomy according to other international expert bodies such as the World Bank (-5.2 per cent in 2020 and 4.2 per cent in 2021) and Organisation for Economic Cooperation and Development (OECD) (-9.3 per cent in 2020 and 2.2 per cent in 2021 for OECD countries in the aggregate).

3.10 During the 2014-2019 period, according to the IMF's WEO data published in April 2020, the Indian economy grew at a faster pace of 6.8 per cent, vis-à-vis the world's annual average of 3.5 per cent,. Among the twenty-three large economies with more than 100 million populations or GDP over $1 trillion, in terms of annual average growth rate, India was one of the fastest growing during 2013 to 2019. Going forward, this generally encouraging picture is tempered by the pandemic and three other sobering developments.

3.11 First, as a proportion of GDP, gross fixed capital formation declined steadily from 34.3 per cent in 2011-12 to 30.8 per cent in 2017-18, and after increasing to 31.9 per cent in 2018-19,

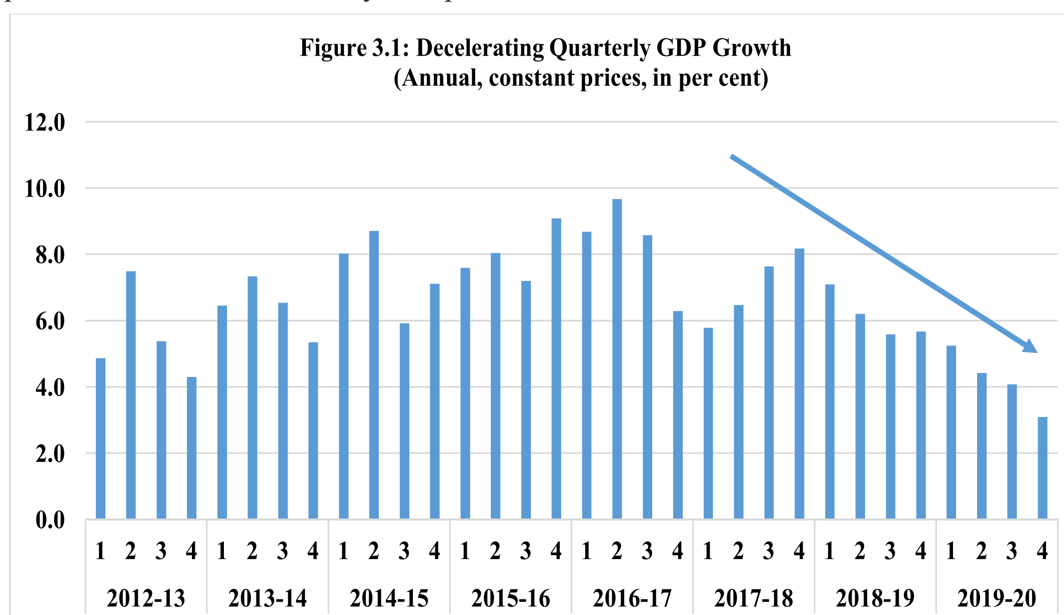
[4] World Economic Outlook October 2020, International Monetary Fund

declined further to 29.8 per cent in 2019-20. This pre-Covid deceleration in investment is likely to only get accentuated with the pandemic and affect growth.

3.12 Second is the problem of sluggish growth in scheduled commercial bank credit to the commercial sector and high non-performing assets (NPA) of banks observed since 2011-12. From a high of 20.6 per cent in 2011-12, such credit growth has declined every year to reach 7.2 per cent in 2018-19 and around 6 per cent in 2019-20.[5] This slowdown, which followed five years of high credit growth of an annual average of over 24 per cent between 2005 and 2010, was partly a result of the easy money policy in response to the Global Financial Crisis in 2008. For scheduled commercial banks, gross NPA as a proportion of gross advances increased from 2 per cent in 2008-09 to 14.6 per cent in 2017-18. It came down to 9.3 per cent in 2018-19 and, with loan moratorium and relaxed asset classification norms, further to 8.5 per cent in 2019-20. The NPA problem is particularly pronounced in public sector banks.[6] The Union Government infused Rs. 80,000 crore in these banks in 2017-18, Rs. 1.06 lakh crore in 2018-19, Rs. 70,000 crore in 2019-20. High NPA levels elevate risk aversion in banks and limit their lending behaviour. The country has seen similarly high NPAs between 1996 and 2002, which had been successfully handled by the recapitalisation of public sector banks and a buoyant economy. The adverse impact of the Covid-19 pandemic on the economy has added an element of complexity to the ongoing NPA problem.

3.13 Third is the deceleration in quarterly GDP growth, year-on-year, observed since 2016-17 (Figure 3.1). In the fourth quarter of 2019-20, the economy grew by an estimated 3.1 per cent over the corresponding quarter of the previous year. The Covid-19 pandemic hit the country at the end of this last quarter of 2019-20, when the economy was already decelerating. GDP in the first quarter of 2020-21 declined by 23.9 per cent.

Figure 3.1: Decelerating Quarterly GDP Growth
(Annual, constant prices, in per cent)



[5] *Overview in Financial Stability Report, RBI, July 2020.*
[6] *Financial Stability Report 2019.* Reserve Bank of India https://m.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=931

3.14 The pandemic has complicated fiscal management at the Union and State Government levels and the federal fiscal arrangement in more ways than one. First, it has led to the need for higher expenditure on treatment and health-care facilities for the Covid-affected and for providing relief to those who have lost their livelihoods because of the Great Lockdown. The disruption in economic activity brought to the fore the magnitude of migrant – particularly inter-State migrant – labour in the country and the associated problems. Census 2011 reported the number of inter-State migrants at around 54 million. Roughly a half of this migration, particularly by females, may have been triggered by inter-State marriages. Migration was mostly from the poorer States to the richer States, particularly on the coast (Figures 3.2 and 3.3). With the loss of livelihoods induced by the lockdown, the migrant labourers decided to leave their mostly squalid living quarters in urban slums to the more comforting and secure place they call 'home.' Hundreds of thousands of home-bound migrant labour trudging along highways with their meagre household effects on their heads will remain an enduring visual memory of the Covid-19 pandemic. Governments had to intervene by providing food and shelter along the way, quarantine facilities once they reached home and even organise special trains to take them home. The reverse flow of migrants also brought to focus the responsibilities of the host States whose economies these migrants had been contributing to. Cash transfers as well as additional food grains were distributed free for meeting the needs of returning workers as well as others, and steps initiated to make the ration card portable across the country.

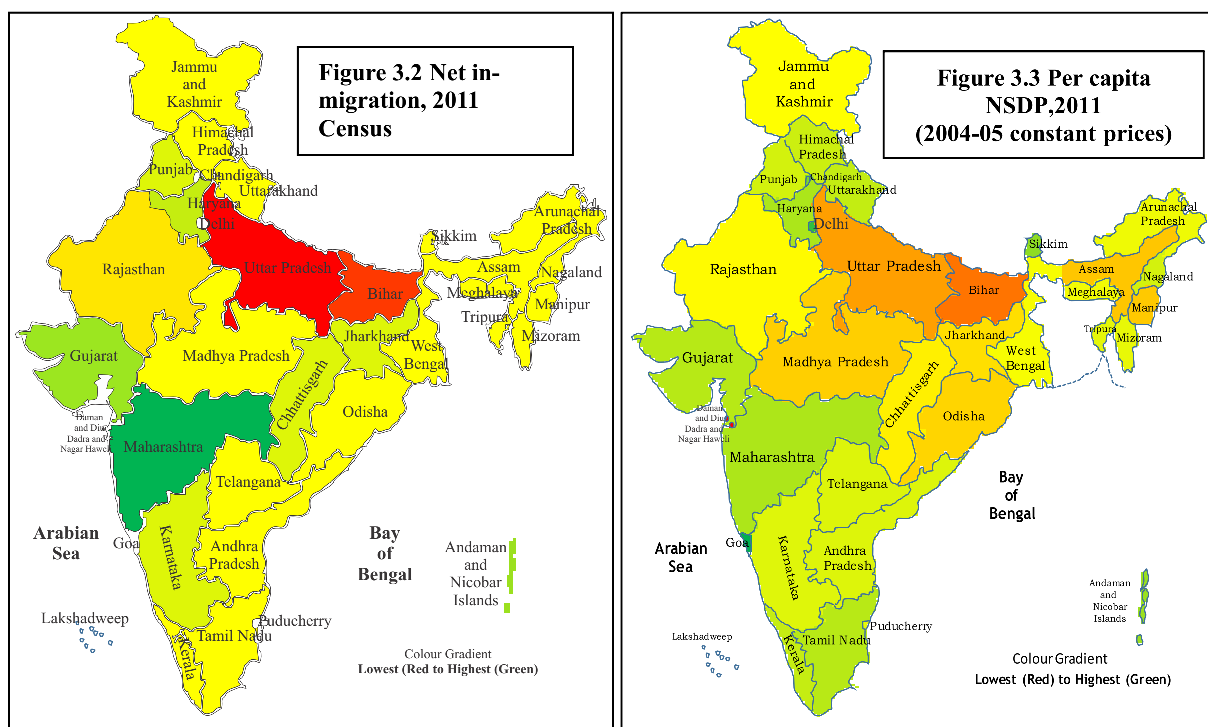


Figure 3.2 Net in-migration, 2011 Census

Figure 3.3 Per capita NSDP,2011 (2004-05 constant prices)

3.15 Second, the pandemic has adversely affected revenues of both levels of government. Declines in tax revenues can be particularly sharp with contraction in activity. When personal

incomes fall, people move from higher tax slabs to lower slabs and, in severe cases, even below the exemption level. Similarly, with decline in output and sales, but the burden of fixed costs and amortization of loans continuing, many businesses incur losses instead of earning profits. Thus, revenues from personal and corporate income taxes tend to decline faster than income, and buoyancy – that is percentage change in revenues for a percentage change in income – can be higher than that observed in the past with rising income. Similarly, with decline in income and activity, consumers cut back on non-essential commodities and, as a result, revenues from indirect taxes decline faster than income. In the shadow of the pandemic, governments are likely to face a twin crisis of a resource crunch with a rising trend in expenditure or what has been described as a 'scissors effect' in Chapter 2.

3.16 Third, the extent to which balance sheets of businesses have been affected and organisational and informational capital lost are not yet clear. Nevertheless, given how the pandemic has suddenly and severely disrupted economic activity, by discouraging activity that require close human contact, there is need for a fiscal stimulus. Monetary policy can resolve liquidity problems, but solvency problems require a fiscal antidote. The scope for a fiscal stimulus, however, is circumscribed by the limited and halting progress achieved on fiscal consolidation in seventeen years since the enactment of the Fiscal Responsibility and Budget Management (FRBM) Act in 2003. Most importantly, a robust expansionary fiscal policy to counteract the economic fallout of the pandemic will require an equally credible exit plan with a committed path of fiscal consolidation.

3.17 Fourth, the pandemic has magnified the challenge in a federal structure of having a healthy division of the so-called 3 Fs – finance, functions and functionaries – between the Union and the States. Because of Article 293 of the Constitution, State Governments operate under borrowing limits and, hence, budget constraints, approved by the Union Government. The budget constraint of the Union Government, by contrast, is self-imposed and, at least in the past, has been discretionary. Admittedly, being closer to the ground, the State Governments can be expected to be better equipped to counteract the impact of the pandemic by designing and implementing suitable interventions at the local level. However, the abiding objective of equalising the availability of some of the essential public goods and services and delivering them more efficiently across States can be marshalled to argue in favour of the Union's intervention. Furthermore, although the pandemic, unlike natural disasters, did not destroy physical properties and was also not a sudden one-stop event, it was a disaster alright, and the Union Government has traditionally played a major role in disaster relief. The pandemic calls for a healthy resolution of the tension between the widely acclaimed subsidiarity principle – which argues in favour of dealing with issues at the most immediate level consistent with their resolution – and the inter-state spill-over effects of public expenditure and growing Union's intervention in areas relating to the State List and Concurrent List of the Constitution.

Review of Goods and Services Tax

3.18 One of the major changes impacting the fiscal landscape of India in past few years has been the implementation of GST. A comprehensive value added tax (VAT) with a unified indirect tax structure was recommended by the Task Force on the FRBM Act headed by Vijay Kelkar in 2002. GST, which had been on the reform agenda for well over two decades, finally came into force in July 2017. After lengthy consultations and discussions with all stakeholders, it followed the passage of the Constitution (One Hundred and First) Amendment Act in 2016 and the subsequent enactment by Parliament and all the State legislatures of their respective laws to operationalise GST.

3.19 GST was envisaged to bring in considerable efficiency gains in the economy with its `one-nation-one-market-one-tax' paradigm and the attendant gains in tax-compliance, simplification of the tax structure and elimination of barriers to domestic production and trade. In terms of government finances, it was expected to improve the overall tax-GDP ratio in the medium term and lead to higher Union transfers to States. It was also historic in finally moving taxation of goods and services from the 'origin' to 'destination' principle.

3.20 One of the defining features of GST in India is the establishment of the GST Council in which Union Government as well as all State Governments and Union Territories with legislatures are represented. The Council has full decision making powers with respect to GST by majority voting. Hence, the Council is an important milestone in fiscal federalism in the country.

3.21 GST is a consumption-based value-added tax on goods and services with dual levy by both the Union and the States. In a significant move, a multiplicity of taxes levied at differential rates by the Union and State Governments on goods and services were subsumed under GST (Table 3.1).

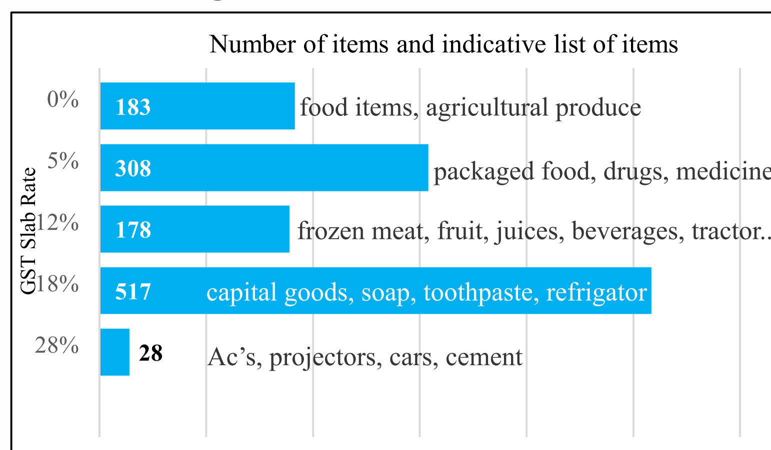
Table 3.1: Taxes Subsumed in GST and Their Rates (in June 2017)

Union Taxes	Rate (%)	State Taxes	Rates (%)
Central Excise duty	12.36	Value Added Tax (VAT)	10-14.5
Service Tax	15	Entry Tax	0-12.5
Central Sales Tax (CST)	2	Luxury Tax	3-20
Countervailing Duties (CVD)	12.36	Entertainment Tax	15-50
Special Additional Duty of Customs (SAD)	4	Purchase Tax	10-14.5
Additional excise duties	5-10	Taxes on lottery, betting & gambling	10-15

3.22 Under the present GST, both the Union and the States have concurrent powers to levy tax on a common base. States levy and collect State GST (SGST) and the Union levies and collects the Central GST (CGST). For any particular good or service or a combination of the two, the SGST and CGST rates are equal. Reference to the GST rate on a good or service is the sum of the rates of SGST and CGST, and both SGST and CGST are exactly half the GST rate. An integrated GST (IGST) is applied on inter-state movement of goods and services and on imports and exports.[7] IGST is simply a combination of SGST and CGST administered and collected by the Union Government, kept in a separate account, and distributed between the Union and States after settlement of input tax credit and verification of the destination of the goods and services.

3.23 GST rates vary considerably across goods and services. Apart from the standard rate of 18 per cent, there are three slabs of 5 per cent, 12 per cent and 28 per cent. Furthermore, some are exempted and outside the GST net, a few essentials are taxed at zero rate, and bullion is taxed at a special rate of 3 per cent (Figure 3.4).

Figure 3.4: GST Rate Structure



3.24 With many taxes subsumed under it, GST accounts for 35 per cent of the gross tax revenue of the Union and around 44 per cent of own tax revenue of the States. With gross tax revenue of the Union determining the divisible pool of taxes and, hence, transfers from the Union to the States, and changes in States' own taxes affecting their resource requirements, GST has become a critical factor in Indian federal finance. The rate structure of GST, or changes in it, have ramifications on revenues and expenditure of both the Union and the States, and by implication for the fiscal consolidation path of both the levels of government.

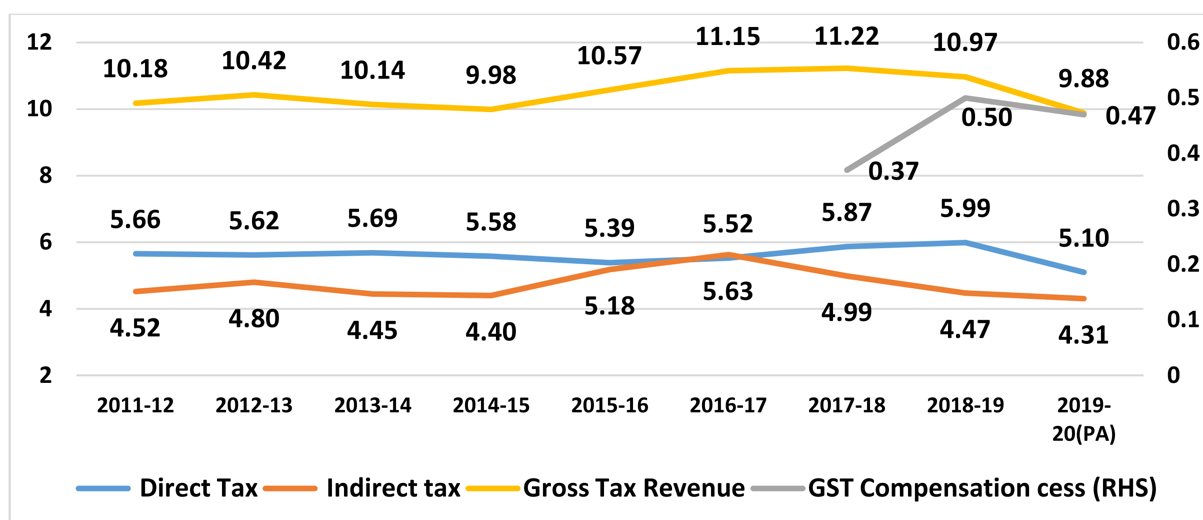
3.25 A systemic reform such as the introduction of GST takes time to stabilise. Hence, while analysing GST, data pertaining to the initial nine months (July-March) of 2017-18 of its implementation may be kept aside. That leaves us with data on monthly revenue collection and returns filing only for 2018-19. While this data limitation is, in itself, a serious constraint for analysis, the frequently changing rate structure and compliance regime adds to the challenge. Hence, while this Commission has drawn some conclusions from the available data, its focus is on the structural and design issues in GST, fiscal implications on the Union and State Governments and inter-governmental transfers.

[7] Exports are fully relieved of IGST through tax credits.

Aggregate impact and implications for the Union

3.26 The gross GST revenue collection in 2019-20 was Rs.11.93 lakh crore, which shows a moderate growth of 2.3 per cent over the gross revenue collection in 2018-19. With nominal GDP growth at 7.2 per cent in 2019-20, the GST buoyancy is observed at 0.3. Such low buoyancy is because of negative growth in collections of IGST on imports. Domestic GST collection grew by 7.7 per cent over the previous year with buoyancy just above unity. The gross GST revenue to GDP ratio for 2019-20 is 5.9 per cent.

Figure 3.5: Union Taxes (percentage of GDP)



Source: Union Receipt Budget for various years; NSO for GDP, CGA provisional accounts 2019-20

3.27 With the introduction of GST, the Union Government has gained powers to tax supply of goods while agreeing to share its service tax base with the States. As Figure 3.5 shows, the introduction of GST has had a significant impact on the Union Government's tax revenues. After excluding the GST compensation cess, indirect tax revenues of the Union have dropped to 4.31 per cent of GDP. This has been offset by a marginal increase in revenue from direct taxes. However, gross tax revenue, excluding GST cess collection, has dropped by almost 1.7 percentage points of GDP from 2016-17 levels. Such a significant fall, unless reversed, will impact tax devolution to States as well as the Union Government's fiscal health and consolidation path in the medium term. Given the already low level of tax revenues as a proportion of GDP, the observed buoyancy – percentage increase in revenue for a 1 per cent increase in GDP, disregarding any discretionary changes in the tax system – of less than unity is a disturbing feature that needs to be redressed by suitable initiatives at the Union level, both in tax policy and tax administration.

3.28 The GST law has assured State Governments guaranteed revenue growth of at least 14 per cent over the 2015-16 collection of subsumed taxes for a period of five years from the date of GST implementation. Any shortfall in this growth is being transferred by the Union Government as GST Compensation Grant from a separate cess being collected for the purpose. States' revenue on

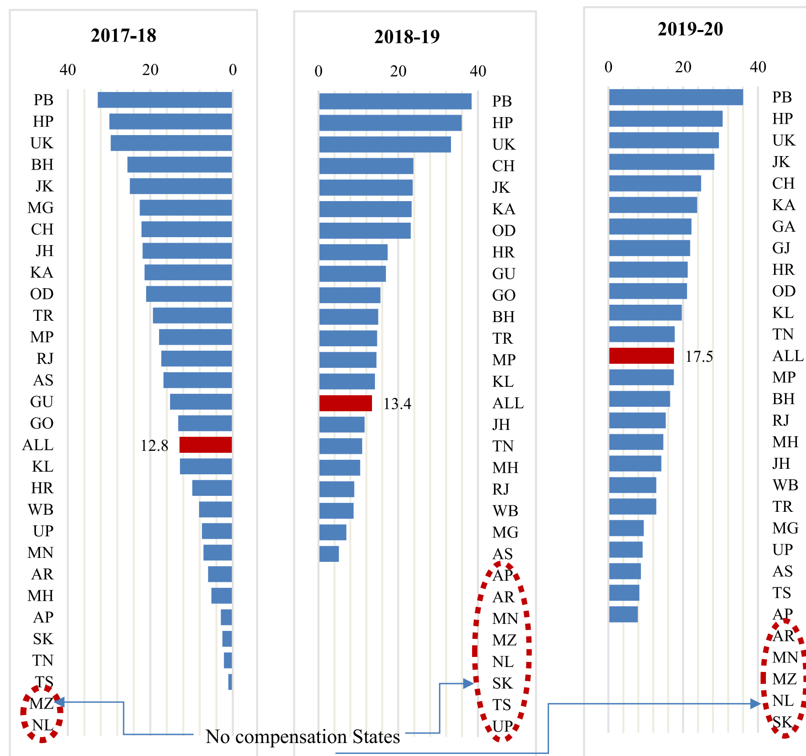
account of SGST is thus protected from 1 July 2017 to 30 June 2022.

3.29 At the time of the GST roll-out, this 14 per cent assured revenue growth would have translated into buoyancy higher than 1. The actual observed buoyancy of subsumed taxes during pre-GST years was significantly below 1. With inflation being contained under the inflation-targeting regime and some sluggishness in the economy, the nominal GDP growth itself is lower than expected. Hence, the protected revenue at an annualised rate of 14 per cent places a substantial burden on the GST system. It has led to GST compensation cess collections falling substantially short of what is required to reimburse States to the extent of their shortfall, thus either necessitating an increase in compensation cess rates or placing an additional burden on the Union Government finances.

Implications for States

3.30 State Governments, while agreeing to implement GST, have had to accept a significant reduction in their fiscal autonomy. Implications for the States vary, depending on factors like proportion of subsumed taxes in their own revenues, growth in taxes during the pre-GST regime, and State's dependence on Union transfers. For example, while, on an average, 44 per cent of States' own tax revenue got subsumed into GST in 2017-18, it ranged from 35 per cent for Andhra Pradesh to 63 per cent for the erstwhile State of Jammu and Kashmir. Similarly, VAT/sales tax, which accounted for almost two-third of subsumed taxes at an aggregate level, constituted only 50 per cent of own tax revenue in the case of Bihar and as much as 83 per cent in Jharkhand.

Figure 3.6: GST Compensation as Percentage of Protected Revenue



3.31 While the full impact of GST is yet to unfold, the first three years suggest an overall disturbing trend and a differentiated impact among States. A sum of Rs. 47,937 crore was released to States as GST compensation in 2017-18, Rs. 75,311 crore in 2018-19 and Rs.1.12 lakh crore in 2019-20. Figure 3.6 gives a snapshot of the impact of GST on individual States as well as all States in terms of shortfall in revenues as a proportion of protected level of revenue. Punjab, Himachal Pradesh and Uttarakhand remain the top three states with shortfalls in all three years. Smaller States, particularly North-Eastern and Himalayan States, appear to have done better, perhaps partly because of the move from the origin to destination principle of taxation under GST. Twenty-seven States received compensation in 2017-18, with aggregate shortfall at 12.85 per cent of the protected revenue. In 2018-19, while fewer States received compensation, with eight of them (including large states like Andhra Pradesh, Telangana, Uttar Pradesh) not needing to be compensated, the aggregate shortfall went up marginally to 13.41 per cent of the protected revenue.

3.32 Shortfall in protected revenue varied widely across years in many States. For example, Tamil Nadu's marginal shortfall in 2017-18 widened to almost 11 per cent of its protected revenue in 2018-19. Such wide swings were also seen in Maharashtra, Haryana and Goa. In 2019-20, the overall shortfall went up significantly to 17.5 per cent of protected revenues for States. Only four north-eastern states did not require any compensation in 2019-20. Large states like Uttar Pradesh, Andhra Pradesh and Telangana, which had not required any compensation in 2018-19, fell short of their protected revenues in 2019-20.

3.33 It is also pertinent to note that trend growth rate of VAT in various States in the pre-GST era was widely different. In aggregate, the trend growth rate of VAT/sales tax in all States for the 2011-12 to 2016-17 period was 12.67 per cent. But it ranged from 7.2 per cent in Bihar to 13.8 per cent in Rajasthan among the large States. The assurance of 14 per cent growth rate for five years, by treating all the States on par in terms of GST revenue growth irrespective of their wide-ranging revenue growth experiences in the past, has created another significant complication in federal finance.

3.34 A key challenge for the Commission, while projecting States' revenues for the 2021-26 period, is that the initial twenty-seven months of the award period are covered by the GST compensation scheme and the last thirty-three months are not. The issue of States with large shortfalls is discussed in greater detail in the projection of State finances in Chapter 4.

3.35 The foregoing analysis suggests that there are structural issues due to changes in the tax structure from the origin-based multiple taxation regime to the destination-based GST regime. Such structural issues may be required to be identified and readjustment may be done to minimise the fiscal and economic impact of GST.

Review of Union Finances

Fiscal Deficit

3.36 The Commission has analysed the three major fiscal indicators – fiscal deficit, revenue deficit and primary deficit – and has compared their relative performance since 2011-12 with the targets set under the FRBM Act and the revised roadmap of fiscal consolidation given by the FC-XIV. Table 3.2 brings out the profile of different fiscal indicators of the Union Government and the performance vis-à-vis the targets set by the FC-XIII, FC-XIV and FC-XV (2020-21).

Table 3.2: Profile of Fiscal Indicators of the Union Government

(per cent of GDP)

Year	Fiscal Deficit		Revenue Deficit		Primary Deficit	Ratio of Revenue Deficit to fiscal deficit%	Debt	GDP Growth (Nominal) %	GDP Growth (Real)%
	Actual	FC Target*	Actual	FC Target*					
2011-12	5.9	**4.8**	4.5	**2.3**	2.8	76.3	51.8	14.4	5.2
2012-13	4.9	**4.2**	3.7	**1.2**	1.8	75.5	51.0	13.8	5.5
2013-14	4.5	**3.0**	3.2	**0.0**	1.1	71.1	50.5	13.0	6.4
2014-15	4.1	**3.0**	2.9	**-0.5**	0.9	70.7	50.1	11.0	7.4
2015-16	3.9	**3.6**	2.5	**2.6**	0.7	64.1	50.1	10.5	8.0
2016-17	3.5	**3.0**	2.1	**2.3**	0.4	60.0	48.3	11.8	8.3
2017-18	3.5	**3.0**	2.6	**1.8**	0.4	74.3	48.2	11.1	7.0
2018-19	3.4	**3.0**	2.4	**1.4**	0.4	70.6	47.9	11.0	6.1
2019-20(RE)	3.8	**3.0**	2.4	**0.9**	0.7	63.2	49.0	7.8	4.2**
2020-21(BE)	3.5	**3.5**	2.7	**2.5**	0.4	77.1	48.7	10.0	

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

*FC XIII ,FC XIV & FC XV (2020-21) Targets are shown in bold with no annual targets specified for the primary deficit.

** Provisional estimates of NSO,

3.37 The fiscal deficit of the Union Government declined steadily from 5.9 per cent of GDP in 2011-12 to 3.4 per cent in 2018-19, but has remained higher than the annual targets set by both the FC-XIII and FC-XIV. In two years, 2017-18 and 2018-19, the target slipped from the budgeted estimates because of specific developments: (a) in 2017-18 the structural change brought by GST meant collection of only eleven months' revenue; and (b) in 2018-19, the income transfer scheme for farmers led to breach in the announced targets. The overall trend in reduction in the fiscal

deficit has been both on account of increase in revenues and reduction in expenditure. The tax-GDP ratio went up by 80 basis points from 10.2 per cent in 2011-12 to 11 per cent in 2018-19 (Table 3.5). The decline in expenditure was a result of reduction in the subsidy outgo from 2.5 per cent of GDP to 1.2 per cent and restricting the growth in committed expenditure despite the pressure of pay and pension revision on account of the Seventh Central Pay Commission recommendations. These will be discussed in detail later in this Chapter. This correction in the fiscal deficit also needs to be viewed in the context of enhanced devolution to the States from 2015-16 onwards. However, the fiscal deficit is expected to go up substantially to 3.8 per cent in 2019-20 (RE) from the budget estimate of 3.3 per cent in 2019-20. The deviation of 0.5 per cent in the fiscal deficit in the revised estimates of 2019-20 is consistent with the FRBM Act. The increase in fiscal deficit is mainly due to decrease in gross tax revenues on account of reforms in corporate tax rates, lower disinvestment receipts and higher capital expenditure. But, as discussed in Chapter 4 of this Report, due to the onset of the Covid-19 pandemic in the last few months of 2019-20 financial year, the rise in fiscal deficit has exceeded the revised estimates. Similarly, while the fiscal deficit is budgeted to go down to 3.5 per cent in 2020-21 (BE), the ongoing pandemic and associated lock-downs have adversely impacted those estimates. A detailed analysis of the projected deficit is in Chapter 4. It is also important to note that the data is on a cash basis and disregards unpaid liabilities and extra-budgetary operations and may not reveal the full picture of fiscal balances.

Revenue Deficit

3.38 The revenue deficit of the Union Government as a proportion of GDP at 4.5 per cent in 2011-12 was brought down to 2.9 per cent in 2014-15 and further to 2.1 per cent in 2016-17. During the first two years of the FC-XIV award period, the revenue deficit as a proportion of GDP remained lower than the targets. It then rose to 2.6 per cent in 2017-18 because of a decrease in non-tax revenue from 1.8 per cent of GDP in 2016-17 to 1.1 per cent of GDP in 2017-18. The revenue deficit declined to 2.4 per cent in 2018-19 and is also pegged at 2.4 per cent in the 2019-20 revised estimates. It is budgeted to go up to 2.7 per cent of GDP in 2020-21 (BE) mainly due to an increase in revenue expenditure.

3.39 The FC-XIV had convincingly argued that the practice of reporting effective revenue deficit should be ended due to analytical problems but that, in line with international best practices, revenue deficit should continue to be reported as an indicator of government borrowing for consumption or recurrent expenditure. In the amended FRBM Act of 2018, revenue deficit as a reporting indicator has been dispensed with, but it continues to be shown as a reference indicator in the Medium Term Fiscal Policy (MTFP) statement. The effective revenue deficit has been removed as the parameter for targeting fiscal outcomes and it is not even shown as reference indicator in the MTFP Statement.

Primary Deficit

3.40 The primary deficit of the Union Government improved substantially from 2.8 per cent in 2011-12 to 0.9 per cent in 2014-15 and has been further estimated to decline to 0.4 per cent in 2018-19. This decline is in line with the reduction in the fiscal deficit (Table 3.2), as interest payments have remained steady at about 3.1 per cent of GDP (Table 3.3) during the period. The primary deficit increased to 0.7 per cent in 2019-20 (RE), but is budgeted to come down to 0.4 per cent in 2020-21 (BE).

3.41 The ratio of revenue deficit to fiscal deficit broadly indicates the extent of borrowings used for revenue expenditure. Table 3.2 also brings out this imbalance and shows that the ratio, which had improved from 76.3 per cent in 2011-12 to 60 per cent in 2016-17, deteriorated sharply in 2018-19 to reach 70.6 per cent. It is budgeted to further deteriorate to 77.1 per cent in 2020-21 (BE) due to higher revenue deficit. However, as discussed in Chapter 4, due to the onset of the Covid-19 pandemic in the last few months of 2019-20, and the projected rise in fiscal deficit, the actuals for 2019-20 and budget estimates of 2020-21 will be adversely impacted.

Sources of Fiscal Imbalance

3.42 Table 3.3 highlights the extent and sources of fiscal imbalance between 2012-13 and 2018-19. Between 2012-13 and 2018-19, as a proportion of GDP, the net revenue receipts of the Union Government decreased by about 0.6 percentage points with an equivalent decline in net tax revenue. The net tax revenue during 2015-16 declined to 6.9 per cent of GDP from 7.2 per cent in 2014-15, mainly due to an increase in the share of States in the divisible pool of taxes by 10 percentage points from 32 per cent in the first year of the award period of FC-XIV. However, the decline was partly arrested by the increase in Union excise duty on petrol and diesel during this period. There was sharp volatility in non-tax revenue collections which fluctuated between a high of 1.8 per cent in 2013-14, 2015-16 and 2016-17 and a low of 1.2 per cent in 2018-19. The non-debt capital receipts remained almost stagnant at 0.4 percent of GDP during the period from 2012-13 to 2016-17, but registered a significant increase in 2017-18 due to higher disinvestment receipts. On the other hand, the total expenditure as a ratio of GDP declined from 14.9 per cent in 2011-12 to 12.2 per cent in 2018-19. Simultaneously, the ratio of revenue deficit to fiscal deficit has shown a steady and significant decline from 2011-12 to 2016-17 by 16.3 percentage points (Table 3.2). However, the ratio has increased by 14.3 percentage points in 2017-18 due to an increase in the revenue deficit, whereas the fiscal deficit remained remained unchanged at the 2016-17 level and did not deteriorate correspondingly due to a decline in capital expenditure. The ratio improved by 3.7 percentage points in 2018-19 mainly due to an improvement in the revenue deficit.

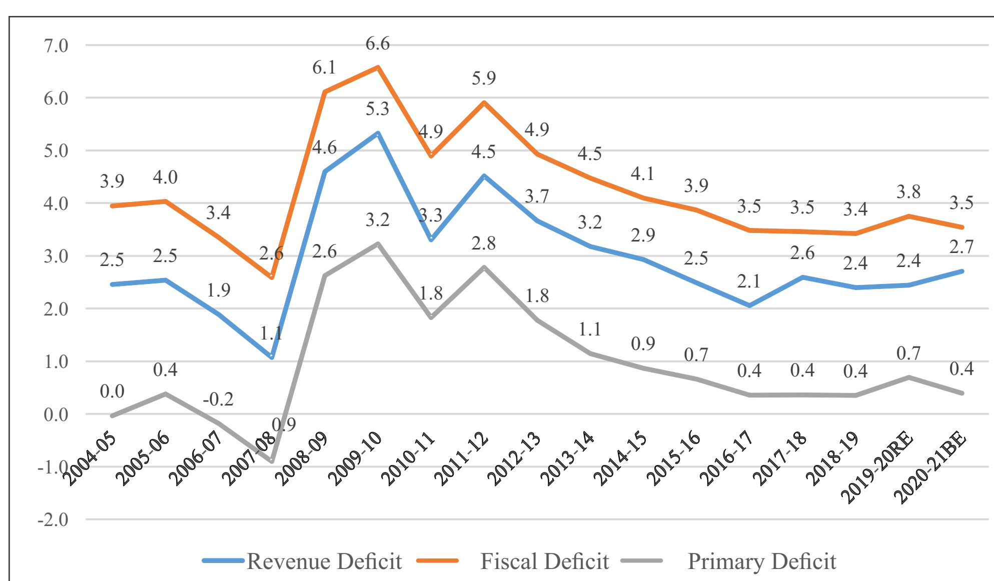
Table 3.3: Fiscal Performance of the Union

(per cent of GDP)

S. No.	Particulars	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20 (RE)	2020-21 (BE)
I	**Net revenue receipts(a+b)**	**8.6**	**8.8**	**9.0**	**8.8**	**8.7**	**8.9**	**8.4**	**8.2**	**9.1**	**9.0**
a)	Non tax revenue	1.4	1.4	1.8	1.6	1.8	1.8	1.1	1.2	1.7	1.7
b)	Net tax revenue	7.2	7.5	7.3	7.2	6.9	7.2	7.3	6.9	7.4	7.3
II	**Revenue expenditure**	**13.1**	**12.5**	**12.2**	**11.8**	**11.2**	**11.0**	**11.0**	**10.6**	**11.5**	**11.7**
	of which: Interest payments	3.1	3.1	3.3	3.2	3.2	3.1	3.1	3.1	3.1	3.1
III	**Capital expenditure**	**1.8**	**1.7**	**1.7**	**1.6**	**1.8**	**1.8**	**1.5**	**1.6**	**1.7**	**1.8**
IV	**Total expenditure (II+III)**	**14.9**	**14.2**	**13.9**	**13.3**	**13.0**	**12.8**	**12.5**	**12.2**	**13.2**	**13.5**
V	**Revenue deficit (II-I)**	4.5	3.7	3.2	2.9	2.5	2.1	2.6	2.4	2.4	2.7
VI	**Fiscal deficit**	5.9	4.9	4.5	4.1	3.9	3.5	3.5	3.4	3.8	3.5
VII	**Non-debt capital receipts**	0.4	0.4	0.4	0.4	0.5	0.4	0.7	0.6	0.4	1.0

Source: Union Budget for various years and GDP from NSO

Figure 3.7 : Revenue Deficit, Fiscal Deficit and Primary Deficit of the Union Government as Percentage of GDP



Source: Union Budget Documents and GDP from NSO

Note: GDP new series (Base Year - 2011-12), back series from 2004-05 to 2010-11.

Trends of Union's Debt and Liabilities

3.43 The Union Government's liabilities as shown in Table 3.4 include all its liabilities against the Consolidated Fund of India and all public account liabilities. From the Statement of Extra Budgetary Resources in the Union Budget, the extra budgetary resources (EBR) have been included for three years – from 2016-17 to 2018-19. For 2019-20 (RE) and 2020-21(BE) EBRs have been included as per the MTFP statement presented with the budget.

Table 3.4: Outstanding Liabilities of the Union Government

(percent of GDP)

S. No.	Particulars	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20 (RE)	2020-21 (BE)
I	**Public debt of which**	**39.0**	**39.6**	**39.4**	**39.6**	**40.0**	**38.8**	**38.9**	**38.7**	**40.1**	**40.0**
a)	Internal debt	37.0	37.9	37.8	38.0	38.5	37.3	37.4	37.3	38.6	38.7
b)	External debt at historical rates	1.9	1.8	1.6	1.6	1.5	1.5	1.5	1.4	1.4	1.4
II	Other liabilities of which	12.8	11.4	11.1	10.5	10.1	9.5	9.3	9.2	8.9	8.6
	Reserve funds and deposits	1.5	1.4	1.4	1.5	1.4	1.4	1.5	1.6	1.6	1.7
III	**Total liabilities** (I+II)	**51.7**	**51.0**	**50.5**	**50.1**	**50.1**	**48.3**	**48.2**	**47.9**	**49.0**	**48.7**
IV.	Adjusted total liabilities of which	53.6	53.1	52.3	50.8	51.4	49.6	49.4	49.5	50.3	50.1
a	**External debt at current exchange rate**	**3.7**	**3.3**	**3.3**	**2.9**	**3.0**	**2.7**	**2.6**	**2.5**	**2.4**	**2.3**
b	**Extra budgetary resources (EBR)**						**0.1**	**0.1**	**0.5**	**0.7**	**0.8**

Source: Union Budget for various years and GDP from NSO

Note 1. Other Liabilities include National Small Savings Funds, State Provident Fund, other accounts such as special deposits of Non- Government Provident Funds and reserve funds and deposits.

2. In Total Liabilities (row III), external debt is at historical prices.

3. In adjusted total liabilities (row IV), external debt is at current exchange rate and cash balance has been adjusted. 2016-17 to 2020-21(BE) includes extra budgetary resources (fully serviced government bonds). MTFP figures for 2019-20 (RE) and 2020-21(BE).

3.44 The Union Government's liabilities, at historical rates of exchange for external debt, stood at 47.9 per cent of GDP on 31 March 2019, as compared to 51.7 per cent on 31 March 2012, in line with the long term trend of decline since 2008-09, when it was 57.3 per cent. The decline was due to reduction in the fiscal deficit as well as the high nominal growth of GDP during the period between 2011-12 and 2018-19.

3.45 After adjustment for external debt at current exchange rates, changes in the cash balance and inclusion of EBRs at the end of March 2019, the debt of the Union Government was estimated at 49.5 per cent. It is expected that Union Government liabilities will go up to 50.3 per cent of GDP in 2019-20 (RE). The Union's budget projects its liabilities to come down to 50.1 per cent of GDP in 2020-21(BE). On 31 March 2019, with only 5.1 per cent of total Union Government's liabilities denominated in foreign currencies, external debt constituted only 2.5 per cent of GDP, and the currency risk to its debt portfolio was limited. Furthermore, with public external debt entirely from official sources, it was secure from volatility in the international financial markets. The compositional shift towards marketable debt continued and the share of marketable securities in total internal debt was 84.4 per cent in end-March 2019.

3.46 The stock of contingent liabilities in the form of guarantees given by the Union Government has increased in absolute terms from Rs. 1.07 lakh crore in 2004-05 to Rs. 4.47 lakh crore at the end of 2018-19. The FRBM Act ceiling of 0.5 per cent of GDP on guarantees that can be extended by the Government during a financial year has resulted in a reduction of the ratio of contingent liability to GDP from 3.3 per cent in 2004-05 to 2.4 per cent in 2018-19. During 2018-19, gross additions at Rs. 77,728 crore were equivalent to 0.4 per cent of GDP, well within the 0.5 per cent annual limit prescribed under FRBM Rules.

3.47 Pursuant to the implementation of the recommendations of the FC-XIV on exclusion of States from the National Small Savings Fund (NSSF), the Union Government's share of investment in NSSF increased. This has led to its relatively reduced reliance on market borrowings, albeit cheaper than NSSF resources, to finance its fiscal deficit.

3.48 The Union Government amended the FRBM Act through Finance Act 2018 (Act 13 of 2018). In the reformed FRBM framework, the focus is on limiting government debt and fiscal deficit. The key amendments mandate the Union Government to:

(i) take appropriate measures to limit the fiscal deficit to upto 3 per cent of GDP by 31 March 2021;

(ii) endeavour to ensure that:

- (a) the general government debt does not exceed 60 per cent;
- (b) the Union Government debt does not exceed 40 per cent of GDP by the end of financial year 2024-25;

(iii) not give additional guarantees with respect to any loan on the security of the Consolidated Fund of India in excess of 0.5 per cent of GDP, in any financial year.

3.49 Revenue deficit and effective revenue deficit, as already mentioned, have been removed as parameters for targeting fiscal outcomes. Further, clearly defined escape clauses and buoyancy clauses, with return paths, have been included to allow deviation from fiscal deficit targets in the event of rare/ unforeseen events. These amendments will provide sufficient flexibility for necessary deviations to enhance the credibility of fiscal rules while, at the same time, preventing their violation.

3.50 The Union Government debt has been clearly defined in the new FRBM Act as:

i) the total liabilities of the Union Government on the security of the Consolidated Fund of India, including external debt valued at current exchange rates;

ii) the total liabilites in the public account; and

iii) such financial liablities of any body, corporate or other entity owned or controlled by the Union Government, which the government is to repay or service from the annual financial statement, reduced by the cash balance available at the end of the date.

In line with the above definition, the Union Budgets of 2019-20 and 2020-21 have categorised as EBRs (fully serviced government bonds) those financial liabilities of entities that are owned or controlled by the Union Government, and the repayment of principal and interest of which are through the Annual Financial Statement in the liabilties statement of the Union Government. It is instructive to note that the fiscal deficit for any year does not include such EBRs as it captures the excess of disbursements over receipts from the Consolidated Fund of India.

Deferred Liabilities and Off-Budget Borrowings

3.51 While fiscal consolidation appears commendable, it has been observed that the Union Government resorted to off-budget financing in the form of deferment of expenditure to the following year, which complicates the picture. To tide over the cash flow problems for meeting its liabilities on account of fertilizer and food subsidies, two different types of arrangements were devised. In the case of the fertilizer subsidy, the liquidity requirements of fertilizer companies arising as subsidy arrears were met through the Special Banking Arrangement (SBA). SBA is short term credit from public sector banks to meet the mismatch in budget allocations and actual amount due at the end of the financial year. The Union Government pays interest to banks at the G-Sec rate and the interest above the G-sec is borne by the fertilizer companies. In the case of food subsidy, to cover the shortfall in the budget allocation for food subsidy, the Food Corporation of India (FCI) resorts to a number of instruments such as bonds, unsecured short-term loans and NSSF loans from Union Government. This is a continuing practice that has also been highlighted by the Comptroller and Auditor General of India (CAG) in its Report no. 20 of 2018 on compliance with the FRBM Act by the Union Government. Although a continuing practice during the entire review period, this practice of short-term borrowings to finance fertilizer subsidies and lending to FCI through NSSF needs to be eliminated by making a full budgetary provision in the year of incurring such expenditures.

Revenues

3.52 Union Government revenues comprise of tax revenues net of States' share, non-tax revenues and non-debt capital receipts (Table 3.3). Net Union revenues, excluding non-debt capital receipts, increased from 8.6 per cent of GDP in 2011-12 to 9 per cent in 2013-14, but

thereafter declined to 8.8 per cent in 2014-15. In the transition from 2014-15 under FC-XIII to 2015-16 under FC-XIV, net Union revenues as a proportion of GDP declined from 8.8 per cent to 8.7 per cent. The decline was marginal, with the enhanced tax devolution to States being offset by a one-time jump in the non-tax receipts from the telecommunications sector. Collections under non-debt capital receipts as a proportion of GDP jumped from around 0.4 per cent during 2011-12 to 2016-17 to 0.7 per cent in 2017-18. Thereafter, it decreased to 0.6 per cent in 2018-19 and is expected to go down further to 0.4 per cent in 2019-20 (RE). However, such non-debt capital receipts are budgeted at a much higher level of 1 per cent in 2020-21 (BE).

Tax Revenue

3.53 The gross tax revenue to GDP ratio of the Union Government increased by 0.8 percentage points from 10.2 per cent in 2011-12 to 11 per cent in 2018-19. Table 3.5 shows the trends of major taxes relative to GDP and in relation to gross tax revenue.

Table 3.5: Performance of Major Taxes of the Union

(as per cent of GDP)

Year	Corporation tax	Income tax	Total direct tax	Customs duties	Union excise duties	Service tax	GST	Total indirect tax	Total Union revenue (Gross)
2011-12	3.7	2.0	**5.7**	1.7	1.7	1.1		**4.5**	10.2
2012-13	3.6	2.0	**5.6**	1.7	1.8	1.3		**4.8**	10.4
2013-14	3.5	2.2	**5.7**	1.5	1.5	1.4		**4.5**	10.1
2014-15	3.4	2.1	**5.6**	1.5	1.5	1.3		**4.4**	10.0
2015-16	3.3	2.1	**5.4**	1.5	2.1	1.5		**5.2**	10.6
2016-17	3.2	2.4	**5.5**	1.5	2.5	1.7		**5.6**	11.2
2017-18	3.3	2.5	**5.9**	0.8	1.5	0.5	2.6	**5.4**	11.2
2018-19	3.5	2.5	**6.0**	0.6	1.3	0.04	3.1	**5.0**	11.0
2019-20(RE)	3.0	2.7	**5.7**	0.6	1.3	0.01	3.0	**4.9**	10.6
2020-21(BE)	3.0	2.8	**5.9**	0.6	1.2	0.00	3.1	**4.9**	10.8

Continued

Table 3.5: Performance of Major Taxes of the Union (cont.)

(as per cent of Union's Gross Tax Revenue)

Year	Corp oration tax	Income tax	Total direct tax	Customs duties	Union excise duties	Service tax	GST	Total indirect tax	Total Union revenue (Gross)
2011-12	36.3	19.3	**55.6**	16.8	16.7	11.0		**44.4**	100.0
2012-13	34.4	19.5	**53.9**	16.0	17.3	12.8		**46.1**	100.0
2013-14	34.7	21.4	**56.1**	15.1	15.2	13.6		**43.9**	100.0
2014-15	34.5	21.4	**55.9**	15.1	15.5	13.5		**44.1**	100.0
2015-16	31.1	19.8	**51.0**	14.4	20.0	14.5		**49.0**	100.0
2016-17	28.3	21.3	**49.5**	13.1	22.5	14.8		**50.5**	100.0
2017-18	29.8	22.5	**52.3**	6.7	13.7	4.2	23.1	**47.7**	100.0
2018-19	31.9	22.7	**54.6**	5.7	11.4	0.3	28.0	**45.4**	100.0
2019-20(RE)	28.2	25.9	**54.1**	5.8	11.8	0.1	28.3	**45.9**	100.0
2020-21(BE)	28.1	26.3	**54.5**	5.7	11.3	0.0	28.5	**45.5**	100.0

Source: Union Budget for various years and GDP from NSO

Note: Total direct taxes include taxes on wealth, other taxes on income and expenditure and others, apart from corporation tax and income tax,.

Direct Taxes

3.54 Direct taxes as a proportion of GDP have ranged between 5.7 per cent in 2011-12 and 6 per cent in 2018-19. The policy of the Union Government on direct taxes is to broaden and deepen the base, while maintaining moderate rates and gradually phasing out exemptions. Revenues from income tax as a a proportion of GDP went up from 2 per cent in 2011-12 to about 2.5 per cent in 2018-19, with the corresponding increase in its share in gross tax revenue from 19.3 per cent in to 22.7 per cent. In 2018-19, while the share of corporation tax in total gross tax revenue decreased from 36.3 per cent in 2011-12 to 31.9 per cent in 2018-19, its proceeds as a proportion of GDP fell from 3.7 per cent to 3.5 per cent. In line with its earlier policy initiatives to rationalise corporation tax to attract investment and promote growth, in September, 2019, the Union Government reduced the tax rate to 22 per cent for domestic companies, if they do not avail of any exemption/incentive provisions. The effective tax rate for these companies shall be 25.17 per cent inclusive of surcharge and cess. Further, a new domestic company incorporated on or after 1 October 2019 making fresh investment in manufacturing has an option to pay tax at the rate of 15 per cent. This benefit is available to companies which do not avail any exemption/incentive and commence their production on or before 31 March 2023. The effective tax rate for these companies shall be 17.16 per cent inclusive of surcharge and cess. The Government has also

taken some new initiatives to mobilise resources through the levy of an additional education and health cess of 1 per cent and a 10 per cent long term capital gain tax on listed equity shares and equity-based mutual funds on capital gains exceeding Rs. 1 lakh.

3.55 Further, higher growth in direct taxes is anticipated due to better tax administration particularly with improvements in the Tax Information Network and increase in the number of tax filers. The number of return filers increased from 3.31 crore in 2013-14 to 6.33 crore in 2018-19, an increase of 91.2 per cent. The number of tax-payers also increased from 5.72 crore in 2013-14 to 8.45 crore in 2017-18, an increase of 47.7 per cent. The year-wise details of tax filers and tax-payers are given in Table 3.6. After the demonetisation exercise in November 2016, there was a widening of the tax base which resulted in a substantial increase in collection from direct taxes in 2017-18.

3.56 In order to provide significant relief to the individual taxpayers and to simplify the income tax law, the Government has brought a new and simplified personal income tax regime wherein income tax rates will be significantly reduced for the individual taxpayers who forgo certain deductions and exemptions with effect from financial year 2020-21.

Table 3.6: Persons Filing Returns and Taxpayers

(Number in crore)

	Return filers	Growth (%)	Tax payers	Growth (%)
2013-14	3.31		5.72	
2014-15	3.51	6.0	6.15	7.6
2015-16	3.91	11.4	6.92	12.7
2016-17	4.47	14.3	7.42	7.2
2017-18	5.45	21.9	8.45	13.9
2018-19	6.33	16.1		

Source : Income Tax Statistics, CBDT

Indirect Taxes

3.57 Indirect taxes, as a proportion of GDP, increased from 4.5 per cent in 2011-12 to 5.6 per cent in 2016-17, primarily because of increased collections of Union excise duties and service tax. Imposition of additional excise duties on petroleum products during 2014-15 and 2015-16, when global petroleum prices fell dramatically from US$ 111.89 a barrel in 2011-12 to US$ 46.17 a barrel in 2015-16, led to a collections going up almost three-fold from 2013-14 to 2016-17. The increase was mainly in special additional excise duty, which is not shareable with the States and is retained by the Union Government. Out of the total collection under indirect taxes (excluding the

GST compensation cess), 20.6 per cent is estimated to come from cess and surcharges during 2019-20 (RE).

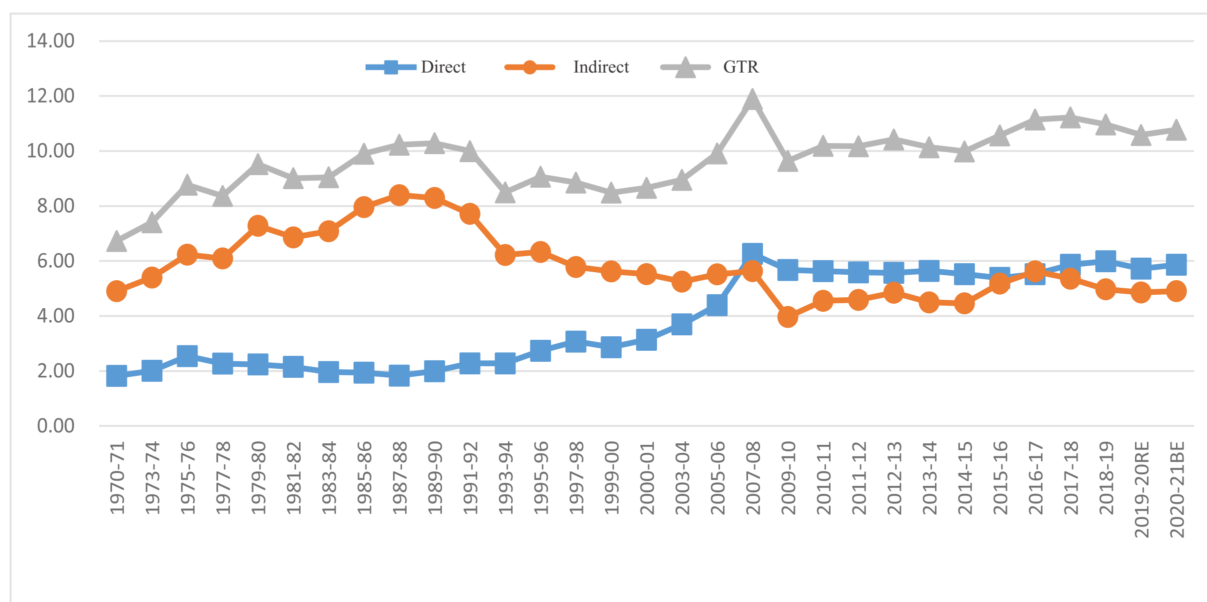
3.58 The ratio of service tax to GDP rose consistently till 2016-17, particularly after the introduction of a negative list in 2012-13. On the other hand, revenues from custom duties, as proportions of both GDP as well as gross tax revenue, have shown a declining trend after 2012-13. Major reasons for the decline are reduction in duties on many items of significant import value, including petroluem, oil and lubricants (POL), and also because of various exemptions. From 2017-18, a significant share of custom and excise duties have been subsumed under GST (except those on POL).

3.59 The introduction of GST has not as yet resulted in the expected high buoyancy in revenues from indirect taxes. During 2018-19, as a proportion of GDP, indirect taxes fell from 5.6 per cent during 2016-17 to 5 per cent, and it is expected to have remained at 4.9 per cent during 2019-20 (RE).

Changing Composition

3.60 Revenues from direct taxes overtook revenues from indirect taxes for the first time in 2007-08 (Figure 3.8). The dominance has been maintained ever since, except in 2016-17 when the two were almost equal partly because of the spike in excise collection already discussed.

Figure 3.8: Union Tax GDP Ratio: Direct Tax, Indirect Tax and Gross Tax Revenue



Source : Union Budget Documents and GDP from NSO

Revenue Foregone

3.61 The Union Government provides a large number of tax incentives for different objectives, such as promotion of exports, expansion of research and development, development of backward areas and employment generation. Units operating in special economic zones (SEZs) and notified backward areas get refunds for indirect taxes and accelerated depreciation is allowed to promote capital investment. Some sectors, such as agriculture, infrastructure, green field manufacturing, warehousing, oil and gas and renewable energy also benefit from tax concessions.

3.62 These concessions and exemptions reduce the revenue collections and adversely impact resources accruing to both Union and State Governments. However, revenue foregone, both as proportions of gross tax revenue and of GDP, has declined from 2011-12 onwards (Table 3.7). Revenue foregone as a proportion of GDP declined from 6.1 per cent in 2011-12 to 4.5 per cent in 2014-15. Similarly, revenue foregone as a proportion of gross tax revenue declined from 60 per cent in 2011-12 to 44.5 per cent in 2014-15. The decline was particularly sharp in 2015-16 because of a change in the methodology of calculating the revenue implication of tax incentives on account of custom duties and Union excise. The estimates for 2017-18 do not include the revenue foregone from excise duty, which was subsumed under GST.

Table 3.7: Trends of Revenue Foregone

(Rs. crore)

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20 (Proj.)
Direct taxes	101141	102256	93047	118593	138658	155840	183580	206113	230415
Indirect taxes	432442	463979	456947	435756	148442	146264	53704	75753	81970
Total revenue foregone	**533583**	**566235**	**549994**	**554349**	**287100**	**302104**	**237284**	**281866**	**312385**
Revenue Foregone as % of gross tax revenue	60.0	54.6	48.3	44.5	19.7	17.6	12.4	13.5	14.4
Revenue foregone as % of GDP	6.1	5.7	4.9	4.5	2.1	2.0	1.4	1.5	1.5

Source: Statements of Revenue Foregone in the Union Budget documents

Note: 1. As excise duty (except that on tobacco products, crude petroleum oil, natural gas, petrol and diesel) has been subsumed in GST, the revenue impact of tax incentives for excise is being discontinued from 2017-18 onwards.

Cesses and Surcharges

3.63 FC-XIV had highlighted the somewhat problematic growing share of cesses and surcharges in Union revenues. 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. Cesses are statutory levies whose proceeds are earmarked for utilisation for specific purposes. The underlying spirit for levying the cess is to serve a specific purpose and provide necessary financial impetus to a particular sector/area of the economy. Hence, the Union Government merely acts as a custodian of funds so collected in the Public Account till these are appropriated for the mandated purpose. Similarly, surcharges are meant to be levied only for short periods. Both cesses and surcharges are excluded from the divisible pool.

3.64 A large number of cesses and surcharges, except those levied on petroleum, have been subsumed into GST. The major ones are additional duty of customs and excise on motor spirit and high speed diesel oil, surcharge on pan masala and tobacco products, cess on sugar, clean enviornment cess and infrastructure cess. In the Union Budget of 2018-19 the erstwhile road cess was rechristened as the road and infrastructure cess and a social welfare surcharge was introduced. Table 3.8 shows the trend of cesses and surcharges, which constituted over 19.9 per cent of gross tax receipts in 2018-19, of which 4.6 per cent is on account of GST Compensation Cess.

Table 3.8: Cesses and Surcharges

(Rs. crore)

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20 (RE)	2020-21 (BE)
Direct taxes	29143	48862	63883	81543	40468	58840	53433	145802	155817	175807
Indirect taxes (excluding GST)	63394	72545	77387	86417	137482	172224	150529	172312	182665	195460
GST compensation cess	0	0	0	0	0	0	62612	95081	98327	110500
Total cesses & surcharges	92537	121407	141270	167960	177950	231064	266574	413195	436809	481767
Total cess & surcharge as % of gross tax revenue of which	**10.4**	**11.7**	**12.4**	**13.5**	**12.2**	**13.5**	**13.9**	**19.9**	**20.2**	**19.9**
GST compensation cess as % of gross tax revenue							**3.3**	**4.6**	**4.5**	**4.6**

Source : Union Budget Documents

3.65 The major reasons for higher receipts from cesses and surcharges in 2018-19 are: (a) increase in the health and education cess on income tax to 4 per cent from the earlier 3 per cent; (b) introduction of a road and infrastructure surcharge; and (c) imposition of social welfare surcharge of 10 per cent on the aggregate duties of customs and imported goods in place of the earlier education and higher education cess of 3 per cent on imported goods. The Union Budget of 2019-20 estimates a further increase in the ratio of cesses and surcharges to the gross tax revenue, as the rate of surcharge on income tax for individuals having income between Rs. 2 crore and Rs. 5 crore has been increased from 15 per cent to 25 per cent. For individuals earning more than Rs. 5 crore, the rate of surcharge has been increased from 15 per cent to 37 per cent.

Non-Tax Revenues

3.66 The major sources of non-tax revenues of the Union Government are dividend/surplus from central public sector enterprises (CPSEs)/public sector financial institutions/Reserve Bank of India (RBI), receipts from the telecommunications sector, interest receipts on the loans extended to State Governments and CPSEs, royalty from off-shore oil fields and fees/user charges. Table 3.9 gives the trends of non-tax revenues. The FC-XIV estimated that non-tax revenue as a proportion of GDP would remain at around 1.53 per cent, assuming a high potential of revenue from the telecommunications and petroleum sectors and dividends. However, collections have fallen short of these estimates by 0.01 percentage points during the period from 2015-16 to 2019-20 (RE). The non-tax revenue of the Union Government, which stood at 1.4 per cent of GDP in 2011-12, increased to 1.8 per cent in 2016-17. Thereafter, it declined significantly by almost 0.7 percentage points in 2017-18, mainly on account of lower telecommunications sector receipts and dividend from the RBI. It is estimated to increase to 1.7 per cent in 2019-20 (RE) mainly on account of higher dividend receipts from the RBI. In absolute terms, the highest collection of 1.8 per cent of GDP was registered in 2016-17 mainly due to record collection of 0.5 per cent of GDP from the telecommunications sector. Since then, telecommunications receipts, classified under the head 'Communication', have started declining. Dividend receipts constitute the largest source of non-tax revenues of the Union Government. Their share in non-tax revenue was 0.60 per cent of GDP during 2018-19. The dividends from RBI increased more than four-fold from Rs.15,009 crore in 2011-12 to Rs.68,000 crore in 2018-19, while dividends from the others increased from Rs. 35,599 crore to only Rs. 45,421 crore. The dividend from RBI during 2019-20 is expected to increase further to Rs. 1.47 lakh crore mainly due to excess transfers as per the revised Economic Capital Framework (ECF).

Table 3.9: Trends in Non Tax Revenues

(Rs. crore)

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20 (RE)	2020-21 (BE)
Interest receipt	20252	20761	21868	23804	25378	16229	13574	12145	11027	11042
Dividend and profit	50608	53761	90435	89833	112127	123017	91361	113421	199893	155395
of which RBI	15009	16010	33010	52676	65896	65876	40659	68000	147988	57128*
Petroleum	12581	14806	16525	14480	9492	10797	10879	14197	12061	14075
Communication	17401	18902	40114	30624	56479	70241	32066	40816	58990	33027
Road and bridges	3050	4007	5298	6103	6887	7324	9064	19866	21589	25161
Others	17780	25118	24631	33014	40897	45223	35801	35261	41955	146316
Total	**121672**	**137355**	**198871**	**197858**	**251260**	**272831**	**192745**	**235706**	**345515**	**385016**
Non tax revenue as per cent to GDP	**1.4**	**1.4**	**1.8**	**1.6**	**1.8**	**1.8**	**1.1**	**1.2**	**1.7**	**1.7**

* provisional

Source : Union Budget, Finance accounts and GDP from NSO

3.67 In the past, interest receipts on loans given to State Governments were an important component of non-tax revenue. This has declined considerably after 2005-06 when intermediation of the Union Government in loans given to State Governments was stopped, following the recommendation of the FC-XII. The interest realisation is mostly on loans of an earlier period.

Non Debt Capital Receipts

3.68 Non-debt capital receipts have two major components: recovery of loans and advances and disinvestment receipts. The quantum of recovery of loans declined from Rs. 18,850 crore in 2011-12 to Rs. 15,633 crore in 2017-18. With no fresh on-lending to the States, except the back-to-back transfer of the loans taken for externally aided projects (EAP), the receipts under this head are showing a gradual declining trend. The other source of recovery of loans is from the public sector enterprises, for repayment of loans earlier extended.

3.69 Disinvestment receipts account for a major share of non-debt capital receipts. The Union Government has adopted four methods of disinvestment: (a) minority stake sale in profit making CPSEs by selling shares via offer for sale; (b) initial public offering of CPSEs; (c) strategic disinvestment of CPSEs; and (d) exchange traded funds (ETFs)[8].

[8] An ETF is a basket of stocks that reflects the composition of an index, like Nifty 50. The trading value of an ETF is based on the net asset value of the underlying stocks that it represents. Unlike regular open-ended mutual funds, ETFs can be bought and sold throughout the trading day like any other stocks. At present, the Union Government operates two ETFs: CPSE – ETF and Bharat-22 ETF

3.70 Strategic disinvestment would imply the sale of a substantial portion of the government shareholding in a CPSE, along with transfer of management control.This method would garner maximum receipts, but is predicated on the willingness of the Government to hand over control to another entity. During 2018-19, the Union Government made strategic disinvestments of four companies and received Rs. 16,000 crore. This included the sale proceeds of Rs. 15,000 crore from the disinvestment of the government's 52.63 per cent share in the Rural Electrification Corporation (REC) to the Power Finance Corporation (PFC), another CPSE. In a similar exercise in 2017-18, government's shares in Hindustan Petroleum Corporation Ltd (HPCL) were sold to the Oil and Natural Gas Corporation (ONGC) to achieve synergies in the petroleum sector through integration of upstream and downstream companies. While the sale of the government's stake in one CPSE to another may serve many strategic purposes, proceeds from such sales are qualitatively different from sales to non-government entities. Around Rs. 69,000 crore was generated through other methods of disinvestment in 2018-19. The ETF route is also being relied upon and, at present, there are two ETFs.

3.71 In November 2005, the Union Government had constituted the National Investment Fund (NIF) into which the proceeds from disinvestment of CPSEs were to be channelised. The corpus of the NIF was to be of a permanent nature and the Fund was to be professionally managed to provide sustainable returns to the Government, without depleting the corpus. In order to align the NIF with the disinvestment policy, it was included in the Public Account of the Union Government from 2013-14 onwards and the disinvestment proceeds are to remain there until withdrawn/invested for the approved purposes.

3.72 The NIF is primarily utilised for the following purposes:

(i) subscribing to the shares being issued by a CPSE on rights basis so as to ensure that the government stake of 51 per cent in the CPSE is not diluted;

(ii) preferential allotment of shares of the CPSE so that Government shareholding does not go down below 51 per cent in all cases where the CPSEs plan to raise fresh equity to meet their capital expenditure programme;

(iii) recapitalisation of public sector banks and public sector insurance companies;

(iv) investment by the Government in RRBs/India Infrastructure Finance Company Ltd (IIFCL)/National Bank for Agriculture and Rural Development (NABARD)/Exim Bank; and

(v) investment in certain entities.

It is relevant to mention here that the FC-XIV had reiterated the recommendations made by the FC-XIII to maintain all disinvestment receipts in the Consolidated Fund for utilisation on capital expenditure. It was further recommended that the NIF should be wound up in consultation with the Controller General of Accounts (CGA) and the CAG.

Table 3.10: Non-Debt Capital Receipts

(Rs. crore)

Particulars	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20 (RE)	2019-20 (BE)
Non-debt capital receipts	**36938**	**40950**	**41865**	**51475**	**62967**	**65353**	**115678**	**112779**	**81605**	**224967**
Recoveries of loan and advances	18850	15060	12497	13738	20835	17630	15633	18052	16605	14967
Disinvestment of equity	18088	25890	29368	37737	42132	47723	100045	94727	65000	210000
Non debt capital receipt as % of GDP	**0.42**	**0.41**	**0.37**	**0.41**	**0.46**	**0.43**	**0.68**	**0.59**	**0.40**	**1.00**

Source: Union Budget for various years and GDP from NSO

3.73 The trend in non-debt capital receipts is shown in Table 3.10. The FC-XIV had projected an increase in these receipts from 0.61 per cent of GDP in 2015-16 to 0.82 per cent in 2019-20. These have not been realised and the disinvestment receipts have fluctuated from year to year with no discernible trend. Market volatility has also affected the outcome. The Union Government has revised the target of disinvestment in financial year 2019-20 from Rs.1.05 lakh crore in the budget estimates to Rs. 65,000 crore in the revised estimates. Disinvestment is budgeted to net in a significantly higher Rs 2.10 lakh crore in 2020-21 (BE), which can be achieved only through aggressive strategic disinvestment of select CPSEs under favourable market conditions.

Trends of Expenditure

3.74 The trends in revenue and capital expenditure, along with the major components of revenue expenditure, are shown in Table 3.11. The total expenditure of the Union Government declined by over 2.7 percentage points of GDP from 14.9 per cent in 2011-12 to 12.2 per cent in 2018-19. Within overall expenditure, the revenue component declined from 13.1 per cent to 10.6 per cent and the capital component from 1.8 per cent to 1.6 per cent during the same period. The trend growth rates of revenue and capital expenditure during this period were 8.3 per cent and 10.5 per cent, respectively, which was lower than the nominal GDP growth of 11.6 per cent. Notwithstanding the implementation of the Seventh Pay Commission award, expenditure declined, as proportion of GDP, during this period mainly because of a decrease in subsidy and defence expenditure (capital and revenue) This trend is budgeted to be reversed by an increase in total expenditure as a proportion of GDP to 13.2 per cent in 2019-20 (RE) and 13.5 per cent of GDP in 2020-21 (BE). As proportions of GDP, revenue and capital expenditure are budgeted at

11.7 per cent and 1.8 per cent, respectively, during 2020-21 (BE). The projected increase in expenditure during 2019-20 and 2020-21 is mainly on account of an increase in allocations to the agriculture and allied sectors.) The major components of revenue expenditure comprising interest payments, pay and allowances, pensions, defence and subsidies are briefly analysed in the following paragraphs.

Table 3.11 Trends of Union Government Expenditure

(per cent of GDP)

Year	Revenue Exp.	Interest Payments	Pay and allowances*	Pension	Defence#	Subsidies Exp.	Capital Exp.	Total
2011-12	13.1	3.1	1.1	0.7	2.0	2.5	1.8	14.9
2012-13	12.5	3.1	1.1	0.7	1.8	2.6	1.7	14.2
2013-14	12.2	3.3	1.0	0.7	1.8	2.3	1.7	13.9
2014-15	11.8	3.2	1.1	0.8	1.8	2.1	1.6	13.3
2015-16	11.2	3.2	1.0	0.7	1.6	1.9	1.8	13.0
2016-17	11.0	3.1	1.2	0.9	1.6	1.5	1.8	12.8
2017-18	11.0	3.1	1.1	0.9	1.6	1.3	1.5	12.5
2018-19)	10.6	3.1	1.1	0.8	1.5	1.2	1.6	12.2
2019-20 (RE)	11.5	3.1	1.2	0.9	1.5	1.3	1.7	13.2
2020-21 (BE)	11.7	3.1	1.1	0.9	1.4	1.2	1.8	13.5

Includes both revenue and capital expenditure on defence services.

*Brochure on Pay and Allowances of Central Government (excluding Defence Services) and Union Budget.

Source : Union Budgets and GDP from NSO.

Interest Payments

3.75 Interest payments form the largest component of Union Government expenditure. The ratio of interest payments to net revenue receipts of the Union Government has narrowly ranged between 34 per cent and 38 per cent during 2011-12 to 2018-19. As a proportion of GDP, it has fluctuated between 3.1 per cent to 3.3 per cent. Both decline in interest rates and some fiscal consolidation have contributed to this.

Major Subsidies

3.76 Subsidies are the second largest component of revenue expenditure. The quantum of subsidies is a key determinant in expenditure management and fostering the path towards fiscal consolidation. The major explicit subsidies of the Union Government are on food, fertilizers and petroleum (Table 3.12). As a proportion of net revenue receipts, total subsidies decreased sharply from 29 per cent in 2011-12 to 14.4 per cent in 2018-19, 14.2 per cent in 2019-20 (RE) and is budgeted at 13 per cent in 2020-21 (BE). The corresponding decrease as a proportion of GDP was

from 2.5 per cent in 2011-12 to 1.2 per cent in 2018-19. But this does not correctly reflect the actual cash out-go as explained in the following paragraph. In the medium to long term, resolute measures are needed for rationalisation of subsidies. Furthermore, volatility in international oil prices is a major risk to the subsidy bill of the Union Government, particularly on liquefied petroleum gas (LPG) and fertilizer.

Table 3.12: Subsidies Relative to Union Government's Net Revenue Receipts

(per cent of net revenue receipts)

Year	Food	Fertiliser	Petroleum	Others	Total
2011-12	9.7 (0.8)	9.3 (0.8)	9.1 (0.8)	0.9 (0.1)	29.0 (2.5)
2012-13	9.7 (0.9)	7.5 (0.7)	11.0 (1.0)	1.1 (0.1)	29.2 (2.6)
2013-14	9.1 (0.8)	6.6 (0.6)	8.4 (0.8)	1.0 (0.1)	25.1 (2.3)
2014-15	10.7 (0.9)	6.5 (0.6)	5.5 (0.5)	0.8 (0.1)	23.4 (2.1)
2015-16	11.7 (1.0)	6.1 (0.5)	2.5 (0.2)	1.9 (0.2)	22.1 (1.9)
2016-17	8.0 (0.7)	4.8 (0.4)	2.0 (0.2)	2.2 (0.2)	17.1 (1.5)
2017-18	7.0 (0.6)	4.6 (0.4)	1.7 (0.1)	2.3 (0.2)	15.6 (1.3)
2018-19	6.5 (0.5)	4.5 (0.4)	1.6 (0.1)	1.7 (0.1)	14.4 (1.2)
2019-20 (RE)	5.9 (0.5)	4.3 (0.4)	2.1 (0.2)	2.0 (0.2)	14.2 (1.3)
2020-21 (BE)	5.7(0.5)	3.5(0.3)	2.0(0.2)	1.7 (0.2)	13.0 (1.2)

Source: Union Budget for various years and GDP from NSO

Note: Figures in brackets show explicit subsidies as ratio of GDP

3.77 Following the implementation of the National Food Security Act, 2013 (NFSA), food subsidy covers approximately 80 crore beneficiaries. Between 2011-12 and 2015-16, food subsidy as a proportion of net revenue receipts increased from 9.7 per cent to 11.7 per cent. The increase as a proportion of GDP was from 0.8 per cent to 1 per cent. The reported cash outflow, however, does not reflect the true impact of food subsidy. For example, in 2016-17 the cash outgo on account of this subsidy was Rs. 1.10 lakh crore (0.7 per cent of GDP), in 2017-18 Rs. 1 lakh crore (0.6 per cent of GDP) and in 2018-19 Rs.1.01 lakh crore (0.5 per cent of GDP). However, in addition, the Union Government gave loans to the FCI from the NSSF of Rs. 70,000 crore in 2016-17, Rs. 65,000 crore in 2017-18 and Rs. 97,000 crore in 2018-19. These are not reflected in the overall subsidy figures appearing in Tables 3.11 and 3.12.

3.78 Targeting of food subsidy is expected to have improved with electronic point of sale (e-PoS) devices at fair price shops authenticating beneficiaries at the time of distribution of foodgrains and also electronically capturing the quantum distributed to families. While the resulting saving from better targetting of food subsidy may have been Rs. 17,500 crore per year, there has been no reduction in allocation nor any savings in the budgeted expenditure on a net basis, as improved targetting has been offset by the inclusion of new beneficiaries in the scheme.

3.79 The long-awaited full de-control of the pricing of diesel and petrol came on 1 January 2015, and with the progessive rationalisation of excise duties on diesel and petrol, the distortionary price difference between diesel and petrol finally disappeared in early May 2020. The petroleum-related subsidies are now restricted to kerosene and LPG. While the Union Government has implemented DBT for LPG, the analogous reform of kerosene subsidy is ongoing. Kerosene allocation to States for distribution through the public distribution system has been rationalised from 2016-17 and steps have also been taken to enhance DBT coverage for kerosene. In view of these measures, the petroleum subsidy as percentage of net revenue receipts has declined from 9.1 per cent in 2011-12 to 1.6 per cent in 2018-19 and from 0.8 per cent to 0.1 per cent of GDP during the same period. Kerosene subsidy has declined steeply from Rs. 28,215 crore in 2011-12 to Rs. 3,659 crore in 2020-21 (BE). This has arguably been one of the most far-reaching expenditure reforms in the last five years. There has been, however, an increase in the petroleum subsidy outgo as a result of the Pradhan Mantri Ujjwala Yojana (PMUY). Under this scheme, about seven crore LPG connections have been provided to the below povery line (BPL) families so far since May 2016, with a support of Rs. 1,600 per connection. This may increase the subsidy burden on LPG in the future unless the subsidy regime is further rationalised to eliminate non-poor beneficiaries or there is a cap on the number of subsidised cylinders.

3.80 The fertilizer subsidy as a proportion of net revenue receipts declined from 9.3 per cent in 2011-12 to 4.5 per cent in 2018-19, and as percentage of GDP, from 0.8 per cent to 0.4 per cent . In 2016, the Department of Fertilizers chalked out a programme to implement DBT for fertilizer subsidy in a modified form through a pilot project in sixteen districts. With the introduction of neem-coating of urea from the kharif season of 2016, consumption of urea is estimated to have declined by 8.66 lakh metric tonne (MT) over 2015-16. The savings in subsidy is estimated to be approximately Rs. 12,000 per MT, resulting in a total saving of Rs. 1,000 crore.

Defence Expenditure

3.81 Expenditure on defence services, on both revenue (excluding defence services pension) and capital accounts, as a proportion of GDP, has steadily decreased from 2 per cent in 2011-12 to 1.5 per cent in 2018-19 (Table 3.11). In 2020-21 (BE), such expenditure on revenue and capital accounts, again as ratios of GDP, are estimated at 0.9 per cent and 0.5 per cent, respectively. The defence revenue expenditure in 2016-17 increased by 13.3 per cent and in 2017-18 by 12.5 per cent mainly on account of higher outgo on salaries with implementation of the revised pay scales of the three defence services. During 2018-19, it increased by a further 5.1 per cent. Between 2011-12 and 2018-19, defence revenue expenditure grew faster (10 per cent) than the increase in defence capital outlay (4.7 per cent), and resulted in a reduction of the share of defence capital outlay in total defence services expenditure (excluding defence pension) from 40 per cent in 2011-12 to 33 per cent in 2018-19.

3.82 The total defence services expenditure (including defence services pension), as a ratio of GDP, declined from 2.4 per cent in 2011-12 to 2.1 per cent in 2018-19. It is budgeted to go down to

2 per cent in 2020-21 (BE). This decline has taken place even as defence services pension, again as a ratio of GDP, increased from 0.43 per cent in 2011-12 to 0.48 per cent in 2014-15 and further to 0.57 per cent in 2016-17 due to the implementation of revised pay scales and one rank one pension (OROP). It is expected to be at the level of 0.6 per cent in 2020-21 (BE). In 2020-21 (BE), the defence services salary and pension constitute around 59 per cent of the total expenditure of the Ministry of Defence, followed by capital outlay (24 per cent) and stores, adminstration of the defence services, construction of roads and bridges and the Coast Guard organisation accounting for the balance.

3.83 The capital outlay on defence services increased at the rate of 4.7 per cent a year from 2011-12 to 2018-19. During this period, the highest annual growth of 12.2 per cent was registered in 2013-14 and the lowest (-) 2.4 per cent in 2015-16. Capital outlay as a proportion of GDP has decreased from 0.8 per cent in 2011-12 to 0.5 per cent in 2020-21 (BE). Similarly, capital outlay as a proportion of total defence services expenditure (including defence pension) has declined from 32.6 per cent to 24.9 per cent during the same period.

Pay and Allowances and Pensions

3.84 Pay and allowances (Table 3.11) of Union Government's civilian employees more than doubled between 2011-12 and 2018-19, from Rs. 95,984 crore to Rs. 2.11 lakh crore, due to the implementation of the Pay Commission's recommendations. While, as a ratio of GDP, such expenditure ranged between 1 per cent and 1.2 per cent during this period, the implementation of the Pay Commission's recommendations led to a marginal increase from 1 per cent in 2015-16 to 1.2 per cent in 2016-17. As on 1 March 2017, the strength of Union Government employees was 32.38 lakh, and went upto 32.63 lakh in 1 March 2019.

3.85 The expenditure of the Union Government on pensions, as a proportion of GDP, also increased - from 0.7 per cent in 2011-12 to 0.9 per cent in 2016-17 - due to the Pay Commission award. This includes the contribution of the Union Government under the new pension scheme (which accounts for 2.4 per cent in the total expenditure under pensions). It is expected to remain at 0.9 per cent in 2020-21 (BE).

3.86 Expenditure on salary, pension and interest payments together accounted for 4.9 per cent of GDP in 2011-12 and increased to 5 per cent of GDP in 2018-19. As per budget estimates of 2020-21, it is expected to remain at the level of 5.1 per cent.

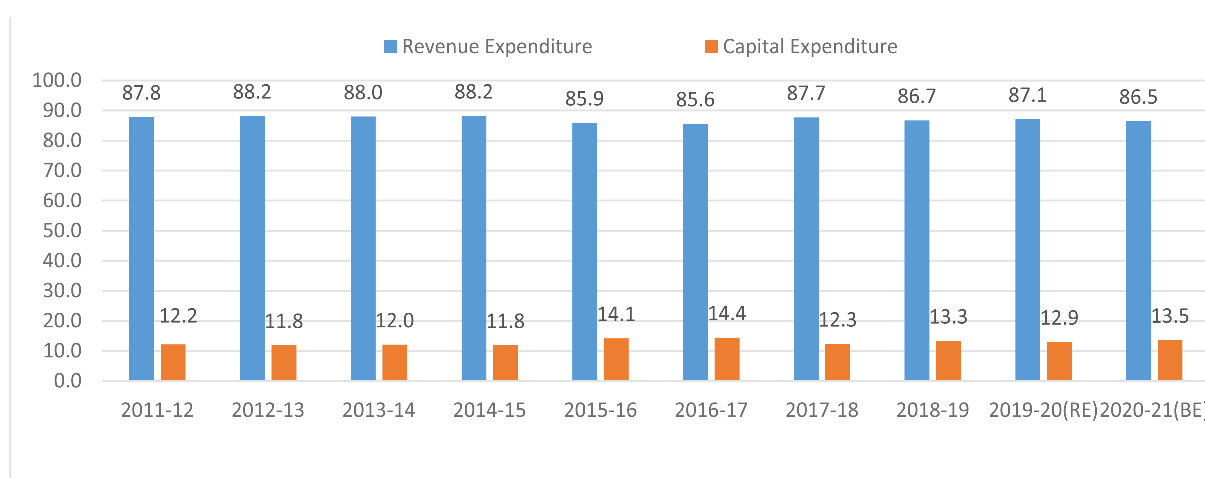
Revenue-Capital Expenditure Balance

3.87 In 2011-12, as a proportion of GDP, the Union Government's revenue expenditure was 13.1 per cent and capital expenditure 1.8 per cent. In 2016-17, the revenue expenditure declined by 2.1 percentage points to 11 per cent while capital expenditure remained at the same level, showing an improvement in the quality of expenditure. But it was shortlived; in 2017-18, while

the revenue expenditure remained at same level of 11 per cent, capital expenditure contracted by about 0.3 percentage points to 1.5 per cent, indicating a significant deterioration in the quality of Union Government's expenditure (Table 3.11). Some of this deterioration was reversed in 2018-19, when revenue expenditure declined by 0.4 percentage point to 10.6 per cent and capital expenditure increased by 0.1 percetage point. The relative share of capital expenditure in total expenditure increased from 12.2 per cent to 14.4 per cent during the period 2011-12 to 2016-17. Thereafter, it declined significantly by 1.1 percentage points cent to reach 13.3 per cent in 2018-19. The trends of revenue and capital expenditure accounts are shown in Figure 3.9.

Figure 3.9: Relative Percentage Share of Revenue and Capital Expenditure

(percentage of total expenditure)



Source : Union Budgets

Review of State Finances

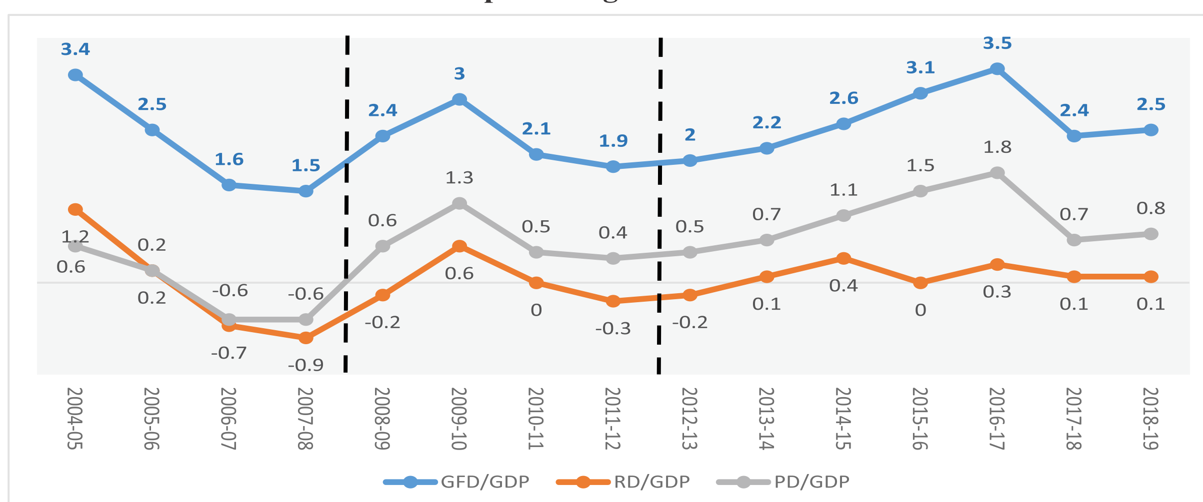
3.88 As discussed earlier, the large number of changes in public finances over the last five years have had significant implications for the finances of State Governments. The replacement of the Planning Commission with the NITI Aayog and the subsequent closing of the funding window under the Plan schemes has had varying impact on the finances of States. Similarly, the implementation of the recommendations of the FC-XIV from April 2015 and the launch of GST in July 2017 have changed the inter-governmental fiscal relations in several ways. At the level of States, three additional developments have had an impact on state finances: the implementation of the UDAY (Ujjwal DISCOM Assurance Yojana) scheme for improving the fiscal health of power distribution companies, implementation of the recommendations of state pay commissions and the increasing tendency of State Governments to waive off farm loans.

Trends in Aggregate Fiscal Indicators

3.89 Before embarking on a discussion on State finances from 2011-12, it is instructive to look at the period from 2004-05 onwards. The combined fiscal position of States can be divided into three broad phases (Figure 3.10). State finances showed a general improvement between 2004-05 and 2007-08 in the key parameters of combined fiscal deficit, revenue deficit and primary deficit. The combined fiscal deficit of all States declined from 3.4 per cent to 1.5 per cent during this period while the combined revenue deficit of 1.2 per cent turned into a surplus of 0.9 per cent. The improvement was largely on account of enhanced revenues and improvement in tax efficiency with the introduction of VAT, the debt consolidation and write-off (Debt Consolidation and Relief Facility (DCRF) facility provided by the FC-XII) and the enactment of FRBM Acts by States.

Figure 3.10: Trends in Aggregate Fiscal Indicators of States

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



Source: Finance Accounts; GDP: NSO (2011-12 series) and NSO back-series 2004-05 to 2011-12 (Base 2011-12)

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

3.90 The 2008-09 to 2011-12 period witnessed two major shocks: pay revision by States, in response to recommendations of the Sixth Central Pay Commission and the global financial crisis (2008-09). Tax devolution from the Union as well as the States' own tax revenue, as a proportion of GDP, declined between 2008 and 2010 on account of tax concessions granted to combat the anticipated downturn in the economy during the global slowdown. While slackening its own fiscal rules under the FRBM Act, the Union Government also relaxed the same for the State Governments and permitted them to borrow beyond their respecitve FRBM limits in 2008-09 and 2009-10. As a result of all these factors, as a proportion of GDP, the States' fiscal deficit increased from 1.5 per cent to 3 per cent between 2007-08 and 2009-10. However, increased transfers was one of the major reasons for the marginal improvement in fiscal indicators from 2009-10 to 2011-12.

3.91 Various factors contributed to the steady worsening of the aggregate fiscal indicators of the States from 2011-12 onwards (Table 3.13). There was a decline in their own tax and non-tax revenues. Their combined fiscal deficit breached the 3 per cent ceiling for the first time in 2015-16 and was a high of 3.5 per cent in 2016-17. Outstanding liabilities of State Governments have been registering double digit growth since 2012-13. The capital expenditure of the States increased to 3.3 per cent in 2016-17 from 2.4 per cent in 2014-15 (Table 3.15). Major policy factors like UDAY, implementation of new pay commission awards following the Seventh Pay Commision award, farm loan waivers and pending accounting issues related to GST implementation have been the main contributors to the strained fiscal health of States. Nevertheless, the States, in the aggregate, were able to bring down the gross fiscal deficit to GDP ratio below 3 per cent in 2017-18 and 2018-19. This trend was also reflected in the reduction of the primary deficit to GDP ratio. This fiscal improvement, however, came mainly at the cost of compression of capital expenditure which, as a proportion of GDP, declined from 3.3 per cent to 2.5 per cent. Both components of capital expenditure, namely capital outlay and loans and advances declined, with a sharp decline in the latter on account of power, and food storage and warehousing. In 2017-18, some States converted past loans to the power sector into grants or equity. Debt to GDP ratio remained more or less stagnant around 24 per cent between 2016-17 and 2018-19.

Table 3.13: Trends in Aggregate Fiscal Indicators of States – Deficits and Debt

(In per cent)

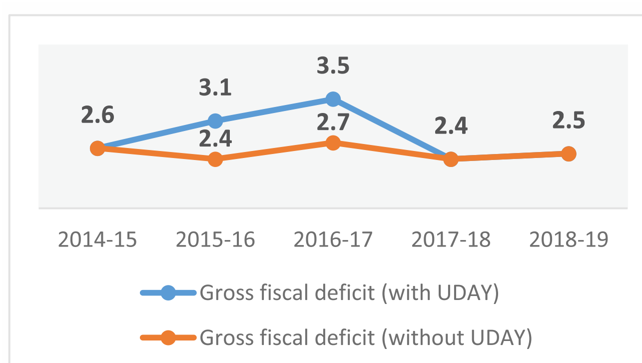
All State Aggregate	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20 (RE)	2020-21 (BE)
GFD/GDP	1.9	2.0	2.2	2.6	3.1	3.5	2.4	2.5	3.1	2.7
RD/GDP	-0.3	-0.2	0.1	0.4	0.0	0.3	0.1	0.1	0.8	0.1
PD/GDP	0.4	0.5	0.7	1.1	1.5	1.8	0.7	0.8	1.5	1.0
RD/GFD	-14.1	-10.4	4.3	14.0	1.3	7.6	5.8	5.3	24.0	5.1
Outstanding Debt & Liabilities/GDP	22.6	22.0	21.6	21.9	23.0	24.3	24.4	24.5	25.5	25.4

Source: Finance Accounts, State Budgets 2020-21; GDP: NSO (2011-12 series)

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)

Figure 3.11: Impact of UDAY(as percentage of GDP)



3.92 A total of twenty-seven States (including the erstwhile State of Jammu and Kashmir) signed up for the UDAY scheme for the financial and operational improvement and revival of power distribution companies. Sixteen State governments took over the debt of power distribution companies (DISCOMs), while eleven signed up for only improving operational efficiencies without any takeover of debt. Under the scheme, sixteen State Governments issued bonds to take over the debt of DISCOMs and transferred these proceeds to DISCOMs in a mix of grant, loan and equity. Figure 3.11 presents the gross fiscal deficit of State Governments with and without UDAY. It can be seen that the fiscal deficit of all the States with UDAY is 3.1 per cent of GDP in 2015-16 and 3.5 per cent in 2016-17. However, when UDAY liabilities are excluded, it falls to 2.4 per cent in 2015-16 and 2.7 per cent in 2016-17. UDAY, therefore, had an impact of 0.7 per cent of GDP in 2015-16 and 0.8 per cent in 2016-17. The total debt-GDP ratio of these States also increased from 22.6 per cent in 2011-12 to 24.3 per cent in 2016-17. The capital expenditure of the States increased from 2.4 per cent in 2014-15 to 3.3 per cent in 2016-17 as the States provided support to DISCOMs largely through loans under UDAY. As the restructuring of DISCOM debt was completed in 2016-17, there was no burden on this account in 2017-18 and the fiscal deficit came down to 2.4 per cent in 2017-18.

3.93 Based on the recommendations of the FC-XIV, the Union Government implemented a basic incentive-compatible framework for State Governments to adhere to fiscal targets. The States were eligible for an additional borrowing limit of 0.25 per cent over and above 3 per cent of fiscal deficit for any given year for which debt-GSDP (gross state domestic product) ratio was less than or equal to 25 per cent in the preceding year. A further additional borrowing limit of 0.25 per cent of GSDP was given in a year if the interest payments were less than or equal to 10 per cent of the revenue receipts in the preceding year. These were subject to the condition that the State does not have a revenue deficit. Despite the availability of this window, the aggregate additional borrowings over net borrowing ceilings allowed to States under this dispensation were a modest Rs. 12,269 crore (seven states), Rs. 12,873 crore (nine states) and Rs. 12,664 crore (ten states) for the years 2016-17, 2017-18 and 2018-19, respectively.

3.94 In 2015-16, the States eliminated their aggregate revenue deficit mainly because of their larger share in the devolution of taxes following the implementation of FC-XIV recommendations. In 2016-17, the revenue deficit increased to 0.3 per cent largely because almost one-third of the aggregate expenditure by States on UDAY was in the form of grants. This reduced to 0.1 per cent in 2017-18 and remained at the same level in 2018-19.

3.95 Interest payments by State Governments, which is the difference between fiscal deficit and primary deficit, remained in the range of 1.5 per cent to 1.7 per cent of GDP between 2011-12 and 2018-19. With the steep increase in the fiscal deficit and only a marginal increase in interest payments, the primary deficit also increased from 0.4 per cent in 2011-12 to 1.8 per cent in 2016-17, but reduced to 0.7 per cent of GDP in 2017-18.

Trends in Aggregate Revenues

3.96 The aggregate revenue receipts of States as a proportion of GDP increased from 12.6 per cent in 2011-12 to 13.6 per cent in 2018-19 (Table 3.14). While aggregate own tax revenue of the States, again as a proportion of GDP, remained in the range of 5.9 per cent to 6.6 per cent of GDP from 2011-12 to 2018-19, it tapered downwards after peaking in 2012-13. The own non-tax revenue remained in the range of 1 per cent to 1.2 per cent during the same period. The bulk of the increase in aggregate revenue receipts as a percentage of GDP was mainly on account of increased devolution and grants-in-aid from the Union.

3.97 Aggregate tax devolution to States, as a proportion of GDP, increased from 2.9 per cent in 2011-12 to 4 per cent in 2018-19 and grants-in-aid increased from 2.1 per cent in 2011-12 to 2.3 per cent in 2018-19. However, it may be noted that compensation to States on account of GST is booked as grants-in-aid to States. The increased tax devolution was mainly due to the implementation of the FC-XIV's recommendations. The increase in total transfers from the Union to States was equivalent to 1.2 per cent of GDP between 2011-12 and 2018-19.

3.98 A part of the increase in grants-in-aid from the Union to the States was because of a change in methodology of disbursing the grants for various CSS. Earlier such grants-in-aid bypassed the State budgets, but from 2014-15 onwards, these were routed through the State budgets. This contributed to the increase in grants-in-aid, as a proportion of GDP, shooting up from 1.8 per cent in 2013-14 to 2.7 per cent in 2014-15. However, such grants-in-aid declined to 2.4 per cent in 2015-16 mainly due to the discontinuation of financial assistance provided to States in the form of NCA, SCA and SPA given by the erstwhile Planning Commission. But due to the compositional shift of transfers cosequent to the FC-XIV award, the overal transfers increased.

Table 3.14: Trends in Aggregate Revenue Receipts of the States

(per cent of GDP)

All State Aggregate	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20 (RE)	2020-21 (BE)
Total Revenue Receipts	12.6	12.6	12.2	12.8	13.3	13.3	13.3	13.6	13.8	14.1
a. Own Tax Revenue	6.4	6.6	6.3	6.2	6.2	5.9	6.0*	6.1	6.3	6.4
b. Own Non-Tax Revenue	1.1	1.2	1.2	1.2	1.1	1.1	1.0	1.1	1.1	1.2
Total Own Revenue (a+b)	7.5	7.8	7.5	7.4	7.3	7.0	7.0	7.3	7.4	7.6
c. Tax Devolution	2.9	2.9	2.8	2.7	3.7	3.9	3.9*	4.0	3.4	3.6
d. Grants-in-Aid	2.1	1.9	1.8	2.7	2.4	2.3	2.3	2.3	3.0	3.0
Total Transfers from the Union (c+d)	5.1	4.8	4.7	5.4	6.0	6.3	6.3	6.3	6.4	6.6

* In the year 2017-18, an amount of Rs. 67,998 crore on account of IGST has been booked under devolution to States in the Finance Accounts of States.

Source: Finance Accounts, State Budgets 2020-21; GDP: NSO (2011-12 series)

3.99 Aggregate own tax revenue of States increased at a trend growth rate of 10.26 per cent between 2011-12 and 2018-19, substantially below normative levels based on longer term trends estimated by the FC-XIV. Given the already low levels of tax revenues mobilised by States, the observed buoyancy of 0.86 is disconcerting. The impact of implementation of GST on State finances has already been discussed in an earlier section. Their aggregate own non-tax revenue growing at a trend rate of 10.45 per cent also displayed a buoyancy of only 0.88, substantially below one. With increase in transfers from Union to States during the period, the States' total revenue receipts, as a proportion of GDP, showed some increase from 2011-12 to 2018-19.

Trends in Aggregate State Expenditure

3.100 The revenue expenditure of States as a percentage of GDP increased steadily from 12.3 per cent in 2011-12 to 13.7 per cent in 2018-19 (Table 3.15). A marked increase was seen in revenue expenditure as proportion of GDP from 12.3 per cent in 2013-14 to 13.1 per cent in 2014-15. A part of this may be attributed to the routing of CSS grants through the budgets of the States.

Table 3.15: Trends in Aggregate State Expenditure

(per cent of GDP)

All State Aggregate	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20 (RE)	2020-21 (BE)
I. Revenue expenditure	12.3	12.4	12.3	13.1	13.3	13.6	13.5	13.7	14.6	14.3
General services										
of which:	4.4	4.3	4.3	4.3	4.4	4.4	4.6	4.8	4.9	4.9
Interest payments	1.6	1.5	1.5	1.5	1.6	1.6	1.7	1.7	1.7	1.7
Pension	1.5	1.5	1.5	1.5	1.5	1.5	1.6	1.7	1.7	1.7
Other general services	1.4	1.4	1.3	1.3	1.3	1.3	1.3	1.4	1.5	1.6
Social services										
of which	5.0	5.0	5.0	5.1	5.4	5.5	5.3	5.4	5.9	5.8
Education	2.4	2.4	2.4	2.5	2.5	2.5	2.4	2.4	2.5	2.5
Health	0.6	0.6	0.6	0.7	0.7	0.7	0.7	0.8	0.8	0.8
Economic services	2.6	2.8	2.6	3.3	3.2	3.3	3.2	3.1	3.4	3.2
Compensation & assignment to local bodies and aid materials	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
II. Capital expenditure	2.4	2.2	2.2	2.4	3.1	3.3	2.5	2.5	2.7	2.7
III. Total expenditure	14.7	14.6	14.5	15.6	16.4	16.9	15.9	16.2	17.3	16.9

Source: Finance Accounts,, State Budgets 2020-21; GDP: NSO (2011-12 series)

3.101 Higher revenue expenditure of the 'development' category for education, sports, art and culture, social security and welfare, relief on account of natural calamities, rural development and energy has contributed to the growth in revenue expenditure. Committed expenditure comprising pensions, interest payments and administrative services increased only marginally during this period. Interest payments increased from 1.6 per cent of GDP in 2011-12 to 1.7 per cent in 2018-19. On the other hand, expenditure on pension remained at 1.5 per cent from 2011-12 to 2016-17 but increased to 1.7 per cent in 2018-19 mainly due to implementation of the Pay Commission award.

3.102 Revenue expenditure on general services was more or less constant at around 4.4 per cent of GDP from 2011-12 to 2016-17. During this period, such expenditure on social services increased from 5 per cent to 5.5 per cent and economic service expenditure increased from 2.6 per cent to 3.3 per cent. However, there was a marked change in the composition of revenue expenditure from 2016-17 to 2018-19. While revenue expenditure on general services increased from 4.4 per cent to 4.8 per cent of GDP with increases in expenditure on interest and pensions, there was a corresponding decline from 5.5 per cent to 5.4 per cent in social services and from 3.3 per cent to 3.1 per cent in economic services.

3.103 Revenue expenditure on education (2.5 per cent of GDP) and health (0.7 per cent of GDP) remained almost constant between 2011-12 and 2018-19 (Table 3.15). Furthermore, as a proportion of total revenue expenditure, such expenditure on education declined from 19.8 per cent to 17.3 per cent while that on health increased from 4.8 per cent to 5.5 per cent. A partially redeeming feature of this change was that the reduction in the share of revenue expenditure on education was lower for States with GSDP below the national average. Importantly, the increase in the share of revenue expenditure on health was higher for these States with below average GSDP as compared to the better off States.

3.104 In 2018-19, the average per capita revenue expenditure on education for North-Eastern and Himalayan (NEH) States at Rs. 5,970 was higher than the corresponding figure of Rs. 3,267 for other States in general. Similarly, the corresponding per capita revenue expenditure on health of Rs. 1,987 for NEH States was almost double of Rs.1,035 for general States. The below-average States in each category require extra attention (Table 3.16).

Table 3.16: States Spending Less than Average Per Capita Revenue Expenditure on Health /Education (2018-19)

Social Sector	North-Eastern and Himalayan States with per capita spending less than NEH States average	General States with per capita spending less than average of general States
Education (NEH States average is Rs.5,970 and general States average is Rs.3,267)	Assam, Manipur, Meghalaya and Triputa	Bihar, Jharkhand, Madhya Pradesh, Punjab, Telangana, Uttar Pradesh and West Bengal
Health (NEH States average is Rs.1,987 and general States average is Rs.1,035)	Assam, Manipur and Uttarakhand	Bihar, Jharkhand, Madhya Pradesh, Maharashtra, Punjab, Uttar Pradesh and West Bengal

3.105 Most of the States have implemented revised pay scales following the recommendations of the Pay Commission. While this impacted the revenue expenditure of States, the overall impact on State finances was cushioned and spread over a few years by States resorting to various methods like delaying the implementation of the awards, non-payment of arrears, payment of arrears in instalments (sometimes spaced over two-three years), impounding of arrears into general provident fund accounts and partial implementation of pay commission awards with reduced allowances or allowances at pre-revised rates.

Box 3.1 : Farm Loan Waivers

An increasingly important factor, and a worrying one, that has begun to impact the finances of States are the farm loan waivers that have been announced by various States since 2014. Fortunately, after 1990 and 2008, the Union Government has not annouced any such schemes. Farm loan waivers are often justified on the grounds of falling prices of agricultural commodities and recurring droughts. The RBI Study of State Budgets (2017-18 and 2018-19) has highlighted that the debt waiver schemes of Andhra Pradesh and Telangana announced in 2014 had significant fiscal implications amounting to Rs. 24,000 crore (4.6 per cent of GSDP) and Rs. 17,000 crore (3.4 per cent of GSDP) respectively, while Tamil Nadu's loan waiver scheme of 2016 amounted to Rs. 6,000 crore (0.5 per cent of GSDP). In 2017, Maharashtra, Uttar Pradesh and Punjab sanctioned farm loan waivers of Rs. 34,000 crore (1.3 per cent of GSDP), Rs. 36,000 crore (2.7 per cent of GSDP) and Rs. 10,000 crore (2.1 per cent of GSDP) respectively. States like Rajasthan, Madhya Pradesh and Chhattisgarh announced new loan waiver programmes in 2018-19 to the tune of Rs. 18,000 crore (1.9 per cent of GSDP), Rs. 36,500 crore (4.5 per cent of GSDP) and Rs. 6,100 crore (1.7 per cent of state GSDP), respectively. Karnataka expanded its loan waiver programme from Rs. 18,000 crore announced in 2017-18 to Rs. 44,000 crore (3.4 per cent of GSDP) in 2018-19 (RBI Report 2019-20).

It is difficult to ascertain the exact amount of farm loans waived by State Governments from a perusal of the Finance Accounts. This is because individual States have different ways of treating these waivers, that often include interest subvention, in their accounts.

As per information obtained by the Commission from the States, since 2014-15, thirteen States gave no farm loan waivers, seven States (erstwhile Jammu and Kashmir, Karnataka, Punjab, Rajasthan, Tamil Nadu, Telangana and Uttar Pradesh) gave details of waivers aggregating about Rs. 79,000 crore from 2014-15 to 2019-20. However, this data cannot be relied on to gauge the actual quantum of farm loan waivers for a number of reasons. First, some of the States did not respond. Second, the data was self-reported and could not be independently verified. Third, the treatment of interest subvention varied across States. Finally, there was very little congruence between budgeted amounts and actual spends.

Besides the Pradhan Mantri Kisan Samman Nidhi (PM-KISAN) of the Union Governmnet, six States budgeted for State income support scheme in year 2019-20. Such income support schemes are relatively more inclusive and do not have the moral hazard problem that is inherent in farm loan waivers.

3.106 Aggregate capital expenditure of States as a percentage of GDP, after increasing from 2.4 per cent in 2011-12 to 3.3 percent in 2016-17, decreased to 2.5 per cent in 2017-18. A significant increase in capital expenditure was seen in 2015-16 and 2016-17, mainly on account of UDAY bonds taken over by the States. As stated earlier, the decline in capital expenditure was on account of both its components - capital outlay and loans and disbursements. For almost all States, while capital outlays (including on roads and bridges and irrigation and energy) declined, loans and disbursments came down for the power sector and for food storage and warehousing. Total expenditure of State Governments increased to 16.2 per cent in 2018-19 from 14.7 per cent in 2011-12.

3.107 Aggregate revenue expenditure of States increased at a trend growth rate of 13.52 per cent during the period 2011-12 to 2018-19. The buoyancy of revenue expenditure with respect to aggregate GSDP of States during this period was 1.14. Aggregate capital expenditure of States grew at a trend growth rate of 14.77 per cent, and resulted in an even higher buoyancy of 1.24.

State Finances: A Comparative Perspective

3.108 Annex 3.1 to 3.12 provide detailed data on fiscal indicators of States from 2011-12 to 2020-21(BE). Some important observations are:

i. In 2011-12, only six States (Haryana, Kerala, Maharashtra, Meghalaya, Punjab and West Bengal) had a revenue deficit, but the number went up to ten in 2018-19 (Andhra Pradesh, Haryana, Jammu and Kashmir, Kerala, Meghalaya, Punjab, Rajasthan, Tamil Nadu, Uttarakhand, and West Bengal) (Annex 3.1).

ii. Figure 3.12 decomposes the change in the revenue deficit-GSDP ratios of general States from 2011-12 to 2018-19. Increase in the revenue deficit can be due to three reasons: decrease in own revenue, decrease in Union transfers and/or increase in revenue expenditure. In the case of the seventeen general States (except Telangana), ten showed an increase/worsening of the revenue deficit. Further, seven general States saw a decline in own revenue to GSDP ratio over the period, fourteen saw an increase in revenue expenditure, while Central transfers as percentage of GSDP increased in all States except Goa. This implies that revenue deficit of States increased in spite of higher Central transfers as a result of the award of the FC-XIV.

iii. Seven of the eleven NEH States saw an increase in revenue deficit as percentage of GSDP during this period (Figure 3.13). Own revenue declined in five States, while revenue expenditure increased in all but five states (Assam, Manipur, Mizoram, Sikkim, Tripura). Due to the reduction in Plan grants to these States, total Central transfers as a percentage of GSDP declined in five NEH States (in percentage points) – Manipur, Mizoram, Nagaland, Sikkim, Tripura.

iv. The fiscal deficit increased in eleven of seventeen general States (barring

Telangana) and six out of eleven NEH States from 2011-12 to 2018-19. Figures 3.14 and 3.15 show a similar trend in the debt to GSDP ratio, which increased in twelve general States and four NEH States.

v. The own tax revenue to GSDP ratio reduced from 2011-12 to 2018-19 in nine general States and three NEH States (Figure 3.16).

Figure 3.12: Increase (+) in Revenue Deficit in General States: (2018-19 over 2011-12)

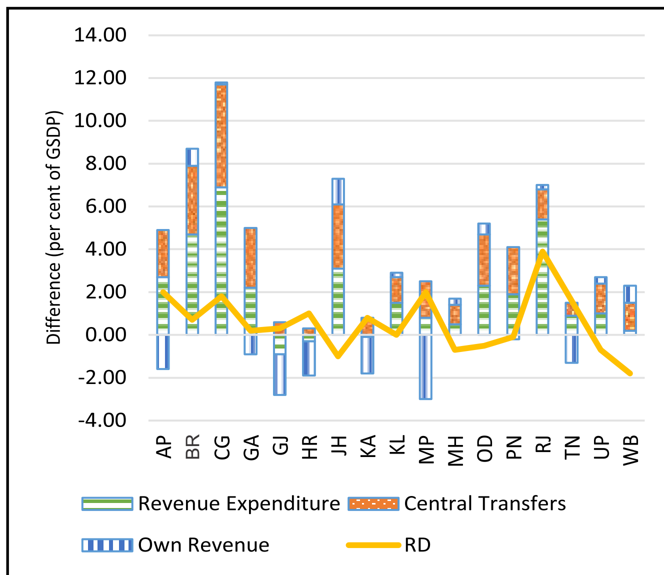


Figure 3.13: Increase (+) in Revenue Deficit in NEH States: (2018-19 over 2011-12)

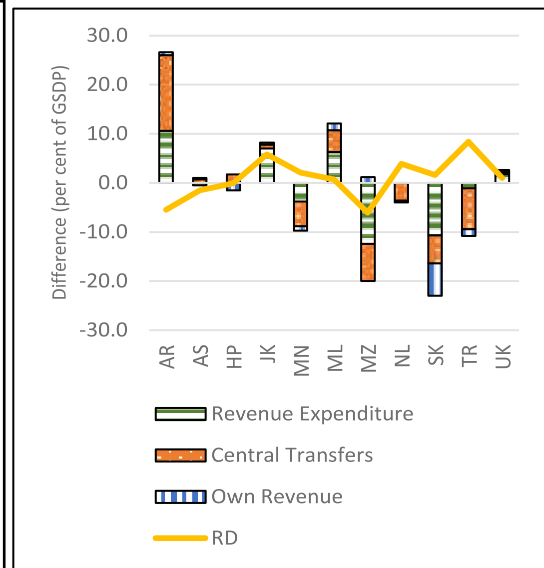


Figure 3.14: Debt/GSDP and its Difference (+Increase/-Decrease) in General States (2018-19 over 2011-12) (in percentage points)

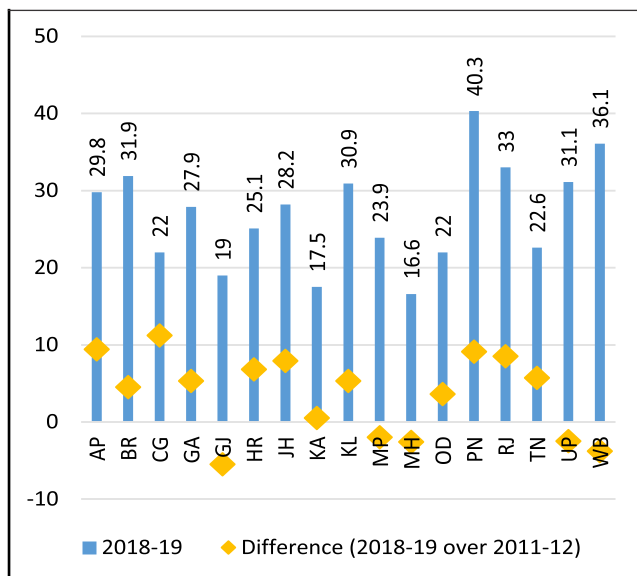


Figure 3.15: Debt/GSDP and its Difference (+Increase/-Decrease) in NEH States (2018-19 over 2011-12) (in percentage points)

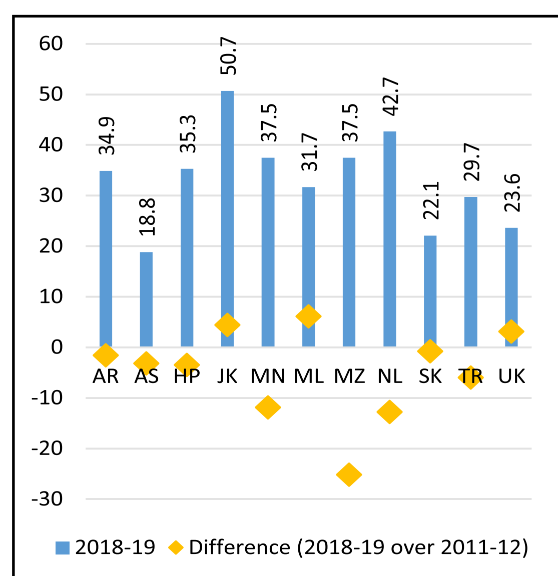
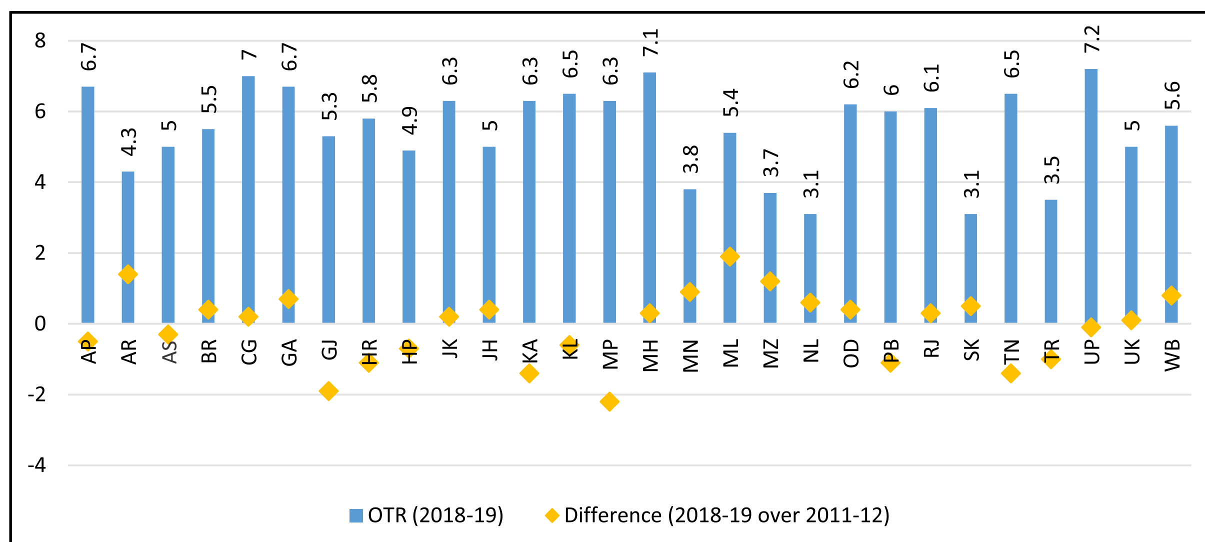


Fig 3.16: Own Tax Revenue/GSDP Ratio in 2018-19 and Difference in the Ratio in 2018-19 over 2011-12 (in percentage points) (+ Increase/- Decrease)



Per Capita Revenue Expenditure

3.109 A general purpose transfer should enable States to provide comparable level of public services to all its people. Hence, transfers should equalise expenditure levels of States to achieve the minimum standards in respect of specified services and to mitigate regional differences in social and infrastructural indicators. The FC-XIV, in its assessment, had adopted the principle of partially equalising revenue expenditures across States by making an aggregate assessment of the per capita revenue expenditure needs of States to enable all of them to spend a certain minimum expenditure within the constraints of an overall resource envelope. Keeping this in view, it is relevant to compare the per capita revenue expenditure across States (Annex 3.9). As the NEH States have a high unit cost of providing public services, the average per capita revenue expenditure in 2018-19 was Rs. 29,220 as compared to Rs. 19,206 in the general States (Table 3.17). However, there is a wide variation among the NEH States, with Assam having the lowest per capita expenditure at Rs.16,668 and Sikkim the highest at Rs. 79,191.

3.110 In the general States, per capita revenue expenditure in 2018-19 ranged between Rs.10,515 in Bihar and Rs.31,823 in Kerala. Goa, being a small and developed State, is an outlier with a per capita revenue expenditure of Rs. 72,154. Bihar, Uttar Pradesh and Jharkhand are at the bottom and, ironically, these are the three States that require a significant push in their developmental expenditure.

Table 3.17: Per Capita Expenditure

(in Rs.)

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Total Expenditure								
All States	10712	11981	13213	15578	17955	20363	21091	23519
General States	10287	11557	12776	15079	17532	19822	20426	22753
NEH States	17006	18251	19652	22931	24183	28319	30923	34830
Revenue Expenditure								
All States	8959	10143	11224	13155	14589	16364	17798	19842
General States	8612	9793	10857	12729	14176	15859	17246	19206
NEH States	14098	15320	16633	19438	20667	23798	25944	29220
Capital Expenditure								
All States	1753	1838	1989	2422	3366	3999	3294	3677
General States	1675	1764	1919	2350	3356	3963	3180	3546
NE&H States	2909	2932	3019	3493	3516	4521	4980	5610

Source: Finance Accounts; Population Estimates: NSO

Cash Balances

3.111 In the period under review, State Governments, in aggregate, reported sizeable cash balances in the form of intermediate treasury bills (ITBs) and auction treasury bills (ATBs). According to data provided by the Ministry of Finance, the total cash balances of all States stood at Rs.1.57 lakh crore in end March 2016, Rs.1.91 lakh crore in end March 2017, Rs. 2.11 lakh crore in end March 2018 and Rs 1.94 lakh crore in end March 2019. In this regard, the FC-XIV had observed that 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 expenditure. It further stressed the need to analyse the reasons that lead to holding of such costly large cash balances and to take corrective action.

3.112 In 2016-17, cash balances of States amounted to 5.12 per cent of outstanding debt and 1.25 per cent of GDP, which reduced to 5.07 per cent of outstanding debt and 1.24 per cent of GDP in 2017-18. This further reduced to 4.20 per cent of outstanding debt and 1.03 per cent of GDP in 2018-19. The RBI Report on State Finances 2019-20 has shown that a few States have been parking sizeable cash balances in the more durable segment such as ATBs. Weekly auctions were also introduced with a view to even out cash flow mismatches while keeping the bare minimum cash balances. The States should ensure that the borrowing calender is calibrated to achieve the goal of minimising cash balances at the end of the year.

Trends in Inter-Governmental Transfers

3.113 While the previous sections have reviewed the finances of the Union and State Governments, it is essential to look at inter-governmental transfers which are primarily in the form of transfers from the former to the latter. The transfers can be broadly categorised as Finance Commission transfers and other transfers. For the sake of simplicity, we will refer to these other transfers as non-FC transfers. The recommendations of the FC–XIV have increased the transfers to States, and there has also been a shift in the composition of overall transfers.

3.114 The Finance Commission transfers are made under Articles 270, 275 and 280 of the Constitution, whereas the non-FC transfers are primarily made under Article 282 of the Constitution, which states that: "The Union or a State may make any grants for any public purpose, notwithstanding the purpose is not one with respect to which Parliament or the Legislature of the State, as the case may be, make laws". It is often argued that Article 282 is only a residual Article to enable the Union or a State to make a grant for any public purpose. However, over the years the transfers through the institution of the Planning Commission and for the purpose of CSS acquired a disproportionate importance in the overall transfers to States. The abolition of the Planning Commission in 2015-16 has now translated into a reduced flow under the non-FC category. However, as a proportion of the Union's gross revenue receipts, the non-FC grants, after declining from 16.77 per cent in 2017-18 to 15.45 per cent in 2018-19, increased to 18.61 per cent in 2019-20 (RE) and 18.22 per cent in 2020-21 (BE) (Table 3.18).

Quantum and Components of Transfers

3.115 The relative shares of Finance Commission transfers as proportions of gross revenue receipts and of GDP and the ratio of Finance Commision and non-FC revenue transfers to State Governments are presented in Table 3.18. For the sake of comparability, from FC-XII onwards we have included the transfers to State implementing agencies as transfers to States, though in the category of 'other transfers.' Prior to 2014-15, direct transfers to implementing agencies were not taken as part of State Finance Accounts and were captured only in the Union Government's accounts. However, to get clarity on the structural shifts in the transfer system, it was important to include the direct transfers to implementing agencies in the States as part of the total transfers to the States. The FC-XIV cited three key reasons for this: (a) States were required to make matching contributions; (b) the implementing agencies were manned by State Government officials and, in some cases, headed by ministers; and (c) the implementing agencies perform quasi-government functions of delivering public services. The Union Government recognised this and has included them in the transfers to State Governments from 2014-15 onwards.

Table 3.18: Transfers from the Union to States as Proportion of Gross Revenue Receipts

(in per cent)

Commission	Finance Commission Transfers			Other Transfer (Non-FC)	Total Transfers* (4+5)	Ratio of FC to Non-FC Transfers	Total Transfers as percentage of GDP
	Share in Central Taxes	Grants	Total Finance Commission Transfers				
1	2	3	4	5	6	7	8
FC-XII (2005-10)	22.03	4.35	26.38	21.01	47.39	55.7 : 44.3	6.03
FC-XIII (2010-15)	23.80	3.96	27.75	20.47	48.22	57.6 : 42.4	5.76
2010-11	21.68	3.12	24.79	23.87	48.66	50.9 : 49.1	6.45
2011-12	25.27	4.35	29.62	23.73	53.35	55.5 : 44.5	6.17
2012-13	24.84	3.86	28.70	19.96	48.66	59.0 : 41.0	5.74
2013-14	23.79	4.03	27.82	17.93	45.75	60.8 : 39.2	5.45
2014-15	23.41	4.28	27.70	18.57	46.27	59.9 : 40.1	5.35
FC-XIV (2015-19)	31.37	4.51	35.88	14.74	50.62	70.9 : 29.1	6.30
2015-16	29.66	4.96	34.61	13.24	47.86	72.3 : 27.7	5.93
2016-17	30.57	4.80	35.38	13.04	48.41	73.1 : 26.9	6.26
2017-18	31.87	4.37	36.24	16.77	53.01	68.4 : 31.6	6.55
2018-19	32.88	4.05	36. 92	15.45	52.38	70.5 : 29.5	6.39
2019-20RE	26.15	4.93	31.08	18.61	49.69	62.5 : 37.5	6.10
FC-XV (2020-21)							
2020-21(BE)	27.93	5.34	33.27	18.22	51.48	64.6 : 35.4	6.43

*Transfers include direct transfers to State implementing agencies.

Source: 1) Basic data from Union Budget.

2) GDP: NSO (2011-12 series) and NSO back-series 2004-05 to 2011-12 (Base 2011-12)

3.116 It is instructive to note there has been both a shift in the quantum of total transfers and its composition. The ratio of total transfers to GDP has increased from 5.76 during the FC-XIII period to 6.30 during the first four years of the FC-XIV award period. The shift is quite visible when we look at the actual figures of the five years spanning both the award periods: the ratio increased from 5.35 in 2014-15 to 6.39 in 2018-19.

3.117 The impact of increase in devolution from 32 per cent to 42 per cent can be clearly seen in the share of devolution in the gross revenue receipts, which was 23.8 per cent in the FC-XIII period and is 31.37 per cent in the first four years of the FC-XIV award period. This has, in turn, enhanced the total transfers in relation to the gross revenue receipts from 48.22 per cent to 50.62 per cent over the two periods. It may be noted that the increase in devolution (7.57 percentage point of gross revenue receipts), as intended by the FC-XIV, is only partially offset by a 5.73 percentage point decrease in non-FC transfers.

3.118 In terms of composition, the shift is more significant. While about 59.9 per cent of total transfers were through the Finance Commision route in 2014-15, this increased to 70.5 per cent in

2018-19. Though there has been some reversal in this trend in 2019-20 (RE) and 2020-21 (RE), the FC-XIV recommendations have substantially altered the landscape of federal fiscal transfers. The sharp increase in tax devolution has resulted in the share of general-purpose transfers going up significantly, but this has been offset in two ways. First, with the abolition of the Planning Commission, assistance such as NCA, SCA and SPA have been discontinued. Second, States' share in CSS has been enhanced to reduce the support of the Union Government.

3.119 Table 3.19 shows the total transfers in relation to a number of parameters such as total expenditure, gross tax revenue and the gross revenue receipts of the Union Government. In 2017-18, there is a sharp jump in the transfers as a percentage of gross revenue receipts on account of two reasons: transfer to the GST Compensation Fund amounting to Rs. 55,657 crore (2.64 per cent of the gross revenue receipts) and a Rs. 49,752 increase in CSS and Central sector scheme transfers (2.36 per cent of gross revenue receipts) to States over the previous year.

Table: 3.19: Trends and Structure of Union Transfers, Including Direct Transfers

(in per cent)

S No	Particulars	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20 (RE)	2020-21 (BE)
1	Total FC transfers as percentage of total Union transfers	50.9	55.5	59.0	60.8	59.9	72.3	73.1	68.4	70.5	62.5	64.6
2	Non- FC transfers as percentage of total Union transfers	49.1	44.5	41.0	39.2	40.1	27.7	26.9	31.6	29.5	37.5	35.4
3	Total Union transfer as percentage of total Union expenditure	41.1	41.3	40.5	39.2	40.1	45.6	48.7	52.3	52.4	46.2	47.5
4	Total Union transfers as percentage of gross revenue receipts (GTR+NTR)	48.7	53.3	48.7	45.7	46.3	47.9	48.4	53.0	52.4	49.7	51.5
5	Union transfers as percentage of gross tax revenue	62.1	60.6	55.1	53.7	53.6	56.1	56.1	58.3	58.3	57.6	59.7
6	Union transfer as percentage of divisible pool	71.1	68.9	63.5	62.3	62.9	64.9	65.9	69.4	75.1	73.3	75.6
7	Devolution as percentage of gross tax revenue	27.7	28.7	28.1	27.9	27.1	34.8	35.4	35.1	36.6	30.3	32.4
8	Cess and surcharges as percentage of gross tax revenue (Excl. GST Cess)	11.1	10.4	11.7	12.4	13.5	12.2	13.5	10.6	15.3	15.6	15.3

Source: Union Budget

Note: 1) GTR – gross tax revenue; NTR – net tax revenue
2) Union transfers include GST compensation cess

The compensation cess is estimated to be 4.1 per cent and 3.9 per cent of the gross revenue receipts for 2018-19 and 2019-20 (RE) respectively. It is also noteworthy that though the FC-XIV gave a 10 percentage point jump in the States' share of the divisible pool, when this devolution is seen in the context of gross tax revenue, the enhancement is only about seven percentage points over the two award periods.

Ceiling on Transfers

3.120 In the past, Commissions have been giving an indicative ceiling of the revenues to be transferred to State Governments as a proportion of gross revenue receipts of the Union Government. The FC-XI had for, the first time, set the norms for transfers as a proportion (37.50 per cent) of Union revenues (tax and non-tax taken together) in aggregate terms, leaving the components to be determined separately but within the overall ceiling. It was envisaged that to promote the path towards fiscal consolidation, all transfers, like tax devolution, grants-in-aid and grants in other forms like Plan grants, would be decided in the light of the prescribed ceiling and within the resource profile of the Union Government and the contemplated deficit levels. The ceiling of 37.50 per cent itself was determined with the objective that it would not disrupt finances at both levels of government.The FC-XII had increased the indicative ceiling to 38 per cent, which the FC-XIII had further increased to 39.5 per cent. However, Table 3.19 shows that the actual Union transfers have ranged between 46.3 per cent and 53.3 per cent of gross revenue receipts during the FC-XIII period. These figures include direct transfers to the State implementing agencies. The FC-XIV, in its report, observed that the indicative ceiling on transfers suggested by previous Finance Commissions did not restrain the Union Government from making larger transfers to the States. It further recommended that about 49 per cent of the gross revenue receipts could be transferred to the States during the award period in order to address the needs and expectations of the States and to ensure the prevailing level of transfers to them. Table 3.18 shows that over the first four years of FC-XIV award period, the actual transfers to the States have been 50.6 per cent of the gross revenue receipts of the Union.

Combined Revenues, Expenditures and Transfers

3.121 The proportion of transfers from the Union to the States in the combined revenues is shown in Table 3.20. The share of the Union Government (taking into account its resources net of all transfers) has been in the range of 28.3 per cent to 33.4 per cent over the period from 2010-11 to 2018-19. Similarly, the share of the States has been in the range of 66.6 per cent to 71.7 per cent of the combined revenue receipts. The total transfers also include the direct transfers that were being routed through the State implementing agencies prior to 2014-15. The devolution of Union taxes has increased from 14 per cent of combined revenue receipts in 2010-11 to 20.6 per cent in 2018-19, while the other grants have decreased from 15.4 per cent to 9.7 per cent over the same period.

Table 3.20: Relative Share of Union and States in Combined Revenue Receipts

(per cent)

	Revenue Receipts before transfer	Union Revenue receipts after transfers	Devolution	Transfers FC Grants	Other Grants	Total Transfers (Dev. +Grants)	Revenue Receipts before transfer	State Revenue receipts after transfers
1	2	3	4	5	6	7	8	9
2010-11	64.7	33.2	14.0	2.0	15.4	31.5	35.3	66.8
2011-12	60.6	28.3	15.3	2.6	14.4	32.3	39.4	71.7
2012-13	60.3	31.0	15.0	2.3	12.0	29.4	39.7	69.0
2013-14	61.3	33.2	14.6	2.5	11.0	28.0	38.7	66.8
2014-15	61.0	32.8	14.3	2.6	11.3	28.2	39.0	67.2
2015-16	63.0	32.9	18.7	3.1	8.3	30.2	37.0	67.1
2016-17	64.8	33.4	19.8	3.1	8.4	31.3	35.2	66.6
2017-18	63.7	29.9	20.3	2.8	10.7	33.8	36.3	70.1
2018-19	62.7	29.9	20.6	2.5	9.7	32.8	37.3	70.1
2019-20 RE	62.5	31.4	16.3	3.1	11.6	31.0	37.5	68.6
2020-21 BE	62.3	30.2	17.4	3.3	11.3	32.1	37.7	69.8

Source: State & Union Budgets and Finance Accounts, Finance Commission Division.

Note 1: The data of transfers is taken from Union Government.

Note 2: Direct transfers to State Implementing Agencies are included in transfers.

3.122 Table 3.21 indicates the relative shares of the Union Government and State Governments in the combined revenue expenditure. The share of the Union Government has reduced from 45.2 per cent to 37.5 per cent of combined revenue expenditure between 2010-11 to 2018-19. On the other hand, the relative share of the States has increased from 54.8 per cent to 62.5 per cent over the same period.

Table 3.21: Relative Share of Union and States in Combined Revenue Expenditure

(per cent)

Year	Union including grants (FC+other)	Union excluding grants (FC+other)	Grants (FC+other)	States excluding grants (FC+other)	States including grants (FC+other)
1	2	3	4	5	6
2010-11	61.3	45.2	16.1	38.7	54.8
2011-12	59.2	44.5	14.7	40.8	55.5
2012-13	56.6	43.9	12.7	43.4	56.1
2013-14	55.8	43.9	11.9	44.2	56.1
2014-15	52.9	41.0	11.9	47.1	59.0
2015-16	50.2	40.0	10.1	49.8	60.0
2016-17	49.4	39.0	10.4	50.6	61.0
2017-18	50.3	38.4	12.0	49.7	61.6
2018-19	48.4	37.5	10.9	51.6	62.5
2019-20 RE	51.4	38.4	12.9	48.6	61.6
2020-21 BE	52.4	39.2	13.2	47.6	60.8

Source: State & Union Budgets and Finance Accounts, Finance Commission Division.

Note 1: The data of transfers is taken from Union Government.

Note 2: Direct transfers to State Implementing Agencies are included in transfers.

Summary of Union Finances

3.123 To summarise, the key features in the trends in Union finances in recent years are:

(i) The period from 2011-12 to 2018-19 was a phase of fiscal consolidation, despite challenges arising from increase in devolution. The fiscal deficit came down from 5.9 per cent to 3.4 per cent, accompanied by a simultaneous reduction in the revenue deficit from 4.5 per cent to 2.4 per cent. However, it was higher than the fiscal adjustment path recommended by both the FC-XIII and FC-XIV. The fiscal consolidation path, however, has been adversely impacted by Covid-19 pandemic in the last quarter of 2019-20 and 2020-21.[9]

(ii) The tax-GDP ratio improved by only a modest 80 basis points from 10.2 per cent to 11 per cent of GDP. About half of this was on account of buoyant income tax. At the same time, the rationalisation of corporation tax for companies resulted in a fall in the share of this tax from 3.7 per cent to 3.5 per cent of GDP. Given the already low tax-GDP ratio, the Union Government mobilising more taxes remains an imperative necessity.

(iii) Along with the improvement of the fiscal indicators, the debt to GDP ratio

[9] For a detailed review of 2019-20 and 2020-21 please refer to Chapter 12

declined steadily from 51.8 per cent in 2011-12 to 47.9 per cent in 2018-19. The decline in debt was largely due to reduction in the fiscal deficit during the period 2011-12 to 2018-19. The excess of growth of nominal GDP over the average nominal interest rate also facilitated the decline in debt-to-GDP ratio.

(iv) Both growth of GDP and growth in collection of revenues in the terminal year of current award period are expected to be below the FC-XIV estimates and adds to uncertainty of projections of both revenues and taxes.[10]

(v) Cesses and surcharges steadily increased over the review period with a direct impact on the size of the divisible pool. In 2017-18, introduction of GST saw the merger of a number of cesses and surcharges into the GST.

(vi) The dividends received from the RBI, public sector financial institutions and CPSEs have been robust and became the largest contributor under the non-tax revenue category. Within the category of dividend and profits, there is disproportionate dependence on the RBI. Interest receipts on loans outstanding from States continue to decline, since no fresh loans are being extended to them.

(vii) Disinvestment receipts, which fall under non-debt capital receipts, were well short of the estimates suggested by the FC-XIV. However, with the Government adopting different methods of disinvestment, there is scope for further improvement, though challenges of sustainability remain. While the sale of government stake in one CPSE to another may increase the cashflow under disinvestment and serve other strategic purposes, it is debatable whether such sale is as much of a 'disinvestment' as the sale to a non-government category.

(viii) On the expenditure front, there was significant contraction of more than two percentage points of GDP largely on account of the reduction in subsidies. Expenditure on subsidies, particularly on petroleum products and fertilizers, declined significantly providing fiscal space to the Union Government, but food subsidies increased on account of commitments under the NFSA and the annual increase of minimum support prices on wheat and rice, as well as the cost of carrying and handling stocks well above the buffer stock norms. This remains a challenge despite the introduction of DBT and the use of technology. The expansion of coverage of subsidised LPG to BPL beneficiaries as part of the Ujjwala scheme calls for a review of LPG subsidy to non-BPL sections and restrictions on the number of refills eligible for subsidy in this category. However, large payments to the FCI in the form of NSSF loans were not reflected in the expenditures on subsidy. In addition, the fertilizer subsidy payments were also carried over to subsequent years translating into lower expenditure during certain years.

(ix) The share of committed expenditures has been relatively stagnant, barring in

[10] Chapter 4 has a detailed review of terminal year 2019-20 and 2020-21

2017-18, due to revision of pay and pension. Unanticipated expenditures such as OROP, which have long term implications, added to the fiscal pressure. Defence expenditure declined relative to GDP and the ratio of revenue to capital expenditure gradually increased in the review period.

(x) Fiscal consolidation was achieved with a somewhat altered fiscal roadmap, but there was substitution of expenditure in some sectors through EBRs. Even if these are taken into account, there has still been a moderate fiscal correction. The recent slowdown in demand and moderation of growth will increase the pressure on the Union Government to adopt counter-cyclical measures which would be expansionary in nature and impact the fiscal indicators. Given these headwinds, the award period will be crucial as it will set the tone for the fiscal correction path during the entire period.

Summary of State Finances

3.124 The main trends in State finances can be summarised as:

i. There was a general deterioration in the aggregate fiscal position of States during the period 2011-12 to 2018-19, which was reflected in an increase in the aggregate gross fiscal deficit and revenue deficit relative to GDP by 0.6 and 0.4 percentage points, respectively. Despite this decline, States, in aggregate, have managed to keep the fiscal deficit within targets, excluding the UDAY component. However, the revenue account of few States remained under stress in spite of higher transfers from the Union Government because of declining own tax revenue and increasing revenue expenditure.

ii. The fiscal indicators for 2015-16 and 2016-17 were severely impacted by the borrowings under the UDAY programme, which is also likely to affect the expenditure during the award period on account of the interest outgo on such borrowings. Reform of the power sector remains a major concern and challenge. States will have to ensure that all the operational parameters are met within the UDAY timelines and remain extremely cautious against any slippage.

iii. The aggregate outstanding debt and liabilities, as a proportion of GDP, increased from 22.6 per cent in 2011-12 to 24.5 per cent in 2018-19.

iv. With the implementation of the recommendations of the FC-XIV, aggregate tax devolution from the Union to States as a proportion of GDP increased from 2.9 per cent in 2011-12 to 4 per cent in 2018-19. This led to an increase in untied funds to the States, thus giving them enhanced flexibility to prioritise their expenditure needs

v. The share of States in GTR of Union Government has declined from 62.1 per cent in 2010-11 to 58.3 per cent in 2018-19. This can partly be attributed to the increase in the

cesses and surcharge component of the Union Government. At the same time, there was also a 0.3 percentage point decline in the aggregate own tax revenues of the States over the period, led by some of the bigger States like Andhra Pradesh, Assam, Gujarat, Himachal Pradesh, Karnataka, Madhya Pradesh, Punjab and Tamil Nadu. This trend needs to be reversed quickly. This decline was observed even before the introduction of GST.

vi. Shortfall in GST revenues have remained a cause of worry. States have witnessed high volatility in GST collections with differential impact on their finances. The cushion of GST compensation till June 2022 has eased the process of transition for States. However, States need to rapidly improve implementation, reduce tax evasion and under-invoicing. The States which are lagging in harnessing the potential of GST will need some structural change over the medium term to increase their own revenue.

vii. The aggregate own non-tax revenue as a percentage of GDP has remained flat for States. More effort is required from State Governments to improve non-tax revenues.

viii. The aggregate revenue expenditure as a proportion of GDP increased significantly from 12.3 per cent in 2011-12 to 13.7 per cent in 2018-19, with a marginal improvement in the social services category and moderate increase under the economic services category. Capital expenditure remained steady, but there was a modest spike both in 2015-16 and 2016-17 on account of UDAY.

ix. States' expenditure on social services, including on education and health, as a proportion of GDP has seen a steady increase over the past few years. However, there are large inter-State variations. Wide disparities in social service and economic service expenditure is quite worrying and may hinder the country's progress in achieving SDG targets.

x. Farm loan waivers and increase in subsidies have long term implications for State finances. The increasing tendency of State Governments to grant farm loan waivers is posing a burden on their budgets. The policy is expected to have a wider deleterious impact on the credit culture in a State by incentivising wilful defaults, demoralising the conscientious borrowers who regularly serviced their loans, and increasing the reluctance of banks in lending in the State. Further, each such waiver granted makes it even more difficult to reject such similar demands in the future.

Chapter 4

Pandemic Times: Analysis for the Future 2021-26

In keeping with the approach of the previous Finance Commissions, we have adopted normative principles with the objective of building fiscal sustainability in austere times. The revenue growth has been inadequate in the face of rising expenditure. Erosion of the tax-GDP ratio and virtual stagnation in non-tax revenues even before the onset of the Covid-19 pandemic have made it imperative for us to re-prioritise expenditure by both the Union and the States in our assessment. We have assessed the expenditure needs with the objective of ensuring austerity in establishment-related expenses and eliminating profligacy and leakages in the administration of subsidies and public spending through appropriate strategies. This will enable channelising the consequent savings into developmental expenditure in specified social and economic sectors to promote growth and fiscal consolidation during our award period and beyond. It is also possible, in our view, to strengthen the revenue base through institutional reform and administrative measures to enhance resources at all levels of government. These principles underpinned our assessment of the revenue and expenditure of the Union and the States.

Introduction and Context

4.1 This chapter lays out our projection of revenue, expenditure and financing requirements of the Union and the State Governments for the period 2021-26. It, thus, sets the background for our devolution scheme and fiscal consolidation roadmap presented in subsequent chapters. After setting the context, this chapter discusses the projection of the finances of the Union Government and the State Governments; it then concludes with summary and recommendations.

4.2 There are three major aspects to this Chapter. First, the projections developed were guided by the terms of reference (ToR) of the Commission, which required us to consider the following:

(i) The resources of the Union and State Governments for five years and their revenue potential and fiscal capacity.

(ii) The demand on the Union Government's resources particularly for defence, internal security, infrastructure, railways, climate change, administration of Union Territories without legislature and other committed expenditure and liabilities.

(iii) The demand on the State Governments' resources, particularly for socio-

economic development and critical infrastructure, assets maintenance, balanced regional development and the liabilities of their public utilities.

(iv) The impact of the goods and service tax (GST), payment of GST compensation to the States and abolition of a number of cesses on the finances of the Union and the States.

4.3 The immediate dimension that has a bearing on our projections is the Covid-19 pandemic and its human, economic and fiscal impact. Governments at all tiers are facing a loss of tax base, and revenue, albeit of different magnitudes. Against this, there are additional critical requirements of spending for public health management, income support and for stimulating the economy. Hence, it is essential to reprioritise expenditure, ensure accountability in spending, and lay the foundation for raising additional resources through administrative and policy reforms.

4.4 Thirdly, the changes in the principles and rules of fiscal management that have occurred in recent years have also impacted our projections. The classification of expenditure into 'Plan' and 'non-Plan' was removed from the accounts of the Union and of most of the States with effect from 2017-18. This made us take a holistic view of the spending plans on the revenue account of the Union and States. Further, the introduction of the GST closely intertwined the tax base for major indirect taxes of the Union and the States.

Finances of the Union Government

4.5 In normal circumstances, we would have projected the Union Government's finances based on the budget estimates for 2020-21, with some calibration. However, the economic contraction caused by the pandemic made us reconstruct the entire set of revenue numbers for 2020-21 before proceeding further.

Views of the Union Government

4.6 The Commission had a series of interactions with the Ministry of Finance, apart from discussions with line ministries on sectoral issues. The Ministry of Finance, on behalf of the Union Government, submitted two memoranda to us – a comprehensive one in 2019 and a concise update in 2020 in view of the changed environment. While arriving at the aggregate expenditure requirements of the Union, these documents consolidated sectoral demands and articulated spending plans under national development priorities. The line ministries made separate submissions outlining their respective demands from the Commission.

4.7 The Union Government projected an average annual growth of 9.6 per cent in its expenditure during our award period, reasoning that: (a) it is primarily responsible for achieving the sustainable development goals; (b) it is the national clearing house for spreading good ideas, schemes and actions; and (c) it alone can coordinate efficient delivery of certain public services by building national standards of performance and evaluation. The Union Government split its revenue expenditure into four mutually exclusive items: Union's commitments, national

development priorities, Finance Commission grants to State Governments and other transfers to State Governments.

4.8 Subsequent to the current drop in activity, the Union Government expects that the economy will recover on the strength of the reforms that it has undertaken. The Union Government projected that real gross domestic product (GDP) growth will improve gradually to 8 per cent in 2025-26, with an inflation assumption of around 4 per cent. Gross tax revenue was projected to grow at 13.4 per cent per annum during the entire period, with a rising buoyancy of 1.2, taking the tax to GDP ratio from 10.3 per cent in 2021-22 to 11.1 per cent in 2025-26. On the expenditure side, the Union's commitments – including interest payments, pensions and salaries, subsidies, defence and others – were projected to decline from 9.4 per cent of GDP in 2021-22 to 8.6 per cent in 2025-26. In contrast, it assessed that the spending on national development priorities, including education, health, housing, employment, water supply and sanitation, social security and welfare, agriculture, rural development, power and digital technology would need to modestly increase from 2.5 per cent of GDP to 2.7 per cent during the period. On the whole, as per the Union Government's projections, revenue expenditure will decline from 13.7 per cent of the GDP in 2021-22 to 12.4 per cent in 2025-26 while capital expenditure will increase from 2.1 per cent of GDP to 2.3 per cent.

GDP at Current Market Prices

4.9 Assessment of both the expenditure needs as well as the likely revenues to be mobilised by the Union and the State Governments is closely related to the growth prospects of the economy, measured by the nominal GDP or GDP at market prices. The assessment that we presented in our Report for the Year 2020-21 has been overtaken by the Covid-19 pandemic. Considerable uncertainty remains regarding when the pandemic, which has affected all countries in the world in terms of human lives, productive capacity and economic activity, is going to abate and also the nature of recovery. The risks entail careful calibration of projecting the nominal GDP growth in the coming quarters of 2020-21 and the years of our award period.

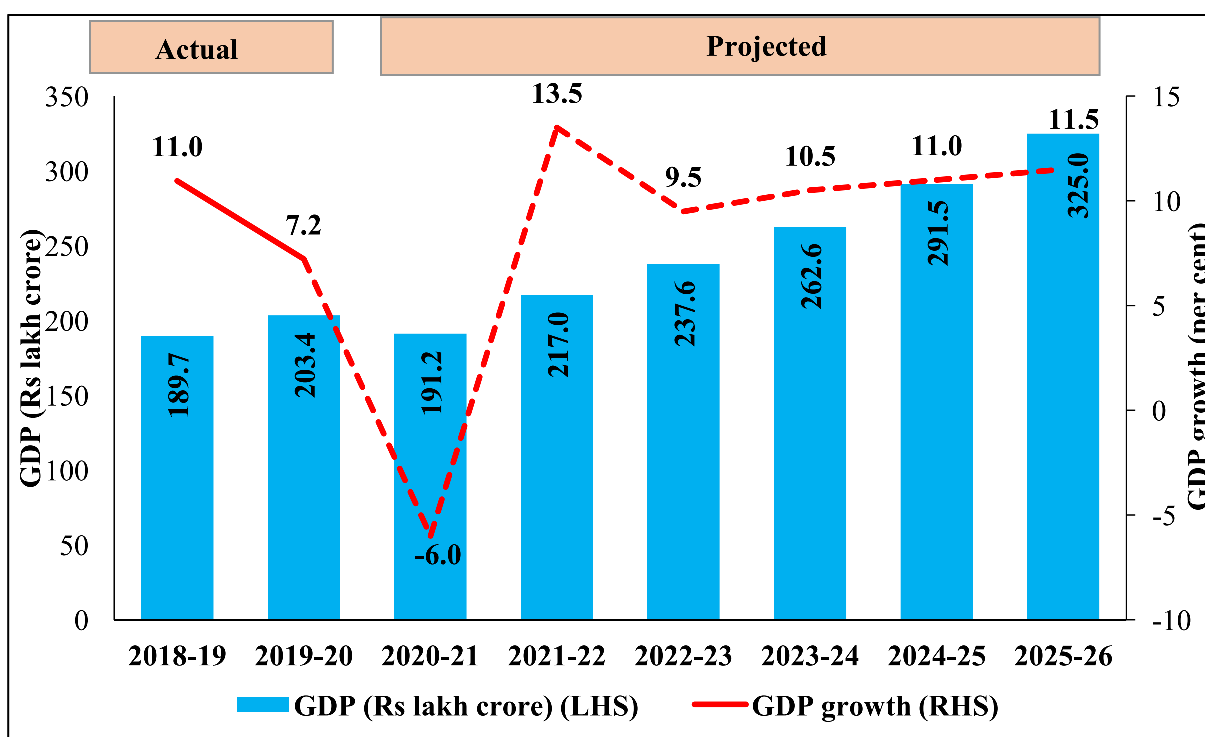
4.10 After consultations with domain experts and considering the views of the Union Government, we have divided the entire six-year period of 2020-21 to 2025-26 into two parts. We expect heightened uncertainties to continue in 2020-21 and 2021-22; and expansion in activity from 2022-23 onwards for the balance four years of our award period. Accordingly, we have not assumed a constant nominal GDP growth throughout our award period, but have employed a differentiated growth path. We start by revisiting the projection of nominal GDP for 2020-21. In the first quarter (Q1) of 2020-21, GDP at market prices contracted by 23.9 per cent in real terms and 22.6 per cent in nominal terms. Data for the second quarter (Q2) will be available only on 27 November 2020. Available in the interim are high-frequency indicators like the index of industrial production (IIP), production of key intermediate goods, data on mobility in public spaces and revenue collections of governments. With a progressive easing of the lockdown,

many of these show a milder contraction since May. Retail or consumer price inflation has crossed 7 per cent mark in September 2020, while inflation based on the wholesale price index has moved to positive territory. Downside risks on the real economy front are likely to be associated with upside risks on the inflation front. Considering the high frequency indicators and the progressive easing of the lockdown, we project a gradual recovery in activity from Q2 to Q4 of 2020-21 and assess a contraction in nominal GDP of about 6 per cent for the full year of 2020-21.

4.11 In our view, the large contraction in 2020-21 opens up the possibility of a sharp growth recovery going forward. While the pace of the recovery is uncertain, some analysts believed that the growth recovery will have a V-shape. According to our assessment, the recovery in 2021-22 may not fully be to the level of real activity of 2019-20. However, after a decline of 6 per cent in nominal GDP in 2020-21, we project nominal GDP to grow by 13.5 per cent in 2021-22. High growth in nominal GDP in 2021-22, because of the low base in 2020-21, will be followed by a growth of 9.5 per cent in 2022-23. The four-year block of 2022-23 to 2025-26, we project, will be a period of sustained expansion of activity. Our assumptions about the levels and rates of growth of GDP at current market prices for 2021-22 to 2025-26 are given in Figure 4.1.

Figure 4.1: Nominal GDP: Levels and Growth

(Actuals till 2019-20 and projections thereafter)



Assessment of Gross Tax Revenue for 2021-2026

4.12 In making our assessment of the tax revenue for the Union Government for the period 2021-22 to 2025-26 we analysed both the tax-specific buoyancies of the past period (2011-12 to 2018-19) and the more recent decline in tax collections evident from the provisional accounts of 2019-20 and the recent tax collection data of 2020-21. The Fourteenth Finance Commission (FC-XIV) projected a trend growth rate of 15.2 per cent during 2015-16 to 2019-20. The gross tax revenue of the Union Government increased at a trend rate of 13.9 per cent per annum during 2015-16 to 2018-19. This meant an aggregate buoyancy of 1.25, similar for both direct and indirect taxes. However, there has been a sharp contraction of gross tax revenue by 3.4 per cent in 2019-20 on account of two major factors. First, the onset of the pandemic in the last month of the year dampened tax collection, which was already strained by economic slowdown. Second, revenue foregone through the reduction in the tax rate for domestic companies affected corporate tax collections significantly.

4.13 When economic activity suddenly falls during crises, evidence points to income-based taxes decelerating more steeply than consumption-based taxes. Moreover, requirements of social distancing due to the pandemic have affected consumption considerably in 2020-21. We assessed that if tax policy remained the same, the gross tax revenue of the Union would contract by 10.6 per cent in 2020-21, as against the projected contraction of 6 per cent in nominal GDP. However, post the Budget 2020-21, there was a significant change in the tax policy of the Union Government in the form of an increase in the special additional duty of excise and road cess on petrol and diesel. We have conservatively assessed that the additional revenue from this policy change will be around Rs. 80,000 crore in 2020-21, even though the Union Government projected higher collections. Considering the impact of this measure, we estimated that the gross tax revenue of the Union Government will only contract by 6.7 per cent in 2020-21, which is still slightly steeper than the GDP contraction. The impact on the divisible pool will be sharper because the increased cess collections are not sharable.

4.14 Our assessment of taxes is presented mostly in terms of growth and buoyancy. The absolute numbers are presented in Annex 4.1. A comprehensive treatment of the issues in different taxes and their revenue potential is available in Chapter 5. The projections reflected in this Chapter have assumed that the operational and administrative issues related to coverage and evasion flagged in Chapter 5 are progressively resolved during 2021-2026.

Indirect Taxes

4.15 At present, three major indirect taxes of the Union Government include Central GST (CGST), Union excise duties on petroleum products and basic customs duties. During the period 2011-12 to 2018-19, indirect taxes grew by 14.5 per cent while GDP grew by 11.6 per cent. This meant a buoyancy of 1.25 during the period. However, the higher growth in indirect taxes was partly due to efforts for mobilising additional tax resources, mostly by way of increased excise

duties and cesses on petroleum products, and less pronouncedly in service tax and custom duties. If the impact of these tax policy changes is neutralised, the growth in indirect taxes during the period appears more or less similar to the growth rate of GDP. In 2019-20, the growth in indirect taxes was only 1.6 per cent. This was because of the initial impact of the pandemic at the close of the financial year, which led to additional time being given for clearing tax dues going into the next financial year, 2020-21.

4.16 A modest expectation from the GST was that its buoyancy with respect to GDP would, at least, reflect the observed weighted buoyancy of taxes subsumed under it. However, available numbers indicate that GST buoyancy during 2017-2020 was less than that of subsumed taxes during 2011-2017. Many factors have contributed to this. Research has indicated that operational issues like weaknesses in its IT system, non-compliance in filing tax returns, inability to match invoices to the desired levels and issues in settlement of input tax credit dampen the efficiency of GST. Policy issues like inverted duty structure and successive reduction in tax rates and the consequent compromise of the revenue neutrality of GST rates have also affected the revenue performance. In our projections, we have assumed that in the next two years, the issues related to compliance with requirements of filing tax returns, streamlining of the IT platform and invoice matching will be resolved and thereafter the revenue neutrality of rates will be gradually achieved.

4.17 As per the existing GST framework, the compensation cess will be withdrawn from July 2022. However, in the light of the ongoing deliberations in the GST Council, we have assumed that this revenue will continue to be collected in some form till 2025-26. We have dealt with the deployment of the proceeds of the cess in paragraphs 4.69 to 4.71.

4.18 Union excise duty collections are now limited to those from petroleum products. The long-term growth in the consumption of petroleum products has been a stable 6 per cent per annum, which is unlikely to be substantially different during the projection period. Excise duties on petroleum products are mostly specific duties. Given this, and assuming that the rates of taxes and cesses are maintained at the current levels, revenue from excise duty on petroleum is likely to grow in tandem with the growth in consumption of petroleum products. The downside risk is that – as observed in the past – specific duties tend to get revised downwards whenever crude prices shoot up in the world market and vice versa. Our assessment of GDP growth is greater than the observed growth in consumption of petroleum products; and hence its buoyancy is assessed to be less than unity.

4.19 The collections from customs duties are limited to those from basic customs duties, as the countervailing duties and special additional duties on imports have been subsumed under GST. Growth in revenues from basic customs duties was highly volatile during 2011-12 to 2016-17. However, its growth trend, at an annual average rate of 5.9 per cent, was closely aligned to the trend growth of the rupee value of import of goods and non-factor services, which was 6 per cent during the aforesaid period. In 2017-18 and 2018-19, the import growth outstripped GDP growth, before collapsing in 2019-20. However, over a longer period, import growth tracked GDP growth

closely. Given the above, a plausible way of projecting revenue realisation from customs duties during the award period would be to link it to a buoyancy of unity with respect to GDP. However, credible cross-country analysis has indicated that streamlining of the complicated tariff structure can, without an increase in the rate structure, lead to efficiency and revenue gains. We expect that such reforms over the next five-year period will improve the buoyancy of customs duties.

4.20 Figure 4.2 summarises the discussions on projection of revenues of the Union Government from indirect taxes relative to the projected GDP growth.

Direct Taxes

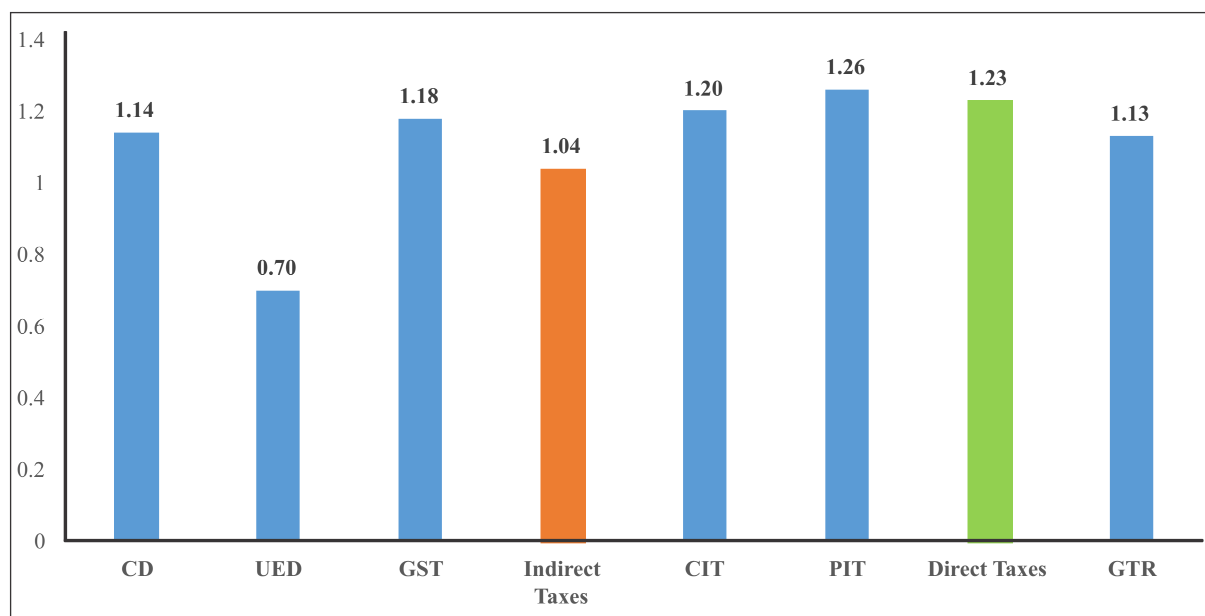
4.21 The direct tax revenue of the Union Government emanates predominantly from taxes on the income of corporations and individuals. The revenues from both personal and corporate income tax consist of basic collections and the realisation from cesses and surcharges. In 2018-19, basic collections accounted for about 87 per cent and 84 per cent of corporate income tax and personal income tax respectively. Direct taxes had a buoyancy of 1.10 during 2011-12 to 2018-19, significantly lower than 1.80 observed in the previous decade.

4.22 The number of income tax payers in different tax-paying brackets recorded an even and broad-based growth between assessment year (AY) 2012-13 and AY 2018-19. The increase in the number of income tax returns filed during this period, particularly those from the higher tax-paying brackets, is encouraging. However, we have noted with concern that the tax base is still very narrow. The number of taxpayers who filed returns in AY 2018-19 was about 5.87 crore, which was only around 4.4 per cent of the total population. Further, out of these, 40.4 per cent were in the nil tax bracket and another 52.8 per cent in the tax-bracket below Rs. 1.5 lakh.

4.23 Our analysis, presented in Chapter 5 indicates that the operations of a large number of individual proprietorships and partnerships are not effectively tracked. With the help of information from GST returns, increasing number of formal transactions and the trail of bank transactions, tax administration should be able to monitor tax compliance more efficiently and promptly. We are also of the opinion that after having brought down the corporate and personal income tax slabs to globally competitive levels, there is a need to review the myriad exemptions, incentives and thresholds. We, while making projections of income tax collections during the award period, have assumed that the measures to widen and deepen the income tax base will be scaled up during the award period.

4.24 As the economy picks up momentum, emerging out of the pandemic, the compensation of employees and profits in the organised sector is likely to improve progressively. The Department of Revenue, Ministry of Finance, in its submission to the Commission has expressed confidence that the pace of direct tax collections will also pick up gradually with improved efficiency in tax administration. Considering the above, we have adopted the buoyancy of 1.23 in direct taxes during 2021-22 to 2025-26. Figure 4.2 gives our buoyancy assumptions for specific taxes of the Union Government.

Figure 4.2: Buoyancy of the Union Government's Taxes during 2021-22 to 2025-26



Note: CD=custom duties; UED=Union excise duties; GST = Goods and Services Tax; CIT=corporation tax; PIT=personal income tax; GTR=gross tax revenue

Cesses and Surcharges and the Divisible Pool

4.25 Cesses and surcharges are currently levied on all major direct and indirect taxes, including GST. The compensation cess levied on GST, till it ceases to exist, will largely reflect the buoyancy of GST. The other cesses and surcharges, levied under provisions of Articles 270 and 271 of the Constitution respectively, will mirror the trends in the taxes on which they are levied. These cesses and surcharges (excluding GST compensation cess) averaged 13.1 per cent of the gross tax revenue during the 2016-17 to 2018-19 period. This component amounted to Rs. 3.18 lakh crore in 2018-19. With the increase in the special additional duty on excise and road cess on petrol and diesel in 2020 and with the assumption that there will be no further change in their current structure, these cesses and surcharges are estimated to average 18.4 per cent of gross tax revenue between 2021-22 and 2025-26.

4.26 The pool of tax resources of the Union required to be shared between the Union and the States – the divisible pool – excludes from the gross tax revenue the cost of collection of taxes, cesses and surcharges and tax revenue of the Union Territories. The cost of collection has remained around 0.7 per cent of gross tax revenue in recent years and is expected to remain around that level. Combining the projection of all taxes, and the items to be excluded from the divisible pool, the Commission has estimated that this pool will be around 76.2 per cent of gross tax revenue and 67.2 per cent of the gross revenue receipts (gross tax revenue plus non-tax revenue) during the projection period.

Tax to GDP Ratio

4.27 Based on our assessment, the tax-GDP ratio of the Union Government increases by 0.7 percentage point from 9.8 per cent in 2020-21 to 10.5 per cent in the terminal year of 2025-26. This will still be less than the 11 per cent tax-GDP ratio achieved in 2018-19. As we have discussed in Chapter 5, over the medium term, there should be revenue gains from administrative and procedural improvements leading to better compliance and thus bringing the tax-GDP ratio in line with trends in the recent past.

Non-Tax Revenues

4.28 The non-tax revenue of the Union consists mainly of dividends and profits from public undertakings and entities, including dividends and surpluses from the Reserve Bank of India (RBI), receipts from the auction of telecom spectrum, interest receipts and other receipts. These revenues grew at an annual rate of 5.8 per cent during the period of the FC-XIV. In a growing economy, non-tax revenue, especially of dividends and profits, can be reasonably expected to keep pace with GDP growth. But collections from some major sources have shrunk in recent years. Interest receipts of the Union, mainly from loans extended to the State Governments, are unlikely to grow during the projection period. The receipts from spectrum auctions are likely to improve as the telecom scenario improves gradually and auctions gain momentum. Likely divestment of shares of public sector enterprises (PSEs) will affect the sustainability of the dividends and profits from these enterprises. In contrast, we expect that miscellaneous receipts collected in the exercise of sovereign functions, regulatory charges, license fees and user charges for public goods and services, fines and other fees will increase significantly during the award period.

4.29 Upon careful evaluation of these considerations, we have assessed the non-tax revenues of the Union to grow at the same rate as GDP, that is, at an annual rate of 11 per cent during 2021-22 to 2025-26.

Non-debt Capital Receipts

4.30 Non-debt capital receipts have two components – recovery of loans and advances and proceeds from public sector disinvestment. With hardly any fresh on-lending to the States except for the back- to-back transfer of loans against externally aided projects, the receipts from recovery of loans and advances have been declining. We have adopted the annual amounts furnished by the Union in its revised memorandum to us.

4.31 After reaching a historical high of over Rs. 1 lakh crore in 2017-18, disinvestment proceeds declined to Rs. 94,727 crore in 2018-19 and Rs. 50, 304 crore in 2019-20 (provisional accounts). Out of the total proceeds from disinvestment between 2014 and 2020, 60 per cent was through minority stake sales, 12.2 per cent was from buyback, 20.2 per cent from strategic

disinvestment and 7.6 per cent from other means. Going forward, there are limitations to minority stake sale due to considerable disinvestment through this route in the last five years, leading to depletion of government stocks available for sale. The way forward through strategic sales will remain contingent on market appetite, resolution of issues relating to land title, lease and land use with stakeholders, issues of labour unions and the impact of the pandemic on financial markets.

4.32 Accordingly, while assessing the prospects of disinvestment proceeds, we also considered the market capitalisation of equity holdings of the Government of India available for minority sale as well as for strategic sale and the possibilities of disinvestment in unlisted PSEs. As against the disinvestment proceeds of Rs. 2.1 lakh crore budgeted for 2020-21, we have factored in only Rs. 50,000 crore, assuming that the balance will be realised only in subsequent years, when the market conditions improve. Balancing these considerations and based on inputs from the Department of Investment and Public Asset Management (DIPAM) in the Ministry of Finance, we assessed that the disinvestment proceeds will increase to Rs.1.2 lakh crore in 2021-22 and will gradually decline to Rs. 0.80 lakh crore in 2025-26.

Revenue Expenditure

4.33 The total revenue expenditure of the Union Government can be broadly classified into own revenue expenditure of the Union and transfers to State Governments and Union Territories. The accounts of 2018-19 show that 77.1 per cent of the revenue expenditure of the Union Government was its own revenue expenditure. and the remaining 22.9 was by way of transfers (excluding tax devolution).

4.34 Four components of own revenue expenditure accounted for 65.9 per cent of the Union Government's total revenue expenditure: (a) civil and defence pensions and salaries and other allowances for civil employees, account for 16.1 per cent; (b) revenue expenditure of defence services including salaries constitutes 9.70 per cent; (c) subsidies for food, fertilizer and petroleum constitute 11.10 per cent and (d) interest payments constitute 29 per cent. The Union Government's own development-oriented expenditure accounts for the remaining 11.2 per cent of total revenue expenditure.

4.35 **In keeping with the approach of the previous Finance Commissions, we have adopted normative principles with the objective of ensuring fiscal sustainability. We have been guided by the imperatives of reprioritising expenditure by economising establishment-related expenses, removing inefficiencies in the administration of subsidies, minimising leakages in public spending and channelising the resultant savings into developmental expenditure in social and economic sectors. These principles underpin our assessment of the revenue expenditure of the Union and the States discussed in subsequent sections.**

Interest Payments

4.36 Interest payments of the Union Government depend on four factors – the level of outstanding liabilities, the effective interest rate of these liabilities, incremental borrowings and the weighted interest rate of incremental borrowings. Interest payments of the Union Government grew annually at an average rate of 9 per cent during the 2014-15 to 2019-20 period.

4.37 Marketable debt accounted for 68.8 per cent of the total outstanding liabilities of the Union by end-March 2019. The weighted average coupon rate (WACR) of market borrowings remained more or less the same at around an annual average of 8 per cent during the five-year period 2008-09 to 2012-13 and the subsequent five-year period, 2013-14 to 2017-18. However, WACR has been declining steadily during the five years ending 2018-19. This trend, if sustained, will exert a downward pressure on interest payments during the 2020-21 to 2025-26 period. However, there will be an upward pressure on interest payment liabilities because of the requirements of higher fiscal deficit during the period, which is dealt with in paragraphs 4.53 and Table 4.1.

4.38 The average interest cost of the debt stock is arrived at by dividing interest payments during a year with average debt stock. Average debt stock is a simple average of outstanding debt at the beginning and at the end of the year. Considering inflation expectations and emerging interest rate scenario, we have assessed the average cost of incremental borrowings to the Union Government at 6 per cent during the period 2020-21 to 2025-26. Based on these assumptions, we have worked out that the growth of interest payments will be 9.6 per cent per annum during the period 2020-21 to 2025-26. As a proportion of GDP, interest payments will gradually decline from 3.55 per cent in 2020-21 (reassessed) to 3.31 per cent in 2025-26.

Pensions and Salaries

4.39 While assessing pensions and salaries, we kept in view the likely strain on the revenue stream of the Government and the need to observe strict fiscal discipline, particularly in non-developmental expenditure. The implementation of the recommendations of the pay commissions in the past have accounted for the peaks and troughs in pension and salary pay-outs of the Union Government relative to both its revenue expenditure and GDP. Except for the impact of pay commissions or one-off policy decisions like one-rank-one-pension of defence pensioners, growth in expenditure on pensions and salaries of the Union has been generally lower than that of aggregate revenue expenditure. The period 2021-2026 is unlikely to witness another pay commission or any drastic step-up in pensions and salaries, except normal dearness allowances and increments. We also expect that the inflation scenario will be benign during 2020-2026.

4.40 The Government of India has, as of now, frozen the dearness allowance to its employees and dearness relief to its pensioners due from January 2020 to July 2021, clarifying that this will be restored only prospectively. Based on this decision, we do not expect any growth in the salary

requirements for 2020-21 over 2019-20. In view of the strain on revenues, for 2021-22 also we expect that the Union Government will enforce suitable economy measures in its committed expenditures to off-set any increase on account of dearness and other allowances. Accordingly, we have factored in a growth rate of 1 per cent in salaries and 1.5 per cent in pensions in these two years (2020-21 and 2021-22). Thereafter, we have employed an annual growth of 5 per cent in salaries and 5.5 per cent in pensions, keeping in mind the need for annual increment of employees, dearness allowance/relief of employees and pensioners and the normatively assessed change due to attrition in the workforce. We also expect that the expenditure on government workforce will be prudently rationalised, with emphasis on functional efficiency, to stay within the means. Our projections are presented at Annex 4.1.

Defence Revenue Expenditure

4.41 Salary and allowances constitute close to two-thirds of defence revenue expenditure. In 2018-19, the expenditure on the pay and allowances of the three forces was 56 per cent of the total and another 7 per cent was spent on account of the pay and allowances of the civilians (in the defence segment). Defence revenue expenditure grew at a trend growth rate of 9.2 per cent during the period 2015-16 to 2019-20 (PA). In order to make estimates for the projection period, we have considered the budget estimates of 2020-21 as the base. The salary component was projected with the same norms employed for the projection of the salaries of other government employees during 2021-2026.

4.42 We have assessed that the non-salary component of the defence revenue expenditure should grow at a robust pace so as to ensure a reasonable level of maintenance of defence assets. Hence, we have estimated that this component of defence revenue expenditure should keep pace with GDP growth during 2021-2026.

Subsidies

4.43 Food, fertilizer and petroleum subsidies are the major subsidies of the Union Government. We have noted the steps taken by the Union Government to reform different subsidies. Measures like the automation of the supply chain of subsidised food grains and the weeding out of the ghost ration cards have helped contain the rise of the food subsidy. On the other hand, factors like expanded coverage of subsidised food grains under the National Food Security Act (NFSA) 2013, regular increases in minimum support price (MSP) of food grains and unchanged central issue prices have exerted considerable upward pressure on food subsidy. Reforms like decontrol of petroleum prices and direct benefit transfer of LPG subsidy helped to rein in petroleum subsidy.

4.44 Report 20 of 2018 of the Comptroller and Auditor General of India on Union Finances showed that the full impact of the increasing food and fertilizer subsidies was not absorbed in the

Union Budget for a number of years. The cumulative impact of the budgetary under-provision was around Rs. 3.10 lakh crore for food subsidy and Rs. 40,000 crore for fertilizer subsidy by end-March 2020. This legacy burden needs to be distinguished from the current burden of food subsidy. At the same time, we are of the view that there is adequate potential for mobilising additional resources by streamlining the administrative structure of the Food Corporation of India (FCI) and introducing efficiency measures in handling, storage and transportation of food grains.

4.45 More than three-fourth of the food subsidy is currently incurred on the operations undertaken by the FCI and the remaining portion on subsidised provision of food grains under the NFSA from decentralised procurement by States. We have assessed the current requirements of food subsidy in 2021-22 by taking into account the population coverage, per unit consumer subsidy and buffer-stocking and distribution cost. Subsequent to this, given the current levels of MSP and beneficiary coverage under food subsidy, we have assumed that any incremental growth in subsidy during 2022-23 to 2025-26 will be largely limited to indexation to inflation. Increases in the economic cost of food grains will need to be partially offset by increases in central issue prices of subsidised food grains, which is permissible under the NFSA.

4.46 The liability of the accumulated burden should be met from additional resources to be mobilised by the Union Government, through administrative and governance reforms that will release scarce resources for clearing outstanding liabilities. We expect that the Union Government will draw up an appropriate plan for introducing such measures that will ensure repayments in a time-bound manner. As we have factored in the entire current expenditure on food subsidy for the award period, the Union Government should not take further recourse to extra budgetary resources on this account.

4.47 Petroleum subsidy, currently limited to subsidised kerosene and LPG, will depend on change in consumption, revision in subsidised prices and movements in international prices and exchange rate. The consumption of LPG may increase in the projection period, but this will be associated with a reduction in the use of subsidised kerosene. Considering that the international prices of petroleum and gas are projected to remain benign in the medium term, we have adopted the modest figures of petroleum subsidy furnished in the Union Government memorandum.

4.48 Fertilizer subsidy has fluctuated around an annual average of Rs. 71,300 crore in the 2015-2020 period and it is budgeted around the same number in 2020-21. The same level has been kept for all the five years from 2021-22 to 2025-26. Thus, the inflation-adjusted value of fertilizer subsidy will decline during the period. Miscellaneous subsidies, mainly interest subsidies, accounting for about 11 per cent of the total subsidies, have been assessed to decline by 10 per cent annually from 2020-21 (BE) to 2026, allowing for a steep erosion in its real value during the period. As in the case of food subsidy, we expect the Union Government to formulate pricing and governance reforms that will eliminate recourse to extra budgetary resources.

4.49 The sum of the projection of the different components of committed revenue expenditure

yielded a growth of 6.9 per cent in the aggregate own revenue expenditure of the Union vis-a-vis an estimated 9.5 per cent growth during 2015-16 to 2019-20 (PA). This reflects the strict fiscal discipline that we recommend for the period 2021-22 to 2025-26.

Transfers to States and Union Territories

4.50 The transfers from the Union Government to the States, Union Territories and local governments on the revenue account consist mainly of schematic transfers (Central sector schemes and Centrally sponsored schemes), GST compensation and Finance Commission transfers, including revenue deficit grant, grants for disaster management, grants to the local self-governments and other specific grants.

4.51 As per the budget estimates for 2020-21, these transfers totalled Rs. 7.09 lakh crore on the revenue account. We have adopted this budget estimate with certain corrections made in the first supplementary demand for grants for the differences between the budget estimates and the approved recommendations of the Finance Commission on revenue deficit grant and disaster management grants to the States. These are charged expenditures on the Union Government and would need to be provided for. Going forward, for 2020-2026, the following assumptions have been made for transfers to the sub-national governments.

i. The schematic transfers of the Union Government in the form of centrally sponsored schemes (CSS) and central sector schemes to the State and Union Territory Governments amounted to 12.81 per cent of the gross revenue receipts of the Union Government during the award period of the FC-XIV (2015-16 to 2019-20). As per the figures derived from the provisional accounts for the Union Government for 2019-20, these transfers were approximately Rs. 2.5 lakh crore. Compared to this, the budget estimate for 2020-21 at Rs. 3.84 lakh crore was very high. We reassessed the budget estimate with a realistic downward revision to Rs. 3.46 lakh crore. For 2021-22 to 2025-26, we have pegged the schematic transfers to the States to an average of 12.82 per cent of the gross revenue receipts of the Union Government, similar to the FC-XIV period.

ii. The transfers recommended by the Finance Commission will be fully provided for. The details are in Annex 4.1 to 4.3 and in Chapter 10. Aggregate transfers to the states are presented in Annex 4.3 and 4.4.

iii. Recent deliberations in the GST Council and developments in the provision of GST compensation to the States lent credence to an assumption that the commitments of the Union for providing compensation to the States till Q1 2022-23 will be honoured, but may not be extinguished by the year 2022-23. Our treatment of GST compensation to the States is detailed at para 4.69 to 4.71 of this Chapter.

Developmental Revenue Expenditure

4.52 The remaining portion of revenue expenditure (excluding transfers to States and Union Territories) includes the non-salary, non-subsidy expenditure in different sectors by the Union Government and its institutions. This generally constitutes the developmental component of the revenue expenditure of the Union Government. In our report for 2020-21, we had assessed a growth provision equalling the projected GDP growth for this part of expenditure, considering the need to provide for important sectors like science and technology, atomic energy, external affairs and space. In 2020-21, we have assessed that this component of expenditure will go up to Rs. 4.38 lakh crore from the budgeted Rs. 3.44 lakh crore on account of significant interventions in the health sector and other sectors to fight the spread and impact of the pandemic. Keeping this mind, we have kept this component at the 2020-21 levels in 2021-22, and then applied a robust trend growth of 8.4 per cent annum during 2022-23 to 2025-26. We also expect the Union Government to review and rationalise the large number of Central sector schemes to reduce infructuous expenditure.

4.53 Our assessment of the different components of revenue expenditure of the Union results in an aggregate trend growth rate of 6.4 per cent per annum.

Capital Expenditure and Key Relativities with respect to GDP

4.54 Table 4.1 summarises the projection of the Commission of Union finances for the period 2021-22 to 2025-26.

Table 4.1: Key Fiscal Variables of the Union Government as per cent of GDP

	2019-20 PA	2020-21 BE	2020-21 Reassessed	2021-22	2022-23	2023-24	2024-25	2025-26
Gross tax revenue	9.88	10.77	9.81	9.84	9.94	10.07	10.25	10.47
Cesses and surcharges retained by the Union (except GST compensation cess)	1.55	1.65	1.92	1.88	1.86	1.85	1.84	1.85
Divisible pool	7.75	8.51	7.32	7.40	7.52	7.66	7.84	8.05
Net tax revenue to the Union	6.67	7.27	6.80	6.79	6.85	6.92	7.02	7.16
Non-tax revenue	1.60	1.71	1.35	1.35	1.35	1.35	1.35	1.35
Revenue receipts	8.27	8.99	8.15	8.15	8.20	8.27	8.38	8.51
Non-debt capital receipts	0.34	1.00	0.36	0.64	0.48	0.41	0.36	0.30
Capital expenditure	1.66	1.83	1.84	1.70	1.51	1.53	1.54	1.49
Revenue Expenditure	11.55	11.70	14.07	13.08	12.67	12.16	11.69	11.32
Fiscal deficit	4.60	3.54	7.40	6.00	5.50	5.00	4.50	4.00

i. The own revenue expenditure relative to GDP declines gradually during the projection period because: (a) the Union finances are unlikely to be impacted by another pay commission during the next five years; and (b) non-developmental components of revenue expenditure have been assessed on a normative basis that a resource-strained fiscal path demanded.

ii. We expect the Union Government will introduce additional resource mobilisation measures as indicated by us that will enable accumulated off-budget liabilities on subsidies to be cleared in a time-bound manner and eliminate further recourse to extra budgetary resources. Hence, their clearance is not built into our assessment.

iii. The share of development-oriented transfers to the States and local governments have been calibrated at a stable level despite the strain on Union finances. These include specific purpose transfers for sectors that require urgent attention and augmented investment. It is important for the Union Government to re-prioritise its expenditure and review the CSS to focus on investment in health, education, nutrition and income generation measures for faster economic recovery and long term sustainability of growth. This is also necessary, considering the constraints on the revenues of States and the expected demands on their resources to off-set the decline in the size of the divisible pool due to increase in the quantum of cess and surcharge.

iv. In our report for 2020-21, we had stressed the importance of public investment to support economic revival. This requirement is paramount in the emerging milieu. Keeping in mind the need to preserve the space for capital expenditure, and the need to support the budgets of States, we have provided for a glide path to the reduction in the fiscal deficit of the Union.

4.55 Annexes 4.1 and 4.2 present the detailed picture of our assessment of Union finances for 2021-2026.

Assessment of State Finances

Approach of the Commission

4.56 Similar to our report for 2020-21, and keeping in view the approach followed by previous Finance Commissions, past trends as well as recent developments, we have adopted normative principles and procedures for assessing the revenue and expenditure of the States. The base year (2018-19, the year for which the latest Finance Accounts are available) was calibrated with required adjustments to ensure comparability of data across States. Wherever relevant, the budget estimates of 2020-21 have also been used.

Adjustments in Receipts and Expenditure

4.57 The projection of revenue expenditure of States requires a comparable data set from the Finance Accounts. We needed to develop comparable State fiscal data for the base year, 2018-19, by making adjustments, which have been traditionally carried out by previous Finance Commissions, including the FC-XIV and by us in our first report. The details are as follows:

(i) **Lotteries:** If net receipt from lotteries (that is, receipts on lotteries at major head (MH) 0075 minus expenditure MH 2075) was positive, it was added back to the receipts. If the net receipt from lotteries was negative, it was assumed to be zero.

(ii) **Power sector:** From revenue expenditure, we deducted grants and subsidies on power (from MH 2801 and from any other head where it was booked). Revenue expenditure on account of the Ujwal DISCOM Assurance Yojana (UDAY) was also removed from MH 2801. For those States where the power sector is run commercially, the receipt on power (MH 0801) was retained. For the States where the power sector is run departmentally, if the net receipt on power (MH 0801-MH 2801) was negative, the same was taken as zero. However, if the net receipt was positive, we factored that into the assessment of receipts.

(iii) **Transport undertakings:** For the transport sector, we carried out adjustments similar to those for the power sector.

(iv) **Grants in aid from the Union Government:** We removed the following items of expenditure which were based on the Union Government grants: (a) revenue expenditure on account of scheme-based Central assistance and (b) grants-in-aids for local self-governments. The expenditure on calamity relief from MH (2245) was excluded from the base year. Considering that the States will have to provide a matching share in the State Disaster Risk Management Fund, this portion has been projected separately from 2021-22 onwards and added back to revenue expenditure.

(v) **Major State-specific subsidies and farm loan waiver:** Food subsidy and farm loan waiver have been removed from the revenue expenditure of the States in 2018-19.

(vi) **IGST transfers to the States:** The Integrated GST (IGST) amount transferred to the States in 2018-19 has been added to each State's SGST as per the ratio of an individual State's SGST to the all-States' SGST in 2018-19.

(vii) **Reserve fund expenditures:** Revenue expenditure from the reserve funds (except Consolidated Sinking Fund and Guarantee Redemption Fund) has been netted out.

(viii) **Contra entry for receipts/ payments:** Receipts/payments of contra-entry nature have been removed from both non-tax receipts and revenue expenditure. For example, in the case of irrigation projects, some States pay interest on capital, which may get reflected in own non-tax revenue as interest receipts. Entries of such a nature were adjusted to avoid double counting.

Gross State Domestic Product

4.58 The National Statistical Office (NSO) provided the comparable estimates of gross state domestic product (GSDP) of States for the period 2011-12 to 2018-19. These have the advantage of being based on the same principles and uniform methodology of estimation across States. The base year for the projection of GSDP is 2018-19. We noted that GSDP numbers for 2019-20 are available for many States from their own calculations, but these are not certified by the NSO. Most of the States made these estimates the basis for their budgets for 2020-21. However, the economic scenario changed significantly in the last two months of 2019-20. Hence, we did not consider calculations made by the States for the years beyond 2018-19. To ensure uniformity in methods and approach, we made our own projections of GSDP from 2019-20.

4.59 We assessed the GSDP growth of States in two stages.

i. In stage 1, for the year 2019-20, we extrapolated the trend in GSDP growth rate during 2011-12 to 2018-19 for each State. While arriving at our projections of GDP for 2020-21, at the all-India level, we made assumptions about the behaviour of broad sectors like agriculture, industry, public administration, defence and social services, and other services and assessed them separately before arriving at the aggregate GDP growth rate. We, however, noted that sectoral growth rates of individual States could vary around the national average, as in the past. To account for these differences, we assessed the elasticities of sectoral growth rates of States with respect to the corresponding sectoral growth for the aggregate of States during 2011-2019. We combined this information with our assessment of national growth in the sector for 2020-21 to arrive at the State-wise growth in the sector. This procedure was followed for each sector, before consolidating these and arriving at the initial estimates of aggregate GSDP growth rate for each State in 2020-21. For the period 2021-22 to 2025-26, sharp differences in GSDP growth were ironed out by grouping States in six categories (four for General States and two for NEH States) and assigning the average growth of each group to all States within the group.

ii. In stage 2, we made a five-fold distinction between the States in terms of their per capita revenue expenditure, averaged for 2017-18 and 2018-19: (a) those with per capita revenue expenditure at 140 per cent or more of the average for all States; (b) those with such expenditure between 130 per cent and 140 per cent of the all-State average; (c) those with such expenditure between 100 per cent and 130 per cent of the all-State average; (d) those with such expenditure between 80 per cent and 100 per cent of the all-State average; and, (e) those with such expenditure at 80 per cent or less of the all-State average. Higher public spending per capita, with proper allocations and efficient use, should also yield higher growth. Accordingly, we normatively assessed that the higher the per capita revenue expenditure, the higher should be the GSDP growth to support such higher expenditure, and vice versa. We also distinguished between the NEH States and general States at this stage and benchmarked them around the group average. While GSDP growth rates were distinguished for four categories of States (categories 'a', 'b', 'd',

and 'e' above) based on their per capita revenue expenditure, the category 'c' above was generally assigned GSDP growth rates derived from the sectoral calculations in stage 1.

iii. This principle was extended broadly to the following years also with adjustment of extreme values. This method ensured that the all-State growth rate in each year is identical to the projected national growth during our award period. The method also ensured a degree of progressivity and equity in our calculations, while also giving due consideration to fiscal discipline.

4.60 The resultant growth estimates are placed at Annex 4.5. The calculations also yielded GSDP growth of NEH States, which is on an average, less than that of the general States.

Own Taxes Revenue

4.61 The own tax revenue of the States can be divided broadly into two – SGST, which was 41.5 per cent of own tax revenue in 2018-19, and non-GST taxes which was 58.5 per cent.

Non-GST Taxes of States

4.62 The non-GST taxes of State Governments are: sales tax on petroleum and alcohol (24.3 per cent of own tax revenue), State excise (12.3 per cent), stamp duties (10.4 per cent), vehicle tax (5.7 per cent), electricity duty (3.5 per cent) and others (2.3 per cent). Our assessment of own tax revenue of States, as in the case of the Union, combined indications from past trends and the necessity to raise resources needed for health and income support and to fight the economic slowdown precipitated by the pandemic. Besides, from the normative perspective, the tax to GSDP ratio has to improve considerably compared to its recent performance. For this, it is important for States, just as in the case of the Union, to tighten and improve tax administration to ensure greater compliance and deepening of the tax base. This is also critical to avoid excessive borrowings and the likelihood of an unsustainable debt path.

4.63 For the year 2020-21, we assessed that the non-GST taxes will contract for all States, the rate of contraction being 1.7 times the contraction in each State's GSDP. The projection of non-GST taxes was done in two stages. In the first stage, States were distinguished normatively on the basis of two considerations. First, we distinguished between the NEH states and the general States. Second, we calculated the deviation of States from the average ratio of non-GST tax collections to GSDP in the aforesaid two categories. For 2021-22, a buoyancy of 1.15 was taken as the general norm for both NEH and general States in the first stage. For NEH States, the non-GST taxes to GSDP ratio averaged 2.49 per cent and for general States, this ratio averaged 3.87 per cent. We noted that the NEH States, in general, may have constraints relating to land ownership laws and infrequent transactions in land, etc. in their efforts to improve collections from non-GST taxes. We then divided the NEH States in two sets of buoyancies of 1.15 and 1.20 during 2022-23 to 2025-26, making higher buoyancy applicable for States with lower ratio of

non-GST taxes to GSDP and vice versa.

4.64 Non-GST taxes of the general States should show significant improvement in rate structure, compliance and collections because these taxes have shown lower buoyancy than the taxes subsumed under GST. Hence, in the first stage, we divided these States in two sets of buoyancies of 1.25 and 1.30 during 2022-23 to 2025-26 in a similar way.

4.65 At the second stage, we made a distinction between the States which are higher by 40 per cent or more than the average per capita revenue expenditure (averaged separately for general States and NEH States for 2017-18 and 2018-19) and other States with effect from 2021-22. We assessed normatively that the first category should have a higher tax buoyancy to support their higher expenditure. For the other States, we maintained the buoyancies determined at the first stage.

State GST

4.66 The all-State growth and buoyancy in SGST (post the IGST settlement) should mirror those in CGST. However, the buoyancy of individual States has been different. In the first stage, the States have been differentiated normatively on the basis of two considerations – first, the category of States (general States or NEH States), and second, deviation of a State from the average ratio of SGST to GSDP in the two categories. For the year 2020-21, as in the case of non-GST taxes, we assessed that the SGST will contract for all States, the rate of contraction being 1.7 times the contraction in each State's GSDP. For 2021-22, a buoyancy of 1.10 was taken as the general norm for both NEH and general States. We then divided the NEH States in three sets of buoyancies of 1.30, 1.25 and 1.10 during 2022-23 to 2025-26, with the highest buoyancy for States with lowest SGST to GSDP ratio. We divided general States also in three sets of buoyancies of 1.30, 1.20 and 1.10 during 2022-2026 period in similar way. The average SGST to GSDP ratio was 2.35 per cent and 2.79 per cent respectively for the NEH States and general States in 2018-19. We distinguished the SGST buoyancy modestly for the intermediate range of general and NEH States considering that the tax potential of the latter lies in the destination-based GST, not in the other taxes.

4.67 At the second stage, we assessed normatively that the States which are higher by 40 per cent or more than the average per capita revenue expenditure should have a higher tax buoyancy. For the other States, we maintained the buoyancies determined at the first stage.

4.68 The aforementioned procedure ensured the following.

(i) The all-State SGST buoyancy during 2021-26 matches substantially the buoyancy of CGST.

(ii) The tax buoyancy of NEH States, on an average, is less than that of the general States.

(iii) The all-State tax to GSDP ratio improved by 0.7 percentage points from 2020-21 to 2025-26 (Annex 4.6).

Treatment of GST compensation

4.69 Until June 2022, States' GST revenues are protected by a Constitutional scheme that guarantees an assured annualised, compounded 14 per cent growth of revenue from erstwhile State taxes subsumed under GST. This 14 per cent growth is calculated on the certified actual collection of subsumed taxes in 2015-16 (called protected revenue). The shortfall – that is, the difference between protected revenue and actual SGST collection in any year – will be compensated by the Union Government from the resources available in the GST Compensation Fund, which will be replenished with the proceeds from the GST compensation cess and "such other proceeds decided by the GST Council".

4.70 The SGST revenue fell short of the assured path for many States in each year after the GST roll-out, resulting in a need for compensation every year. The expected significant shortfall of SGST revenue vis-à-vis the assured path in 2020-21, 2021-22 and Q1 of 2022-23, coupled with sluggishness in collections from the GST compensation cess, has already led to a considerable gap. Going by our projections, the estimated shortfall of SGST vis-à-vis the assured path – including the backlog from previous years – will amount to about Rs. 7.10 lakh crore until June 2022 (only to the States). From our projections of collections from GST compensation cess, it turns out that the compensation cess fund will have an amount of only Rs. 2.25 lakh crore by that time, from the collections of 2020-21 to Q1 2022-23.

4.71 The GST Council is yet to decide on its approach towards the requirements of GST compensation to the States, over and above the collections from the compensation cess till Q1 2022-23. However, our assumptions and calculations are as follows, on the basis of the recent deliberations and decisions of the GST Council including the legal opinion of the Attorney General.

(i) States' shortfall from the assured path of SGST will be fully compensated.

(ii) The aforementioned shortfall in the requirements of compensation till Q1 2022-23 will be met by extending the levy of GST compensation cess till the year 2025-26.

(iii) In the interim, the transitional requirements of liquidity of the States could be met from borrowings, either by the Union or by the States.

(iv) We are not including or quantifying the debt implications of the borrowings under the proposals. The fiscal deficit and debt path worked out by us excludes the borrowing that the States may do under any arrangement worked out between them and the Union, consequent upon decisions in the GST Council.

(v) We have estimated the collection from GST compensation cess through 2025-26. Our calculations showed that the estimated collection from the compensation cess, if extended till 2025-26, will be just enough to clear the liabilities towards the States. We have built in this income stream to the revenues of the States, in proportion to the estimated shortfall of each State, year-wise (Annex 4.8).

Non-tax Revenue

4.72 Own non-tax revenues of the States include interest receipts, dividends and profits, royalties, irrigation receipts, receipts from forestry and wildlife, receipts from elections, etc. These revenues grew at a trend rate of 10.4 per cent during 2011-12 to 2018-19 with a buoyancy of 0.9.

4.73 As in the case of tax revenues, we followed a two-stage procedure for assessing the non-tax revenues of the States till 2025-26. We took a macro view first and assessed that, with focus on rationalising and increasing fees and user charges, with a buoyancy of 1.1, the growth of these revenues should modestly outpace the GSDP growth of each State. In the second stage, we have normatively assumed that the buoyancy of those States that exceeded the average (of the group, as spelt out earlier) per capita revenue expenditure by 40 per cent or more should have a higher buoyancy of 1.30 in order to support their expenditure without reliance on excessive borrowings. The projected ratios of non-tax revenue to GSDP are given in Annex 4.7.

Revenue Expenditure

4.74 The adjusted revenue expenditure for 2018-19 of States (adjustments being those mentioned in para 4.57) formed the basis for projection. Expenditure on interest payment, pensions, elections, disaster management and compensation and assignment to local governments have been projected separately. This is because the factors that determine the growth in these items are different from those that determine the rest of the revenue expenditure. The aforesaid items have been added back to the revenue expenditure once the remaining projections are complete. The norms adopted for assessment of different items of expenditure are presented below.

Interest Payments

4.75 We adopted a two-stage procedure for the projection of interest payments for 2021-2026. The budget estimates of 2020-21 have been adopted as the base for projection. The projected addition to the stock of outstanding liabilities each year has been taken to be the fiscal deficit for each State. The assumptions on the year-wise fiscal deficit to GSDP ratio of States are presented in Chapter 12 on fiscal consolidation. We have further assumed that the interest rate on fresh borrowings of the State Governments will be a uniform 6.6 per cent during 2020-2026. Standard calculations based on these assumptions yielded a growth rate of interest payments for each State for each year – some above 9 per cent and some below 9 per cent. However, we are of the view that all States should make efforts towards debt consolidation and a simple barometer of that is the rate of growth of interest payment. Therefore, in the second stage of the projection, the projected growth rates in excess of 9 per cent have been brought down to 9 per cent, while the growth rates below 9 per cent have been kept unchanged.

Pensions

4.76 The budget estimates of pension payments for 2020-21, along with the revised estimates for 2019-20, have been adopted as the base for projection. The pension payments have been projected with uniform norms for all States. The year-wise norms have been aligned to those for the Union Government discussed in para 4.39 to 4.40.

Election

4.77 We devised a methodology to account for the different State election cycles. We considered the pattern of election-related expenditure of the previous five years and projected each year with a five-year inflation indexation at the rate of 4 per cent per annum from the base year (that is, five years before). Thus, for instance, the election-related expenditure in 2021-22 has been projected with a five-year inflation indexation at the rate of 4 per cent per annum upon the corresponding expenditure in 2016-17.

Compensation and Assignments to Local Governments

4.78 The States should assign proceeds of taxes to local governments based on the recommendations of the State Finance Commissions. A uniform annual growth of 4 per cent has been applied to this component from the base of the budget estimates for 2020-21 for all States.

Remaining Revenue Expenditure

4.79 While projecting the revenue expenditure of the States, we had employed the 'scheme, non-scheme' distinction in our report for the year 2020-21. We had, then, noted that the booking of expenditure done by the States did not follow a uniform pattern, but we kept the 'scheme, non-scheme' distinction with our assumptions and judgements. Examination of the accounts for 2018-19 for many States showed continuing issues in separating States' own schematic expenditure and their full salary and related components from the rest. Considering that this report of the Commission is for five years, we did not employ these assumptions and ratios for this Report. The separation of schematic and other expenditures (split into capital and revenue components and Union and State shares) is an important analytical distinction, which is weakened by data-related issues. It is important that these accounting differences are ironed out forthwith to facilitate comparison of important components of State Government expenditure and the aggregation of the States' accounts with the Union's accounts.

4.80 We employed the ratios derived from the Finance Accounts of each State to separate the developmental component from the rest. The developmental revenue expenditure consists of the States' contribution to the CSS as well as expenditure on schemes formulated and implemented by State Governments from their resources. We have treated all such expenditure on par with the

developmental component of the revenue expenditure of the Union Government, with a trend growth rate of 8.4 per cent per annum during 2022-23 to 2025-26. The only difference is for 2021-22, in which this expenditure has been kept the same at the reassessed levels of 2020-21 for the Union, while a growth of 4 per cent has been accorded to the State Governments.

4.81 The other component largely includes salaries, other establishment expenditure and the expenditure on maintenance of assets. We have assigned marginally higher growth rates to this part of revenue expenditure for 2021-2026 compared to assumptions made for the Union Government's salary component, because this includes expenditure on maintenance of assets also. We projected this component with a trend growth rate of 5.1 per cent per annum during 2021-22 to 2025-26, as opposed to annual growth of 4.4 per cent assigned to the salary bill of the Union Government during the period.

Aggregate Revenue Expenditure and Pre-Devolution Revenue Deficit

4.82 With the aforesaid methodology for projection, the aggregate revenue expenditure of all the States taken together shows a trend growth rate of 6.3 per cent per annum from the base of 2020-21 to 2025-26. The resulting estimation of the pre-devolution revenue deficit is presented in Annex 4.9. It may be noted that in the calculation of pre-devolution revenue deficit, the State accounts were netted of Central transfers of all kinds – both grants and tax devolution.

Summary and Recommendations

4.83 We based our projections for the period 2021-2026 on the provisional accounts of 2019-20 and the reconstructed estimates for 2020-21for the Union and the Finance Accounts of 2018-19 for the States, with the exception of some components where the Budget 2020-21 formed the basis of calculation. Considering the change in the economic and fiscal scenario on account of the pandemic, assumptions about GDP, GSDP, revenue and expenditure components have been reconstructed for 2020-21.

4.84 Our revenue norms from 2021-22 have been arrived at on the basis of the requirements of mobilising resources for funding development expenditure by implementing administrative and procedural reforms. We noted that distinct improvements are possible in the collections from GST, direct taxes of the Union and non-GST taxes of the States with institutional and administrative reforms and use of IT-based solutions. This assessment gets reflected in the improvement of tax to GDP ratio by 0.7 percentage points each for the Union and the States by 2025-26.

(para 4.27 and 4.68)

4.85 We have treated the expenditures arising out of current transactions separately from the accumulated liabilities of extra-budgetary transactions. We quote from our report for 2020-21, “Outstanding extra-budgetary liabilities need to be clearly identified and eliminated in a time-

bound manner with transparent reporting of deficit and debt as provided in the amended FRBM Act of 2018". We reiterate this statement. The liability of the accumulated burden needs to be fully met and will need additional resources beyond our projections to be mobilised by the Union Government, through administrative and governance reforms that will release scarce resources for clearing outstanding liabilities. We expect that the Union Government will draw up an appropriate plan for introducing such measures that will ensure repayments in a time-bound manner. As we have factored in the entire current expenditure requirements of the Union and State Governments for the award period, they should not take further recourse to any extra budgetary resources.

(para 4.43 to 4.48)

4.86 Progressivity and equity were brought into our calculations by differentiating States with higher spending in per capita terms from other States and assigning them higher targets of GSDP growth and tax buoyancy. We also employed similar principles for assessing the non-tax revenues of the States. The initial levels of tax-GSDP ratio of the States was also considered while making our projections.

(para 4.58 to 4.68)

4.87 States were brought to a comparable base of revenue and expenditure in 2018-19 by removing subsidies, UDAY-type grants and farm loan waiver from the base and giving the same treatment to Central transfers. We have also endeavoured, wherever possible, to bring in symmetrical treatment between comparable items of revenue and expenditure of the Union and the States. We did not remove the pan-Indian subsidies of the Union from its base, but subjected them to tight norms.

(para 4.57)

4.88 In keeping with the approach of the previous Finance Commissions, we have adopted normative principles with the objective of ensuring fiscal sustainability in austere times. We have been guided by the imperatives of reprioritising expenditure by economising establishment-related expenses, removing inefficiencies in the administration of subsidies, minimising leakages in public spending and channelising the resultant savings into developmental expenditure in social and economic sectors. We assessed the committed revenue expenditure of the Union and the States with the objective of prudential management of scarce resources, particularly in the initial years. At the same time, we have endeavoured to keep reasonable space for developmental revenue expenditure and for capital expenditure for the Union and all the States.

(para 4.35, 4.39 to 4.48 and 4.75 to 4.81)

4.89 Our analysis and projections at different stages were affected by inconsistent accounting of receipts and expenditure that made it very difficult to ensure comparability of the base level of expenditure and revenue across States. It is important that these accounting differences are ironed out forthwith to facilitate comparison of important components of State Government expenditure and consistent State level fiscal analysis and the aggregation with the Union's accounts.

(para 4.79)

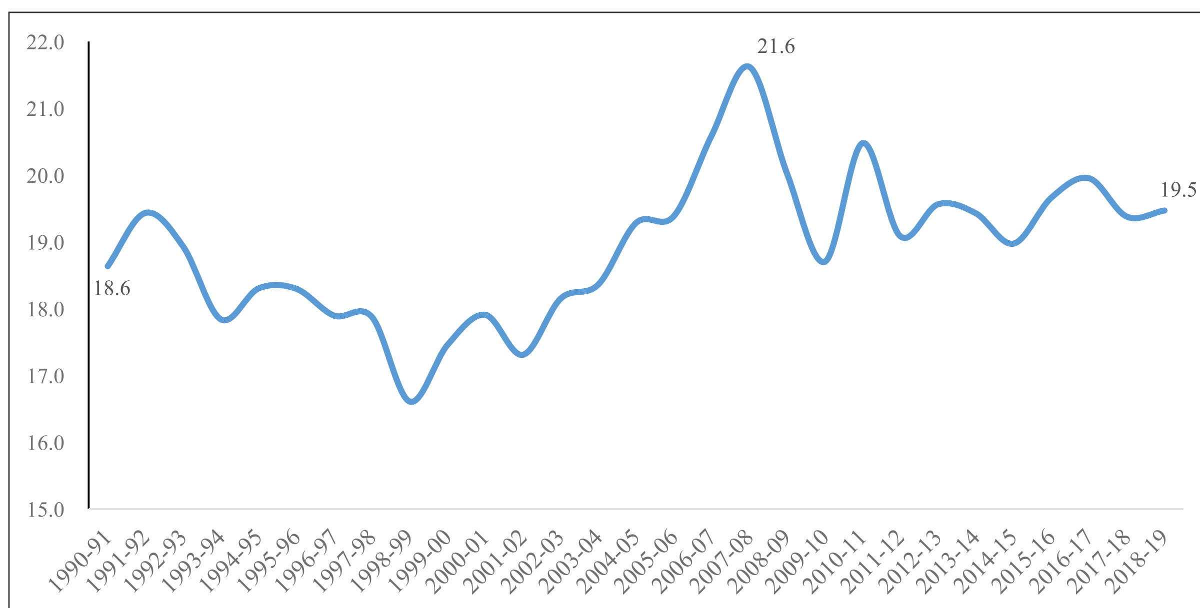
Chapter 5

Resource Mobilisation

This Chapter discusses the imperative of stepping up efforts for raising the resources of governments at all levels, in the context of increasing requirements of public expenditure and stagnant revenues relative to gross domestic product (GDP). The Covid-19 pandemic has widened the gap between revenue and expenditure of governments. We analyse the major direct and indirect taxes with untapped revenue potential. We conclude that, with appropriate corrective measures in tax administration and policy, the tax to GDP ratio could, in time, be raised by 5 percentage points. Corrective measures recommended by us bear the potential of yielding revenue gains from GST, personal and corporate income taxes as well as property taxes at the local government level.

5.1 Public spending in India needs to better meet the expectations of social and physical infrastructure, employment, livelihood support and security. However, resource availability to meet these growing needs has remained an enduring challenge. The strain of these expenditure pressures has been showing up in the budgets of different tiers of government. What compounds these difficulties is the deteriorating revenues of the government relative to gross domestic product (GDP) in recent years (Figure 5.1). The growth in taxes from the late 1990s till 2007 was

Figure 5.1: General Government Revenue (tax plus non-tax) as % of GDP



Source: Union Budgets, CAG and NSO

largely due to improvement in the collection of direct taxes, particularly corporate tax. More recently, in 2015 and 2016 there was a brief spike in tax collections due to the increase in excise duty rates and the levy of cess to off-set the rapid fall in crude prices. At the onset of the Covid-19 pandemic in March 2020, tax and non-tax revenues for both the Union and States had already been declining. The pandemic has affected the economy in multiple ways. No sector of the economy - financial, monetary, fiscal and real – has escaped the adverse fallout. Both informal and formal sectors are impacted significantly. Hence, building avenues for sustained additional financial resources for governments at different tiers, including the third tier, is inescapable. This is what this chapter attempts to address.

Table 5.1: General Government Revenue (tax plus non-tax) and Expenditure (as % of GDP)

Country/country group	Revenue		Expenditure	
	2011-2012 average	2017-2018 average	2011-2012 average	2017-2018 average
Advanced Economies				
United Kingdom	36.0	36.6	43.6	38.9
United States	29.2	30.1	38.1	35.2
Average	35.5	36.2	41.4	38.6
Emerging Market and Middle-Income Economies				
Brazil	34.9	30.7	37.4	38.2
China	27.4	28.0	27.6	32.3
India	19.6	20.0	27.5	26.4
Russia	34.6	34.4	33.7	33.7
South Africa	26.9	28.6	31.1	32.9
Average	29.2	27.2	30.2	31.2
Asia	24.9	25.5	26.5	29.8
Low-Income Developing Countries				
Average	17.5	14.6	19.2	18.4
Asia	16.0	16.1	19.1	19.4

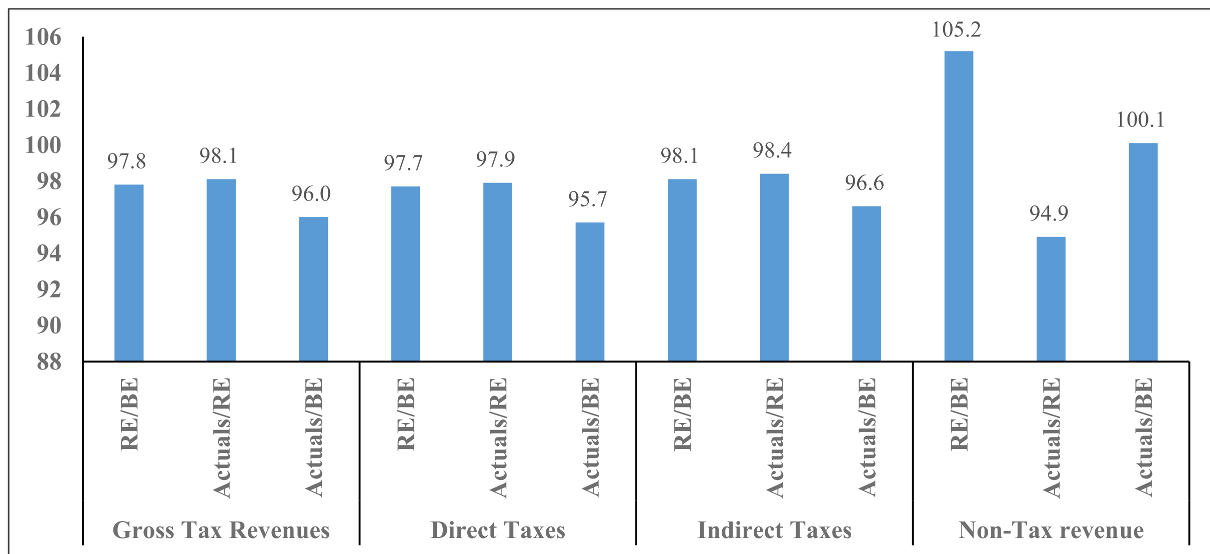
Source: Fiscal Monitor, April 2020, IMF

5.2 Table 5.1 brings out two salient points. First, India's revenue to GDP ratio has been virtually stagnant in the last decade and much lower than that of its peers. Second, it is evident that its financing requirements are substantially larger than its comparator countries and, despite high debt financing, public spending in India remains lower than its peers. Many research studies,

including one that was done for this Commission by the International Monetary Fund (IMF), have indicated the large gap in tax collections of more than 5 per cent of GDP, compared to its potential. Thus, even while recognising that there is great scope for improving efficiency in public spending, the immediate reason for fiscal pressures faced by governments at all tiers in India stems from the inability to mobilise adequate non-debt resources.

5.3 Another problem relates to budget marksmanship. Figure 5.2 shows that for the Union Government, the actual tax collections during the last ten years, on an average, was 4 per cent less than what was budgeted. The gap between revised estimates and actuals is by no means negligible. This prediction error leads to ad hoc expenditure management, typically in the second half of the financial year, that includes cuts in developmental expenditure creating uncertainties for implementing agencies, reneging on contractual obligations and payments, and significant carry-overs of liabilities. The problem is equally present in States, though it is sharper for some.

Figure 5.2: Budget Marksmanship of the Union Government in Revenues during 2010-2020 (average, in per cent)



Source: Union Budgets

5.4 In this chapter, we follow a bottom-up approach by estimating the additional potential from different revenue sources. It is possible that the Covid-19 pandemic will have a long-standing effect on the country's GDP, with implications for tax bases of both direct and indirect taxes. Hence, most of the conclusions on additional resources in this chapter are expressed in relation to GDP, not in absolute numbers.

Revenues of the Union

5.5 During 2015-16 to 2019-20, the Fourteenth Finance Commission (FC-XIV) period, gross tax revenues constituted about 84 per cent of the gross non-debt receipts of the Union Government. Out of the rest, 12 per cent was non-tax revenues and the remaining 4 per cent was non-debt capital receipts, primarily proceeds from disinvestment. More than half of the Union Government's non-tax revenues since 2015-16 was on account of the transfer of profits and dividends from public non-financial and financial corporations, including the Reserve Bank of India (RBI). These non-tax receipts are largely dependent on economic growth, while proceeds from disinvestment are often treated as a financing item in standard fiscal literature. Hence, going forward, the strength of the revenue of the Union Government will almost fully depend on the buoyancy of its taxes and economic growth.

Goods and Services Tax

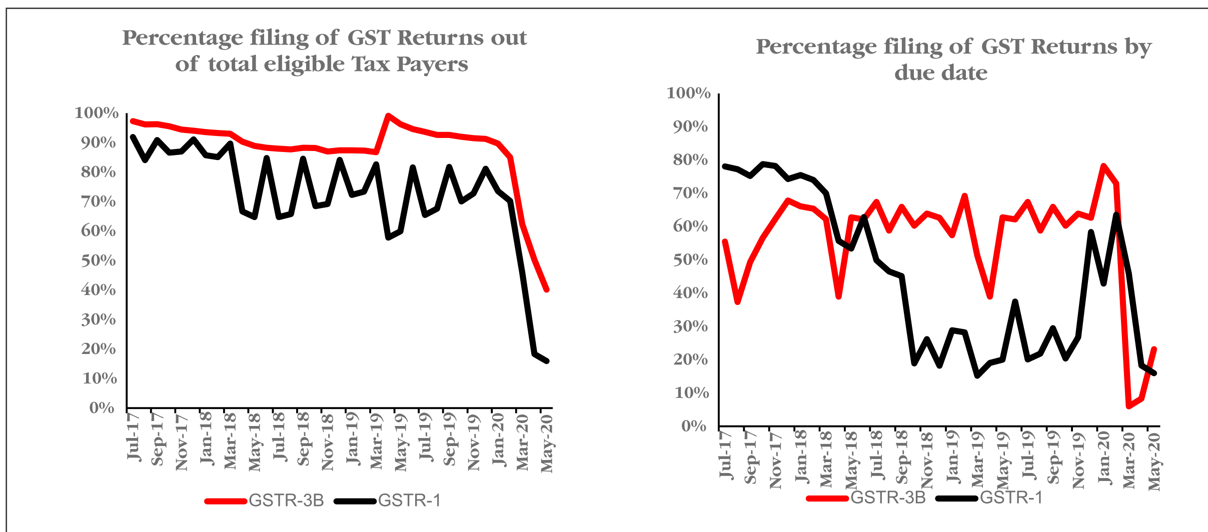
5.6 Improving the efficiency of the goods and service tax (GST) will strengthen both Union and State finances – the latter to a larger extent because under the current scheme of tax devolution, more than 70 per cent of total GST revenue accrues to the States. Revenue realisation from GST has been much below expectations so far as discussed below.

5.7 ***Inverted duty structure:*** In a GST regime, with multiple rates, the balance of the rate structure of intermediates and final goods and services has important implications. In many cases, this rate structure is inverted, leading to large refunds and less-than expected net tax collections being available to the general government. In 2018-19, about 78.5 per cent of the tax liability on the taxable outward supplies was paid through input tax credits. In contrast, as per the national accounts, the ratio of value added to gross output in the economy was 49.3 per cent in 2018-19, which means that slightly more than Re. 1 worth of inputs yields Re. 1 of value added. One of the important reasons for the higher than 50 per cent input tax credit could be the inverted duty structure for many items. This can be corrected even without the weighted effective tax rate going up, with a salutary impact on net revenue collections of the general government.

5.8 ***Compliance:*** The other reason for the above -mentioned inconsistency could be input tax credit frauds. In March 2020, it was reported to Parliament that 1,620 cases of fake invoices of GST amounting to Rs. 11,816 crore were detected in 2018-19 and 3,866 cases amounting to Rs. 11,378 crore during April-January 2020. However, these are only detected cases. In its Report No. 11 of 2019 on GST, the Comptroller and Auditor General (CAG) observes, “Even after two years of roll out of GST, system validated Input Tax Credit through “invoice matching” is not in place and non-intrusive e-tax system still remains elusive. The complexity of return mechanism and the technical glitches resulted in roll back of invoice-matching, rendering the system prone to ITC frauds. Thus, on the whole, the envisaged GST tax compliance system is non-functional.” There are serious handicaps to the systematic detection of frauds because of the following reasons.

i. Out of two monthly returns that are required to be filed by the tax-payers, GSTR-1 (detailed monthly return on outward supplies, matched by corresponding invoices, which facilitates invoice matching) and GSTR-3B, the compliance in filing of GSTR-1 has always been less than the filing of the self-assessed and summary GSTR-3B, through which taxes are paid (Figure 5.3).

Figure 5.3: GST Returns filing as Per cent of Total Eligible Tax Payers



Source: GSTN data as on 24 September 2020

ii. The problem with the over-reliance on GSTR 3B has been that input tax credit (ITC) claims cannot be verified from this. The aggregate data on GSTR 3B also leads to misleading inferences like the following:

(a) The taxable outward supplies as per the GSTR 3B return data were as high as Rs. 652 lakh crore in 2018-19. This can be compared to the total value of output of Rs. 348 lakh crore in the economy as per the national accounts, which should roughly be the upper limit for taxable turnover. Thus, the reporting of taxable turnover in GST returns on the aggregate is not consistent with the comparable aggregate figures from the national accounts. There is no validation within the system to establish consistency between taxable value and tax paid as per GSTR 3B.

(b) If taxable outward supplies as per the GSTR 3B are to hold good, then the effective GST rate, as per GSTR 3B, turns out to be 6.1 per cent, which is much lower than the effective rate derived from GSTR1.

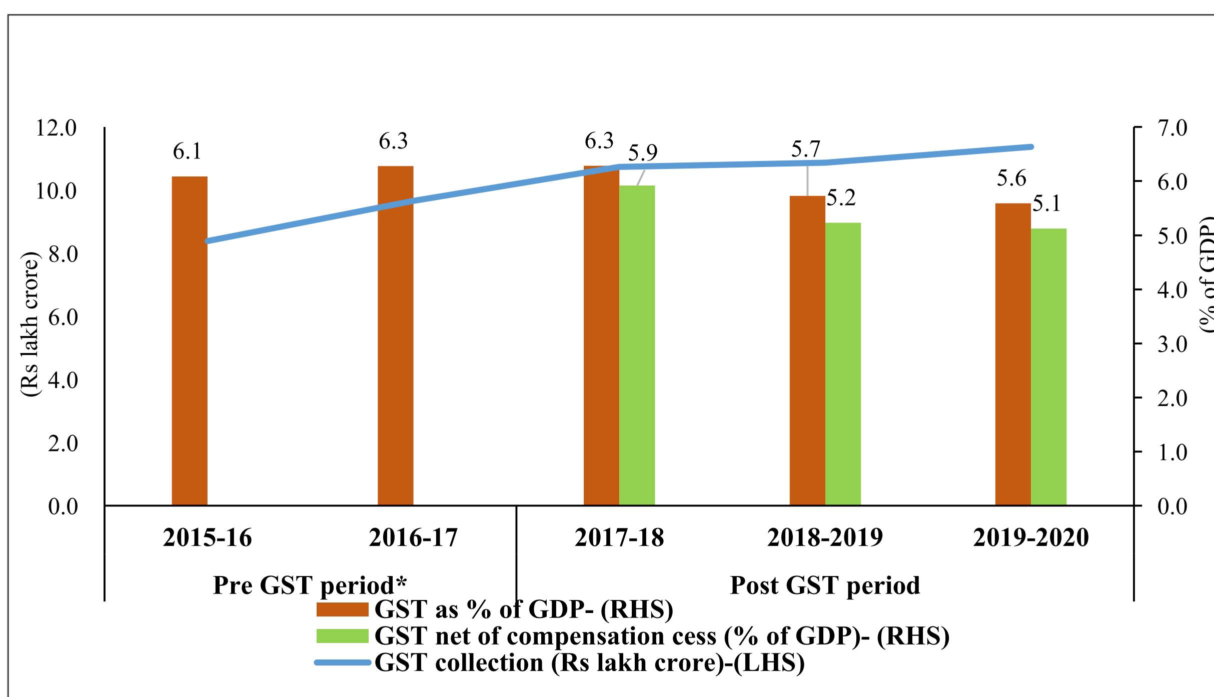
iii. Delays and non-compliance in filing returns, especially of the comprehensive GSTR1, makes it difficult to monitor tax evasion on a regular basis. Sample-checks of

outlier input tax credits cannot fully capture frauds.

iv. The lack of correspondence between aggregates on GST payments made by companies, as seen from the corporate tax data, and aggregates from GST returns makes macro crosschecks difficult. This is explained in Annex 5.1. It is paramount that tax authorities (both of direct and indirect taxes) should find a way to overcome technical impediments, including differences in accounting codes, etc. and operationalise the tax information system efficiently. This, in our view, will improve the efficiency of the entire GST structure, ensure better compliance, check evasion and enable early settlement of ITC and other adjustment claims.

5.9 ***Revenue neutrality:*** Figure 5.4 shows that general government revenues from the taxes subsumed under GST was around 6.3 per cent in 2016-17. However, collections under GST, net of compensation cess, was around 5.1 per cent of GDP in 2019-20. Collections under GST compensation cess of about 0.5 per cent of GDP are netted out as this was an addition under GST, and did not have any parallel in the pre-GST period. A change in tax structure can be said to be revenue neutral if the modified tax is able to realise revenue comparable to the original tax regime, relative to the tax base. In this sense, the much-needed revenue neutrality of GST stands compromised. Correcting the inverted duty structure and problems related to invoice matching in the next two years should progressively help India's GST to re-establish its revenue neutrality.

Figure 5.4: GST Collections vis-à-vis Collection from Taxes Subsumed Under GST



Source: Union Budget, Finance Accounts, CAG and MoSPI

Note: *GST data for pre GST period are of taxes subsumed under GST (Union & State)

5.10 ***Medium term target:*** The rate neutrality of GST, which was compromised in the multiple downward adjustments of rates subsequent to the introduction of the tax, needs to be restored. Immediately, the focus should be to streamline its technology platform and to ensure prompt filing of returns and invoice matching. The streamlining of the GST rate structure will greatly help to move towards its revenue potential. The calculations are presented in Box 5.1. Overall, the ambition should be to achieve GST revenue (net of revenues from GST compensation cess) of around 7 per cent of GDP over the medium term.

Box 5.1: Revenue Gap in GST – an approximation

Revenue neutral rate (RNR): There were at least four different estimates of the RNR of GST before its implementation.

(a) The Task Force appointed by the FC-XIII: RNR at 12 per cent (5 per cent for the Central GST and 7 per cent for the State GST). The Task Force noted that this was a steep decrease from the combined CENVAT and VAT of 20.5 per cent.

(b) IMF: RNR of 11.6 per cent. It used the national accounts data on final consumption and supply and use tables for 2011-12. Very few exemptions were considered.

(c) NIPFP: RNR in excess of 17 per cent with different scenarios.

(d) Report on RNR and Structure of Rates chaired by the then Chief Economic Adviser: RNR of 15 per cent (preferred estimate) and 15.5 per cent (alternative estimate).

The arithmetic average of these RNR estimates is around 14 per cent.

Current effective GST rate: On behalf of the FC-XV, the NIPFP did a study and concluded that the effective tax rate estimated from GSTR-3B was too low, perhaps because of reporting issues and that the effective tax rate from GSTR-1 was about 14 per cent. However, this was based on return data only till October 2018. In September 2019, the Reserve Bank of India estimated that after multiple rate adjustments, the effective weighted average GST rate declined from 14.4 per cent at the time of inception to 11.6 per cent. The IMF did an analysis of GST, on our behalf, and indicated that current effective tax rate is around 11.8 per cent.

Restoring the RNR will mean: (a) merging the rates of 12 per cent and 18 per cent; (b) operating with a three-rate structure of a merit rate, standard rate and demerit rate of around 28 per cent to 30 per cent; and, (c) minimising exemptions.

GST potential: The potential for GST collections can be assessed with the help of the latest supply and use tables (2015-16). We have adopted the standard macro approach, quoted in the Report on the Revenue Neutral Rate on GST in 2015. The formula is:

B=Y-E + M - X - [(1- e) (N+I)], where B is the potential GST base; the other variables are explained in the table below. The assumptions included full compliance, full pass-through of the GST into prices, GST as a single positive rate and a zero rate on exports. The absolute numbers below are not important as they relate to 2015-16, the ratios are verified to be robust in later years too.

Estimation of GST collection gap relative to GDP using supply and use tables for 2015-16 (values are in Rs. lakh crore)			
Y= Output at basic prices	252.4	Applying above formula, tax base, B	69.7
M=Import of goods and non-factor services, adjusted for exemptions	25.6	GDP at current prices	137.7
X= Export of goods and non-factor services, adjusted for exemptions	23.7	GST rate	14%
Exempted Value (E) = (unprocessed farm produce, public administration & defence, education and health)	52.6	Estimated GST collection in 2015-16	9.8
Exempted value/ Total output (e) =exempt ratio	0.21	GST to GDP ratio: estimate of potential	7.1%
Fixed capital formation (N)	39.8	GST to GDP ratio: current (without proceeds of compensation cess)	5.1%
Value of intermediate output (I)	126.8	Gap as % of GDP	2.0%

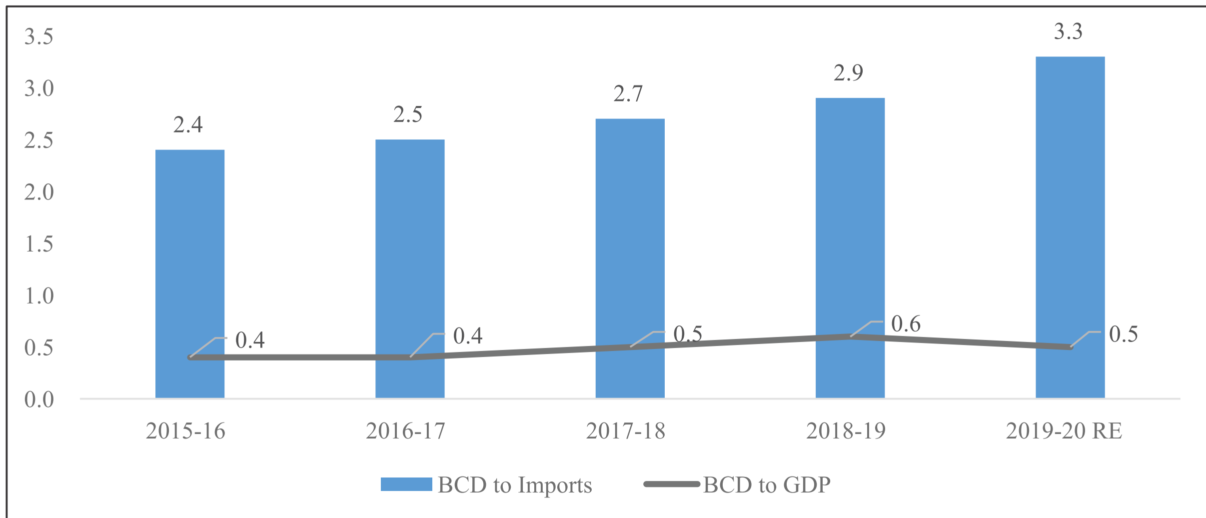
Collection efficiency which is the ratio of GST collections to the product of final consumption expenditure and standard rate and is a summary measure of efficiency of GST, stands below 50 per cent now. At the potential estimated above, it will be around 60 per cent, which is around advanced country benchmarks.

Streamlining Customs Duty Structure

5.11 There is high dispersion across India's complex and multiple rate tariff structure. According to World Trade Organization data, the ad-valorem tariff structure of India in 2019 comprised 94 per cent of the total tariff lines and included fifty-three Most Favoured Nation (MFN) applied rates, ranging from 0 to 150 per cent, with an average rate of 18 per cent. Bound duties account for 74 per cent of total tariff lines and range from 0 to 300 per cent. While the nominal MFN applied rates are higher than in trading partners, the average effective custom duty rate is lower. Research shows that revenue may increase with trade liberalisation accompanied by a simpler rate structure with an improvement in customs procedures and reduction in non-tariff barriers.

5.12 India's basic customs duty collections stood at 0.6 per cent of GDP and 2.9 per cent of its merchandise imports in 2018-19 (Figure 5.5).

Figure 5.5: Basic Custom duty as % of Merchandise Import and GDP



Source: Union Budgets, Department of Commerce and MoSPI

Note: BCD for 2019-20 is revised estimates

5.13 The efficiency gains from the following mix of policies will likely have a positive revenue impact in the medium term.

(i) Broad banding industrial finished products on MFN basis.

(ii) Broad banding intermediate industrial products and industrial raw materials on MFN basis.

(iii) Continuing with zero rating of imports to facilitate global value chain-related exports.

(iv) Streamlining and reducing non-tariff barriers.

Income Taxation by the Union Government

5.14 Direct taxes have undergone substantial reforms in the last decade, with favourable impact on tax compliance. However, while the statutory rates were reduced and the slabs got revised upwards, the plethora of exemptions and concessions did not get reduced proportionately. As a result, there is ample evidence of under-reporting of incomes and evasion, especially in the unorganised sector.

Personal Income Tax

5.15 For non-corporate entities, the slabs and rates of personal income tax are applicable. The following statistics throw light on the developments in the recent years.

(i) The number of tax returns of the assessees under personal income tax grew at a trend rate of about 19 per cent during 2011-12 to 2017-18. The reported gross total income in this segment grew at an annual rate of about 18 per cent. The collections from personal income tax grew at an annual rate of 16.6 per cent.

(ii) Most of the increase in non-corporate entities who declared business incomes from assessment year 2012-13 to assessment year 2019-20 took place in the income class of Rs. 2.4 lakh to Rs. 5 lakh. Table 5.2 suggests bunching of returns around the tax avoidance zone. There are a large number of individual proprietorships and partnerships outside the organised sector whose operations and income flows are not effectively tracked. With increasing formalisation of the economy and with the help of instruments like information from GST returns and bank transactions, the tax administration should be able to track them more effectively. Table 5.2 also shows that while the share of returns in the tax-paying bracket (income of Rs. 5 lakh and above) increased by more than 7 percentage point, their income share went up only marginally.

Table 5.2 Business Income of the Non-Corporate Sector

Classes (in Rs.)	% of Returns		Income share (%)	
	AY: 2012-13	AY: 2019-20	AY: 2012-13	AY: 2019-20
Above zero to 2.4 lakh	68.48	23.90	29.25	6.91
2.4 lakh to 5 lakh	22.21	59.38	20.92	42.48
5 lakh and above	9.32	16.72	49.83	50.60

Source: Department of Revenue

(iii) Salary income accounted for about 59 per cent of the declared incomes in this segment, while 27 per cent was business income.

(iv) Out of the 5.53 crore individuals that filed returns in this segment, 40.5 per cent did not pay any tax. Another, 53.2 per cent, whose annual income averaged Rs. 5.6 lakh, paid a tax of Rs. 22,538 each on an average, which means an effective tax rate of only 4 per cent. Their contribution to tax collections accounted for about 21 per cent. The remaining 6.3 per cent accounted for about 79 per cent of tax collections under personal income tax. This skewed picture emerges because of the plethora of exemptions and deductions, lack of effective surveillance and also the structure of tax slabs and rates.

5.16 Table 5.3, which presents tax threshold levels at purchasing power parity terms in different countries along with their tax rates and per capita gross national income, shows that in some ways, India's threshold level and the lowest rate of tax are generally comparable to those of major developing countries and lower than those of many developed countries. The threshold

limits may be kept at the current level for some time to build stability in tax regime and to ensure greater predictability and better tax planning for the taxpayer.

Table 5. 3: Comparison of Tax Regimes Across Countries

Country	Minimum tax rate (%)	Maximum tax rate (%)	Minimum threshold level ($_ppp)	2019 per capita GNI (PPP $)	World Bank classification (*)	2019 GNI per capita, (current US$)
United States	10.0	40.0	9275	65880	HI	65760
Sweden	20.0	25.0	56107	57300	HI	55840
Australia	19.0	45.0	12641	51560	HI	54910
Netherlands	8.0	52.0	25042	59890	HI	53200
Canada	15.0	33.0	9084	50810	HI	46370
United Kingdom	20.0	45.0	18373	48040	HI	42370
Japan	5.0	45.0	3815	44780	HI	41690
South Korea	6.0	42.0	1710	43430	HI	33720
China	3.0	45.0	12000	16740	UMI	10410
Brazil	7.5	27.5	10139	14850	UMI	9130
South Africa	18.0	45.0	12418	12630	UMI	6040
Indonesia	5.0	30.0	12886	11930	UMI	4050
Sri Lanka	4.0	24.0	9931	13230	LMI	4020
India	5.0	30.0	11788	6960	LMI	2130
Zambia	25.0	37.5	8621	3580	LMI	1450

Source: Our calculations based on different country sources, IMF, OECD, World Bank

Note: Countries like US and Canada have provincial taxes, which are not reflected in this table.

(*) World Bank country classification is based on 2019 GNI per capita in current US$, Atlas method. Low income (LI): < US$1,036; Lower-middle income (LMI): US$1,036 - US$4,045; Upper-middle income (UMI): US$4,046 - US$12,535; High income (HI): > US$12,535

5.17 When India has opted for moderate tax rates and thresholds at the entry levels of income, it is important that the tax base is properly captured. Annex 5.2 makes it clear that there is significant room for improvement in the tax base. This is where the recommendations of the Tax Administration Reform Commission (TARC), 2013, become all the more relevant. The major recommendations relate to:

(i) Reviewing various exemptions under different tax laws.

(ii) Expanding coverage of provisions relating to tax deduction at source (TDS) and tax collection at source (TCS) to more transactions, which leave behind an audit trail. This will act as a deterrent to tax evasion and aid in the collection of tax at the transaction stage itself.

(iii) Closer co-ordination between agencies involved in TDS and TCS, filers of

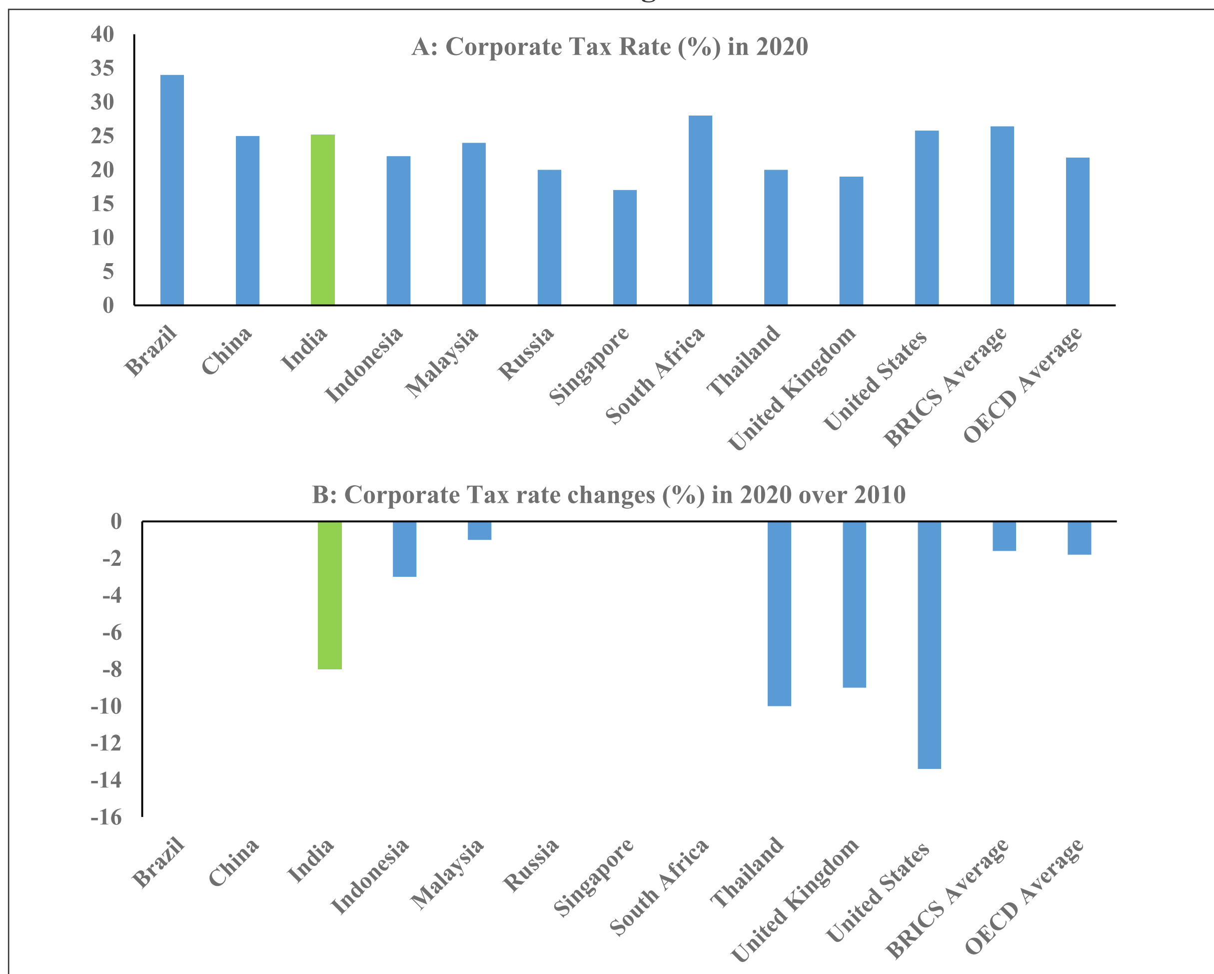
withholding tax and information filers for various financial transactions to trace assessees not filing returns.

(iv) Timely clarifications by authorities and improvement in the quality of orders from the angle of fairness, legality and propriety, irrespective of revenue consequences, will reduce disputes. Conduct of multi-year audits against the current single-year audit may also be considered.

Corporate Tax

5.18 With the correction in the corporate tax rate in September 2019 to a base rate of 22 per cent for those companies which do not avail of exemptions (without cesses and surcharges), India stands aligned to global benchmarks – India's rate is close to the BRICS and Organisation for Economic Cooperation and Development (OECD) averages. India undertook one of the sharpest corrections in rates over the last decade (Figure 5.6).

Figure 5.6 A&B: Rates of Corporate Tax Across Countries in 2020 and Change From 2010



Source: OECD

5.19 Public sector companies had about 18 per cent share of total corporate profits and 15 per cent of the tax liability in 2018-19. Multinational corporations account for more than 50 per cent of the total corporate tax collections in India. The effective tax rate on companies, inclusive of surcharge and cess, in 2018-19 was 27.84 per cent. The reduction in the statutory rate by 8 percentage points (for companies opting to do without concessions) can improve tax collections over a five-year frame. Two important channels include (a) increase in the post-tax return on investment that can, in turn, boost investment, aggregate profits and other incomes, spurring economic activity and also augmenting revenues from personal income tax and indirect taxes and (b) disincentive effect on multinationals for their profit shifting behaviour. These effects will take time to realise and may require complementary reforms for improving ease of doing business. Apart from this, the grandfathering of tax holidays done in 2017 should bring in buoyancy effects during the award period.

5.20 The revenue that was lost on account of the reduction in corporate tax rate in 2019 was around 0.7 per cent of GDP. Were new investments to respond, the positive impact of the reduction in tax rates on profits and incomes could compensate, over the next five years, much of the revenue lost from rate reduction.

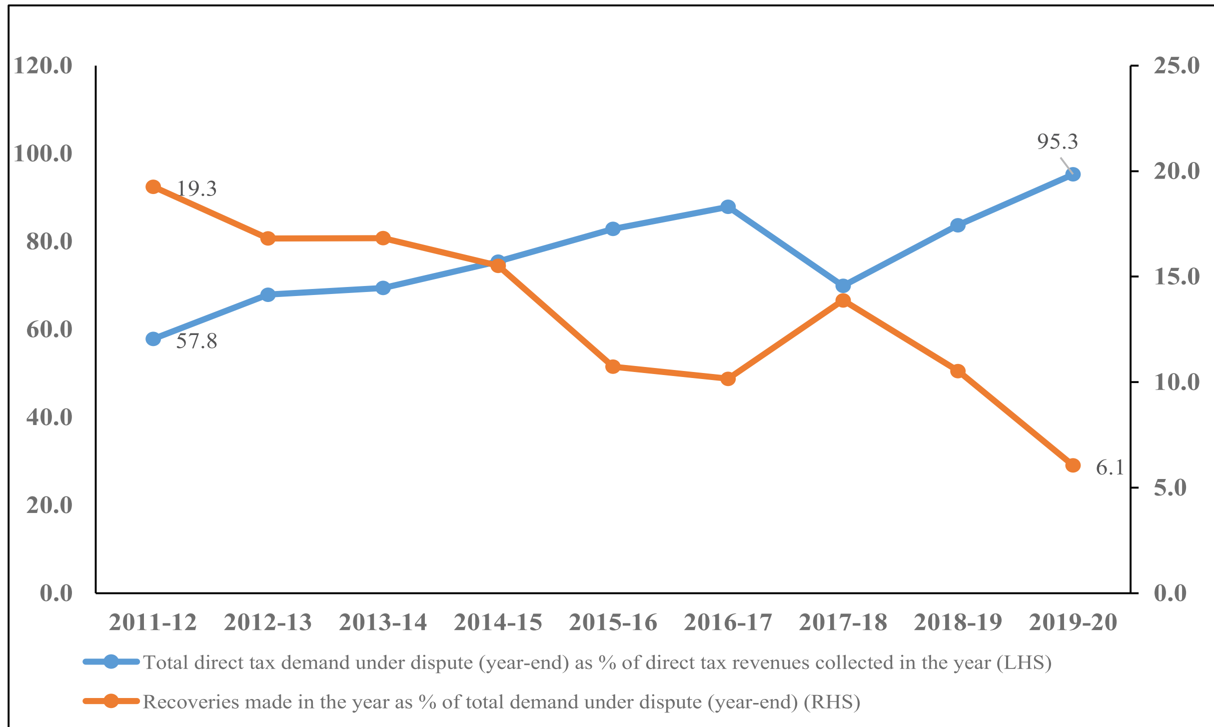
5.21 Between 2014-15 and 2018-19, direct taxes to GDP ratio of the Union Government increased by 0.4 percentage points. This should continue in the next five years, suitably adjusting for the tax policy change in 2019-20. Annex 5.2 which sees the national accounts and tax return data in a consistency framework indicates that tax collections can improve significantly with improvement in tax administration, streamlining of exemptions and capturing untapped incomes in the tax bracket. The concessions given to perquisites also need to be reviewed. Under an environment of improved tax administration and policy changes, overall, the revenue from the direct taxes of the Union has scope to improve 1.5 to 2 percentage points of GDP over the medium term and go beyond this in the next decade. Continuing improvements in direct tax collections is essential to impart greater progressivity to the tax structure.

Increasing Incidence of Disputes in Direct Taxes

5.22 The stock of direct tax demand at dispute was Rs. 9.99 lakh crore at end-March 2020 (Table 5.4). It had increased at a trend growth rate of 16.3 per cent from its level of Rs. 2.86 lakh crore at end-March 2012. Figure 5.7 shows that this stock amounted to more than 95 per cent of direct tax collections in 2019-20. In contrast the total recoveries made out of the demand under dispute grew at a modest trend rate of 3.7 per cent per annum. The High-Level Committee (HLC) to Interact with Trade and Industry on Tax Laws (November 2016) noted several cases where different views were taken in different jurisdictions on the same issue. It recommended that there should be a body at the highest level in the Central Board of Direct Taxes (CBDT) and Central Board of Indirect Taxes and Customs (CBIC) to clarify all matters of interpretation so that there is consistency and uniformity across jurisdictions. The HLC also recommended that data should be

maintained on a case-wise basis. It stated that every case where an assessment order becomes a matter of dispute should be recorded at every level of adjudication with the details of the relevant revenue official in order to analyse the case, draw lessons for the future and feed into the relevant official's performance reporting.

Figure 5.7: Stock of Disputed Tax Demand Versus Direct Tax Collections



Source: Central Board of Direct Taxes

5.23 Table 5.4 also shows that the pendency at the level of the departmental appellate mechanism increasingly accounted for a larger chunk of the disputed tax demands. Seeing the trends in the stock of tax amounts under dispute and the annual recoveries from such disputed amounts against the background of the direct tax collections, it seems that tax disputes are progressively becoming a losing battle for the Government.

5.24 This requires an urgent departmental resolution irrespective of revenue consequences. Timely clarifications and removal of doubts by authorities, review and improvement in the quality of orders passed from the angles of fairness, legality and propriety and conduct of multi-year audits as against the current single-year audit will help stem the origin of disputes.

Table: 5.4: Increase in Direct Tax Demand Under Dispute

Year	Total direct taxes under dispute - year end (Rs. crore)	Percentage pendency at different levels				Total direct tax collection (Rs. lakh crore)
		CIT(A)	ITAT	HC/SC	Others	
2011-12	2.86	44.5	37.0	7.9	10.6	4.94
2012-13	3.80	51.6	31.0	5.0	12.3	5.59
2013-14	4.43	54.2	31.8	5.0	9.0	6.39
2014-15	5.25	53.4	30.7	7.9	8.0	6.96
2015-16	6.15	60.2	24.9	10.8	4.0	7.42
2016-17	7.47	60.5	24.1	11.6	3.7	8.50
2017-18	7.00	58.3	25.4	12.7	3.5	10.02
2018-19	9.53	65.6	21.0	9.6	3.8	11.38
2019-20	9.99	69.3	17.6	9.0	4.0	10.49

Source: Central Board of Direct Taxes

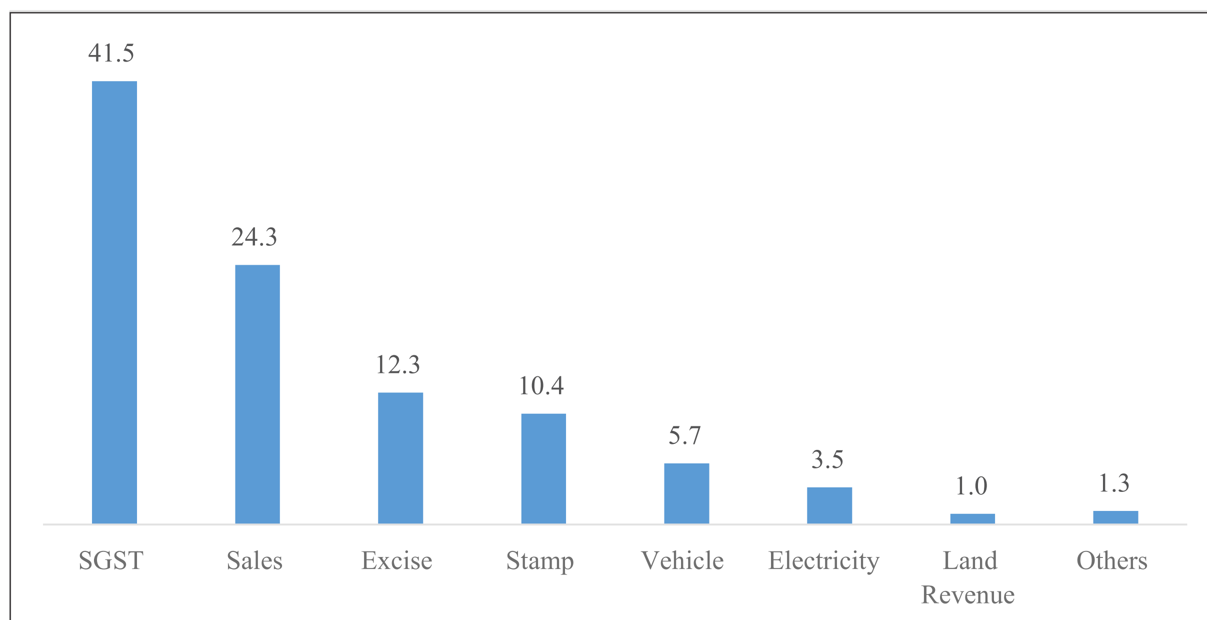
Note: CIT(A) – Commissioner of Income Tax (Appeals); ITAT – Income Tax Appellate Tribunal; HC – High Court; SC – Supreme Court

Non-GST Taxes at the State Level

5.25 About 41.5 per cent of States' tax revenue, subsumed under State GST (SGST), is under the pooled taxation powers of the general government (Figure 5.8). Another 17 per cent, the petroleum component of VAT, can be brought under that pool by a decision of the GST Council. The inclusion of petroleum under GST can reduce the cascading effect on goods with significant petroleum inputs, but can have transitional revenue implications. Petroleum VAT has generally declined from its very high rates of 2016-17; still the range is fairly large. The rates of electricity duty, another tax that can potentially be subsumed under GST, are generally lower than 15 per cent, but are widely varying across States. For seven States, the realisation from electricity duty was nil in 2018-19, while for another eight States, its share was less than 1 per cent, and for the remaining thirteen States, the average share of collection from electricity duty in own tax revenue was 4.6 per cent.

5.26 A significant part of the revenue buoyancy of States is actually or potentially linked to GST. **States will need to step up field efforts for expanding the GST base and for ensuring compliance, commensurate with their field strength and infrastructure for VAT and GST collection.** States should also widen their tax base by enhancing initiatives to mobilise more resources from taxes like stamp duties. The latter is the focus of the ensuing discussion.

Figure 5.8: Percentage Share of Taxes in States' Own Tax Revenue: 2018-19



Source: Finance Accounts of States, CAG

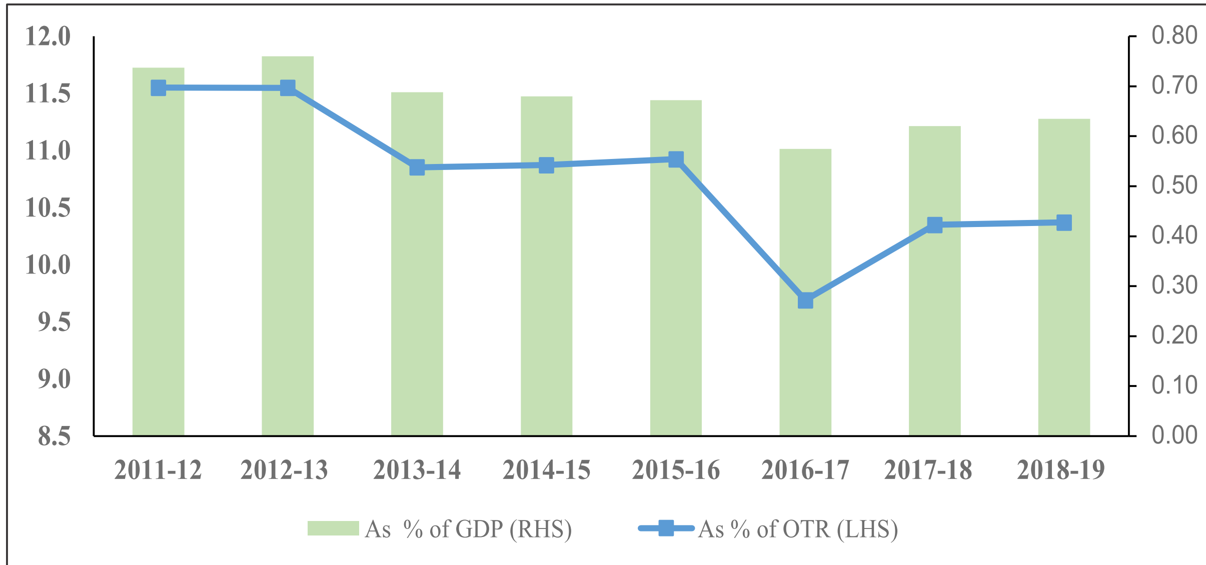
Stamp Duties and Registration Fees

5.27 The Constitution divides the responsibility of fixing stamp duty rates between the Union and States. However, it is collected and retained by the State where the instrument is executed. The Indian Stamp (Collection of Stamp Duty through Stock Exchanges, Clearing Corporations and Depositories) Rules, 2019 of the Union Government came into effect from July 2020. The new rules tried to address the stamp duty regime, recognising the technological changes in the field of financial securities and to provide for a centralised mechanism under which stamp duty is to be collected at one place by one agency (that is, through the stock exchanges or clearing corporations authorised by the stock exchange or by the depositories) on one instrument.

5.28 In the past, Indian stamp duty rates were exceptionally high, often above 10 per cent, while most countries in the world have rates that are less than 5 per cent[1]. This led to under-declaration of property values and lower collection of property taxes and capital gains taxes. Many States have revised stamp duty rates downwards to 5 per cent or below. Most States have also digitised land and property records. Research has indicated that although the stamp duty rationalisation policy in India may improve the efficiency of the housing market, it may not increase the stamp duty revenue collection as other policies having a bearing on per capita income also play a role in improving revenue collection[2]. Figure 5.9 shows that stamp duty and registration fee collections as per cent of GDP and the own tax revenue of States declined during 2011-2019.

[1] Alm, J.. Annez, P., & Modi, A. 2004. Stamp Duties in Indian States: A Case for Reform. World Bank Policy and Research Working Paper 3413
[2] Mukherjee, Vivekananda, 2013. "Determinants of Stamp Duty Revenue in Indian States South Asian Journal of Macroeconomics and Public Finance, 2(1): 33-58 SAGE Publications

Figure 5.9: Stamp Duties and Registration Fee Collections of All States as Percentage of GDP and Total Own Tax Revenue



Source: Finance Accounts of States, CAG and MoSPI

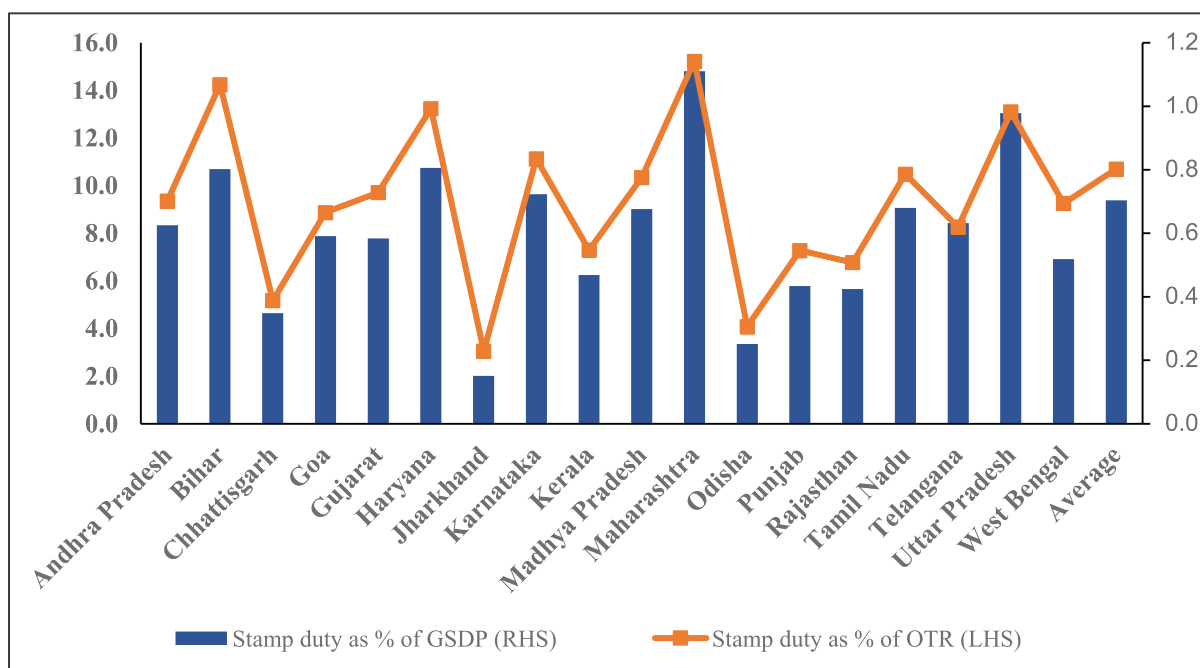
5.29 Figure 5.10 shows that many richer States, which are known to have buoyant property transactions, lag behind the average in terms of realisation from stamps and registration. One of the most important issues attested by researchers, Economic Survey, 2017-18 and the audits of stamp and registration departments by the CAG is the persistent undervaluation of property in registration. The Economic Survey pointed out that the guidance value or fair value of land fixed by State Governments, at which properties tend to get registered, are considerably lower than the market value of land. The CAG, upon sample cross-checks, reported that the loss of revenue to governments occurs because of misclassification of documents, undervaluation of property, short levy of stamp duty and registration fees and other irregularities.

5.30 There are many ways that State Governments can cross-check the wedge between market prices of properties and their fair values. One useful source can be the Residex of the National Housing Bank, an urban housing price index computed for housing properties in fifty cities across India that makes use of valuation data collected from primary lending institutions and data collected through market survey for under-construction properties, apart from registration data collected from official agencies. Another useful cross-check can be the data from private real estate portals abundantly present in States with buoyant property transactions. These portals give differentiated price quotations for different kinds of properties at different locations.

5.31 It is recommended that States should integrate computerised property records with registration of transactions. Research has indicated that computerised registration systems have

reduced the transaction costs for owners[3]. It is important that State Governments streamline their methodology of property valuation to yield regular and realistic updates of values, close to market values and greater revenues from property registrations. This will also help property taxation at the third tier of government, which is dealt in subsequent sections and in Chapter 7, although this will likely need greater effort in improving local administrative capacity.

Figure 5.10: Stamp Duties and Registration Fee Collections of General States as Percentage of GSDP and Own Tax Revenue



Source: Finance Accounts of States, CAG

The Third Tier - Property Tax and Professions Tax

5.32 Chapter 7 of this report on Empowering Local Governments delineates the property tax structure in the country. The design of property taxation, argued normally on the basis of benefit principle and ability-to-pay principle, has to guard against the possibility of creating disincentives to financial savings, which is important in the current Indian context. It is important to design a comprehensive taxation of house and commercial property, in such a way that it is both revenue-productive and progressive. This section discusses the taxation of houses, on which the available survey data gives scope to estimation.

[3] Deininger, Klaus and Goyal, Aparajita, 2012; Going Digital: Credit Effects of Land Registry Computerization in India. Policy research working paper; no. WPS 5244 Washington DC, World Bank Group

Estimating House Tax Potential at the Local Government Level

5.33 The Economic Survey 2017-18 estimated that the collection of house taxes in rural areas relative to their potential for select five states (Andhra Pradesh, Karnataka, Kerala, Tamil Nadu and Uttar Pradesh) averaged about 20 per cent. It made use of the housing data from Census 2011, the National Sample Survey Organisation (NSSO) Sixty-Ninth Round (July-December 2012) report on 'Drinking Water, Sanitation, Hygiene and Housing Condition in India', online data on size of houses and their prices from widely quoted real estate websites, and the Central Public Works Department (CPWD) plinth area rate of construction. The Survey assumed tax rates of 0.1 per cent of the property value for households with two living rooms, 0.2 per cent for households with three to five rooms and 0.3 per cent for households with more than five rooms.

5.34 Partly based on the approach given in the Economic Survey, we attempted to estimate the house tax potential for rural and urban areas separately for all States using the unit level data from NSSO Seventy-Sixth Round on Drinking water, Sanitation, Hygiene and Housing Conditions' conducted in July-December 2018 (DWSHH 2018). The detailed step by step procedure was as follows:

Step 1: From the unit level data of DWSHH 2018, the size of houses was estimated. The house floor area was estimated separately for different size categories of houses – those with one room, two rooms, three rooms, four rooms, five rooms and six and more rooms.

Step 2: A value of Rs. 1,900 per square foot of floor area for 2011-12 was inflated by 20 per cent based on the plinth area rate of CPWD 2019 - Cost Index. As a result, for 2019, the value of floor area was assumed at Rs. 2,280 per square foot uniformly for all States.

Step 3: The total value of houses was estimated by multiplying the area in square feet estimated in Step 1 by Rs. 2,280 on average uniformly for all States to get the tax base.

Step 4: House tax rates were assumed at the same rate adopted by the Economic Survey 2017-18, that is 0 per cent for houses with one room, 0.1 per cent for two rooms, 0.2 per cent for three, four and five rooms and 0.3 per cent for 6 and above rooms. The tax potential was estimated by multiplying the tax rates with the respective tax bases as calculated in Step 3.

5.35 The overall assessment of potential for house tax collections derived from this methodology at the 2019 prices is Rs. 42,160 crore for rural areas and Rs. 23,184 crore for urban areas. The imputation of the same valuation per square foot of house area in rural and urban areas may have led to underestimation of potential in the urban areas. The State-wise estimated house tax potential in 2019 for both rural and urban areas is at Annex 5.3. Recommendations on property taxes have been made in Chapter 7. It is expected that with changes in law and providing flexibility to local governments to levy tax not below a floor (as against the current ceiling) we can expect a growth in revenues on this account.

Rationalising Professions Tax

5.36 The power of the State Legislature to impose a professions tax is derived from Article 276 of the Constitution read with Entry 60 of the List II- State List of the Seventh Schedule. Article 276 states that no one shall be required to pay more than Rs. 2,500 by way of professions tax to any State or any local authority within that State. The initial tax limit of Rs. 50 per annum per person was raised to Rs. 250 in 1950 and subsequently to Rs. 2,500 in 1988 by the Constitution (Sixtieth Amendment) Act, 1988. At present, twenty-one States are imposing professions tax. In some States, the levy is generally applicable to all persons engaged in any employment or in any profession whereas in the others, it is only for enumerated professions. In some States, the tax is levied and collected by the State, but in others, municipal bodies also levy and collect the tax under a State legislation.

5.37 The FC-XI maintained that States should either levy professions tax to supplement the resources of local governments or empower them to levy it, and that the rates should be suitably revised to bring them nearer to the ceiling prescribed under the Constitution. Further, it recommended that the ceiling fixed in 1988 needs to be suitably enhanced and that Parliament should be empowered to revise the ceiling without having to amend the Constitution every time. The FC-XII endorsed the suggestion made by the State Finance Commissions to raise the ceiling on professions tax. The FC-XIV recommended raising the ceiling from Rs. 2,500 to Rs. 12,000 per annum. It also recommended that Article 276(2) of the Constitution be amended to increase the limit and to vest the power to impose limits on Parliament, with the caveat that the limit should adhere to Finance Commission recommendations.

5.38 The reason for giving Parliament the power to determine the limits of professions tax was that the States should not have unlimited power to raise a second income tax in the name of professions tax. The following amendment to the Constitution of India will be sufficient to ensure revenue buoyancy to the States from professions tax and to check against excessive empowerment of the Union Government in fixing limits:

1. In clause (2) of Article 276, for the words “two thousand and five hundred rupees per annum” the words “such amount as Parliament may by law specify” shall be substituted.

2. In Article 276 of the Constitution, after clause (2), the following provisions shall be inserted:

    “Provided that no Bill or amendment which imposes or varies the amount shall be introduced or moved in either House of Parliament except on the recommendation of the President made in pursuance of a recommendation of the Finance Commission to this effect.”

    “Provided further that nothing contained in clause (2) shall be construed to give Parliament the power to prescribe different limits on the amount payable as tax on professions, trades, callings and employment for different States.”

5.39 Since the Finance Commission makes its recommendations to the President, it would be constitutionally appropriate that the recommendation to change the limit of professions tax is made by the Finance Commission to the President.

5.40 The simplest way to revise this ceiling is to index it to the accumulated inflation over the intervening years, in order to protect the real value of the 1988 ceiling. This will not adjust for the real increase in professional incomes that occurred during this period, but will only correct for cumulative inflation. Mere correction of inflation, not considering the increase in the underlying incomes, also divests the professions tax of the potential criticism of duplicating income tax. This indexation has been attempted by annually increasing the ceiling of Rs. 2,500 by inflation calculated from the implicit GDP deflator for each year. By this method, the upper ceiling of annual professions tax of Rs. 2,500 fixed in 1988 at 1988 prices works out to around Rs. 18,000 at 2019-20 prices.

5.41 This means that professions tax collections by urban local bodies in India have the potential to grow by more than seven times with the same number of assessees just by rationalising rates.

Summary of Recommendations

5.42 The pandemic has given rise to two competing considerations in the short to medium term. First, there is the need for sizeable resources for the general government to deal successively with the increased demands for health interventions and medical infrastructure, income generation programmes and fiscal support for economic revival. Second, the sharp contraction in economic activity has adversely affected revenue collection, especially tax revenues. This fiscal predicament has been described as a 'scissors effect' in Chapter 2. Fully meeting the estimated tax gap could result in a 5 percentage point improvement in the tax-GDP ratio from its level of 16 per cent in 2019-20 over the medium term. But this would happen only with significant improvement in governance of tax administration across the three tiers of government. The changes required to close the tax gap are both administrative/operational and tax policy-related. In the ensuing section, our recommendations are arranged in three segments; (a) administrative/operational changes, (b) tax policy changes and (c) other changes that will help achieve the full potential.

Administrative/Operational Changes

(i) The IT platform of GST needs to be rectified forthwith and strict compliance ensured with the timelines of filing GST returns, which should lead to seamless invoice-matching and identification of frauds. This should also facilitate regular flow of consistent data on turnovers, output GST, input tax credits and net collections, with possible degree of disaggregation to facilitate scrutiny, analysis and feedback to policy.

(para 5.8 to 5.10)

(ii) The unit level information from GSTN should help in expanding the breadth of direct taxes. Tax authorities need to overcome technical impediments and operationalise the tax information system efficiently. (Action by Union and the States).

(para 5.8 to 5.10 and annex 5.1)

(iii) States will need to step up field efforts for expanding the GST base and for ensuring compliance, commensurate with their field strength and infrastructure for VAT and GST collection. (Action by States).

(para 5.26)

(iv) With the help of information from GST returns, the increasing number of formal transactions and the trail of bank transactions, the direct tax administration should track individual proprietorships and partnerships more effectively (Income Tax – Action by Department of Revenue, Government of India).

(para 5.15)

(v) Closer co-ordination should be ensured between agencies involved in TDS and TCS, filers of withholding tax and information filers for various financial transactions to trace assessees not filing returns. (Income Tax – Action by Department of Revenue, Government of India).

(para 5.17)

(vi) To reduce excessive dependence on income tax on salaried incomes, it is important to expeditiously expand coverage of provisions relating to TDS and TCS to more transactions and incomes, which will leave behind an audit trail that acts as a deterrent to tax evasion. (Income Tax – Action by Department of Revenue, Government of India).

(para 5.15 to 5.17)

(vii) Another issue that calls for urgent departmental resolution, irrespective of revenue consequences, is disputed direct taxes. Timely clarifications and removal of doubts by authorities, review and improvement in the quality of orders passed and conduct of multi-year audits as against the current single-year audit will help stem the origin of disputes. The constitution of an apex body at the highest level in the CBDT and CBIC to clarify all matters of interpretation will help ensure consistency and uniformity across jurisdictions. The data on disputes should be maintained on a case-wise basis, facilitating analysis of cases and drawing of lessons for the future. (Income Tax—Action by Department of Revenue, Government of India).

(para 5.22 to 5.24)

(viii) At the State Government level, stamp duty and registration fees have large untapped potential. States should integrate computerised property records with

registration of transactions and capture the market value of properties. State Governments should also streamline their methodology of property valuation to yield regular and realistic updating of property values. This will also help property taxation at the third tier of government. (Stamp duty and registration fees: Action—State Governments).

(para 5.27 to 5.31)

Tax policy changes

(ix) The inverted duty structure between intermediate inputs and final outputs present in the GST for many items should be resolved by streamlining its multiple rate structure. This can be corrected even without the weighted effective tax rate going up, with a salutary impact on net revenue collections of the general government. (GST—Appropriate recommendations by Union and the States for action by the GST Council).

(para 5.7)

(x) Efficiency gains can be similarly reaped in customs duty collections by reducing its multiple rate structure: (a) broad banding industrial finished products on MFN basis; (b) broad banding for intermediate industrial products and industrial raw materials on MFN basis; (c) streamlining and reducing non-tariff barriers; and (d) continuing with zero rating of imports to facilitate global value chain-related exports. The changes at (a) to (c) above may be made in calibrated fashion. (Customs Duty—Action by Department of Revenue, Government of India).

(para 5.13)

(xi) The myriad exemptions under different direct tax laws that breeds tax evasion, especially by the richer groups will need to be reduced. Incentives leading to ambiguous interpretations and evasion will need to be eliminated. The concessions given to perquisites also need to be reviewed comprehensively. The threshold limits may be kept at the current level for some time to build stability in the tax regime and to ensure greater predictability and better tax planning for the taxpayer. (Income Tax—Action by Department of Revenue, Government of India).

(para 5.15, 5.16 and 5.21).

(xii) The Union Government may initiate action for a Constitutional amendment to effect a change that enables periodic revision of the limits of professions tax upon the recommendations of the President of India, after taking cognisance a recommendation to this effect by the Finance Commission. (Action by Department of Revenue, Government of India).

(para 5.36 to 5.41)

Institutional and tax policy changes that will help achieve the full potential

(xiii) It is important to restore the revenue neutrality of the GST rate, which was compromised by the multiple rate structure and several downward adjustments of rates. The rate structure can be rationalised by merging the rates of 12 per cent and 18 per cent. The system can be operated with a three-rate structure of a merit rate, standard rate and demerit rate. Efficiency and revenue gains require that exemptions be minimised. (GST—Appropriate recommendations by the Union and the States for action by the GST Council).

(para 5.10 and Box 5.1)

(xiv) Over-reliance on consumption-based taxes by the general government, which reduces the progressivity of the tax system, should be reduced by widening the net of income and asset-based taxation. Different tiers of the Government should review their Constitutional entitlements to income and asset-based taxation and assess the feasibility of each untapped tax power, so that the erosion of the tax base and evasion of tax payments can be halted. Wherever inadequate devolution of taxation powers hinders resource mobilisation at the third tier of Government, especially in asset-based taxes, such devolution should be immediately undertaken and local administrative capacity strengthened.

(Annex 5.2)

Chapter 6

Towards Cooperative Federalism: Balancing Equity and Efficiency

In the spirit of cooperative federalism, this chapter contains our recommendations of resource allocation between the Union and the States as well as among the States. It starts with a discussion on the vertical fiscal imbalance created by the Constitutional assignment of revenues and expenditures. It then goes on to explain our approach on vertical devolution while presenting the views of the Union and the States. On horizontal devolution, the chapter discusses our approach to meet the needs of the States while giving due regard to the considerations of equity and efficiency.

6.1 Para 4 (i) of this Commission's terms of reference (ToR) which flows from Article 280(3) of the Constitution of India mandates it to make recommendations regarding "(a) 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".

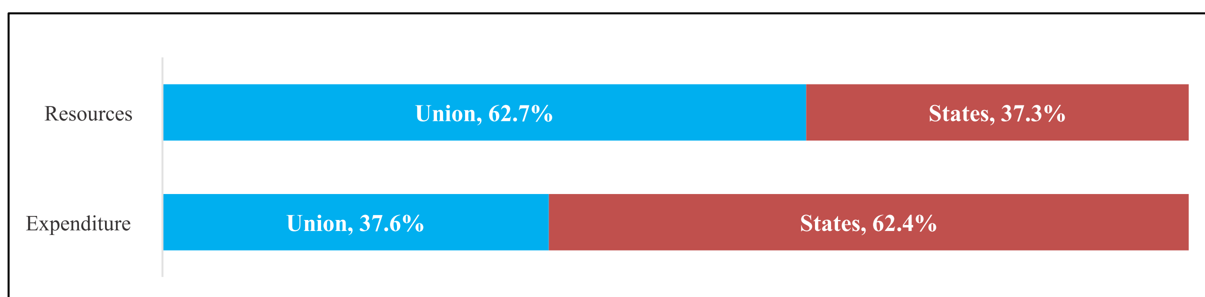
6.2 A very important task of the Commission is to recommend the division of the net proceeds of taxes collected by the Union Government. These net proceeds constitute the divisible pool (after excluding cesses, surcharges and cost of collection) between the Union and the States. This is called the vertical devolution or the vertical sharing of taxes. The first part of this chapter covers this Commission's views on the vertical fiscal imbalance, trends in vertical devolution and aggregate inter-governmental transfers, in the context of the views of the Union and State Governments.

6.3 The second part of the above ToR mandates this Commission to recommend the shares of each State from the divisible pool of taxes which are devolved. This is called horizontal devolution or horizontal sharing of taxes. The second part of this chapter covers this Commission's views on the horizontal imbalance existing among States and the historical perspective on the horizontal sharing approach. It recognises the views expressed by various State Governments on horizontal sharing, the approach adopted and recommends the inter se shares of States in horizontal devolution.

Vertical Fiscal Imbalance

6.4 The Constitution empowered both the Union and the States to raise revenues from different sources of taxation and also assigned responsibilities to incur expenditure through

Figure 6.1: India's Vertical Fiscal Gap (2018-19)



subjects in three lists – Union List, State List and Concurrent List – in the Seventh Schedule. By Constitutional design, this distribution has assigned higher and more buoyant taxation and resource raising powers to the Union Government whereas higher responsibilities for incurring expenditure have been assigned to the States.

6.5 For example, in 2018-19, the Union Government raised 62.7 per cent of the aggregate resources raised by both the Union and States, whereas the States spent 62.4 per cent of the aggregate expenditure of the Union and the States (Figure 6.1). There is thus a structural vertical imbalance which necessitates orderly transfer of resources from the Union to the States. At an aggregate level in 2018-19, the States could generate their own resources to meet only 44.8 per cent of their total expenditure. This means that the remaining 55.2 per cent needed financing through vertical resource transfers and/or by contracting debt.

6.6 Due to this basic design, the Constitution has stipulated that the Finance Commission assess the vertical fiscal imbalance which is likely to arise during its award period and recommend the sharing of resources based on such assessment.

Vertical Sharing

6.7 Finance Commissions, historically, have been recommending a proportion of the taxes collected by the Union Government for devolution to the States. Until the Tenth Finance Commission (FC-X), separate percentages were recommended for devolution of income tax and Union excise duties. However, after the Eightieth Amendment to the Constitution, net proceeds of all taxes[1] (after deducting cess, surcharge, and cost of collection) collected by the Union are shareable with the States. These constitute the divisible pool of taxes. The States' shares in the divisible pool recommended by the last four Finance Commissions is given in Table 6.1.

[1]Articles 270 and 279 read together defines 'Net proceeds of taxes' as all the taxes, except cess and surcharges, reduced by cost of collection.

Table 6.1: States' Share in Divisible Pool

	FC-XI (2000-05)	FC-XII (2005-10)	FC-XIII (2010-15)	FC-XIV (2015-20)	FC-XV (2020-21)
States' share in divisible pool (%)	29.5	30.5	32.0	42.0	41.0*

* Vertical share for twenty-eight states after adjustment for the reorganisation of the erstwhile State of Jammu and Kashmir into the two Union Territories of Jammu and Kashmir and Ladakh. The FC-XIV award was for twenty-nine States.

6.8 The FC-XIV expressed 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. Driven by this view, it recommended 42 per cent of the divisible pool for sharing with the States, up from the 32 per cent share recommended by the FC-XIII. While recommending this change, the FC-XIV did not expect it to lead to significantly higher aggregate transfers to States, but instead to more of a compositional shift in overall transfers in favour of greater tax devolution as compared to grants.

6.9 In this Commission's Report for the Year 2020-21, stability and predictability of resources was considered an essential component of long-term good budgeting and the vertical sharing of resources was retained at the same level as that recommended by the FC-XIV. We only adjusted for the newly carved out Union Territories of Jammu and Kashmir and Ladakh, keeping the balance share broadly equivalent at 41 per cent for the remaining twenty-eight States.

Submissions and Views of States

6.10 Almost all the States were of the considered view that the devolution of taxes from the divisible pool should, at a minimum, be a 50:50 distribution between the Union and the State Governments, especially given the declining share of the divisible pool in gross revenues. Their basic argument was that the States have much larger expenditure responsibilities as compared to the Union, especially in sectors such as education, health, police, law and order, agriculture and allied activities, irrigation, forests and environment preservation, power, roads, social welfare, drinking water and sanitation.

6.11 For State Governments to meet these expenditure responsibilities, a large devolution of gross revenues is inescapable because the committed expenditures on the sectors falling within the States' responsibilities are disproportionately much higher than their own tax and non-tax resources.

6.12 States also emphasised that with the introduction of the goods and services tax (GST), they have significantly lost their financial autonomy of imposing differential tax rates. Pre-GST, States could take individual measures for additional resource mobilisation by calibrating their tax

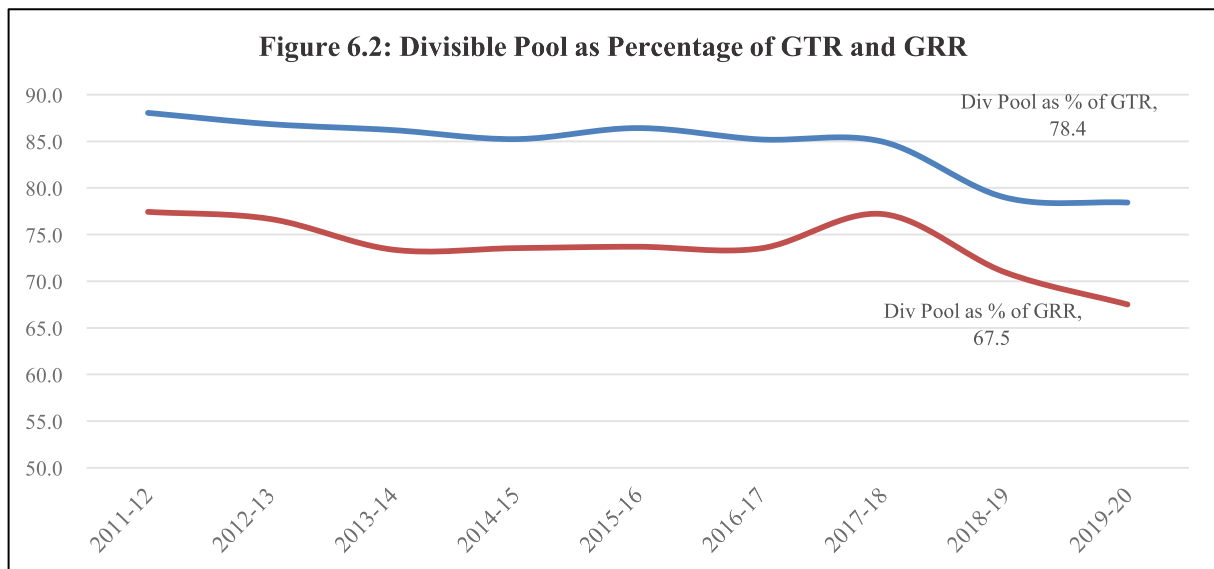
rates autonomously. However, now the GST Council has to approve any tax rate changes. Since practically all taxable commodities are covered under GST, the States have lost much of their individual resource raising ability.

6.13 It was hoped that, under the new GST regime, States would have gained through the sharing of service tax revenues. However, in the aggregate, the States have had to contribute a larger proportion of their revenues to the common GST pool as compared to the Union. Some estimates were placed before us that the contribution to the combined GST pool has been roughly in the proportion of 48:52 by the Union and the States.

6.14 State Governments also argued that tax devolution from the divisible pool is the most frictionless means for States to receive their share of resources. Only such unconditional transfers could protect the autonomy of the State Governments, as this federal autonomy is a basic ingredient of the Constitution.

6.15 At the same time, State Governments also represented that the Union has significantly shrunk the divisible pool over time through excessive and rising cesses and surcharges. These are, under the Constitution, non-shareable with the States. Figure 6.2 indicates that the divisible pool as a percentage of the gross revenues of the Union has been consistently falling as more and more resources are raised through non-shareable cesses and surcharges; currently the divisible pool accounts for just two-thirds of gross revenues. States further agreed that the Finance Commission should, therefore, work out a mechanism so that the 50:50 division should objectively account for the cess and surcharges currently retained by the Union from gross revenues.

Figure 6.2: Divisible Pool as Percentage of GTR and GRR



GTR: gross tax revenue; GRR: gross revenue receipts

Submissions and Views of the Union Government

6.16 The Union Government has not explicitly stated its preferred division ratio between the Union and the States. However, the general line of reasoning has been that it has very large responsibilities on account of defence, internal security and interest payment obligations for its own debt. It also needs sufficient financial resources to provide for national developmental priorities in diverse areas such as railways, road transport, health, education, agriculture, poverty alleviation schemes, recapitalisation of public sector banks and subsidies, including for food and fertilizer.

6.17 The tenor of the Union's argument has also been that the FC-XIV had significantly raised the devolution share from 32 per cent to 42 per cent and this considerable increase had unduly strained its fiscal position. Therefore, it was implied that there could be merit in appropriately recalibrating the devolution percentage below the present 42 per cent, especially since the Union needs a much greater proportion of the gross tax revenues for meeting its own committed liabilities, as also for the new national developmental priorities and flagship programmes such as the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS), Ayushman Bharat programme, Pradhan Mantri Awas Yojana, Pradhan Mantri Gram Sadak Yojana, Pradhan Mantri Fasal Bima Yojana, Swachh Bharat and Pradhan Mantri Kisan Samman Yojana.

Approach, Perspective and Recommendation

6.18 We have carefully considered all aspects of the above differences in the approaches and submissions of the Union and the States.

6.19 As far as the States' issue of the need for a 50:50 division is concerned, we have recognised that, besides the devolution from the divisible pool of gross tax revenues, there are substantial financial flows through grants which are borne by the Consolidated Fund of the Union for disaster relief, local bodies, revenue deficit grants and any other sector/State specific grants that are awarded by the Finance Commission. In addition to the Finance Commission grants, the Union also finances many other grants/transfers to the States through various Centrally Sponsored Schemes (CSS) and Central sector schemes.

[2] Non-FC grants from 2017-18 onwards also includes GST Compensation to States which amounts to 2.6, 2.1 and 4.8 per cent of GRR in 2017-18, 2018-19 and 2019-20 respectively.

Table 6.2: Central Transfers to States as Percentage of Gross Revenue Receipts

FC	Year	Share in Central taxes (A)	FC grants (B)	Total FC transfers C=A+B	Non-FC grants (D)	Total transfers E=C+D
FC-XIII	2010-11	21.7	3.1	24.8	23.9	48.7
	2011-12	25.3	4.4	29.7	23.7	53.4
	2012-13	24.8	3.9	28.7	20.0	48.7
	2013-14	23.8	4.0	27.8	17.9	45.8
	2014-15	23.4	4.3	27.7	18.6	46.3
	2010-15	**23.8**	**4.0**	**27.8**	**20.5**	**48.2**
FC-XIV	2015-16	29.7	5.0	34.7	13.2	47.9
	2016-17	30.6	4.8	35.4	13.0	48.4
	2017-18	31.9	4.4	36.3	16.8	53.0
	2018-19	32.9	4.0	36.9	15.5	52.4
	2019-20*	27.9	5.3	33.2	15.4	48.6
	2015-20	**30.6**	**4.7**	**35.3**	**14.9**	**50.2**

*Source: Union budget of respective years; * Provisional actuals from CGA*

6.20 As seen in Table 6.2, when we take the sum of the devolution of taxes and the various grant components, we observe that the Union Government has, in practice, been transferring about 50 per cent of its gross revenue receipts – the sum of its gross tax revenues and gross non-tax revenues – with about 2 per cent variation on each side. The higher transfers from 2017-18 onwards can be attributed to GST compensation to States being transferred as grants. Therefore, while constitutionally the Union is not obligated to share its non-tax revenues with the States, in practice this 50:50 distribution is in fact subsuming all the components of gross revenue receipts (including the cess and surcharge components, as also the non-tax revenues components).

6.21 Thus, through the combination of the Finance Commission transfers and the Union's voluntary transfers through various schemes – the States are already receiving about half of the gross revenue receipts. In this broader sense, the States' broad expectations of financial transfers from the Union are being significantly met.

6.22 As for the Union Government's view that the FC-XIV recommended a disproportionately high jump from 32 per cent to 42 per cent, we specifically note that the two percentage figures are not strictly comparable. The FC-XIII while working on 32 per cent devolution for States, was cognizant of the fact that substantially greater transfers to the States from the Union would also take place through its own recommended grants, as well as the other mechanisms for the flow of Plan funds through the Planning Commission.

6.23 In the post-Planning Commission period, the FC-XIV made adjustments recognising that many transfers from the Union to the States through the Plan transfer channels of normal Central assistance, special Plan assistance, State-specific grants and tied assistance would no longer be

available to the States. The FC-XIV also expected a compositional change in the aggregate transfers in favour of tax devolution.

6.24 It is noted that the FC-XIV estimated, as per its recommendations, that the aggregate transfers to the States would be about 49 per cent of the gross revenue receipts of the Union. The Union accepted this sharing arrangement between States and the Union when the award was implemented over the financial years 2015-2020. In fact, the provisional actuals of the Union Government for 2019-20 show it as transferring a slightly higher share of gross revenue receipts to the States.

6.25 On the basis of these facts, our view on the future contours of the vertical devolution of resources between the Union and the States is to share gross revenue receipts similarly in about equal ratio between the Union and States, while assuming no further decline in the divisible pool as a proportion of gross revenue receipts. This balance has been achieved through 41 per cent of the divisible pool being devolved to the twenty-eight States and the balance devolution taking place through various forms of Finance Commission and non-Finance Commission transfer mechanisms.

6.26 It is well recognised that the stability and predictability of resources is the most essential component of good long-term budgeting and fiscal marksmanship for both the Union and States. It is, therefore, our considered view that there should be broad continuity in the availability of resources through the divisible pool.

6.27 It could be argued that while the overall share of States may be about half of the gross revenue receipts, this can be compositionally altered in the form of a smaller share of tax devolution and a relatively larger flow of conditional grants from the Union to the States. This matter too has been carefully examined by us. We do note that the experience has been that the tax devolutions are a more progressive and frictionless form of transfers.

6.28 However, more importantly, as we have noted in our report for 2020-21, higher tax devolution vis-a-vis grants enable higher revenues to States especially when Central taxes are buoyant. In case of a decline in revenues, as is currently being experienced, the burden sharing pressure by both the Union and States has some advantages. On the one hand, it helps the Union perform its macro-economic stabilisation role. On the other hand, the grants are fixed absolute numbers, rather than percentages and, thereby, give predictability to the States by way of automatic stabilisation.

6.29 **Accordingly, we recommend the vertical share of States at the same level as recommended by us for 2020-21 – 41 per cent of the divisible pool for 2021-22 to 2025-26**. As we noted in our report for 2020-21, this vertical devolution has been adjusted to factor in the reorganisation of Jammu and Kashmir. This level of vertical transfers will allow appropriate fiscal space for the Union to meet its demands as well as maintain an adequate level of unconditional resources for the States.

Horizontal Sharing

6.30 After determining the States' aggregate share in the divisible pool, our task was to recommend inter se distribution of this among the States. This is called horizontal devolution. Finance Commissions in the past have recommended this horizontal devolution based on appropriate objective parameters or formulae. These, as expected, have not been uniform over time. The formulae used for horizontal devolution can be broadly divided into two patterns, as summarised in Box 6.1.

Box 6.1 Phases in Horizontal Devolution

Phase 1: From First to Seventh Finance Commission

- Till FC-VII, income tax and Union excise duties were shared using different parameters.
- Income tax was broadly shared using population and tax contribution parameters.
- The FC-III considered equity parameters like relative backwardness, scheduled caste/scheduled tribe (SC/ST) population, financial weakness etc. for distribution of Union excise duty for the first time.
- In the case of distribution of Union excise duty, the FC-VII considerably reduced direct weightage of population and increased weightage of equity parameters, like inverse of per capita income, percentage of poor etc.

Phase 2: From Eighth to Fourteenth Finance Commission

- FC-VIII to FC-X recommended similar parameters, including equity considerations, for distribution of both income tax and Union excise duties.
- After the Eightieth Amendment to the Constitution, a single sharing formula from the divisible pool of taxes was recommended from FC-XI onwards. Parameters used by earlier Finance Commissions continued in the formulae.
- Weightage for equity parameters increased significantly, with a proportionate decrease in direct weightage for population.
- The FC-X introduced fiscal performance criteria for the first time with 10 per cent weight to tax efforts of States. Later, criteria like fiscal discipline and fiscal capacity were used by Finance Commissions.

6.31 Horizontal devolution of taxes has been mainly driven in the past by considerations of need, equity and performance. Balancing equity and efficiency is never an easy exercise. Some Finance Commissions have also given due consideration to fiscal disabilities and fiscal discipline in the devolution formula. Table 6.3 summarises the criteria used and the weights assigned by the last four Commissions.

Table 6.3: Criteria and Weights (%) in Previous Finance Commissions

	Criteria	FC-XI (2000-05)	FC-XII (2005-10)	FC-XIII (2010-15)	FC-XIV (2015-20)
Need and cost disability	Population (1971)	10.0	25.0	25.0	17.5
	Population (2011)				10.0
	Area adjusted	7.5	10.0	10.0	15.0
	Forest cover				7.5
Equity	Index of infrastructure	7.5			
	Income distance	62.5	50.0		50.0
	Fiscal capacity distance			47.5	
Performance	Tax efforts	5.0	7.5		
	Fiscal discipline	7.5	7.5	17.5	
		100	**100**	**100**	**100**

Submissions and Views of States

6.32 Almost all the States, in their memoranda submitted prior to our report for 2020-21 as well as subsequently, have emphasised retaining income distance as a criterion with varying weights ranging from 15 per cent to 55 per cent in their memoranda. A few States have suggested a modified income distance criterion by adjusting for agriculture, or excluding the per capita income of high-income districts etc. A State has also suggested use of the inverse of income in place of distance of income. Many States have raised concern that the use of population data of 2011 in the formula would be disadvantageous to those which improved their demographic management. Half the States have suggested retaining forest cover/area as a criterion with suggested weights ranging from 4 per cent to 15 per cent. Few States have suggested modifying the forest cover criteria by including open forest, tree cover, alpine meadows, glaciers etc. Almost all the States have suggested area as a criterion in their memoranda with weights ranging from 5 per cent to 20 per cent. Some of them have suggested keeping the minimum floor of 2 per cent of the area share as was done by the FC-XIV and FC-XIII. A few States have suggested adjustment of area by giving weight to the international border in a State, hilly terrain, wetlands, among other things.

Approach and Recommendations

6.33 The horizontal devolution formula is designed to focus on specific objectives to be achieved through such devolution, such as: (i) to help bridge the vertical fiscal gap of the States; (ii) to provide horizontal equity (by providing higher share to poorer regions); (iii) to equalise fiscal capacities of States (revenue equalisation); (iv) to provide for cost differentials among States for providing basic public service (expenditure equalisation).

6.34 As discussed earlier, a fiscal gap exists for all the States due to the large structural mismatch between the States' own resources and their committed/development expenditure liabilities. To achieve the first objective of bridging the vertical gap of the States, the transfer of resources should be based on needs-based criteria. Per capita transfers based on population and cost disabilities address this objective.

6.35 Given the large differences in the resource base available and the status of development in India, fiscal equalisation is an essential objective while distributing resources amongst States. Though fiscal equalisation has been recommended by almost all recent Finance Commissions, India does not have any fully accepted definition of equalisation. It may, thus, be worthwhile to examine the equalisation definition adopted by other federal countries like Canada and Australia (also discussed in Chapter 2) .

6.36 Canada's constitution mandates the federal government to follow the 'principle of making equalisation payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.' Australia's Commonwealth Grants Commission defines equalisation as 'if each State made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard.' Both Canada and Australia use the detailed representative tax system (RTS)[3] approach for deciding on equalisation payments. Due to their definitional differences, Canada adopts only revenue equalisation (one-sided equalisation) whereas Australia also takes expenditure differentials into consideration while deciding on equalisation payments.

6.37 The RTS approach requires a detailed and highly sophisticated system for arriving at a tax-base for each revenue source available to the States. It has also been criticised for being highly complex and non-transparent unless the system is sufficiently developed.

6.38 The alternative to the RTS approach is the use of macro indicators like gross state domestic product (GSDP) and per capita income which are relevant for assessing the potential resource base of each jurisdiction. In many ways, macro indicators are more transparent and simpler to understand for the public. Furthermore, there is strong correlation between such macro indicators and the theoretically well-defined fiscal capacity or tax base.[4] Hence, Finance Commissions have used an equalisation formula based on macro indicators to determine the shares of States.

6.39 This Commission seeks to harmonise the principles of expenditure needs, equity and performance in determining the criteria for horizontal sharing. As discussed, need is a basic tenet of inter-governmental resource transfer. Each State has its own unique enablers as well as disabilities, irrespective of the policy choices made. We address such cost and economic

[3]RTS is a method to measure the revenue raising capacity of a jurisdiction by applying the national average tax rate to a tax base within a jurisdiction.

[4]Wilson Leonard, 2006, `Macro Formulas for Equalisation', Chapter 12, A Practitioner's Guide to Intergovernmental Fiscal Transfers (edited by Anwar Shah, World Bank)

differentials by applying the equity principle and equalising fiscal capacities. The efficiency principle has also been applied to reward and incentivise States to perform better, in terms of the utilisation of resources available to them.

6.40 Another important lesson is the need for stability and predictability in transfers. Hence, the three principles of need, equity and efficiency ought to be carefully balanced in assigning weightages within the formula.

6.41 Based on the above principles and considerations, this Commission had recommended a horizontal devolution formula in its report for 2020-21. We are of the opinion that this formula continues to meet all the aforesaid considerations and the approach outlined above. Hence, we are recommending continuation of the same criteria and weights for determining inter se shares of States for the 2021-22- 2025-26 award period. However, we have updated the underlying data for calculating the shares wherever possible. The following part of the chapter explains each criterion in more detail.

Need Based Criteria

Population

6.42 The population of a State represents the needs of the State to undertake expenditure for providing services to its residents. It is also a simple and transparent indicator that has a significant equalising impact.

6.43 Many States, in their memoranda, have raised concerns over the use of population data of 2011 for devolution purpose. Their concern is that the States which have controlled their population would be at a disadvantage if the latest population data is used instead of the 1971 data. Nevertheless, all the States suggested population criteria to be retained in the formula. Para 8 of this Commission's ToR specifies that "the Commission shall use the population data of 2011 while making recommendations." All previous Commissions since FC-VI (award period 1974-79) have been using population data of 1971 while making their recommendations. The FC-XIV had expressed a view in its report that, though the use of dated population data is unfair, they were bound by the ToR. This Commission is of the view that fiscal equalisation being recommended by it is designed to meet the present needs of the States, and that is best represented by the latest population data. Further, the specific ToR has mandated the use of 2011 population data and so this is what this Commission has done.

6.44 Since significant parts of the devolution formula will be scaled by the population, a significant weight to the population criterion will get reflected through the overall devolution formula. Hence, we have assigned standalone population a weight of 15 per cent for shares under this criterion. Annex 6.1 gives the method and calculation table for the inter se shares under this criterion.

Area

6.45 All Finance Commissions since the FC-X have used area as another criterion in the devolution formula on the ground of need – the larger the area, greater is the expenditure requirement for providing comparable services. A majority of the States have also suggested retaining area as a criterion in the horizontal devolution formula. We agree with the argument that a larger area incurs some additional administrative costs. However, it may not lead to proportional increase in cost of providing services. Hence, we have maintained a moderate weight of 15 per cent for the area criterion in consonance with the approach of FC-XIV. It is also true that States incur certain minimum costs even if the area is very small. Hence, we have continued with the same adjustments as done by the FC-XIV as well as FC-XIII and FC-XII while calculating the shares of geographical area of the States, by assigning a floor of 2 per cent share to those States with less than 2 per cent share in the actual area. Area share has thus been calculated using the same method as the FC-XIV. Annex 6.2 gives the actual geographical area, area share and adjusted area shares of States as calculated by this Commission.

Forest and Ecology

6.46 Forest cover was used as a criterion in the devolution formula for the first time by the FC-XIV on the grounds that while the forest cover maintained by States provide wider ecological benefits, it also imposes opportunity costs that need to be compensated. The FC-XIV assigned 7.5 per cent weight to forest cover in the devolution formula.

6.47 Many States have suggested forest cover or some variation of it as a criterion in the devolution formula. Some have also suggested including tree cover outside the forest, mangrove forest, incremental change in forest etc. as criteria. However, some other States have suggested dropping forest cover as a criterion. We had also commissioned studies by domain experts on the impact of including forest cover in the devolution formula. These studies have helped strengthen our view that given the importance of forest and environmental issues in the present times, it is important to retain the forest criterion in the devolution formula. There are also cogent arguments that this criterion is needed as a reward for providing ecological services and to overcome disabilities arising from areas dedicated to dense forests (areas covered by very dense and moderately dense forests).

6.48 The forest and ecology criterion has factored in both the ecological services being provided by the State's forest cover to the country as well as the cost disabilities. This is arrived at by calculating the share of the dense forest of each State in the aggregate dense forests of all the States. We have assigned a weight of 10 per cent for the forest and ecology criterion. The increase in weight is also a recognition of forests, a global public good, as a resource that ought to be preserved and expanded through afforestation of degraded and open forests for national benefit as well as to meet our international commitments. Annex 6.3 gives the forest cover and shares of States in the criterion.

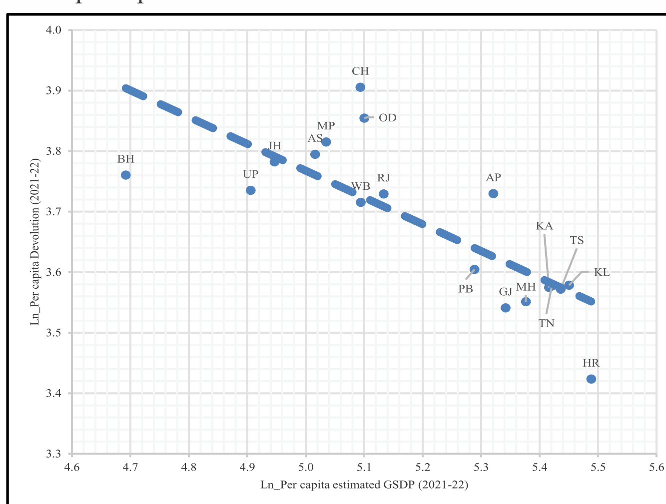
Equity-based Criterion

Income Distance

6.49 Distance of per capita income has been used as an equity criterion in the devolution formula by previous Commissions, with weights assigned in a range of 33.5 per cent (FC-IX) to 62.5 per cent (FC-XI). This criterion is intended to make the devolution formula more equalising and progressive, so as to provide higher devolution to States with lower per capita income (and lower own tax capacity). Here, per capita GSDP is used as a proxy for the distance between States in tax capacity. Poorer States with low per capita income also have higher expenditure needs to provide for comparable services. Hence, the income distance criterion helps provide for two-sided equalisation.

Box 6.2: Progressivity of horizontal distribution

The Covid-19 crisis has placed a heavy burden on the health infrastructure of States, especially those with low per capita income which also have poorer health facilities. As the chart for twenty major States shows, our recommended devolution is progressive on a per capita basis, signalling that we have recommended higher per capita tax devolution to States with lower per capita income.



6.50 Almost all the States have suggested retaining of the income distance criteria in the horizontal devolution formula. Horizontal equity is thus an important redistributive aspect which can be achieved through this criterion. Hence, this Commission has retained the income distance criterion with a weight of 45 per cent.

6.51 Income distance has been calculated using a methodology similar to the one that was adopted by the FC-XIV. A three-year average (2016-17 to 2018-19) per capita comparable GSDP has been taken for all the States. Income distance has been computed by taking the distance of each State from the State having highest per capita GSDP. In this case, Goa has the highest per capita GSDP followed by Sikkim. Since they are small and outlier States, the State with the third highest per capita GSDP – Haryana – has been taken as the benchmark to avoid distortions. The distance of the per capita GSDP of each State from Haryana's per capita GSDP has been calculated. Goa, Sikkim and Haryana have been assigned the income distance as calculated for the State with the fourth highest per capita GSDP - Kerala. Such distance has been scaled by the population (Census 2011) of each State and then the share of each State has been computed. It is also noted that the most of the lower per capita income States are also the more populous States. Therefore, use of population scaling of income distance makes it more progressive. Annex 6.4 gives details of the methodology and the calculation table for the income distance criterion.

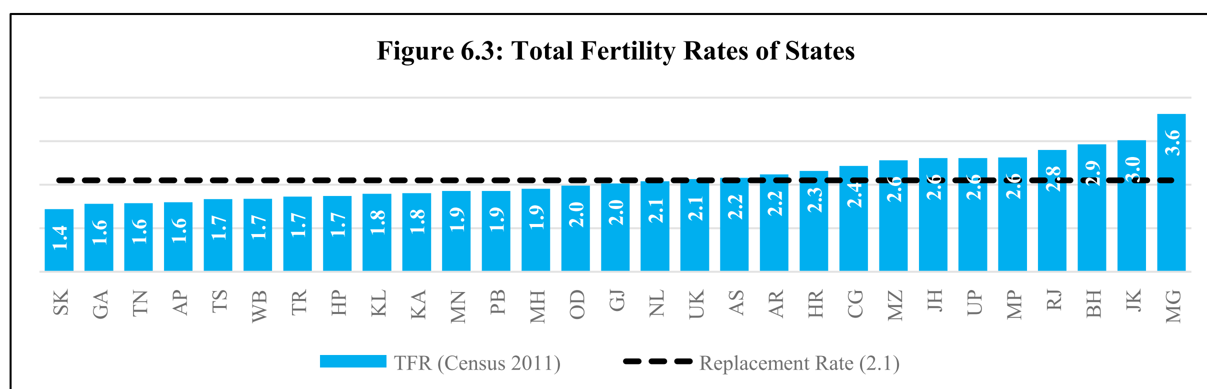
6.52 Use of income distance criterion meets equity considerations and makes tax devolution highly progressive in favour of low per capita income States. As shown in Box 6.2, lower per capita income States receive higher per capita tax devolution through the horizontal formula.

Performance-based Criteria

Demographic Performance

6.53 All the Finance Commissions since FC-VI (1974-79) were mandated to use the population data of the 1971 Census while recommending their awards. After almost four decades, this Commission has been mandated to use the population data of the most recent Census. As mentioned earlier, some States had raised serious concerns regarding this. We feel that the use of the latest Census data, and sudden change of underlying data, should not unfairly put some States which have performed well on the national objective of demographic management at a disadvantage. Our ToR also makes reference to consider performance incentives to States for the efforts and progress made in moving towards the replacement rate of population growth. Hence, we have decided to recommend a new performance-based criterion to reward States which have performed well in this regard and adopted policies for improved demographic management.

Figure 6.3: Total Fertility Rates of States



6.54 This Commission recommends a criterion of demographic performance by using a measure of total fertility rate (TFR) data of all States. This criterion has been computed by using the inverse of TFR of each State, scaled by the population data of Census 1971. Figure 6.3 shows State-wise total fertility rates as per the Census 2011. States which have achieved lower TFR will be scored higher on demographic performance whereas States with higher TFR will receive a lower score. Better performance in the reduction of TFR also serves as an indirect indicator for better outcomes in health (especially maternal and child health), nutrition as well as education. Hence, this criterion also rewards States with better outcomes in those important sectors of human capital. Since this is an important performance criterion to reward efforts made by States in controlling their population and achieving better human capital outcomes in education and health, we have decided to assign a total weight of 12.5 per cent. Annex 6.1 gives details of the

methodology and the calculations for this criterion.

Tax effort

6.55 The FC-X, FC-XI and FC-XII used tax effort of States as a criterion in the devolution formula to reward State's own tax performance. Many States have suggested inclusion of tax performance criteria to incentivise States with higher efficiency of tax collection. This Commission is of the view that the inclusion of tax effort as a criterion will reward the States with higher tax collection efficiency and, at the same time, will also encourage all States to be more tax efficient.

6.56 The tax effort of States is computed by first calculating the ratio of per capita own tax revenue of a State and its per capita GSDP over three years (2016-17 to 2018-19) and then taking the ratio thereof. This ratio has been scaled by the population of the State. Annex 6.5 gives the calculation table for this criterion. A weight of 2.5 per cent has been assigned to this.

6.57 Overall, the horizontal formula and the weights attached to the criteria are summarised in Table 6.4. The End Note of this chapter explains the methodology and mathematical model for computing inter se horizontal shares of all States.

Table 6.4: Criteria and Weights assigned for Horizontal Devolution

Criteria	Weight (%)
Population	15.0
Area	15.0
Forest and ecology	10.0
Income distance	45.0
Tax and fiscal efforts	2.5
Demographic performance	12.5
	100.0

6.58 For the period 2021-22 to 2025-26, the inter se shares of States in the net proceeds of the taxes (divisible pool) as recommended by this Commission, based on the methodology described above, are given in Table 6.5.

Table 6.5: Inter se Shares of States

State	Share (%)
Andhra Pradesh	4.047
Arunachal Pradesh	1.757
Assam	3.128
Bihar	10.058
Chhattisgarh	3.407
Goa	0.386
Gujarat	3.478
Haryana	1.093
Himachal Pradesh	0.830
Jharkhand	3.307
Karnataka	3.647
Kerala	1.925
Madhya Pradesh	7.850
Maharashtra	6.317
Manipur	0.716
Meghalaya	0.767
Mizoram	0.500
Nagaland	0.569
Odisha	4.528
Punjab	1.807
Rajasthan	6.026
Sikkim	0.388
Tamil Nadu	4.079
Telangana	2.102
Tripura	0.708
Uttar Pradesh	17.939
Uttarakhand	1.118
West Bengal	7.523
	100

Summary of Recommendations

i. We recommend retaining the vertical share of 41 per cent of the divisible pool of taxes for the States during the award period of this Commission. (para 6.29)

ii. To arrive at the inter se shares of States in the devolution, we have retained the horizontal devolution formula recommended in our report for the year 2020-21. (para 6.41)

iii. On horizontal devolution, while we agree that the Census 2011 population data better represents the present need of States, to be fair to, as well as reward, the States which have done better on the demographic front, we have assigned a 12.5 per cent weight to the demographic performance criterion. (para 6.54)

iv. The horizontal formula and the weights attached to the criteria are summarised in Table 6.4. (para 6.57)

v. For the period 2021-22 to 2025-26, the inter se shares of States in the net proceeds of the taxes (divisible pool) as recommended by this Commission, based on the methodology described above, are given in Table 6.5. (para 6.58)

End Note

The inter se share of ith state in the tax sharing formula, S_i, is determined as the weighted sum of State shares by six parameters or criteria – population, area, forest and ecology, income distance, fiscal and tax performance and demographic performance:

$$S_i = \sum_{m=1}^{6} S_i^m \, \omega_m$$

where ω_m = weight of mth parameter and S_i^m is the inter se share of the i-th State as per the mth parameter.

Methods of calculating each criterion/parameter are as follows:

1. **Population**

$$Inter\ se\ share\ of\ i^{th}\ state = \frac{POP_{i2011}}{\sum_{j=1}^{28} POP_{j2011}}$$

where POP_{jy} is population of the jth State as per Census of year y.

2. **Area**

Area shares have been calculated in two-steps.

Step 1. $Inter\ se\ share\ of\ i^{th}\ state = \frac{Area_i}{\sum_{j=1}^{28} Area_j}$

where $Area_i$ = the actual geographic area of ith state.

Step 2. For States with actual area share less than 2 per cent, floor share of 2 per cent is fixed. To arrive at the final shares, remaining State shares are adjusted for the total to add up to 100.

3. **Forest and Ecology**

- Forest Cover (F_i) = Very Dense Forest + Moderately Dense Forest

$$FC_i = Inter\ se\ share\ of\ i^{th}\ state = \frac{F_i}{\sum_{j=1}^{28} F_j}$$

4. **Income Distance**

- Three-year (2016-17 to 2018-19) average of per capita GSDP of ith State ($GSDPPC_i$)
- d_i is distance (difference) of ith state's $GSDPPC_i$ from third highest state's, namely Haryana's, GSDPPC
- Top three GSDPPC States -- Goa, Sikkim and Haryana -- are assigned notional distance of the fourth highest state, namely Kerala
- $D_i = d_i * POP_{i2011}$

$$Inter\ se\ share\ of\ i^{th}\ state = \frac{D_i}{\sum_{j=1}^{28} D_j}$$

5. Demographic Performance

- From Census 2011, total fertility rate of ith State (TFR_i) calculated from Age-Specific Fertility Rates ($ASFR_{i,k}$) where $ASFR_{i,k}$ is the kth age-specific fertility rate in the ith State.

$$ASFR_{i,k} = \frac{Number\ of\ live\ births\ last\ year\ in\ the\ k^{th}\ age\ group\ of\ females\ in\ the\ i^{th}\ state}{Mid-year\ female\ population^{\#}\ in\ the\ k^{th}\ age\ group\ in\ the\ i^{th}\ state}$$

The female population as registered in the age group by Census 2011 is taken as the mid-year female population.

Total Fertility Rate of ith State is,

$$TFR_i = 5 \times \sum_{k=15-19}^{45-49} ASFR_{i,k}$$

Where k = 15-19, 20-24, 25-29, 30-34, 35-39, 40-44, 45-49.

- DP_i = demographic performance of the ith State is given by

$$DP_i = \frac{1}{TFR_i} \times POP_{i,1971}$$

- Inter se share of States by demographic performance is given by

$$Inter\ se\ share\ of\ i^{th}\ state = \frac{DP_i}{\sum_{j=1}^{28} DP_j}$$

6. Tax Effort

- T_i= three-year (2016-17 to 2018-19) average of per capita own tax revenue of the ith State.
- $\overline{GSDPPC_i}$ = three-year average (2016-17 to 2018-19) of $GSDPPC_i$.
- Tax ratio $t_i = \frac{T_i}{\overline{GSDPPC_i}}$
- Tax effort of ith State $TE_i = t_i \times POP_i$

$$Inter\ se\ share\ of\ i^{th}\ state = \frac{TE_i}{\sum_{j=1}^{28} TE_j}$$

Chapter 7

Empowering Local Governments

In our Report for the Year 2020-21, we had recommended total grants of Rs. 90,000 crore to local governments in the ratio of 67.5:32.5 between rural and urban local bodies. Now, for the five-year period 2021-26, we recommend grants of Rs. 4,36,361 crore for local governments.

In view of the fast pace of urbanisation and future needs of the cities to act as engines of growth, and in continuation with the principles followed in the report for the year 2020-21, the ratio of inter se distribution of the grants recommended for rural and urban local bodies gradually moves from 67.5:32.5 in 2020-21 to 65:35 in 2025-26, which is the final year of our award period. For the inter se distribution of grants amongst the States, the weightage is 90 per cent on population and 10 per cent on area.

Out of the total grants earmarked for panchayati raj institutions, 60 per cent is earmarked for national priorities like drinking water supply and rainwater harvesting and sanitation, while 40 per cent is untied and is to be utilised at the discretion of the panchayati raj institutions for improving basic services.

The Commission adopted a differentiated approach in the allocation of grants to urban local bodies. Given the importance of metropolitan areas, fifty Million-Plus cities are provided with a Challenge Fund of Rs. 38,196 crore over the five-year award period. Almost one-third of this fund is for achieving ambient air quality based on identified parameters, while the remaining two-thirds is for meeting service level benchmarks on drinking water supply, rainwater harvesting and water recycling, solid waste management and sanitation.

Out of the total grant of Rs. 82,859 crore recommended for cities with less than a million population, 40 per cent of the grants is untied while 60 per cent is tied to the national priorities of drinking water, rainwater harvesting, solid waste management and sanitation.

For all local governments, both urban and rural, web-based availability of annual accounts for the previous year and audited accounts for the year before previous is an entry level qualification for grants. For urban local bodies, an additional entry level condition for receiving grants is the notification of minimum floor rates of property taxes by the relevant State followed by consistent improvement in the collection of property taxes in tandem with the growth rate of State's own gross state domestic product.

In view of the challenges of the current pandemic, out of the total grants for local governments, Rs. 70,051 crore is earmarked for the improvement of health services.

We have recommended Rs. 8,000 crore to States as grants for incubation of new cities and Rs. 450 crore for facilitating shared municipal services. The Ministry of Housing and Urban Affairs, in consultation with the States, will draw up appropriate modalities for the administration of both these grants.

7.1 Para 4 of the terms of reference (ToR) mandates the Commission 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 based on the recommendations made by the Finance Commission of the State." In addition, para 7 mandates the Commission to consider proposing measurable performance-based incentives for States, at the appropriate level of government for "(vii) provision of grants in aid to local bodies for basic services, including quality human resources, and implementation of performance grant system in improving delivery of services" and "(ix) progress made in sanitation, solid waste management and bringing in behavioural change to end open defecation."

The Evolution of Local Self-Government

7.2 Panchayats have been the fulcrum of local self-government since ancient times, exercising both executive and judicial powers over village-level issues ranging from land distribution and tax collection to disputes. However, they were not part of the formal government structure. The framers of the Constitution recognised the need to empower panchayats for the development of rural areas and Article 40 of the Directive Principles of State Policy specified that "The State shall take steps to organise village panchayats and endow them with such powers and authority as may be necessary to enable them to function as units of self-government." Since what are described in popular parlance as the urban local bodies and rural local bodies constitute local self-government in the Constitutional sense, the chapter's title is "Empowering Local Government."

7.3 The conceptualisation of the local self-government system post-Independence was done through the reports of four important committees: Balwant Rai Mehta Committee (Committee on Panchayati Raj Institutions,1957), Asoka Mehta Committee (1977-1978), G.V.K. Rao Committee (Committee On Administrative Arrangements for Rural Development and Poverty Alleviation Programmes,1985) and L.M. Singhvi Committee (1986). However, it was not until 1992, with the enactment of the Seventy-Third and Seventy-Fourth Amendments to the Constitution, that these institutions were formalised in the governance system. The year 1993 was epoch-making in decentralised governance in India with the emergence of a clear third tier in both rural and urban areas. This also broadened the role of the Finance Commission through the insertion of the sub-clauses (bb) and (c) to Clause (3) of Article 280 of the Constitution, wherein Article 280(3)(bb) refers to the measures needed to augment the Consolidated Fund of a State to supplement the resources of the panchayats in the State on the basis of the recommendations made by the Finance Commission of the State. Similarly, Article 280(3)(c) refers to the measures needed to augment the Consolidated Fund of a State to supplement the resources of the municipalities in the State on the basis of the recommendations made by the Finance Commission of the State. According to the Ministry of Panchayati Raj (MoPR), since then, approximately 3.1 million representatives are regularly elected to about 0.26 million rural local bodies all over the

country. Providing basic services at the grassroots level makes them the primary interface between citizens and the government.

7.4 Like rural local bodies, urban local bodies also have a long history. The Municipal Corporation in Chennai (then known as Madras) was set up in 1687, and the Municipal Corporations of Kolkata (then Calcutta) and Mumbai (erstwhile Bombay) followed in 1726. There are around 206 Municipal Corporations and 1,683 municipalities and 2,411 Nagar Panchayats.[1,2]

Approach of Previous Finance Commissions

Terms of Reference

7.5 Subsequent to the Seventy-Third and Seventy-Fourth Amendments, so far four Finance Commissions – FC-XI to FC-XIV – have given their recommendations for local bodies. The ToR was the same for all the Commissions. Each, accordingly, deliberated on the critical issues related to the effective functioning of the local governments and made suitable recommendations.

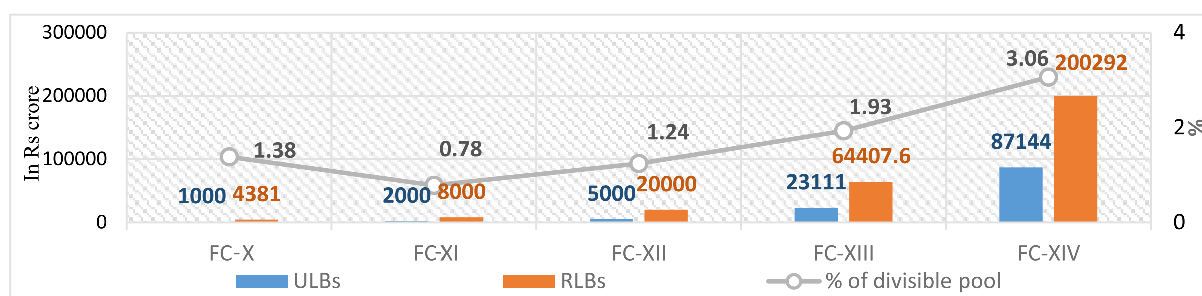
7.6 Since the FC-X was constituted in 1992, a year before the Amendments came into force, its ToR did not specify considering grants for the local bodies. However, it still recommended grants, which were equivalent to 1.38 per cent of the divisible pool, to the rural local bodies and urban local bodies in order to enable them to discharge the new role assigned to them during its award period.

Quantum of Flows

7.7 Grants recommended by successive Finance Commissions in absolute terms have been growing (Figure 7.1). For example, at Rs 2,87,436 crore, the combined grants for rural and urban local bodies recommended by the FC-XIV were three times the Rs. 87,519 crore recommended by the FC-XIII. Except for the FC-XIII, all the previous Commissions recommended such grants in absolute terms and not as a proportion of the divisible pool. If we express these grants as a proportion of the divisible pool, except for the FC-XI, the share of local governments has increased from one Commission to the next to reach 3.06 per cent under the FC-XIV. *We, in our Report for the Year 2020-21*, recommended a total grant of Rs. 90,000 crore for the year 2020-21, which was equivalent to 4.31 per cent of the divisible pool estimated by the Commission for that year.

[1] Nagar Panchayats also include town municipal councils, small town committees, town councils, notified area committees
[2] This information is compiled from the topic notes provided by the State Governments to us

Figure 7.1: Grants to Local Governments by Various Commissions



Note: RLBs – rural local bodies; ULBs – urban local bodies

7.8 The actual amounts disbursed, however, have fallen short of the amounts recommended by the Commissions (Table 7.1). The shortfall has fluctuated between 5 per cent and 18 per cent for the rural local bodies and between 10 per cent and 18 per cent for urban local bodies. The shortfalls – which were the highest for rural local bodies under the FC-X and for urban local bodies under the FC-XIII – were because of failure of the local governments to meet the conditionalities attached to the performance grants by the Commissions. Sometimes the concerned Union ministries had also added to these conditionalities.

Table 7.1: Grants Recommended Versus Actual Releases

(Rs. crore)

	Rural Local Bodies			Urban Local Bodies		
Grants	**Recommended**	**Released**	**% Released**	**Recommended**	**Released**	**% Released**
FC-X	4381	3576	81.6	1000	834	83.4
FC-XI	8000	6602	82.5	2000	1752	87.6
FC-XII	20000	18927	94.6	5000	4470	89.4
FC-XIII	64408	58257	90.7	23111	18980	82.1
FC-XIV	200292	179491	89.6	87144	74259	85.2

Note: FC-XIV: amount released till 2019-20 RE. For FC-XIII: allocation recommended was based on actual divisible pool realised. Grants proposed by FC-XIII were dynamic in nature: a) The basic grant was equivalent to 1.50 per cent of the previous year's divisible pool; b) the performance grant – effective from 2011-12 – was 0.50 per cent for 2011-12 and 1 per cent thereafter, up to 2014-15; c) grants-in-aid for local bodies in a year was based on a proportion of the divisible pool of the previous year's revised estimates; and d) Rs. 1,357 crore was allocated as special areas grant. The allocation recommended to rural local bodies also included Rs. 1,357 crore allocated to the special areas

Basis of Horizontal Distribution

7.9 Different Commissions followed distinct criteria while recommending resources to the States for local governments. While population and geographical area were common to all the

previous five Commissions, both equity and efficiency criteria like distance from highest per capita income, index of deprivation, index of decentralisation and revenue effort varied across Commissions (Table 7.2).

Table 7.2: Criteria for Distribution of Grants to States for Local Governments by Finance Commissions

(in per cent)

	FC-X	FC-XI	FC-XII	FC-XIII		FC-XIV	FC-XV
				RLB	ULB		
Population	100	40	40	50		90	90
(Census)	*1971*	*1971*	*2001*	*2001*		*2011*	*2011*
Geographical area	-	10	10	10		10	10
Distance from highest per capita income	-	20	20	10	20	-	-
Index of decentralisation	-	20	-	15		-	-
Index of deprivation			10	-		-	
Revenue effort	-	10	20	-		-	-
Proportion of scheduled castes/ scheduled tribes in population	-	-	-	10	0	-	-
FC local body grants utilisation index	-	-	-	5		-	-

Basic and Performance Grants

7.10 The FC-X stipulated that State Governments should prepare suitable schemes and issue detailed guidelines for the utilisation of grants. The local governments were required to raise matching contributions for this purpose. No grant amount was to be used for expenditure on salaries and wages.

7.11 The FC-XI made it clear 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 like provision of primary education, primary health care, safe drinking water, street lighting and sanitation, maintenance of cremation and burial grounds, public conveniences and other common property. These grants were untied, barring the stipulation prohibiting the payment of salaries and wages.

7.12 The FC-XII recommended that panchayats should use the grants to improve service delivery relating to water supply and sanitation. The rural and urban local bodies were also expected to give high priority to expenditure for the creation of databases on their finances and maintenance of accounts through the use of modern technology and management systems.

7.13 The FC-XIII stipulated six conditions for rural local bodies and nine conditions for urban

local bodies to access the performance grant. All these conditions had to be met in each of the award years. A special area grant was provided for the areas excluded from Part IX and IX-A of the Constitution. This grant had two components – a special area basic grant and a special area performance grant. Four conditions had to be met to avail of the latter. In case States were unable to draw their performance grant, the amount not drawn was to be redistributed in a specified manner.

7.14 The FC-XIV recommended grants in two parts – an unconditional basic grant and a conditional performance grant. For duly constituted gram panchayats, the ratio between the unconditional basic grant and conditional performance grant was 90:10 and for municipalities the ratio was 80:20. The basic grant was intended to be used to improve the status of specified basic civic services. The performance grant was based on revenue improvement, with the criteria (including the quantum of incentive to be given) left to be determined by State Governments. In order to be eligible for performance grants, the local governments would have to show an increase in own source of revenue and also submit audited annual accounts. Municipalities, in addition, had to publish the service level benchmarks relating to basic urban services each year. In addition, the MoPR stipulated some more conditions for availing of performance grants like completion of the Gram Panchayat Development Plan, display of sector-wise expenditure in a dashboard and assignment of scores to Gram Panchayats based on (a) percentage increase in the quantum of own source revenue, (b) open defecation free (ODF) status of Gram Panchayats and (c) level of immunisation in Gram Panchayats.

7.15 Unlike the FC-XIV, our report for 2020-21 provided grants to all the three tiers of panchayats as well as to areas under the Fifth and Sixth Schedules of the Constitution and Cantonment Boards in urban areas. Fifty per cent of the grants to rural local bodies were tied to (a) sanitation and maintenance of ODF status and (b) supply of drinking water and rainwater harvesting. As the grants were stipulated only for one year, no performance conditions were imposed for their release. For the Million-Plus cities, that is cities or urban agglomerations with population more than a million, in 2020-21, the total grant of Rs. 9,229 crore was fully tied (Rs. 4,400 crore for the improvement of ambient air quality and Rs. 4,829 crore for the improvement of conservation, supply and management of water and efficient solid waste management). This grant was to be released in two equal instalments, and the release of the second instalment with respect to ambient air quality in the second half of 2020-21 was conditional on improvement in air quality. The first instalment was to be used for steps relevant for measurement as well as improvement of services. Going forward, a roadmap clearly indicated that such performance criteria would determine the release of the relevant grants in the 2021-22 to 2025-26 period. For urban local bodies in towns other than Million-Plus cities, 50 per cent of the grants were tied to (a) drinking water (including rainwater harvesting and recycling) and (b) solid waste management. In our report for 2020-21, we paid particular attention to the long-standing issue of non-availability of accounts, including audited accounts, in the public domain on a timely basis.

Accounts and Audit

7.16 For any part of the government using tax-payers' money, availability of accounts (including audited accounts) in the public domain on a timely basis is a primary requirement for good governance. In the absence of such information, previous Finance Commissions have also highlighted the difficulties in realistically assessing the requirement of resources by rural and urban local bodies for carrying out their core functions and for development expenditure. Various Commissions, starting from the Eleventh, have highlighted this issue, but there has been inadequate progress on this front. To bring an end to this long-standing vexed issue, we had clearly stated, in our report for 2020-21, that availability of accounts (unaudited) for the previous year and audited accounts for the period preceding the previous year in the public domain online would be an entry-level condition for qualifying for any grant.

7.17 There are two major problems with the accounts of local governments in India: (a) the lack of timely accounts, including audited accounts, on a timely basis and (b) the classification of their accounts to make them amenable to consolidation with Union and State Governments' accounts. The FC-XI recommended that the Comptroller and Auditor General (CAG) 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 its audit report should be placed before a committee of the State legislature.

7.18 The FC-XII recommended that the compilation of disaggregated data in the formats suggested by the CAG is necessary for State Finance Commissions to be able to assess the income and expenditure requirements of the local governments. Priority should be given to the creation of a database and maintenance of accounts through the use of modern technology and management systems.

7.19 The FC-XIII recommended that while the CAG should provide technical guidance and supervision, a major portion of the actual auditing would have to be undertaken by the local fund audit departments. Hence, all State Governments should strengthen their local fund audit departments appropriately through both capacity building of existing manpower as well as augmentation of personnel.

7.20 The FC-XIV recommended that accounts prepared by the local governments should distinctly capture income from own taxes, assigned taxes, grants from the State, Finance Commission grants and grants for any agency functions assigned by the Union and State Governments. In addition, it also recommended that technical guidance and support arrangements by the CAG should be continued and States should facilitate local bodies to compile accounts and have them audited in time.

7.21 In our report for 2020-21, we recommended timely availability of accounts, both before and after audit, of individual local governments online in the public domain from 2021-22 as the entry level conditions for both rural and urban local bodies to qualify for its recommended grants.

Treatment of Excluded Areas

7.22 Under Article 243M of the Constitution, the Seventy-Third and Seventy-Fourth Amendments do not apply to the Fifth and Sixth Schedule areas (areas where the States have not enacted laws for establishing duly-elected panchayats and municipalities). After the enactment of the Panchayats (Extension to Schedule Areas) Act (PESA), 1996, the areas that remain excluded are given in Table 7.3.

Table 7.3: Areas where Provisions of Parts IX and IX-A of the Constitution Do Not Apply

State/Area within a State	Provisions under which exempt
Meghalaya	Exempt under Article 243M and covered by Sixth Schedule, except selected areas of Shillong Municipal Areas
Mizoram	Exempt under Article 243M, with two administrative districts Lawngtai and Saiha covered by Sixth Schedule
Assam:Bodoland, North Cachar and Karbi Anglong districts	Covered by Sixth Schedule
Tripura	Only Tripura tribal district is covered by Sixth Schedule
Nagaland	Exempt under Article 243M and not covered by Sixth Schedule
Manipur: Hill areas for which District Councils exist	Exempt under Article 243M and not covered by Sixth Schedule
West Bengal: The hill areas of the district of Darjeeling, covered by the Darjeeling Gorkha Hill Council	Exempt under Articles 243M (3) /243ZC (2) of the Constitution and not covered by Sixth Schedule

7.23 The FC-X mandated that grants would be distributed to even those States which are not required to have panchayats in order to supplement the resources of similar local level representative bodies. However, the FC-XI stipulated that its award for Excluded Areas should be made available to the respective States only after the enactment of relevant legislative measures for the extension of the provisions of the Seventy-Third and Seventy-Fourth Amendments to such areas.

7.24 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 noting that a bill for amending the Sixth Schedule in order to extend certain provisions of the Seventy-Third and Seventy-Fourth Amendments to these excluded areas was then under consideration in the Ministry of Home Affairs.

7.25 While the FC-XIII recommended grants of Rs. 1,357 crore for the Excluded Areas after considering Parts IX and IX-A, Articles 244, 280 and 275 of the Constitution, the FC-XIV did not recommend grants to these areas.

7.26 While the FC-XIV recommended no grants to the Excluded Areas, we, in our report for 2020-21, recommended grants for such areas falling within a State, based on population and area in the ratio of 90:10.

Status and Effectiveness of State Finance Commissions

7.27 According to the Constitution (Articles 243-I(1) to 243-I (4)), SFCs are, at the State level, what the Finance Commission is at the level of the Union. As originally envisaged, Finance Commissions are to make recommendations on measures to augment the Consolidated Fund of a State to supplement the resources of local governments on the basis of recommendations made by SFCs.

7.28 Article 243-I of the Constitution requires SFCs to be appointed at the 'expiration of every fifth year'. The intention of this clause appears to be that all State Government transfers to local governments should be governed by the mandate of a current SFC. The mandate given to an SFC should thus be applicable only for a period of five years and should not be extended. In practice, this has not happened. Finance Commissions have not got the benefit of recommendations of SFCs, as most State Governments did not constitute them in time and did not give due importance to strengthening this critical constitutional mechanism. Even now, only fifteen States have set up the fifth or the sixth SFCs. Several States have still not moved beyond the second or third SFC. The current Commission too faces a similar challenge in suggesting measures based on the recommendations of SFCs. Table 7.4 shows the current status of SFCs in the States.

Table 7.4: Status of Constitution of SFCs

State	Last SFC Constituted
Assam, Bihar, Punjab, Rajasthan	VI
Haryana, Himachal Pradesh, Kerala, Madhya Pradesh, Maharashtra, Odisha, Sikkim, Tamil Nadu, Tripura, Uttarakhand and Uttar Pradesh	V
Andhra Pradesh, Karnataka and West Bengal	IV
Chhattisgarh, Goa, Gujarat, Jharkhand and Manipur	III
Arunachal Pradesh, Mizoram	II
Erstwhile Jammu and Kashmir, Telangana	I

Source: MoPR inputs submitted to FC-XV

7.29 SFCs face significant challenges in the form of poor administrative support, inadequate resources for their smooth functioning and the delayed placement of action taken reports (ATR)

before State legislatures. According to a study by the National Institute of Public Finance and Policy (NIPFP), commissioned by us, the average delay in SFCs submitting their report has been about sixteen months.

Views of Stakeholders

Union Government

7.30 The Commission held meetings with various Union Ministries to understand the requirement of funds during its award period. The MoPR and Ministry of Housing and Urban Affairs (MoHUA) are the nodal ministries dealing with rural local bodies and urban local bodies respectively and have advocated comprehensive schemes and quantum of grants that should flow to both. These are summarised below.

Ministry of Panchayati Raj

7.31 The MoPR submitted its revised memorandum to us after we submitted the report for 2020-21. The Ministry suggested that grants to the panchayati raj institutions for the award period of 2021-26 should be raised to Rs. 10 lakh crore. It also suggested that for the initial four years, that is 2021-22 to 2024-25, this grant may be kept as 50 per cent untied for ensuring basic services and 50 per cent tied to drinking water supply and sanitation. In the fifth year, 2025-26, the tied component of the grant may be reduced to 25 per cent and the untied may be increased to 75 per cent, taking into account the progressive saturation that is expected to be achieved in drinking water supply and sanitation. Out of the untied grants, the panchayati raj institutions may be allowed to carry out the basic services through either outsourcing or contract engagements. They may also utilise the grants for various revenue/recurring expenditures such as operation, maintenance, wage payments, internet and telephone expenses, fuel expenses, rentals and contingency expenditure during calamities.

7.32 The Ministry sought an additional grant of Rs. 12,000 crore for the five-year period to enable Gram Panchayats without an office building to construct one in a time-bound manner. It also requested grants for the construction of multi-purpose community halls/centres in all Gram Panchayats, in order to provide a critical rural infrastructure for the holistic development of rural areas and for community-based organisations such as women self-help groups. The MoPR also highlighted the critical role played by the panchayati raj institutions by leveraging community capacities (Box.7.1).

Box 7.1: Partnerships, Convergence and Community Cadre

Representatives of panchayati raj institutions across the country have been very active in controlling the spread of the Covid-19 pandemic. They have collaborated closely with various stakeholders, self-help groups (SHGs), frontline health workers – auxiliary nurse midwife (ANM), accredited social health activists (ASHA) and anganwadi personnel – to roll out several initiatives such as didi/community kitchens set up under the Mid-Day Meal programme/POSHAN Abhiyan. They also took the responsibility of equipping the SHGs to run community kitchens and supplied food grains through the public distribution system. The panchayati raj institutions, operating as the third tier at the grass root level, highlighted the necessity and benefits of developing and tapping community capacities in times of crisis and creating a strong social cadre.

Ministry of Housing and Urban Affairs

7.33 The MoHUA also submitted a revised memorandum, after the release of our report for 2020-21, highlighting the following issues:

i. The mandatory condition of growth of property tax in tandem with the growth of gross state domestic product (GSDP) in order to qualify for grants, made by us in the report for 2020-21, may be removed as there is no correlation between the two. Instead, it should be mandatory for urban local bodies to notify a road map for increasing collection of property taxes and user charges to cover operations and maintenance cost.

ii. The MoHUA must be made the nodal ministry with respect to grants for Million-Plus cities to take steps to check air pollution, like use of mechanical sweeping machines, promotion of non-motorised transport (pedestrian and cycle), paving the side flanks of the road with facility for water percolation, etc. The Ministry of Environment, Forests and Climate Change (MoEF&CC) may be given a separate grant for installation of systems to monitor air quality.

iii. Separate grants may be allocated to urban local bodies for public health infrastructure and primary health care clinics in informal settlements and low-income neighbourhoods.

iv. An active municipal borrowing market must be created through the cityfinance portal, which serves as a national framework of standardised, timely and credible financial information on cities. It facilitates benchmarking, comparison and peer learning between cities on a range of financial indicators.[3]

v. A substantial increase in grants is needed for bridging the resource gap of municipalities, which is anticipated at Rs. 12.27 lakh crore over the period 2021-22 to 2025-26.

vi. Devolution to municipalities may be increased by at least four times (Rs. 3,48,575 crore), as compared to the FC-XIV award.

[3] https://cityfinance.in/home

vii. The MoHUA and the Controller General of Accounts (CGA) should develop an account maintenance system, National Municipal Accounting Manual (NMAM), which will be integrated with the Public Financial Management System (PFMS). For this, the Ministry suggested a total fund requirement of Rs. 213 crore (Rs. 193 crore to State Governments and Rs. 20 crore to the MoHUA).

viii. The Ministry sought Rs. 450 crore for building service centres shared by municipal clusters.

ix. The Ministry was of the view that instead of a model property tax legislation, what is required is a toolkit consisting of (a) best practices across States/cities in each stage of the property tax lifecycle; and (b) model statutory provisions that can be incorporated within existing property tax rules to strengthen administration. It informed us that a consultative group of urban development ministers from six States (Gujarat, Odisha, Tamil Nadu, Punjab, Tripura and Uttar Pradesh), constituted to pursue our recommendations on property tax, has reviewed the municipal legislations of all twenty-eight states and identified the best practices in laws, procedures and on-ground activities.

Ministry of Jal Shakti

7.34 The Department of Drinking Water and Sanitation (DDW&S) in the Ministry of Jal Shakti proposed that 25 per cent of the basic grant for local governments should be earmarked for creating and maintaining drinking water and sanitation infrastructure. Parameters such as achievement and sustenance of ODF status, increase in solid and liquid waste management infrastructure and improvements in access to safe drinking water infrastructure should be set to make the local governments eligible for performance grants.

7.35 The DDW&S is closely working with the MoPR and the Department of Expenditure, Ministry of Finance, on implementing our recommendations, in the report for 2020-21, on tied grants related to water supply and sanitation. Both the MoPR and the DDW&S issued a joint advisory to all States on the broad framework to be followed in respect of these grants. It was proposed that 50 per cent of Finance Commission grants to panchayati raj institutions for water supply and sanitation shall be placed at the disposal of the DDW&S and funds would be channelised through it for better implementation of programmes and proper utilisation of grants. This would help in achieving the goal of the Jal Jeevan Mission to provide assured potable water to every household in adequate quantity and of prescribed quality on a long-term basis. Gram Panchayats should have five-year perspective plans in the form of village action plans indicating quantifiable targets for this purpose.

Ministry of Environment, Forests and Climate Change

7.36 Confident about the systems already created under the National Clean Air Programme

(NCAP), the MoEF&CC had sought funds for air quality improvement in Million-Plus cities from 2020-21 onwards, based on the reductions in the average annual concentrations of both PM_{10} and $PM_{2.5}$. Accordingly, we had recommended grants for 2020-21 and also laid out a roadmap as advised by the Ministry. However, in its revised memorandum, the MoEF&CC favoured a different approach and recommended evaluation of performance grants based on improvement by States on four parameters: (a) strengthening of the institutional framework for monitoring air quality; (b) source-wise cause analysis for air pollution; (c) progress on action plans and compliance of statutory guidelines; and (d) quantification of air quality improvement. The relative weights assigned to these factors shift over the award period, with more emphasis on institution and capacity building in the initial years and on outcomes in the later years.

Other Ministries

7.37 The Ministry of Finance emphasised the importance of setting up of SFCs and suggested that the timely submission of SFC reports may be made a mandatory condition for the transfer of local body grants to States. It also proposed that States be encouraged to transfer more sources of revenue, like registration fees, to local governments.

7.38 The Ministry of Women and Child Development stressed the need to link the performance grants for rural local bodies to indicators relating to women and children. This may include earmarking at least 30 per cent of the total Gram Panchayat budget towards women-centric programmes, encouraging the mandatory establishment of Mahila Sabhas in every State, collection of gender-disaggregated data and regularisation of ASHA workers.

7.39 The Ministry of Tribal Affairs proposed that Excluded Areas should be considered for grants while making recommendations for panchayati raj institutions.

7.40 The Directorate General of Defence Estates, Ministry of Defence, proposed the inclusion of cantonments under the grants for urban local bodies, citing their similarity with municipalities. It sought a grant of Rs. 1,035 crore for sixty two cantonments across seventeen States and two Union Territories (Delhi and Jammu & Kashmir) for our award period. The Department also stressed the dire need of resources for Cantonment Boards owing to their limited taxation capacity and revenue loss on account of taxes being subsumed into GST.

State Governments

7.41 In their memoranda to the Commission, most of the States demanded that we significantly increase support to local governments. Some States also suggested that local governments may be given a share of the divisible tax pool over and above the State's share (as FC-XIII had partially done), so that they get the benefit of buoyancy in the Union's tax revenues.

7.42 Almost all the State Governments urged that grants be provided for all the three tiers of

rural local bodies instead of only Gram Panchayats. Some States, wherever relevant, urged that grants should be provided to the Excluded Areas, as the Constitutional amendment Bill regarding the recognition of village councils is still pending with the Union Government.

7.43 The States had differentiated views on the weightage allotted to parameters for inter se distribution between the States. While some States suggested continuation of the existing parameters of population and area, others suggested the use of indicators of urbanisation rate, transfers of funds, functions and functionaries (3Fs) to local governments, devolution index and so on.

7.44 States like Tamil Nadu and West Bengal suggested that performance-based grants should be linked to (a) green and non-conventional energy initiatives by local governments and (b) digitisation of the provision of various services, assessment (including of property tax) and audit at the grass root level.

7.45 Assam and Kerala advocated the use of the urbanisation rate of States as a parameter for the inter se distribution of grants between rural local bodies and urban local bodies in lieu of the national average rate of urbanisation as applied for the grants for 2020-21. Manipur proposed that we should consider extending local governments grants to Autonomous District Council (ADCs) areas that do not fall under Sixth Schedule Areas in the State but are excluded under Part IX and Part IX-A of the Constitution.

Representatives of Local Governments

7.46 We held detailed consultations with elected representatives of local governments of each tier as well as the ADCs during our visits to the States. Important suggestions received were in the three categories: decentralisation issues, operational issues and issues on utilisation of Finance Commission grants.

Decentralisation Issues

i. In almost every State, representatives of rural local bodies unanimously sought distribution of grants among all the three tiers, because all of them are part of the panchayat system within the Constitution. This would increase the effectiveness of rural local bodies in public service delivery (such as rural connectivity, education, health, drinking water, sanitation) by pooling of human and other resources and skills.

ii. Effective delegation of funds, functions and functionaries is still pending in some States, despite transfer of all twenty-nine subjects to the rural local bodies.

iii. Appropriate measures should be taken to ensure that for the release of grants, no additional conditions, other than those indicated by us, are imposed on local governments by the Union or the State Governments.

Operational Issues

i. The ceiling of annual professions tax should be raised from the current Rs. 2,500.

ii. Local governments should be permitted to levy tax on the properties of the Union and State Governments.

iii. Grants should be provided to the Sixth Schedule areas and other Excluded Areas.

Issues on Utilisation Of Finance Commission Grants

i. Grants should not be rigidly confined to a few specific sectors and local governments should have the flexibility to use these in sectors they consider as priority ones.

ii. Finance Commissions should support the establishment of a GIS-based property tax system for all local governments with the objective of strengthening their revenues.

iii. Funds should be earmarked for the creation of databases at the level of local governments, while providing them the flexibility to hire or outsource specialised manpower for this.

iv. Limited manpower, lack of technical support, high cost of construction in hilly areas and inadequate resources were the main problems of local governments.

v. Municipalities should be provided more resources to create and expand civic amenities. The need for resources has increased manifold because of the severe strain on the existing infrastructure as a result of the increase in floating population and tourists. There is also a need to provide basic urban infrastructure to meet the needs of the growing urban population due to intra- and inter-State migration.

vi. Performance grants are highly commendable as they incentivise and reward better performance, but backward areas face considerable challenges in meeting the performance conditions.

Studies Commissioned by FC-XV

7.47 We commissioned thirteen studies to analyse various issues related to local governments. These can be grouped under four heads:

i. **Analysis of overall trends of FC-XIV flows:** “Devolution of Union Finance Commission Grants to Panchayats” and “Analysis of Fund Flows to Rural Local Bodies” by the Centre for Policy Research (CPR) and “Design of Inter-Governmental Fiscal Transfers in India to Rural Local Governments” by the Indian Institute of Public Administration (IIPA).

ii. **Review and analysis of functioning of SFCs across States:** “Overview of State Finance Commission Reports" by NIPFP.

iii. **The dynamics of the growing urban sector and measures to address the associated challenges:** "Status of Municipal Finance in India" and "Finances of Municipal Corporations in Metropolitan Cities of India" by the Indian Council for Research on International Economic Relations (ICRIER); "A Municipal Finance Blueprint in India" by Janagraha; "Urban Infrastructure and Resilience" and "The Potential of Urbanisation to accelerate post-COVID Economic recovery" by the Indian Institute for Human Settlements (IIHS); and "Property Taxation in India" by the World Bank.

iv. **Analysis of the impact of rising air pollution on urban areas of India: study on "Air Pollution:** Enabling Outcome Linked Clean Air Financing" undertaken by World Resource Institute (WRI), "Targeting Improved Urban Air Quality Outcomes Through Performance Grants" by the World Bank and "Current State and Sources of Air Pollution and Solutions" by The Nature Conservancy.

All the studies are available on the website of the Finance Commission.[4]

7.48 One of the important findings was that the tendency to impose conditionalities has given rise to the temptation by both the Union and State Governments to interfere, in the name of convergence, in the powers of the panchayats to select schemes. It was highlighted that the challenge for the Commission would be to avoid the pitfalls of earlier Commissions and to see how to continue providing largely untied grants to local governments, while ensuring a modicum of expenditure responsibility and accountability. The Commission needs to examine the context in which conditionalities are imposed and whether they set out perverse incentives and are open to subversion.

Immediate Challenges

7.49 The studies also highlighted the key challenges that are being faced by urban areas and how addressing them is the key to enabling them to emerge as growth engines.

Property Taxes

7.50 The report by the World Bank highlighted the fact that India compares unfavourably with Organisation for Economic Co-operation and Development (OECD) as well as BRICS countries such as Brazil and South Africa in terms of revenues from the urban immovable property tax.[5] In 2016, while the average collection from property taxes as a proportion of gross domestic product (GDP) was about 1.1 per cent in the OECD group, it was only about 0.2 per cent in India. In countries such as Canada, the United Kingdom and the United States, property tax collections form the bedrock of local governments' revenues and are about 3 per cent of their

[4] https://fincomindia.nic.in/ShowContentOne.aspx?id=27&Section=1
[5] BRICS is an abbreviation for Brazil, Russia, India, China, and South Africa.

respective GDPs. Several factors lead to low property tax revenue in India: undervaluation, incomplete registers, policy inadequacy and ineffective administration. Another big challenge for property tax administration is the lack of accurate property tax records with the urban local bodies. Some of the best practices from States that can serve as a role model for other States to boost property taxation revenue are listed in Box 7.2.

Box 7.2: Best Practices in Property Taxation in States

Karnataka: AASTHI project for GIS-based property tax system

a. Property tax valuation was changed from annual rental value assessment to a capital value method.

b. The Revenue Departments of all the urban local bodies were computerised and a GIS-based property tax information system put in place.

c. Field surveys using digitised ward maps with individual properties and unique property ID were conducted in over 1.5 million properties.

d. Cadastral-level GIS maps were generated for over 200,000 square km, covering over 3.8 million properties in the State.

Reform Result

a. 1.2 million previously unassessed properties (42 per cent of the total) were brought into the tax net.

b. Revenue increase by 30–40 per cent.

c. Dramatic decline in citizens' complaints of calculation errors owing to the online calculations.

d. Automation resulting in real-time data on collection of property tax by the urban local body.

Ranchi: Optimisation of Tax Collection

In 2014, the Ranchi Nagar Nigam entered into an agreement with a private agency for providing managed services for collection of tax and other charges from properties within the jurisdiction of the urban local body through a competitive bid process.

a. Property tax demand notice was generated in real time using hand-held devices linked with the back office and banking records along with door-to-door collection through cash/cheque/demand draft from the assessees.

b. An online helpline, chat, SMS, and telephonic services were set up for grievance redressal.

Reform Result

Property tax collection in Ranchi Nagar Nigam since outsourcing

Within three years, there was a four-fold increase in property tax collection in Ranchi from Rs. 9 crore in 2014 to Rs. 43 crore in 2017.

Financial Year	2014	2015	2016	2017
No. of tax collectors deployed by the agency	110	110	110	110
No. of properties	96,000	100,000	103,000	160,000
Growth in assessment base	2%	4%	3%	55%
No. of properties per collector	873	909	936	1,455

Source: Ranchi Nagar Nigam.

Pune Municipal Corporation (PMC): Reforms in assessment, billing, and collection project

a) In 2013, the introduction of a GIS-based system for city mapping and creation of unique IDs for all properties led to the creation of a digital property database. This increased the assessed properties by 18 per cent.

b) Self-assessment has been made mandatory every year. Penalties are in place for non-submission, withholding of information and submission of false information.

c) Pune Municipal Corporation moved to a capital value-based system which considers the increasing value of properties for property tax assessment, making it a more progressive and buoyant tax system.

The resultant increase in property tax collection in PMC was 29 per cent in 2011–12. Property tax revenue has doubled from 2013–14, reaching Rs. 1,158 crore in 2016–17.

Source: World Bank Report on Property Taxation to the Commission

7.51 The study by Janagraha analysed the property tax life cycle consisting of five stages: enumeration (counting of properties), valuation (assigning values to properties for the purpose of taxation), assessment (assessing the property tax payable by each property), billing and collection. It was highlighted that though all the States have Municipal Acts, property tax forms a small section in all of them. There is significant variation in Municipal Acts across States (summary of the Acts of all twenty-eight States is at Annex 7.1) with regard to enumeration, valuation, assessment, billing and collection.

Outcome Based Incentives for Metropolitan Cities

7.52 Air pollution has become a critical challenge in metropolitan cities in recent times. Measuring and assessing clean air achievements is not always a straightforward exercise, particularly in the Indian context of limited monitoring of air quality within and outside cities. In its study, the WRI highlighted issues pertaining to the measurement and monitoring of air pollution. First, most of the cities in question must have sufficient monitors in place to meet basic standards for PM_{10}, $PM_{2.5}$, ozone, NOx or other criteria pollutants regulated under India's Prevention and Control of Air Pollution Act, 1981. Second, the degree of control that a city or State has over air pollution varies. City air quality depends not only on the city's actions, but also on climate, weather as well as emissions that originate outside the cities. The ability of cities to control their "own emissions" (emissions within the territorial boundaries) also varies. Air pollution is caused by transportation, construction and road dust, household energy use (biomass burning, emissions from diesel generators), industrial emissions, industrial energy use and improperly managed solid waste, among others. The relative contribution of each of these sources varies across cities. Some of these can be influenced by actions within a city, others are more dependent on State or national policies beyond the control of the cities. In short, effort and achievement are not always tightly correlated.

7.53 Monitoring networks for quantifying improvements in air quality should be based on at least meeting Central Pollution Control Board (CPCB) guidelines for maintenance of monitors and reporting of data, cities should be encouraged to use high quality scientific data beyond that produced by the pollution control board networks and air quality achievements should be assessed across long-running averages of air quality to avoid being influenced by seasonal variations or particular episodes beyond a city's control.

7.54 The World Bank, in its discussion with us, highlighted that air pollution is not a localised phenomenon. The effect of pollution may be felt in cities and towns far away from the source. Thus, there is a need to create an effective and sustained institutional mechanism for inter-State and inter-city coordination, in addition to multi-sectoral synchronisation. A large number of Million-Plus cities do not meet the standards for pollutants (particulate matter). This not only affects people's health but also hinders trade, investment and various economic activities in these cities.

7.55 Strengthening, on an ongoing basis, the knowledge of sources of pollution and emissions and expanding the ambient air quality monitoring network in cities and across States to get consistent year-on-year data of particulate matter is imperative.

Nine Guiding Principles

7.56 We have arrived at our recommendations after duly considering all inputs received from the extensive consultations with the State Governments, representatives of local governments, Union Ministries and reports commissioned for this purpose. The nine guiding principles that run as a common theme across all our recommendations for the local governments are:

i. Relevant ToR and the Constitutional provisions.

ii. Pre-requisite of timely online availability in the public domain of both the accounts of the previous year and audited accounts of the year before the previous year for availing of grants for both rural and urban local bodies.

iii. Pre-requisite of notifying minimum floor on property tax rates by States in order to increase the buoyancy of revenue of urban local bodies.

iv. Inclusive and uniform approach for all three tiers within rural local bodies, Excluded Areas and cantonment areas.

v. Inter se rural and urban share of devolution in the context of the evolving urban complexities and challenges.

vi. Differential needs of urban habitations, including the special needs of emerging large urban areas as “agglomeration economies”.

vii. Air pollution in Million-Plus urban agglomerations.

viii. Focus on national priorities related to (a) strengthening of primary health care and

creation of diagnostics infrastructure for management of disease and epidemics at the local level; (b) solid waste management; (c) provisioning for drinking water and sanitation; and (d) promoting and incentivising water recycling, rejuvenation and rainwater harvesting.

ix. Importance of generation of internal resources like revenues from property taxation and tax on professions.

Absence of SFC recommendations

7.57 The lack of effectiveness of SFCs has already been discussed in detail. Previous Finance Commissions had to make recommendations without the benefit of recommendations of SFCs and they, therefore, developed their own criteria and conditionalities for transferring grants. Thus, despite a Constitutional mandate that recommendations of the SFCs shall be the basis for Finance Commissions to consider the measures to augment the Consolidated Fund of States, this could not be followed. As we have pointed out in para 7.28 and as Table 7.4 clearly revealed, there is no improvement in the situation. It would have been open to us to take into account the failure of State Governments to constitute SFCs in a timely manner or that of the SFCs to give their recommendations and deny grants for local governments in such States. However, we have eschewed this option, keeping in view the genuine requirements of the third tier institutions and the service they provide to the people. At the same time, we note this with dismay and expect all those States which need to discharge the given Constitutional responsibilities to ensure that the SFCs are constituted and their recommendations are implemented in a timely manner both in letter and spirit.

7.58 **Accordingly, we recommend that all States which have not done so, must constitute SFCs, act upon their recommendations and lay the explanatory memorandum as to the action taken thereon before the State legislature on or before March 2024. After March 2024, no grants should be released to a State that has not complied with the Constitutional provisions in respect of the SFC and these conditions. The MoPR will certify the compliance of all Constitutional provisions by a State in this respect before the release of their share of grants for 2024-25 and 2025-26.**

Grants to Local Governments

7.59 Grants to local governments are discussed in six parts: (a) total envelope of grants for local governments, (b) grants for rural local bodies, (c) grants for urban local bodies, (d) grants for health to be channelised through local governments, (e) performance-based grants to the urban sector for the incubation of new cities and (f) grants for shared municipal services.

Total Grants for Local Governments

7.60 **We recommend total grants for duly constituted local governments that add up to Rs. 4,36,361 crore for the period 2021-26. We favour a fixed amount rather than a proportion of the divisible pool of taxes to ensure greater predictability of the quantum and timing of fund flow.**

7.61 **Of these total grants, Rs. 8,000 crore is performance-based grants for incubation of new cities and Rs. 450 crore is for shared municipal services.** These grants are detailed in paras 7.148 to 7.154. **In view of the current pandemic, the Commission has decided to provide grants of Rs. 70,051 crore to strengthen and plug the critical gaps in the health care system at the primary health care level.** The details are at paras 7.136 to 7.147. Table 7.5 details the distribution of the remaining Rs. 3,57,860 crore out of the total grants of Rs. 4,36,361 crore recommended for local governments. The ratio of inter se distribution between rural local bodies and urban local bodies is different for each year; it gradually moves from 67:33 in 2021-22 to 65:35 by the end of the award period.

Table 7.5: Grants to Local Governments

(Rs. crore)

Grants	2021-22	2022-23	2023-24	2024-25	2025-26	Total
1. Total grants for rural and urban local bodies	80207	82613	85091	89997	90003	**427911**
(a) Grants for primary health sector	13192	13192	13851	14544	15272	**70051**
(b) Other grants to be disbursed among the local bodies excluding (a) above	67015	69421	71240	75453	74731	**357860**
Inter-se distribution of grants at (b) above between RLB and ULB	67: 33	67: 33	66: 34	66: 34	65: 35	-
(I) Grants for RLBs	44901	46513	47018	49800	48573	**236805**
(ii) Grants for ULBs	22114	22908	24222	25653	26158	**121055**
2. Grants for incubation of new cities		2000	2000	2000	2000	**8000**
3. Grants for shared municipal services	90	90	90	90	90	**450**
Grand Total (1+2+3)	**80297**	**84703**	**87181**	**92087**	**92093**	**436361**

Grants for Rural Local Bodies

7.62 **A total of Rs. 2,36,805 crore is recommended for duly constituted rural local bodies for the period 2021-26. Inter se distribution amongst the States is with a weight of 90 per cent on population and 10 per cent on the area of the States. The detailed methodology is in Annex 7.2. The share of each State is detailed in Annex 7.3. The quantum of grants for rural local bodies and urban local bodies from the total allocation of grants in each State is based on the ratio 67:33 for the first two years of 2021-22 and 2022-23, 66:34 in the next two years of 2023-24 and 2024-25 and 65:35 in the last year of the award, namely 2025-26.** The details are in Annex 7.4.

All Tiers Covered

7.63 **Similar to what we had done in our report for 2020-21, we recommend that for the five-year award period (2021-22 to 2025-26) grants should go to all the three tiers of panchayati raj institutions.** This is also in line with the suggestion made by almost all elected representatives of panchayats and State Governments. The three tiers are parts of one system and are interlinked through backward and forward linkages. Availability of funds to all three tiers would improve functional coordination among them and facilitate the creation of assets across smaller jurisdictions, thereby increasing project viability in such areas.

Excluded Areas Covered

7.64 The approach of the previous Finance Commissions to the allocation of grants to the Fifth Schedule and Sixth Schedule areas and Excluded Areas has already been discussed earlier. With the passage of the Panchayats (Extension to the Scheduled Areas) Act (PESA), 1996, the provisions of Part IX of the Constitution relating to the panchayats have been extended to the Fifth Schedule areas. The tribal areas included in the Sixth Schedule still remain outside its purview. According to the Ministry of Home Affairs, in February 2019, a draft Constitutional Amendment Bill for Article 280 to extend financial resources and administrative powers to the Sixth Schedule Autonomous Councils was introduced in the Rajya Sabha. In the light of the Constitutional provisions and the ToR, we intensively deliberated upon the issue and decided to follow the path advocated by the FC-XIII.

7.65 The Finance Commission is required to recommend measures to augment the Consolidated Fund of a State to supplement the resources of panchayats and municipalities on the basis of the recommendations made by the relevant SFC. The ToR of this Commission do not include the provisos to Article 275(1) relating to grants to the Sixth Schedule areas. Thus, grants-in-aid meant for panchayats given to the Consolidated Funds of States cannot be expected to be apportioned to the Excluded Areas and the Sixth Schedule areas, as these areas are excluded from the ambit of the recommendations of the SFCs.

7.66 However, this Commission finds no reason to depart from the course of action followed by the previous Commissions who also had similar ToRs. The argument then used was to earmark grants for such Excluded Areas under Article 275, notwithstanding the specific exclusion in the ToR. Accordingly, taking into account the per capita grants that are considered due to every resident in India and in order to promote uniformity of approach across all States in the matter of devolution to local governments, **we recommend that grants shall be distributed to even those areas which are not required to have panchayats (Fifth and Sixth Schedule areas and Excluded Areas) in order to augment the resources available for providing basic services by their respective local level bodies.**

Basis of Intra-Tier Distribution

7.67 **All the tiers in the panchayats – village, block and district – shall receive the grants.** The inter se distribution among all the tiers should be done by the State Governments on the basis of the accepted recommendations of the latest SFC and in conformity with the following bands of (a) not less than 70 per cent and not more than 85 per cent for Gram Panchayats, (b) not less than 10 per cent and not more than 25 per cent for Block Panchayats and (c) not less than 5 per cent and not more than 15 per cent for Zilla Panchayats, subject to the shares adding up to 100 per cent. In States, which have a two-tier system with only village and district panchayats, the allocation will be in the bands of not less than 70 per cent and not more than 85 per cent for village panchayats and not less than 15 per cent and not more than 30 per cent for district panchayats. In the event of SFC recommendations not being available, the inter se distribution within the tiers should be decided by the State Government within the bands indicated above. Once the State-level grants are earmarked for each tier, the intra-tier distribution among the relevant entities across the State should be on the basis of population and area in the ratio of 90:10 or as per the accepted recommendations of the latest SFC.

Table 7.6: Range for Distribution of Funds to the Three Tiers

Range for distribution	Gram Panchayat	Block Panchayat	District Panchayat
Minimum	70%	10%	5%
Maximum	85%	25%	15%

Note: Subject to the percentages adding up to 100

7.68 In respect of allotment of grants for Excluded Areas in a State exempted from the purview of Part IX and Part IX-A of the Constitution, the concerned State shall make allocations on the basis of population and area in the ratio of 90:10. The concerned State Government should allot these grants for each year at the beginning of the financial year and intimate the same to the ministries of Home Affairs and Finance.

Accounts and Audit

Integration of the Financial Management Systems

7.69 In our report for 2020-21, we reiterated that timely availability of audited accounts – separately at the local body level and jointly at the State and all-India level – continues to be a problem despite the emphasis laid by previous Commissions. We consider the availability of accounts online, both before and after audit, of all three levels of government a critical reform agenda. In our report for 2020-21, we recommended that the upgraded PRIAsoft software needs

to be integrated with the Integrated Financial Management Information System (IFMIS) of the State Governments (wherever it exists) and the Public Financial Management System (PFMS) of the CGA in the Union Government in order to generate online accounts by each rural local body, enable online auditing of such accounts and their consolidation at the State and all-India levels.

7.70 To achieve this objective, the report for 2020-21 suggested a two-stage process. First, the integration of the PRIASoft and NMAM systems with the State-level IFMIS and, subsequently, with PFMS to achieve complete integration. It recommended that in 2020-21, under the guidance of the CAG, the concerned ministries and CGA shall develop, on a trial basis, an integrated account maintenance system as stated above for the States before 31 March 2021, ready for full roll-out from 1 April 2021.

7.71 As a follow up on this recommendation, we interacted with all the stakeholders, namely, CAG, CGA, MoPR and MoHUA. It is worth mentioning that MoPR has taken prompt and significant steps in this regard as summarised in Box: 7.3.

Box 7.3: Initiatives by MoPR for Auditing and Integration of Accounts

- ·For creating an Integrated Accounts Maintenance System, the MoPR constituted, on 12 February 2020, a technical committee for harmonisation of heads of accounts comprising representatives of the CAG, CGA, National Informatics Centre and the National Institute of Rural Development and Panchayati Raj.
- On 15 April 2020, the MoPR initiated a programme called Audit-Online for facilitating financial audit of accounts of the panchayats by auditors (either state Accountant General or local fund auditors). The application not only facilitates the auditing of accounts but also for maintaining audit records that have been carried out. A draft Audit Manual has also been prepared by MoPR and shared with the States.
- A roadmap has been laid for the States to complete the exercise in a time-bound manner, especially (a) closure of account books for the year 2019-20 in PRIASoft; (b) registration of auditors on Audit-Online; (c) preparation of an audit plan; (d) completion of training of officials involved in audit; and (d) completion of the entire exercise of online audit of panchayat accounts.

Entry-level Condition for Availing the Grants

7.72 As earlier mentioned, auditing of accounts and their availability online continues to be a pending problem. A new trend, however, is evolving with a few States experimenting by involving external agents like chartered accountants for audit and certification of accounts (Table 7.7). This is an encouraging practice and more efforts in this direction are required across all State Governments.

Table 7.7: States Using Chartered Accountants for Auditing of Accounts

States	Status
Chhattisgarh	Preparation of annual account and audit of the urban local bodies are entrusted to chartered accountant firms and are placed before the general body of each urban local body for perusal.
Madhya Pradesh	Accounts are prepared and certified by the chartered accountants of local governments.
Rajasthan	Department of Local Fund Audit (DLFA) and chartered accountants certify the accounts of urban local bodies.
Sikkim	The DLFA audits the accounts of the local governments and submits a consolidated report to the Sikkim Legislative Assembly. Chartered accountants appointed by the State Government certify the accounts on a year to year basis.

Source: Compiled from inputs received from CAG

7.73 Over the last decade, there has been progress in digitising financial transactions, for example, through PFMS for the Union Government, and IFMIS for the States. However, the usability of all the data is restricted by its generation and collection by different government agencies and departments across all tiers of government in separate and disparate databases primarily for their own purposes. Data is difficult to link, compare and analyse across government entities due to lack of common data standards. A metadata catalogue or common data dictionary is not operational. Ambiguities in definition and discretionary classifications impede meaningful comparison and/or consolidation across levels and entities. For example, the current six-tier accounting classification is not standardised at levels below minor heads across the Union and the State Governments. As there is no standardisation of what is a programme and what is a scheme, minor head and scheme heads are used interchangeably. There are instances where substantive amounts, as much as 25 per cent of total expenditure, are booked under an omnibus minor head called '800-Other Expenditure', obscuring financial reporting. It is well-nigh impossible to get an integrated view of how much the general government (that is Union, States and local governments) or the government at the State level (State Government and the local governments in a State) or even all the local governments in a State are spending on health or education or salaries and wages, or generating in terms of tax revenues.

7.74 While the country has made considerable progress in moving from a manual system of accounts to a digital system, the full benefits of such a move have not been reaped because of a lack of business process re-engineering. Digitisation is much more than putting in numbers in a computer that would have been manually recorded on a piece of paper otherwise. If transactions, like payments, are done in electronic mode, all the necessary details – the purpose, to whom, from where, when and how much – can be captured right at the time of data entry. Once the details of

how a transaction is to be electronically entered has been specified by a rigorous data standard for all levels of government and these standards are followed, generating accounts data on a consistent and uniform basis for all rural or urban local bodies, or integrating the accounts of the local governments with that of the relevant State Governments would be a fairly simple exercise under an IT-led financial reporting framework. We strongly recommend the specification and adoption of a uniform data standard for digital recording of all government transactions at the earliest. We recognise that States are at different stages of evolution with respect to digitisation of accounts with respect to local governments, and some States have more sophisticated systems than others. During the transition period, for these relevant States, we do not suggest regression to lower levels of sophistication with the capture of fewer characteristics of the underlying accounts data but only on the timely online availability, in the public domain, of both the accounts of the previous year and audited accounts of the year before previous according to formats worked out appropriately by the Union, State and local governments.

7.75 With the help of modern digital infrastructure, a receipt or expenditure can have the necessary characterisation at the input stage itself. This will enable appropriate processing of data to produce the various required reports. Online entry of receipts of expenditure in real term basis generate unaudited accounts monthly and yearly and thus the unaudited accounts are automatically available at the end of the financial year.

7.76 Since auditing is necessary to ascertain the transparency and accountability of public funds and this has remained an unfinished task so far, **we recommend the online availability of both provisional accounts of the previous year and audited accounts of the year before previous as entry level condition to avail of the grants.**

7.77 Given the pandemic and the complexities involved in the task for auditing of accounts, in the first and second year of the award period (2021-22 and 2022-23), States need to ensure that at least 25 per cent of the rural local bodies have both their provisional accounts for the previous year and audited accounts for the year before the previous available online in the public domain in order for them to avail of the full grants in 2021-22 and 2022-23. From the third year (2023-24) onwards, States will receive total grants due to the rural local bodies having both provisional accounts of the previous year and audited accounts for the year before previous and making these available online. For example, if for a particular State only 35 per cent of rural local bodies have both provisional accounts for the year 2022-23 and audited accounts for the year 2021-22 and these are available online in 2023-24, then in 2023-24, the State will receive total amount due to these 35 per cent of the rural local bodies for the year 2023-24.

Grants for the Year (t) for a particular State (X)[6] = Grants due to the rural local bodies in State (X) that prepared provisional accounts for the previous year (t-1) and audited accounts for the year before the previous (t-2), and these accounts are available online in the public domain in year (t).

[6] This condition is applicable from 2023-24 onwards

7.78 Provisional annual accounts of a particular year shall be available online in real time basis by 15 May of every subsequent year. To illustrate; the online provisional annual accounts for the year 2020-21 shall be available by 15 May 2021.

Table 7.8: Eligibility Criteria for Rural Local Bodies to Avail Grants

2021-22 and 2022-23
In the first and second year of the award period (2021-22 and 2022-23), States need to ensure that at least 25 per cent of the rural local bodies have both their provisional accounts for the previous year and audited accounts for the year before the previous available online in the public domain in order for them to avail of the full grants in that year.

2023-24, 2024-25 and 2025-26
From the third year (2023-24) onwards, States will receive total grants due to the rural local bodies having both provisional accounts of the previous year and audited accounts for the year before previous and making these available online. For example, if for a particular State only 35 per cent of rural local bodies have both provisional accounts for the year 2022-23 and audited accounts for the year 2021-22 and these are available online in 2023-24, then in 2023-24, the State will receive total amount due to these 35 per cent of rural local bodies for the year 2023-24.

Basic Grants and Tied Grants for National Priorities

7.79 The flagship scheme of Swachh Bharat Mission (SBM) of the Union Government has played a central role in bringing about behavioural change in both the urban and rural areas and has resulted in people maintaining healthy sanitation practices. This mission has a direct link with SDG 6 of clean water and sanitation. Under the SBM (Grameen), over 5.6 lakh villages and 616 districts have been declared as ODF as on 31 March 2019.

7.80 While there has been significant progress in achieving ODF, large parts of rural India continue to face shortage of drinking water facilities. Of the total ODF certified villages, only 41.53 per cent habitations have been provided with piped water supply schemes, as of 31 March 2019. The 112 aspirational districts have piped water supply in only 24.4 per cent habitations against the national average of 44.4 per cent habitations. Only 18 per cent of the rural population could access potable drinking water through piped water supply and only 17 per cent of rural households were provided household piped water connections. The Union Government has proposed a combined approach to water and sanitation through convergence between the National Rural Drinking Water Programme (NRDWP) and the SBM-G. Villages which have been verified as ODF are given priority for piped water schemes under the NRDWP.

7.81 The DDW&S has drawn our attention to the fact that a revalidation exercise conducted on the current status of the piped water coverage found that only around 3.04 crore households or 16 per cent of the total 19.01 crore rural households have tap water connections, and 15.96 crore (84 per cent) households still remain without a functional household tap connection. For all existing tap connections to be made functional, there needs to be a plan for long-term and reliable availability and supply of water. To ensure this, the Union Government has launched a Jal Jeevan Mission with a total outlay of Rs. 3.60 lakh crore, out of which the Union's share is Rs. 2.08 lakh crore.

7.82 As waste generation increases, even in rural areas, it is important for States to provide guidelines and to set up basic infrastructure for its management. Regional collection facilities can be developed where rural household waste, particularly human excreta and faecal sludge, is temporarily stored until sufficiently large volumes accumulate for further processing.

7.83 The solid waste management sector in India is in urgent need of support. While substantial progress has been achieved in the provision of sanitation services in the past decade, much remains to be done to improve solid waste management. The inadequate management of human excreta and faecal sludge in India has significant environmental and human health impact. There is urgent need to intervene to support local governments to provide this essential and basic service to their citizens. This should take the form of incremental solutions, building on the existing systems and on the knowledge and experiences of countries that have managed to transform their sectors.

7.84 We recognise that the country's achievements on the sanitation front need to be sustained and strengthened at all levels. For this, all the three levels of government will have to join hands in the spirit of cooperative federalism. Local governments form a crucial link for implementation and execution of such schemes. In view of the above and to supplement resources of local governments to meet the broader objective of fulfilling national priorities, we recommend the following:

i. 40 per cent of the total grants to be disbursed to rural local bodies shall be untied and can be used by them for felt needs under the twenty-nine subjects enshrined in the Eleventh Schedule, except for salaries and other establishment costs. The expenditure required for auditing of accounts by external agencies approved by the State Government, however, may be borne from this grant.

ii. 30 per cent of the total grants to be disbursed to rural local bodies shall be earmarked for drinking water, rainwater harvesting and water recycling.

iii. 30 per cent of the total grants to be disbursed to rural local bodies shall be earmarked for sanitation and maintenance of ODF status, and this should include management and treatment of household waste, and human excreta and faecal sludge management in particular.

7.85 The year-wise allocations recommended for this purpose are given in Table 7.9. However, if any local body has fully saturated the needs of one category and does not require funds for that purpose, it can utilise the funds for the other category. For example, if a local body saturates its requirement for drinking water, it can utilise the funds for ODF and vice-versa. The respective village assembly/Gram Sabha shall certify this and it will be duly confirmed by the supervising authority of the panchayats or the State Government. The State-wise and year-wise allocations for tied and untied (drinking water and sanitation) grants recommended for the five-year award period are at Annex. 7.4.

Table 7.9: Detailed Year-Wise Grants for Rural Local Bodies

(Rs. Crore)

Grants	2021-22	2022-23	2023-24	2024-25	2025-26	Total Grants
Total Grants	**44901**	**46513**	**47018**	**49800**	**48573**	**236805**
Untied (40%)	17961	18605	18806	19920	19429	**94721**
Tied (60%)	26940	27908	28212	29880	29144	**142084**
(a) drinking water, rain water harvesting and water recycling	13470	13954	14106	14940	14572	**71042**
(b) sanitation and maintenance of ODF status	13470	13954	14106	14940	14572	**71042**

Urbanisation: Engine of Growth

7.86 India is urbanising rapidly. According to Census 2011, at 377.1 million, India's urban population was 31 per cent of the total, up from 286 million (28 per cent) in 2001 (Table 7.10). However, an agglomeration index developed by the World Bank put the share of India's population living in areas with "urban-like" features at 55.3 per cent in 2010. The extent of urbanisation is said to be understated in official data because of hidden urbanisation on the peripheries of major cities.

Table 7.10: Urbanisation Trends

Year	Population in Millions	Level of Urbanisation (%)
1961	78.9	17.96
1971	109.1	19.90
1981	159.5	23.40
1991	217.6	25.71
2001	286.1	27.81
2011	377.1	31.16

7.87 It is argued that India's economic growth momentum cannot be sustained if urbanisation is not actively facilitated. Cities will have to become the engines of the country's growth and development. In general, there is a pattern suggesting that States with a higher share of urban state domestic product have witnessed higher growth in per capita income and lower incidence of poverty. All this tends to support the position that urbanisation, economic growth and poverty reduction are related.

7.88 Many States like Gujarat, Kerala, Maharashtra and Tamil Nadu have, in their memoranda to us, also emphasised the need for greater financing of the urban sector. Many Indian cities are growing through a process of peripheral expansion, with smaller municipalities and large villages surrounding the core city becoming part of the large metropolitan area. *World Urbanization Prospects 2018* has indicated that India's urbanisation will be around 37-38 per cent in 2025 and the urban sector will start overtaking the rural sector from 2045-46 onwards.

7.89 There is a need to act immediately to prepare the urban areas to meet these future challenges and to promote them as engines of economic growth and investment hubs. Accordingly, we recommend that total grants to local governments should be gradually restructured and apportioned between rural and urban local bodies in the ratio of 65:35 by the end of our award period.

Urban Agglomerations-centric Approach

7.90 Out of the total urban population of 377 million (Census 2011), 61 per cent (229 million) live in 475 urban agglomerations that include urban local bodies, census towns and outgrowths. However, till now, urban agglomerations find no place in the urban governance paradigm and is only a census term. Instead, urban agglomerations should be the demographic basis of metropolitan governance in India. According to Census 2011, urban agglomerations with more than a million people contained almost 40 per cent of the total urban population (Table 7.11).

Table 7.11: Urban Agglomerates Distribution (Census 2011)

Classification	Total Population in millions	Per cent share of urban population
Urban agglomerations greater than 1 million	149.5	39.7
Urban agglomerations less than 1 million	80.6	21.4
Not an urban agglomeration	146.9	39.0
Total urban population	377.1	100.0

Source: Census 2011

7.91 In view of the country's differentiated urbanisation pattern, we consider it important to accord differential treatment to the urban agglomerations with more than one million population

relative to other urban areas in the distribution of urban local body grants. Accordingly, urban areas are grouped into two broad categories for recommending grants to urban local bodies: (a) **Category-I cities:** urban agglomerations/cities with more than one million population and (b) **Category-II cities:** other than million-plus cities.

7.92 For the Million-Plus cities, ambient air quality and national priorities for urban drinking water, water harvesting and recycling and sanitation are found to be more critical. For smaller cities and towns with comparatively lesser own sources of revenue, a certain proportion of untied grants from the Finance Commission continues to be an important source of finance apart from a certain amount of tied grants to give a boost to the national priorities like urban drinking water, water harvesting and recycling and sanitation.

Grants to Urban Local Bodies

7.93 **To cater to the growing urbanisation needs, a total of Rs. 1,21,055 crore is recommended for urban local bodies for the period 2021-26. Inter se distribution among States is with a weightage of 90 per cent on population and 10 per cent on area. The detailed methodology for apportionment of funds for urban local bodies is in Annex 7.2. The share of each State is detailed in Annex 7.3.** The quantum of grants based on the rural and urban share described at Table 7.5 is detailed in Annex 7.4.

7.94 As regards the grants earmarked for primary health care, the urban local bodies shall be actively involved in the components of urban health infrastructure to be built by the Ministry of Health and Family Welfare in close coordination with State Governments.

Two Entry Level Conditions for Availing Grants

7.95 **As in the case of the rural local bodies, in order to be eligible for grants, the urban local bodies too have to mandatorily prepare and make available online in the public domain annual accounts of the previous year and the duly audited accounts of the year before previous.** Such audited accounts should include the minimum of a) balance sheet; b) income and expenditure statement; c) cash flow statement; and d) schedules to balance sheet, income and expenditure statement and cash flow statement.

7.96 Given the pandemic and the complexities involved in the task for auditing of accounts, in the first and second year of the award period (2021-22 and 2022-23), States need to ensure that at least 25 per cent of the urban local bodies have both their provisional accounts for the previous year and audited accounts for the year before the previous available online in the public domain in order for them to avail of the full grants in that year. From the third year (2023-24) onwards, States will receive total grants due to the urban local bodies having both provisional accounts of the previous year and audited accounts for the year before previous and making these available online. For example, if for a particular State only 35 per cent of urban local bodies have both

provisional accounts for the year 2022-23 and audited accounts for the year 2021-22 and these are available online in 2023-24, then in 2023-24, the State will receive total amount due to these 35 per cent of urban local bodies for the year 2023-24. Provisional annual accounts of a particular year shall be available online in real time basis by 15 May of every subsequent year. To illustrate, the online provisional annual accounts for the year 2020-21 shall be available by 15 May 2021.

Grants for the Year (t) for a particular State (X)[7] = Grants due to the urban local bodies in State (X) that prepared provisional accounts for the previous year (t-1) and audited accounts for the year before the previous (t-2), and these accounts are available online in the public domain in year (t).

7.97 As indicated in paras 7.50 and 7.51, property taxes are among the most important revenue sources for local governments across the world. It is progressive and, to a large extent, satisfies the 'user pays' principle. The MoHUA has correctly pointed out that property taxes have, regrettably, grown much slower than GDP. This is in spite of the fact that, over the medium term, the value of the properties in most urban centres has grown faster than GDP. This only strengthens the argument for focussing sharply on mobilising more property taxes. Furthermore, as most of the taxes at the local body level have been subsumed under the GST, property taxes can help increase revenue buoyancies at the third tier. Our specific observations and recommendations on property tax are contained in our report for 2020-21 at para 5.2 (xxi):

"The importance of mobilisation of own revenues by self-governing local bodies cannot be overemphasised. It leads to better ownership and accountability. Internationally, property tax is one of the most effective instruments for revenue mobilisation by local bodies. For historic reasons as well as because of vested interests, property tax yields remain negligible in India. We recommend that to qualify for any grants for urban local bodies in 2021-22, States will have to appropriately notify floor rates[8] and thereafter show consistent improvement in collection in tandem with the growth rate of State's own GSDP."

7.98 This condition in the report for 2020-21 shall continue to be applicable as an entry level condition for all the urban local bodies for availing the grants. Further, this condition is over and above the requirement of timely online availability in the public domain of both unaudited accounts for the previous year and audited annual accounts for the year before previous. In a democratic system, proximity of the elected representative to the tax payer often reduces the willingness to mobilise revenues. Moreover, somewhat curiously, some States have ceilings on property tax rates in urban areas, which militates against the entire principle of decentralisation and devolution of finances and functions to local governments. Instead, the provision of a statutory floor to the property tax rate will help promote the buoyancy of such tax revenues and facilitate the mobilisation of revenues by local governments.

7.99 The conditions mentioned above, have a two-fold implication. First, a State can avail of

[7] This condition is applicable from 2023-24 onwards

[8] The minimum floor rate shall have different slab-wise property tax rates for different types of properties; and differential rates for commercial, residential and industrial properties.

the grant only if it notifies the floor rates of property tax by suitably amending the relevant State Municipal and Municipal Corporation Acts. However, this condition is a one-time phenomenon. Once the State has done that, the other condition related to the year-wise consistent improvement in collection in tandem with the simple average growth rate of the State's own GSDP in the most recent five years will also apply. The five-year average has been taken *to avoid any anomaly arising from cyclical or one-off fluctuation in GSDP.* Hence, setting the minimum floor rate is the pre-condition for a State availing of the urban local body grants, but *once this pre-condition is satisfied, the State will receive such total grants based on the urban local bodies meeting the condition of their property tax revenues in the previous year growing in tandem with the average growth rate of the State's own GSDP in the most recent five years.*

7.100 The Housing Price Index, for example RESIDEX by the National Housing Bank, available for many cities in India shows that residential property prices tend to move up as a State develops. There are cities that are exceptions, but given the wide gap between what is actually collected as property taxes and the potential that can be mobilised, the rate of growth of GSDP in the preceding five years provides a good and convenient proxy to measure how far the cities are catching up with their potential property tax revenue during the five years of our award.

7.101 In view of the current pandemic, **we recommend the provision of a one-year window for notifying the floor rates of property tax; this will trigger in two stages from 2022-23. In the first stage, States are expected to notify the floor rates and operationalise the arrangements in 2021-22. The condition of notifying the floor rates of property tax will apply for eligibility of grants from 2022-23. Once the floor is notified, the condition of growth in property tax collection being at least as much as the simple average growth rate of the State's own GSDP in the most recent five years will be measured and taken into account from 2023-24 onwards.**

7.102 For example, if State X has duly notified a floor to the property tax rates in 2021-22, it becomes eligible for getting the entire urban local body grants in 2022-23. But for 2023-24 and onwards it has to meet the second condition of improvement in property tax collection in tandem with the growth rate of the State's own GSDP as well. The growth rate to be achieved in property tax revenue in a particular year will be taken as the simple average of GSDP growth available for the most recent five years. To illustrate, to qualify under this conditionality in 2023-24, the average GSDP growth rate for the period 2017-18 to 2021-22 (provisional or final, whichever is available at the beginning of the year) will be used for calculating the growth in property taxes that has to be achieved in 2022-23. The State will become eligible for grants in 2023-24 only if the urban local bodies have met the condition of actual collections of property tax in tandem with the State's own GSDP growth. If, in 2023-24, only 25 per cent of the urban local bodies have met the second condition of consistent improvement in collection in tandem with the growth rate of State's own GSDP, then the State will receive the total amount due to these 25 per cent urban local bodies in 2023-24. If, in 2024-25, 35 per cent of the urban local bodies have met the condition of consistent improvement in collection in tandem with the growth rate of State's own GSDP, the

State will then receive the cumulative amount due to these 35 per cent of the entitled urban local body grants in 2024-25. However, it may be noted that the State will receive no grant in any of the years, if it has not notified the minimum floor rate. Thus, a State notifying minimum floor is only a necessary condition (and not a sufficient condition) for availing the grants. Once this pre-condition is satisfied the State will receive only the total grants due to those urban local bodies that meet the condition on growth rate of property tax revenue.

Table 7.12: Eligibility Criteria for Urban Local Bodies To Avail Grants

2021-22 and 2022-23
In the first year of the award period, that is 2021-22, a State needs to ensure online availability of at least 25 per cent of both unaudited urban local body accounts for the previous year and audited accounts for the year before the previous to avail the full grants in that year. States are also expected to notify the floor rates of property tax and operationalise the relevant arrangements in 2021-22. The condition of notifying the floor rates of property tax will apply for eligibility of grants from 2022-23 along with which a State needs to ensure online availability of at least 25 per cent of both unaudited urban local body accounts for the previous year and audited accounts for the year before the previous to avail the full grants in that year.

2023-24, 2024-25 and 2025-26		
State has notified minimum floor rate of property tax rate by 2022-23	*Urban local body has met the condition of consistent improvement in collection in tandem with the growth rate of State's own GSDP*	*Urban local body has not met the condition of consistent improvement in collection in tandem with the growth rate of State's own GSDP*
Unaudited annual accounts of the previous year and audited online accounts for year before previous available.	**Can avail the grants**	Cannot avail the grants
Unaudited annual accounts of the previous year and/or audited online accounts for year before previous not available	Cannot avail the grants	Cannot avail the grants

7.103 Moreover, for increasing the buoyancy of property taxes, laws relating to enumeration, assessment, valuation and billing play an important role in the revenues mobilised. There is a need to follow best practices in this regard and codify them in a Model Property Tax Act. This should continue to be a reform agenda in the medium term and State Governments need to pursue this in cooperation with the Union government.

Category-wise Quantum of Grants

Million-Plus Cities Challenge Fund

7.104 In our classification of urban centres, Category I cities consist of fifty urban centres with million plus population – the Million-Plus cities. These fifty, in turn, consist of forty-four urban agglomerations (excluding Delhi, Chandigarh and Srinagar) and six cities which the Census 2011 does not classify as urban agglomerations (Jaipur, Visakhapatnam, Ludhiana, Faridabad, Vasai-Virar City and Kota). The forty-four urban agglomerations encompass sixty-seven cities with a population between 100,000 to less than one million and 1,048 towns with a population of less than 100,000.

7.105 **For these Category-I cities, during its five-year award period, we recommend grants to the tune of Rs. 38,196 crore in the form of a Million-Plus cities Challenge Fund (MCF). This amount is linked to the performance of these cities in improving their air quality and meeting the service level benchmarks for urban drinking water supply, sanitation and solid waste management.**

7.106 Almost a third of the total MCF of each city is earmarked for achieving ambient air quality. The balance two thirds of the city-wise MCF is earmarked for achieving service level benchmarks for drinking water (including rainwater harvesting and recycling) and solid waste management. Detailed State-wise and city-wise grants are in Annex 7.6.

Table 7.13: MCF for Million-Plus Agglomerations /Cities

(Rs. crore)

	2021-22	2022-23	2023-24	2024-25	2025-26	Total Grants
Total Grants	**6978**	**7227**	**7643**	**8093**	**8255**	**38196**
Ambient air quality	2217	2299	2431	2571	2621	**12139**
Service level benchmarks	4761	4928	5212	5522	5634	**26057**

7.107 For the Million-Plus cities/urban agglomerations, the recommended city-wise distribution of grants for the period 2021-26 is on population basis. In the case of urban agglomerations which contain more than one Million-Plus city, the concerned State Government, in consultation with all such entities within the urban agglomeration, shall entrust one urban local body as the nodal entity to receive the grants. This nodal entity will also have the responsibility of achieving the performance indicators for the entire urban agglomeration.

Ease of Breathing

7.108 As indicated in paras 7.52 to 7.55, absence of a metropolitan paradigm has resulted not only in fragmented governance, service delivery and lack of accountability, but also in an inability of such cities to realise agglomeration economies. Since the contemporary challenges

of economic growth with environmental sustainability and equitable access to opportunities and services can be satisfactorily met only at the agglomeration level, we treat the urban agglomerations with more than a million population as a single unit for monitoring of performance indicators.

7.109 Ambient air quality is critical not only for the health and well-being of those living in the Million-Plus cities but also for attracting investment. A city with great 'ease of doing business' is unlikely to attract investments if the ambient air quality makes breathing both hazardous to health and difficult. Particulate matter has been identified as one of the most critical environmental risks globally and poor air quality has been associated with morbidity and mortality due to respiratory, cardiovascular and cerebrovascular diseases.

7.110 Data generated by the National Air Monitoring Programme (NAMP) reveal that particulate matters (PM_{10} and $PM_{2.5}$) are exceeding the permissible levels at many locations, particularly in urban areas. Air pollution is a complex issue because of the variety of sources - industries, automobiles, generator sets, domestic fuel burning, road side dusts and construction activities, to name a few. Aware of the complexities involved and given the paucity of funds, we have considered air quality monitoring as well as its use as a performance metric only for Million-Plus cities.

MCF Administrative Mechanism

Ambient air quality

7.111 For monitoring ambient air quality and disbursing grants to Million-Plus cities, the MoEF&CC shall act as a nodal ministry. In consultation with the respective State Governments, the Ministry shall develop city-wise and year-wise targets on ambient air quality, based on measurable indicators and outcomes. These will be made available in the public domain. The MoEF&CC shall evaluate the improvement in average annual concentrations of PM_{10} and $PM_{2.5}$. The report for 2020-21 made very specific recommendations for evaluation of air quality at para 5.3 (xiii) and Annex.5.3, based on the Ministry's written proposal that for 2021-22, the average annual value of 2021 (as calculated in January 2022) over average annual value of 2019 (as calculated in January 2020) will be taken. The same procedure should be adopted for calculations in subsequent years. However, as stated in para 7.36, *regrettably the MoEF&CC changed its position regarding its capacity to implement the parameters that it had proposed for the report for 2020-21. The Ministry, in its revised memorandum, submitted a different approach by recommending evaluation of performance grants based on improvement of the State on four parameters: They are: (a) strengthening of institutional framework; (b) source-wise cause analysis for air pollution; (c) progress on action plans and compliance of statutory guidelines; and (d) quantification of improvement in air quality. The relative weights assigned to these factors shift across the years with more emphasis on institution and capacity building in the first year to outcomes in the later years.*

7.112 Open waste burning on the streets, activities of small informal industries (for example, rice popping using burning tires), spontaneous combustion in landfills are significant, but overlooked, sources of pollution. Waste decomposition and poorly managed composting also affect air quality by releasing toxic gases as well as methane into the atmosphere. We are also of the view that ending open waste burning, proper solid waste management and composting at landfill sites can play significant role in air quality management. **Hence, we recommend that both informal burning as well as spontaneous combustion at landfills should be monitored carefully.** This could include:

a) Monitoring of open waste burning and chemical traces from waste burning at landfill sites as well as the development of an app to allow reporting by citizens by sending pictures.

b) Process-tracing of waste management in each city to identify where the breakdown in waste management occurs.

7.113 We also took feedback from other experts from the World Bank and WRI about our recommendations in the report for 2020-21. It appears that only persistent efforts lead to a reduction in the complex problem of poor air quality. Furthermore, the improvement in ambient air quality observed in 2020-21 may simply be the outcome of the lockdowns triggered by the Covid pandemic. In view of this, we recommend that a preparatory period of one year be provided to put in place the necessary equipment and procedures to move towards the desired objective of clean air in the medium term. Hence, in the year 2021-22, as suggested by MoEF&CC, **the relative weightages for assessment of city performance on air quality may be based on four parameters: (a) strengthening of the pollution monitoring mechanism; (b) source-wise cause analysis for air pollution; (c) progress on action plans and compliance of statutory guidelines; and (d) quantification of air quality improvement with the weights as prescribed in the Table 7.14.**

7.114 As explained in Annex 7.8, quantification of improvement in air quality has two parts, namely, reduction in particulate matter (PM_{98}) and increase in the number of good days according to improvement in the air quality index (AQI). Management of open waste burning and combustion at landfill sites should constitute an integral part of the air quality improvement index, with suitable weights arrived at on the basis of source-wise cause analysis for air pollution in specific urban agglomerations. We are also of the view that economic use of the landfills should be encouraged by allowing private sector involvement in these efforts to ensure the availability of sufficient and reliable financing. After 2021-22, for all the remaining four years of the award period, the entire weightage will be on the fourth parameter of quantification of improvement in air quality.

7.115 While the MoEF&CC shall handhold and monitor the urban local bodies in these efforts, the MoHUA shall take initiative in implementing parameters (b) , (c) and also management of open waste burning and combustion at landfill sites by the concerned urban local bodies, once the

MoEF&CC, as technical adviser, agrees to the source–wise analysis for air pollution and year-wise action plans from 2021-22 to 2025-26. Details are in Annex 7.8.

Table 7.14: Relative Weightage for City Performance Assessment*

Parameter	2021-22	2022-23	2023-24	2024-25	2025-26
Strengthening of pollution monitoring mechanism	10	-	-	-	-
Source-wise cause analysis for air pollution	10	-	-	-	-
Progress on action plans and compliance of statutory guidelines.	10	-	-	-	-
Quantification of air quality improvement	70	100	100	100	100
Total	**100**	**100**	**100**	**100**	**100**

* Details at Annex 7.8 A and 7.8 B

Air quality monitoring mechanism

7.116 The MoHUA may actively assist cities in reducing the sources of air pollution and improving air quality, as some of its programmes like the Atal Mission for Rejuvenation and Urban Transformation (AMRUT), which has a component relating to development of electric transport, already deal with this. For the final monitoring of the outcome of air pollution reduction, the MoEF&CC shall recommend the release of MCF to the Million-Plus cities and the Ministry of Finance will release the funds directly to the State Government, with an intimation to the State Government, MoHUA and the MoEF&CC. These grants, based on performance, will be released as a single instalment during a year, which is to be decided by the MoEF&CC after consultation with the MoHUA and State Governments.

7.117 Each State Government and urban agglomeration shall sign a memorandum of understanding (MoU) with the MoEF&CC for a year-wise action plan, agreed outcomes to be achieved and quantum of funds to be released. Such action plan shall contain the city-wise details of sources of air pollution and the proposed measures to be taken by them such as deployment of sweeping machines, promotion of non-motorised transport (pedestrian and cycle), and paving the side flanks of the road with facility for water percolation. While the MOEF&CC shall closely involve the State Pollution Control Boards through NCAP grants for strengthening the air quality monitoring infrastructure, it shall build the infrastructure capacities of the Million-Plus cities in controlling air pollution.

7.118 In case of non-achievement of the highest improvement slab by cities, the balance fund would be utilised as follows: 50 per cent of the undisbursed amount will be distributed to the performing cities in a manner that top performers (>10 per cent improvement) get 20 per cent of the amount, second best performers (8-10 per cent improvement) get 17.5 per cent and third best performers (6-8 per cent improvement) get 12.5 per cent.

7.119 The MoEF&CC has also evidentially shown that ambient air quality is not a major problem in eight urban agglomerations with population of over a million on the south-western sea coast , namely, Kannur, Kochi, Kollam, Kozhikode, Malappuram, Thiruvananthapuram and Thrissur in Kerala and Coimbatore in Tamil Nadu. These cities are way below the NAMP threshold for breaching of pollution thresholds by particulate matter. The total grants allocated to these eight cities will, therefore, be linked to their performance in service level benchmarks on solid waste management-star rating, drinking water, water recycling and rainwater harvesting.

Service level benchmarks for drinking water supply, sanitation and solid waste management

7.120 Urbanisation directly contributes to waste generation, and unscientific waste handling causes health hazards and degradation of the urban environment. The definition of municipal solid waste includes refuse from households, non-hazardous solid waste discarded by industrial, commercial and institutional establishments, market waste, yard waste and street sweepings which are collected by the municipal authorities for disposal.

7.121 Waste generation rates are increasing, but with low recycling rates and treatment capacity as well as insufficient number of sanitary landfills, waste is mostly disposed of in dumpsites or burnt openly. To overcome this problem, *the first priority is* to address the most basic and pressing issues of *stopping dumping and providing collection and environmentally-sound disposal services to all citizens.* Landfilling has been practised for many years, has passed stringent environmental tests and is an established disposal method in environmentally cautious economies. It is currently the most financially accessible and environmentally acceptable solution for waste disposal in India. *A second priority* is to introduce *alternative methods of waste management in order to reduce waste disposal requirements.* Material recovery/recycling and other advanced treatments such as waste-to-energy should be pursued in parallel, depending on local conditions. In metro regions with large volumes of waste generation, for example, land availability and transport make landfill options expensive. In such cases, a mix of technologies including landfilling and more advanced solutions should be considered. *A third priority* is closure and rehabilitation of old dumpsites, to reduce exposure and risk to human health and the environment. *Closure and capping of existing dumpsites,* in compliance with environmental regulations, is an urgent and critical need. Local governments should also plan for long-term monitoring and management of these environmentally compromised sites and, depending on site characteristics and costs, land remediation/reclamation potential must be explored for future uses, including potential solid waste management disposal and treatment facilities.

7.122 The MoHUA, in its submission to the Commission, proposed that at least 50 per cent of buildings – newly-constructed residential buildings with plot size of 100 sq. meter or above, and all other buildings such as institutional, commercial, office premises, public buildings – in urban local bodies should have rain water harvesting structures. The Ministry also proposed minimising non-revenue water comprising (a) consumption which is authorised but not billed,

such as public stand posts; (b) apparent losses such as illegal water connections, water theft and metering inaccuracies; and (c) real losses which are leakages in the transmission and distribution networks. For ensuring good quality of water, at least 60 per cent of public water bodies in the urban local body should have water quality of 'D' and above in line with the water quality criteria prescribed by the CPCB in June 2019 in its report on *Indicative Guidelines for Restoration of Water Bodies.*

7.123 **We are of the view that solid waste management, quality water supply, water conservation, water recycling and rejuvenation are all significant national priorities and critical for the long-term sustainable development of cities. Thus, we recommend that the MoHUA shall act as a nodal ministry for determining the urban agglomeration eligible to get MCF funds for drinking water (including rainwater harvesting and recycling), sanitation and solid waste management criteria under service level benchmarks. The Ministry shall evaluate the performance in service level benchmark indicators of solid waste management (attainment of star ratings), water quality and water conservation methods.** Detailed performance criteria are at Annex 7.9.

7.124 As we already stated in the report for 2020-21, these performance grants related to service level benchmarks will be disbursed from the first year of the award period, that is 2021-22 onwards, as the States and these cities have been given adequate time and notice for putting in place a scheme and mechanism for implementation. In case of non-attainment of these benchmarks by a urban agglomeration, the MoHUA, in consultation with the State Government, shall distribute the unallocated grants amongst other non-Million-Plus cities in proportion to their population.

7.125 Each State Government and urban agglomeration shall sign a MoU with the MoHUA for year-wise action plans, agreed outcomes to be achieved and quantum of funds to be released, and make them available in the public domain. The performance of each urban agglomeration for each service level benchmark for the year will be placed in the public domain, including online, in a manner that is easily accessible to the citizens living within it. These grants based on performance will be released as a single instalment during a year, which is to be decided by the MoHUA after consultation with the State Government. On the recommendation of the MoHUA, the Ministry of Finance will release the funds directly to the State Government, with an intimation to it and the MoHUA.

Conditionalities for release of performance grants

7.126 As detailed in para 7.113 and 7.114, we recommend that, as advised by MoEF&CC, the relative weightages for assessment of city performance on air quality may be based on four parameters, namely, (a) strengthening of pollution monitoring mechanism, (b) source-wise cause analysis for air pollution, (c) progress on action plans and compliance of statutory guidelines, and

(d) quantification of air quality improvement. While MoEF&CC shall handhold and monitor the urban local bodies in these, the MoHUA shall take initiative in implementing (b) and (c) by the concerned urban local bodies, once the MoEF&CC, as technical adviser, agrees to the source-wise analysis for air pollution and year-wise action plans from 2021-22 to 2025-26.The details are in Annex 7.8. Hence, it is expected that all the stakeholders are ready for compliance of these conditions from 2021-22.

7.127 Similarly, steps outlined by us in the report for 2020-21 on measuring and publishing solid waste management-related service level benchmarks for basic services shall be followed. Since the stakeholders involved have been advised a year ahead and are expected to be ready for evaluation from 2021-22 onwards, the performance grants will be disbursed from the first year of our five-year award period, that is, 2021-22 onwards. Detailed criteria for performance grants enclosed for Category I cities is given at Annex 7.9. However, though the performance criteria are revolving around only a few service level benchmarks, it would be extremely important to ensure that publication and monitoring of all the service level benchmarks continues. This will facilitate transparency and accountability in service delivery and sustainability of the entire service level benchmarks initiative, which is now of almost fifteen years' vintage. Hence, we recommend that all the service-level benchmarks should be published on www.cityfinance.in along with the audited annual accounts.

Grants for Other Than Million-Plus Cities/ Towns

7.128 **The other than Million-Plus cities/towns shall also get the grants as per population. We recommend a basic grant of Rs. 82,859 crore for a period of five years for these cities.** State-wise details are at Annex 7.5.

Table 7.15: Grants for Non-Million-Plus Cities/Category-II Cities/Towns

(Rs. Crore)

In Rs. Crores	2021-22	2022-23	2023-24	2024-25	2025-26	Total Grants
Total Grants	**15136**	**15681**	**16579**	**17560**	**17903**	**82859**
Untied (40%)	*6054*	*6273*	*6631*	*7024*	*7161*	33143
Tied (60%)	*9082*	*9408*	*9948*	*10536*	*10742*	49716
(a) sanitation (including solid waste and waste water management) and solid waste management and attainment of star ratings as developed by the MoHUA	*4541*	*4704*	*4974*	*5268*	*5371*	24858
(b) drinking water, rainwater harvesting and water recycling	*4541*	*4704*	*4974*	*5268*	*5371*	24858

7.129 Some cities and towns may be part of some urban agglomeration, but they will still receive the grants under this component, as the MCF is an additionality in these cases. These cities have to fulfil the two entry level conditions indicated earlier for availing the grants – making both provisional and audited annual accounts available online in the public domain and the State notifying minimum floor rates for property tax and the property taxes growing in tandem with the GSDP growth rates. (details at paras 7.95 to 7.99, 7.101 and 7.102).

7.130 **Of the basic grants recommended to other than Million-Plus cities, 40 per cent is untied and can be used by the urban local bodies for felt needs under the eighteen subjects enshrined in the Twelfth Schedule, except for salaries and other establishment costs.**

7.131 An overview of the national priorities has already been given earlier. Further, in order to supplement the resources needed to fulfil these priorities, **we are of the view that the remaining 60 per cent of the grants should be tied to supporting and strengthening the delivery of basic services.** Thirty per cent of the total grants to be disbursed to urban local bodies shall be earmarked for sanitation and solid waste management and attainment of star ratings as developed by the MoHUA. This should include management and treatment of household waste, in particular human excreta and faecal sludge, in line with the principles highlighted in para 7.121 and movement towards more innovative and environment-friendly ways to tackle this problem. To improve the current situation, urban local bodies require technical assistance to: (a) move towards professionalising their delivery of solid waste management services and economic use of land filling, either public, private or jointly managed; (b) develop and implement strategic multi-year investment plans that address their local infrastructure and maintenance needs according to their waste generation trends; (c) mobilise resources to fund capital investments and cost-recovery mechanisms that will ensure the sustainability of operations and maintenance plans; and (d) set up monitoring systems to oversee compliance and maintain adequate standards of service provision. Adequate financing is essential to run any type of waste management system and hence private sector involvement in these efforts is recommended to ensure the availability of sufficient and reliable financing. In addition, 30 per cent of the total grants to be disbursed to urban local bodies shall be earmarked for drinking water, rainwater harvesting and water recycling. However, if any urban local body has fully saturated the needs of one category and there is no requirement of funds for that purpose, it can utilise the funds for the other category. Such saturation will also be certified by the respective urban local body and duly confirmed by the supervising authority of municipalities in the State Government. We also recommend that no further conditions or directions other than those already indicated by us should be imposed either by the Union or the State Governments, or any authority, for releasing the funds.

7.132 Intra-city distribution of these grants shall be on the basis of recommendations of the latest SFC. In case the SFC recommendation is not available for distribution within a particular category, allocations should be based on population and area in the ratio of 90:10. The States should also make allotment of grants on population basis for the Cantonment Boards within their territories.

Cantonment Boards

7.133 Cantonments are pioneering urban formations in India. According to Census 2011, there are sixty-two cantonments boards in the country, spread across seventeen States and two Union Territories (the National Capital Territory of Delhi and Jammu and Kashmir). The population living in cantonments accounts for around 0.56 per cent of the total urban population of the country.

Table 7.16: Features of Cantonment Boards and Municipalities

MUNICIPALITY		CANTONMENT BOARD	
Constitutional Provision	**Salient Feature**	**Cantonments Act, 2006**	**Salient Feature**
Article 243 U	Duration of municipality is five years.	Section 14	Duration of elected members of a Board is five years
Article 243 W	Powers, authority and responsibilities of municipality (as per Twelfth Schedule)	Various sections of Cantonments Act, 2006	All functions given in the Twelfth Schedule are assigned to the Cantonment Board.
Article 243 Z	Audit of accounts as per law framed by the State	Cantonment Account Code, 1924	Audit of Cantonment Board is done by Controller General Defence Accounts. CAG also carries out audit of deficit Boards
Article 243ZA	Elections to municipalities are conducted by the State Election Commission	Cantonment Electoral Rules, 2007	Electoral rolls are revised every year by the Cantonment Board and elections are conducted by the Union Government

7.134 The composition and nature of a Cantonment Board is similar to that of a municipality, and this makes it qualify as the local government of cantonment areas. Many State Governments (Karnataka, Madhya Pradesh, Jharkhand, Telangana etc.) have already started sharing their revenue proceeds or allocation of SFC grants with these Boards. However, other States keep these areas outside of their allocations. The FC-XIII was the first Commission to include recommendations for the Cantonment Boards stating that "*the development plans for civilian areas within the cantonment areas (excluding areas under the active control of the forces) should be brought before the district planning committees.*" From the proposal of the Directorate General of Defence Estates, Ministry of Defence, it was learnt that Cantonment Boards are increasingly facing challenges of low revenue base, particularly in view of the taxes being subsumed under GST, low potential for property tax revenue as large areas in the cantonment are under the armed forces and commercial usage of property is quite limited. Cantonment Boards fall under the purview of Entry 3 in the Union List. **However, because of their similarity with municipalities, we are of the view that the State Governments, while deciding the share of**

basic grants among urban local bodies in non-Million-Plus cities, should allot grants on population basis for the Cantonment Boards falling within their territory. However, conditions applicable to other urban local bodies will also apply to the Cantonment Boards. A State-wise list of Boards along with the population is at Annex 7.7. The responsibility for making suitable arrangements on these lines for the Cantonment Boards falling within Union Territories lies with the Union Government.

Timely Release of Grants

7.135 **The grants recommended by us for rural local bodies and non-Million-Plus cities shall be released in two equal instalments each year in June and October, after ascertaining the entry level benchmarks and other requirements recommended by us. The States shall transfer grants-in-aid to the local governments within ten working days of having received them from the Union Government. Any delay beyond ten working days will require the State Governments to release the same with interest as per the effective rate of interest on market borrowings/State Development Loans (SDLs) for the previous year.**

Grants for Health to be Channelised through Local Governments

7.136 The Covid-19 pandemic has brought the limitations of India's health infrastructure to the fore. Apart from the tragic loss of life, the heavy and sudden burden of the pandemic has tended to overwhelm the health care system in almost all countries and result in a shortage of doctor and paramedics, hospital beds, intensive care units (ICUs) and quarantine facilities. We had initiated discussions on health-related issues by constituting a High-Level Group on Health Sector and based on intensive consultations with different stakeholders made observations on its proposed course of action in our Report for 2020-21. The vulnerabilities exposed by the pandemic, reinforced the need to review the earlier strategy and approach. Accordingly, consultations were held with the Ministry of Health and Family Welfare (MoHFW), State Governments, eminent health experts, and expert bodies including the World Bank. The States have an overwhelming share of 70 per cent of the total health related public expenditure, with the balance 30 per cent with the Union. Expenditure on primary health care accounts for a very large share of this expenditure and this, as our consultations brought out, is an area that requires to be strengthened within a short period. We recognise that in the efforts to achieve the ideal of universal health, rural and urban local bodies can play a key role in the delivery of primary health care services especially at the "cutting-edge" level. Strengthening the local governments in terms of resources, health infrastructure and capacity building can enable them to play a catalytic role in health care delivery, including in crisis times.

7.137 We have carefully analysed Articles 243 G and 243 W of the Constitution that deal with the powers, authority and responsibilities of panchayats and municipalities and also entrust them

with the implementation of schemes for economic development and social justice, including those in relation to the matters listed in the Eleventh and Twelfth Schedules. Health and sanitation, including hospitals, primary health centres and dispensaries and family welfare are listed at serial numbers 23 and 24 of the Eleventh Schedule for panchayats, and public health, sanitation conservancy and solid waste management at serial number 6 of the Twelfth Schedule for municipalities.

7.138 Many State Governments have not been proactive in transferring the functions, functionaries and funds to the local governments, as stipulated in the Constitution. The current pandemic has highlighted the critical role of panchayats and their potential to mobilise the community in managing local quarantines for the returning migrant workers, arranging cooked food and water for them and supporting the frontline health workers at the primary health care level. Kerala has established itself as an example where local governments and the staff of public health institutions effectively deliver healthcare at the local level in a collaborative framework (Box 7.4).

Box 7.4: Kerala Reforms for Effective Delivery of Healthcare Services

One major reform implemented in Kerala in 1996 was the transfer of 35-40 per cent of the State Government's development budget to local governments. This transfer was unconditional and was accompanied by training and granting of autonomy to local governments to develop and implement expenditure plans based on local needs and priorities. As part of the move towards decentralisation, sub centres and primary health centres (PHCs) in rural areas were brought under the overall supervision and control of gram panchayats, putting in place mechanisms for greater community involvement. Community health centres (CHCs) and taluk hospitals were under the purview of block panchayats. District hospitals and the management of State-sponsored and Centrally sponsored schemes (CSS) at the district level came under district panchayats. Similarly, CHCs and taluk hospitals in urban areas were transferred to municipalities and Municipal Corporations. While the total number of posts at sub-centres and PHCs remained under State Government control, appointment of temporary staff to offset vacancies came under the purview of Gram Panchayats. Staff working in local governments are State Government staff and the number of positions and transfers are determined at the State level. Local body members such as ward members who head the Village Health, Sanitation, and Nutrition Committees (VHNCs) are actively engaged in convergent action under the National Health Mission (NHM), which has the multipurpose health workers as convenors and ASHA and anganwadi workers as members. This structure has helped the government to engage more closely with the community, respond to local needs, catering to critical gaps like purchase of medicines and hiring of additional workforce as well as to invest in disease prevention activities. This has resulted in increased utilisation of PHCs and sub centres, particularly in villages with strong governance.

7.139 Taking a cue from the Kerala model, we considered this to be an opportune time to involve the third tier in the health sector and extend additional resources to it to strengthen the primary health system at the grass root level. We believe that the involvement of local

governments would also make the health system accountable to the people. We also sought an assessment of existing gaps in the health care delivery system in both rural and urban areas from the Union Government. We also analysed the existing interventions through different programmes, including the CSS of National Health Mission and Aysuhman Bharat. Based on our assessment, we have decided to provide a part of the grants earmarked for the third tier for support to primary healthcare. We have identified interventions that will directly lead to strengthening the primary health infrastructure and facilities in both rural and urban areas. The components identified along with the amount earmarked year-wise are given in Table 7.17. **Thus, a sum of Rs. 70,051 crore out of the grants for local governments have been earmarked for the health sector at the rural and urban local body levels over the award period of five years.**

Table 7.17: Sector-wise Break Up of Health Grants

(Rs. crore)

Total Health Grants	2021-22	2022-23	2023-24	2024-25	2025-26	Total
Support for diagnostic infrastructure to the primary healthcare facilities	3478	3478	3653	3835	4028	**18472**
Sub centres	*1457*	*1457*	*1530*	*1607*	*1687*	*7738*
PHCs	*1627*	*1627*	*1708*	*1793*	*1884*	*8639*
Urban PHCs	*394*	*394*	*415*	*435*	*457*	*2095*
Block level public health units	994	994	1044	1096	1151	**5279**
Urban health and wellness centres (HWCs)	4525	4525	4751	4989	5238	**24028**
Building-less Sub centres, PHCs, CHCs	1350	1350	1417	1488	1562	**7167**
Conversion of rural PHCs and sub centres into health and wellness centre	2845	2845	2986	3136	3293	**15105**
Total Health Grants	**13192**	**13192**	**13851**	**14544**	**15272**	**70051**

Support for diagnostic infrastructure to the primary healthcare facilities

7.140 We intend to give support for diagnostic infrastructure in sub centres, PHCs and urban PHCs under the vision of comprehensive primary health care. Diagnostic services are critical for the delivery of health services, and these grants are intended to fully equip the primary health care facilities so that they can provide some necessary diagnostic services (Annex 7.10 A-I, A-II and A-III).

Block level public health units

7.141 Block public health units (BPHU) would integrate the functions of service delivery,

public health action, strengthened laboratory services for disease surveillance, diagnosis and public health and serve as the hub for health-related reporting.

7.142 The BPHUs will also improve decentralised planning and the preparation of block plans that feed into district plans. In addition, they will improve accountability for health outcomes. Given that the block health facility is co-terminus with the Block Panchayat /Panchayat Samiti/Taluka Panchayat, this has the potential to facilitate convergence with the panchayati raj institutions and the child development project officer of the Integrated Child Development Scheme (ICDS) programme. We propose to provide support to BPHUs in all the States (Annex 7.10 B).

Urban Health and Wellness Centres

7.143 A paradigm shift in urban primary health care is envisaged, based on the learning from the management of the Covid-19 pandemic, which has affected urban areas disproportionately. As part of this shift, universal comprehensive primary health care is planned to be provided through urban Ayushman Bharat-Health and Wellness Centres (AB-HWCs) and polyclinics. Such urban HWCs would enable decentralised delivery of primary health care to smaller populations, thereby increasing the reach to cover the vulnerable and marginalised. It is envisaged that the urban HWCs would create a mechanism for representatives of the Medical Administrative Staff and Resident Welfare Associations to disseminate information on public health issues at least once a month.

7.144 We propose to provide support for setting up urban HWCs in close collaboration with urban local bodies (Annex 7.10 C).

Building-less Sub centres, PHCs, CHCs

7.145 An assessment of infrastructure gaps in rural PHCs/Sub centres based on *Rural Health Statistics, 2019*, shows that 885 PHCs and 33,886 Sub centres do not have the necessary infrastructure to meet the targets of the National Health Policy, 2017. The Commission proposes to provide support for necessary infrastructure for 27,581 HWCs at the sub centre level and 681 HWCs at the primary health centre level in rural areas in close collaboration with rural local bodies (Annex 7.10 D).

Conversion of Rural PHCs and Sub Centres into Health and Wellness Centre

7.146 The Union Government has envisaged the creation of 1,50,000 HWCs by transforming existing sub centres and PHCs as the basic pillar of Ayushman Bharat to deliver comprehensive primary health care. We propose to provide support for necessary infrastructure for the conversion of rural PHCs and sub centres into HWCs so that they are equipped and staffed by an appropriately trained primary health care team, comprising of multi-purpose workers (male and

female) and ASHAs and led by a mid-level health provider. PHCs linked to a cluster of HWCs would serve as the first point of referral for many disease conditions (Annex 7.10 E).

7.147 **Involving panchayati raj institutions as supervising agencies in these primary health care institutions would strengthen the overall primary health care system. Hence, we recommend year-wise State-wise fund allocation spread over five years for this purpose** (Annex 7.10). A Committee headed by the Secretary, MoHFW, and comprising Principal Secretaries of Health of all States should be set up to draw a time line of deliverables and outcomes for each of the five years along with a definite mechanism for flow and utilisation of these grants. This mechanism needs to be in place by April 2021 for the first instalment of funds to start flowing by July 2021. Similarly at the State level, a committee under the Chief Secretary and comprising officials of the State departments of Health, Panchayat Raj and Urban Affairs and select representatives from all three tiers of rural and urban local bodies should be in place by April 2021 and with plans ready for implementation by July 2021. A similar committee also needs to be constituted at the district level under the District Collector/Deputy Commissioner. Thereafter, subsequent steps should be taken at both the Union and State levels in line with plans agreed upon in the respective Committees. We expect that the persons charged with this responsibility at each level of the Union and State Governments will ensure strict adherence to timelines and outcomes as set out in the agreed policy. We also recommend that representatives of the urban local bodies and all three levels of panchayati raj institutions should be involved by entrusting them, in a phased manner, with the responsibility of supervising and managing the delivery of health services. **We also recommend that no conditions or directions other than those indicated in this paragraph should be imposed either by the Union or the State Governments, or any authority, for releasing the grants for health.**

Competition-based Grants for Incubation of New Cities

7.148 The Covid-19 pandemic has brought into sharp focus the well-known problem of inadequacy of appropriate housing and infrastructure facilities in urban areas. Given the trend in urbanisation, the country needs both rejuvenation of old cities as well as the setting up of new cities. The challenge of setting up infrastructure, such as laying of roads, water and sewer lines and provision of sites for schools and colleges and parks in greenfield cities can be less daunting than the problem of setting up such facilities in old established cities. On the other hand, establishment of greenfield cities runs into the problem of land acquisition and rehabilitation. Paradoxically, these problems are more pronounced in States that, because of their higher density of population, need such new cities more than sparsely populated States. Given these complexities, it is better to start on a pilot basis and, hence, **we recommend a performance-based challenge fund of Rs. 8,000 crore to States for incubation of new cities.** The amount available for each proposed new city is Rs. 1,000 crore and a State can have only one new city under the proposed scheme. Thus, a maximum of eight States can avail this grant for eight new cities over the award period of the Commission.

7.149 Determining the viability of building a proposed new city is a challenging proposition. The success of a new city depends on progress in areas such as land acquisition, having a masterplan, obtaining the necessary regulatory approvals, establishing secure source of water, gas and power supply, telecommunication, road, rail and air connectivity, solid and liquid waste management systems, securing the necessary finances for building the new city and establishing a revenue model for the urban local body to ensure its financial viability. Thus, the MoHUA will need to set up an expert committee, which will include independent domain experts and representatives from State Governments, to specify the minimum eligibility conditions to compete for the award. This committee will also have to work out the bidding parameters by which the top eight among the qualifying applicants will be selected. Since the proposed model is in the nature of viability gap funding, the bid parameter will need to be related to the cost in terms of our award per 100,000 residents in the proposed city (or some similar criterion), and calibrated in a manner that the funds are utilised - with commensurate performance and desired outcomes - within the award period, that is, before March 2026.

7.150 One area of concern in this context is the downside risk of delays in implementation of the project, including its abandonment mid-stream. To protect against this risk, the expert committee will have to schedule the release of tranches of the Finance Commission award to a new city in step with the completion of various stages of the project, according to a pre-agreed schedule. Providing a level playing field to all States in competing for the award for incubation of new cities, laying down rules of the competition process and complete transparency in the selection of the winners will be critical for the success of the pilot project.

7.151 We recommend that:

(i) the MoHUA set up an expert committee, which will include some independent domain experts and representatives of State Governments, to specify, by 31 January 2022, the minimum eligibility conditions for competing for the award and how the funds will be released to the winners;

(ii) the expert committee should (a) by 31 March 2022, specify the bid parameter for evaluating competing proposals by States, make it publicly available and call for bids from States by 30 September 2022; (b) announce the winners by 31 December 2022; and (c) recommend the release of the first tranche of the grant by 31 March 2023, and indicate how progress of the project should be evaluated vis-à-vis specified benchmarks for release of subsequent tranche(s).

Shared Municipal Services - Grants for National Data Centre

7.152 There is an urgent need to create an enabling ecosystem for States and urban local bodies to enhance own revenues, access municipal borrowings and implement shared municipal services. An institutionalised mechanism needs to be established to make municipalities "market worthy", with active participation of the financial services sector. The institutional arrangement

needs to be undertaken for implementation of various reforms at the urban local body level like publishing of documents, creating model PPP contracts, modernising municipal budgeting, evolving a national municipal borrowing framework including provisions equivalent to the Fiscal Responsibility and Budget Management Act for urban local bodies.

7.153 Municipal Shared Services Centres are intended to handle the following kinds of services: (a) issue of birth/death certificate, trade license, grievance redressal and other certificates/approvals/collections to citizens by using a model similar to the passport seva kendras; (b) function as a centralised processing centres for accounting, vendor payments, payroll processing etc., like the centre for income tax refunds; (c) doorstep/field services such as collections, maintenance and other last-mile field-level municipal services for which field staff can be optimised across municipalities and shared among a cluster of smaller urban local bodies.

7.154 The MoHUA will need to undertake both ecosystem-building as well as hand-holding for implementation of the Municipal Shared Services Centres. **We recommend a grant of Rs. 450 crore for this.**

Tax on Professions

Rationalising Professions Tax

7.155 The power of the State Legislature to impose a professions tax is derived from the Seventh Schedule, which states that no one shall be required to pay more than Rs. 2,500 by way of professions tax to any State or any local authority within that State. The initial tax limit of Rs. 50 per annum per person, which was raised to Rs. 250 per annum in 1950 and subsequently to Rs. 2,500 per annum in 1988 by the Constitution (Sixtieth Amendment) Act, 1988. At present, a majority of the States are levying professions tax. In some States, the levy is generally applicable to all persons engaged in any employment or in any profession whereas in the others it is only for enumerated professions. In some States, the tax is levied and collected by the State, but in others, municipal bodies also levy and collect the tax under a State legislation.

7.156 The FC-XI and subsequent Commissions recommended enhancement of the ceiling of Rs. 2,500, with FC-XIV recommending that the limit may be increased to Rs. 12,000. Further, while the FC-XI and FC-XIII recommended that this ceiling be changed through a parliamentary legislation, the FC-XIV suggested it be done through a Constitutional amendment. It further recommended that 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. **Since the ceiling for professions tax has not been revised for the last three decades, it is time that the relevant amendment to the Constitution is carried out on a priority basis.** This area is explored in detail in the Chapter 5 on Resource Mobilisation.

Summary of Recommendations

i. The total size of the grant to local governments should be Rs. 4,36,361 crore for the period 2021-26. We favour a fixed amount rather than a proportion of the divisible pool of taxes to ensure greater predictability of the quantum and timing of fund flow.

(para 7.60)

ii. Of these total grants, Rs. 8,000 crore is performance-based grants for incubation of new cities and Rs. 450 crore is for shared municipal services. A sum of Rs. 2,36,805 crore is earmarked for rural local bodies, Rs. 1,21,055 crore for urban local bodies and Rs. 70,051 crore for health grants through local governments.

(para 7.61, 7.62 and 7.93)

iii. For inter se distribution among States for rural and urban local bodies, weightage of 90 per cent should be given to population and 10 per cent to the area of the State. The grant to each State is detailed at Annex 7.4.

(para 7.62 and 7.93)

iv. We recommend that all States which have not done so, must constitute SFCs, act upon their recommendations and lay the explanatory memorandum as to the action taken thereon before the State legislature on or before March 2024. After March 2024, no grants should be released to a State that has not complied with the Constitutional provisions in respect of the SFC and these conditions. The MoPR will certify the compliance of all Constitutional provisions by a State in this respect before the release of their share of grants for 2024-25 and 2025-26.

(para 7.58)

v. The entry level condition for rural and urban local bodies availing any grants due to them is having both provisional and audited accounts online in the public domain. States will receive grants for those rural and urban local bodies that have their provisional accounts for the previous year and audited accounts for the year before the previous, available online.

(para 7.76 to 7.78, 7.95 and 7.96)

vi. For urban local bodies, apart from the entry level condition of having both provisional and audited accounts online in the public domain, after 2021-22, fixation of minimum floor for property tax rates by the relevant State followed by consistent improvement in the collection of property taxes in tandem with the growth rate of State's own GSDP will be an additional mandatory pre-condition.

(para 7.95 to 7.99, 7.101 and 7.102)

vii. To supplement the resources needed to fulfil national priorities, 60 per cent of the grants to rural local bodies should be tied to supporting and strengthening the delivery of two categories of basic services: (a) sanitation and maintenance of ODF status; and (b) drinking water, rain water harvesting and water recycling.

(para 7.84 and 7.85)

viii. Urban local bodies have been categorised into two groups, based on population, and different norms have been used for flow of grants to each, based on their specific needs and aspirations. For cities with million plus population (Million-Plus cities), 100 per cent of the grants are performance-linked through the Million-Plus Cities Challenge Fund (MCF). Basic grants are proposed only for cities/towns having a population of less than a million.

(para 7.104, 7.105 and 7.128)

ix. Category I cities (urban agglomerations with a population of more than one million) will be treated as a single unit for monitoring of performance indicators of ambient air quality and service level benchmarks. One-third of the total MCF of each city is earmarked for achieving ambient air quality. The balance two-third of the city-wise MCF is earmarked for achieving service level benchmarks for drinking water (including rainwater harvesting and recycling) and solid waste management. For drinking water (including rainwater harvesting and recycling) and sanitation and solid waste management criteria under service level benchmarks, the MoHUA shall act as the nodal ministry for determining the eligible urban local bodies.

(para 7.111 to 7.127)

x. Sixty per cent of the basic grants for urban local bodies in non-Million-Plus cities should be tied to supporting and strengthening the delivery of: (a) sanitation and solid waste management and attainment of star ratings as developed by the MoHUA; and (b) drinking water, rain water harvesting and water recycling.

(para 7.130 and 7.131)

xi. We recommend that for the five-year award period (2021-22 to 2025-26) grants should go to all the three tiers of panchayati raj institutions.Since no resident of India should be denied a share of the local body grants, these should be distributed to even those areas which are not required to have panchayats (Fifth and Sixth Schedule areas and Excluded Areas) for augmenting their resources to provide basic services by similar local level bodies.

(para 7.63 to 7.68)

xii. State Governments, while deciding the share of basic grant among various urban local bodies in cities other than Million-Plus cities, shall make allotment of grants (only under basic grants) on a per capita basis for the Cantonment Boards falling within the State.

(para 7.133 and 7.134)

xiii. The grants recommended by us for rural local bodies and non-Million-Plus cities shall be released in two equal instalments each year in June and October after ascertaining the entry level benchmarks and other requirements recommended by us. The States shall transfer grants-in-aid to the local bodies within ten working days of having received them from the Union Government. Any delay beyond ten working days will require the State Governments to release the same with interest as per the effective rate of interest on market borrowings/State Development Loans for the previous year.

(para 7.135)

xiv. Since health grants are meant for addressing the gaps in primary health infrastructure, the allocations would not be on a per capita basis for States or for local governments. Based on the MoHFW proposal, the recommended year-wise State-wise fund allocation for this purpose is provided at Annex 7.10. The MoHFW shall closely coordinate with respective State Governments and work out a mechanism for flow and utilisation of these health grants and also involve panchayati raj institutions at all three levels by entrusting them with the responsibility to supervise and manage the delivery of health services in a phased manner. No conditions or directions other than those indicated in para 7.147 should be imposed either by the Union or the State Governments, or any authority, for releasing the grants for health.

(para 7.136 to 7.147)

xv. A sum of Rs. 8,000 crore is recommended to States as grants for incubation of new cities and Rs. 450 crore for facilitating shared municipal services.

(para 7.148 to 7.154)

xvi. Since the ceiling for professions tax has not been revised for the last three decades, it is time that the relevant amendment to the Constitution is carried out on a priority basis.

(para 7.155 and 7.156)

Chapter 8

Disaster Risk Management

Successive Finance Commissions have followed an expenditure-based approach to determine the allocation of funds for disaster management to State Governments. In a significant departure from the past, in our Report for the Year 2020-21, we had recommended a new methodology, which is a combination of capacity (as reflected through past expenditure), risk exposure (area and population) and hazard and vulnerability (disaster risk index) for determining State-wise allocation for disaster management. This shall be continued for the five-year award period from 2021-22 to 2025-26 also.

Similarly, we have recommended continuation of mitigation funds at both the Union and State levels – National Disaster Mitigation Fund (NDMF) and State Disaster Mitigation Funds – to aid the implementation of mitigation measures in States for the award period, as provided in the Disaster Management Act, 2005. The six types of earmarked allocations within the overall allocation of National Disaster Response Fund and NDMF shall also continue in order to address certain priorities related to preparedness, mitigation and recovery through special initiatives.

A set of ideas and innovations which promote market-based instruments of risk management and identify alternative sources of funding has also been presented.

8.1 Paragraph 9 of the Terms of Reference (ToR) mandates the Commission to "review the present arrangements on financing Disaster Management initiatives, with reference to the funds constituted under the Disaster Management Act, 2005 (53 of 2005), and make appropriate recommendations thereon". Further, Para 7 requires the Commission to "consider proposing measurable performance-based incentives for States, at the appropriate level of government, in following areas: … (iii) Achievements in implementation of flagship schemes of Government of India, disaster resilient infrastructure, sustainable development goals, and quality of expenditure". Subsequently, we were asked to submit two reports, one for the year 2020-21 and a final report for an extended period of 2021-22 to 2025-26. To this end, we had already made our recommendations in Chapter 6 of the Report for the Year 2020-21.

8.2 In this first report, we briefly outlined the current mechanism of disaster risk management. We also gave fifteen recommendations (i to xv) at para 6.4 of the chapter on Disaster Risk Management. These include setting up of mitigation funds, allocation of funds at national and state level, a new methodology to estimate the disaster risk management fund and the allocation of funds to various States to cover both mitigation and response. From the total earmarked grants for disaster management, both for the national and State corpus, 20 per cent was

earmarked for mitigation and the remaining 80 per cent for the response fund. The response fund was further apportioned into three windows, namely Response and Relief, Recovery and Reconstruction and Capacity Building in the ratio of 50.0:37.5:12.5. Further, four priorities were identified under the National Disaster Mitigation Fund (NDMF) and two priorities under the National Disaster Response Fund (NDRF).

8.3 We reviewed these recommendations along with feedback from the Union and the State Governments. We also examined the context of the unprecedented Covid-19 pandemic within the current framework of disaster management in India. Recommendations for disaster risk management covering the period from 2021-22 to 2025-26 are made after considering all relevant issues.

Background

8.4 Disaster management, as a subject and as a facet of Union-State relations, has evolved over the years. Initially, the focus was largely on disaster relief. Earlier Finance Commissions too used the term 'disaster relief' while drafting their recommendations. However, the Disaster Management Act expanded the area of concern and action of both the Union and State Governments to a wide range of disaster management functions, which included relief and response, preparedness and mitigation, as well as recovery and reconstruction.

8.5 The Act also led to the creation of a new institutional structure for disaster management, with the setting up of the National Disaster Management Authority (NDMA) and State Disaster Management Authorities (SDMAs). The role of these institutions and the functions mandated by the Act have influenced the recommendations of Thirteenth and Fourteenth Finance Commissions (FC-XIII and FC-XIV). Successive Finance Commissions have taken a gradual and incremental approach to strengthening financial arrangements for disaster management. Based on their recommendations, a well-structured scheme of funds at the Union and State levels has been institutionalised, supported through guidelines and norms for assistance.

8.6 This scheme of funding for disasters has provided State Governments with a dependable source of assistance to meet their disaster response and relief needs. Further, these funds could be augmented and replenished through a national disaster fund when disasters of rare severity necessitate it. The guidelines and norms for assistance have been periodically revised, resulting in enhanced provisions for those affected by disasters.

8.7 A review of these arrangements every five years provides Finance Commissions an opportunity to introduce innovations in the funding arrangements as well as to improve the efficiency and equity of disaster management funds. The Finance Commissions are called upon to address a much broader task than allocating financial resources to States based on a set of considerations. This broader task is equally about reviewing the context of risk and vulnerability in the country, improving the institutional and policy aspects of disaster management, expanding

its scope, and encouraging more stakeholders to participate in an area which has a direct bearing on the physical safety, security and well-being of the people.

8.8 Over the years, Finance Commissions, through their recommendations, have steadily promoted innovation and reforms in the way governments at different levels support disaster management. We intend to follow the same path and precedent, though with a greater sense of urgency in view of the frequency of disasters and their mounting impacts in human and economic terms.

The Evolving Context of Finance Commission's Recommendations

8.9 Several considerations have guided the process of review and framing of our recommendations. The most important of these has been the ToR. A second important consideration has been the impact of climate change. The country has witnessed large-scale floods in different States (Uttarakhand, Tamil Nadu, Assam, Bihar and Kerala), cyclones; Phailin and Hudud (Odisha), Okchi (Tamil Nadu), Titali (Andhra Pradesh and Odisha), Gaja (Kerala and Tamil Nadu), Bulbul, Fani and Amphan (West Bengal) and successive droughts (Rajasthan, Maharashtra, Karnataka, Andhra Pradesh, and Telangana) over the last five years.

8.10 Third, the NDMA and SDMAs, which have become well-established institutions, have expanded the scope of disaster management beyond the traditional response-and-relief functions to include preparedness, mitigation and recovery and reconstruction. Disaster management has become a more specialised area internationally, with a rich body of literature devoted to risk assessment, risk transfer and risk reduction. Its professional needs have also increased at the national and state levels, as States have undertaken diverse initiatives in different areas of disaster management. The involvement of non-government organisations (NGOs) and the private sector has also helped in expanding participation in disaster management activities, as evidenced recently in some disasters of rare severity.

8.11 Fourth, the Union government has used the provisions of the Disaster Management Act for the management of the Covid-19 pandemic. For such events in the past, State Governments used the provisions of the Epidemic Diseases Act, 1897. As epidemics/pandemics are not explicitly provided in the Seventh Schedule of the Constitution – except the related broader subjects like 'public health' and related entries in the State List and 'preventing the spread of diseases from one state to another' in the Concurrent list – some observers had felt that the Constitutional framework leaves scope for improvements in the clarity of the roles of the Union and States. The Second Administrative Reforms Commission (2006) had recommended the addition of an entry in the Concurrent List for "Management of emergencies, natural or man-made". The National Commission to Review the Working of the Constitution (2002) had also recommended for similar action. It is interesting to note that even for passing the Disaster Management Act in 2005, the Parliament had to trace its legislative competence to the Concurrent List entry at No. 23 - 'Social security and social insurance: employment and unemployment'. We

are given to understand that the Ministry of Home Affairs has constituted a task force for filling the legislative vacuum on the ambit of disasters. In view of this, we are hopeful that the legislative framework to deal with Covid-19 kind of pandemics and related issues would get streamlined soon and we chose to deal with this issue in the chapter on the health sector rather than in the disaster risk management chapter.

8.12 Fifth, the insurance industry has witnessed significant growth in the last decade, especially after the increase in the limit on foreign direct investment in the sector to 49 per cent under the automatic route in 2015-16. Leading global insurance companies have set up operations in India in collaboration with domestic players and a range of life and non-life insurance services and products have been introduced in the market. As household income has increased, the insurance sector in India is likely to experience strong growth through product innovation, lower premiums, better claims management and regulatory supervision. The insurance sector can be leveraged to substantially reduce the financial burden of disaster management by households, particularly well-to-do ones.

8.13 Finally, India is a signatory to three large global frameworks, which were created in 2015: Sustainable Development Goals (SDGs), Paris Agreement on Climate Change and Sendai Framework on Disaster Risk Reduction (SFDRR).[1] These frameworks call for a set of inter-related actions on the part of governments and other stakeholders, which improve mitigation and adaptation, strengthen regulations, reduce risks and vulnerabilities and build greater resilience at the level of the state and civil society. India's commitment to these frameworks call for enabling actions so that we achieve the key indicators of these development frameworks.

8.14 In combating climate change, India has launched eight missions under the National Action Plan on Climate Change (NAPCC) in the specific areas of solar energy, energy efficiency, water, agriculture, Himalayan eco-system, sustainable habitat, green India and strategic knowledge on climate change. Climate actions at the State level are based on the State Action Plans on Climate Change (SAPCC). Thirty-three States/Union Territories have prepared their SAPCCs in line with the NAPCC, taking into account their specific issues relating to climate change. These initiatives, among other things, outline sector-specific and cross-sectoral priority climate actions. The Union Government is also implementing the National Adaptation Fund for Climate Change (NAFCC) to support adaptation measures of States/Union Territories in areas that are particularly vulnerable to the adverse impacts of climate change. Under the NAFCC, thirty projects have been sanctioned in twenty-seven States to tackle the issues related to adaptation in agriculture, water, forestry, etc. The Government of India has also embarked upon ambitious actions in the areas of renewable energy, afforestation, energy efficiency and urban development. As a result of these efforts, India has achieved 21 per cent reduction in the emission intensity of its gross domestic product (GDP) between 2005 and 2014, thereby achieving its pre-2020 voluntary goal of reducing the emission intensity of GDP by 20-25 per cent from 2005

[1] It is called the Sendai framework as it was adopted by the United Nations member states between 14 and 18 March 2015 at the World Conference on Disaster Risk Reduction held in Sendai, Japan.

levels by 2020.[2] The success of the missions launched under the NAPCC is key to India's commitment to the Paris Agreement to combat climate change and achieve its SDGs.

Studies and International Workshop

8.15 Given the changing context and priorities, we commissioned two studies, in collaboration with the NDMA, to prepare our recommendations. Our recommendations have benefitted from these studies and other workshops that we organised in collaboration with the United Nations Development Programme (UNDP) and the World Bank. In one of these, the UNDP, conducted a review of disaster risk financing practices and presented several recommendations, which cover allocations for the SDRFs and the NDRF, diversification of funding windows and sources of resource mobilisation. The second study, undertaken by the Indian Institute for Human Settlements, Bengaluru has focused on urban risks and vulnerabilities and the capacities and resources, which are required to be addressed by the urban local bodies. An international workshop on disaster risk financing held in Delhi on 12 and 13 November 2018 brought together several international experts, senior government officials, and representatives from the private sector and the insurance industry to discuss various aspects of disaster risk financing. The workshop presented several ideas about the size and allocation of disaster funds and the need for diversifying financial instruments and services for improved risk management.

States' Priorities

8.16 State Governments have also submitted memorandums to the Commission. These include several demands which are broadly similar to what they had raised before previous Finance Commissions. The key demands are:

i. SDRF allocation for States needs to be augmented. A majority of States recommended that the existing criteria for allocation, which is based on past expenditures, needs to be reviewed and the considerations of risk and vulnerability need to be taken into account. However, a few States were of the opinion that allocations should continue to be based on past expenditures.

ii. Some States were of the view that the SDRF should be financed entirely by the Union Government, as they find it difficult to provide their matching contribution.

iii. States and SDMAs should have greater flexibility in disbursing relief. The norms of assistance for the SDRF and NDRF are nationally determined, and do not always have flexibility for the unique needs of certain areas, especially remote and hilly terrains.

iv. The list of items considered for, and norms of, assistance included in the guidelines for the NDRF and SDRF should be revised and improved.

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[2] India's Second Biennial Report 2018.

v. The process of assessment for the determination of Union assistance through the NDRF as well as its release should be made faster and more efficient and transparent.

vi. The existing norms of assistance should include more resources for recovery and reconstruction. At present, the allocations are not sufficient for the reconstruction of housing and infrastructure.

vii. Separate allocations need to be made for the resettlement of people in floodplains, coastal areas and hills who have been displaced as a result of the impact of climate change.

viii. Mitigation, which has emerged as an important component of disaster management, should be funded through Union allocation. States are currently funding risk reduction measures on their own, but these funds are insufficient for the task.

ix. States should receive allocation for preparedness measures, which improves their ability to act upon early warnings. These measures would include setting up State Disaster Response Forces, which reduces dependence upon the armed forces, and the National Disaster Response Force.

x. Capacity-building grants introduced by the FC-XIII, which had been very useful in building state capacities in disaster management but were discontinued by FC-XIV, should be restored.

xi. The process of adjustment from the SDRF while releasing the NDRF allocation to the States needs to be reviewed.

xii. States should be provided greater technical assistance through national agencies for supporting their disaster management functions.

xiii. Concerted effort needs to be made to reduce the growing number of incidents of death by lightning. Families of people who die due to lightning should get ex gratia assistance.

xiv. Incidents of elephant attacks, lightning, mining-related fire hazards, snakebites, heatwaves, river and coastal erosion and public health disasters such as Japanese encephalitis, Nipah and the Covid-19 pandemic must be included in the eligible list of disasters for funding support from SDRF and NDRF.

xv. The amount earmarked for State-specific disasters should be increased up to 25 per cent from the current 10 per cent of SDRF allocation, in view of the large number of local calamities not covered under the national list.

Views from Union Agencies and Ministries

8.17 The NDMA has long advocated the setting up of a NDMF and State Disaster Mitigation Funds (SDMFs) so that resources for investment in risk reduction are available. Further, a separate funding window will help implement softer mitigation measures. Such funding is

available at present under scattered heads like Climate Change Fund and Sustainability Mission, among others.

8.18 The UNDP study refers to the Advisory Committee of the NDMA emphasising that the release and utilisation of financial resources from the NDRF and SDRFs should lead to measurable outcomes in terms of preparedness and response at the national and state levels, respectively. The Advisory Committee also noted that capacity building for disaster management should be funded through these mechanisms and suggested that there should be greater accountability in the utilisation of these resources. The National Institute for Disaster Management (NIDM) has also suggested the need for a separate funding for preparedness, capacity building, creating awareness, innovation and research. It has suggested allocations for State Institutes for Disaster Management (SIDMs), which are the State resource centres, for strengthening the disaster management system at the State level.

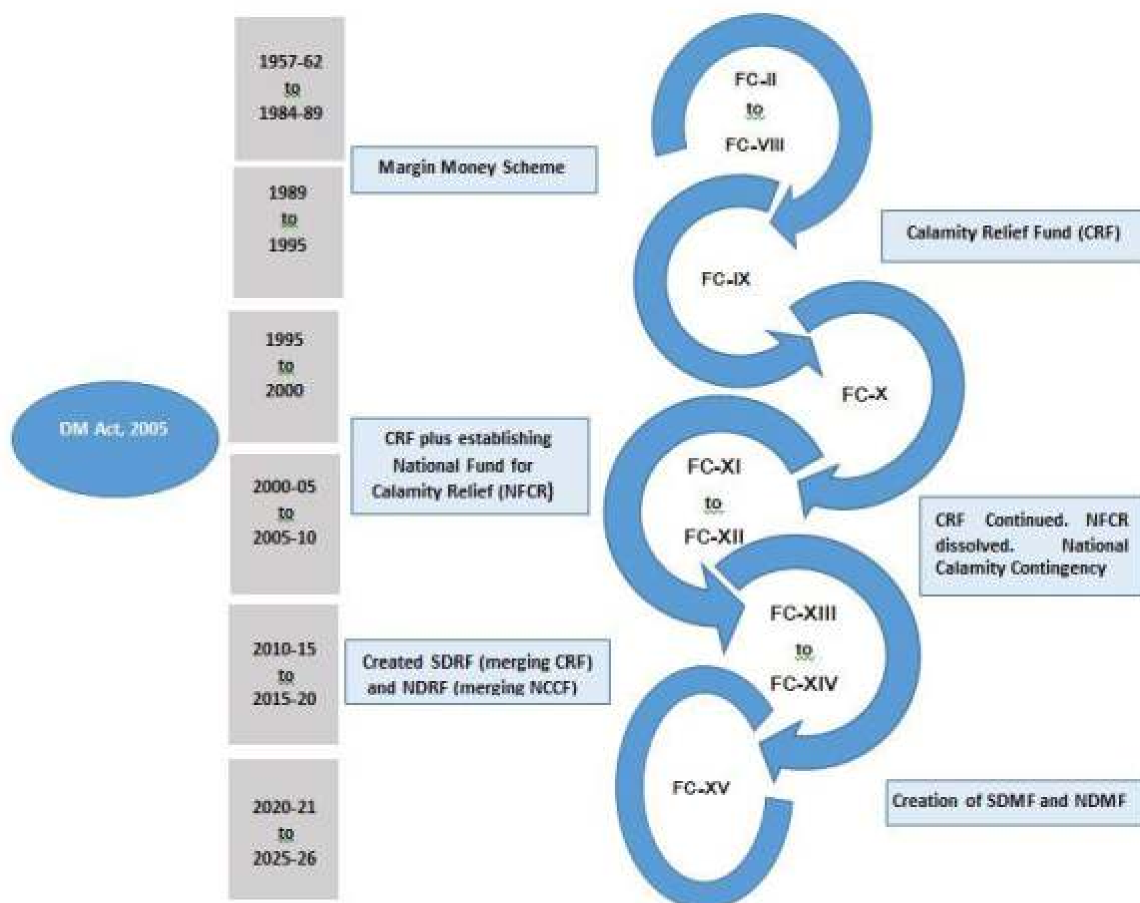
8.19 The ministries expressed their sectoral concerns. The Ministry of Agriculture and Farmers' Welfare has introduced new norms for the declaration of drought, based on a range of indicators, which the States need to follow. It has also suggested that the States should promote the Pradhan Mantri Fasal Bima Yojana (PMFBY) for reducing losses suffered by farmers. The Ministry of Home Affairs has suggested that the SDRF allocations be increased significantly and requested for financial assistance to strengthen and support disaster governance at State and district levels as well as the National Disaster Response Force. The Ministry of Finance suggested that the Commission may consider size of population, area, fiscal discipline and the vulnerability to disasters of each State while determining the size of the SDRF corpus and also earmark allocation for undertaking measures related to disaster preparedness. Further, it has also recommended the setting up and earmarking of allocation for the NDMF. The Ministry of Defence has requested for a review of procedures of funding disaster relief so that reimbursements to defence forces for disaster relief work are received in a near real time frame.

8.20 These priorities and views are based on the actual experiences of dealing with disasters. It casts an important responsibility on us to respond to these clearly and improve the existing system. In doing so, we need to place our recommendations in the context of the disaster risk financing system that has evolved over the years through the wisdom of previous Finance Commissions. We need to improve the existing system in a way that is fiscally sustainable, empowers State and local governments and retains the strength of our system while introducing innovations based on international practices. In brief, these improvements and innovations represent continuity with change. The Commission interacted extensively with the NDMA and other specialists in the field and is happy to note that expertise in disaster management have emerged with the necessary capacity and resources to take reforms and innovations to their logical conclusions.

Evolution of Disaster Risk Financing

8.21 The evolution of disaster risk financing in India over more than six decades in line with recommendations of successive Finance Commissions has been mapped in Figure 8.1. The important aspects of recommendations relating to disaster management from the FC-II (1957-62) to this Commission (FC-XV) are summarised and provided in Annex 8.1.

Figure 8.1: Evolution of Disaster Risk Financing in India



Key Features of Disaster Risk Financing

8.22 The mechanism of disaster risk financing in India reflects the distribution of responsibility in respect of disaster management. It is the State Governments which respond immediately to disasters – organising rescue, evacuation and relief and providing people with assistance. After the disaster event, the responsibility for recovery and reconstruction also lies primarily with the State Governments. The Union Government extends secondary support

through deploying the National Disaster Response Force and the armed forces at the request of State Governments. The Union Government and its agencies also provide financial and technical assistance whenever necessary.

8.23 As a result, it is the State Governments which incur most of the expenditures on disaster management. These expenditures are, at present, met through the SDRF. When States exhaust their SDRF resources, they can request financial assistance through the NDRF by submitting memorandums to the Union Government. The NDRF, which is set up at the Union level, replenishes and reinforces the State funds following a set of guidelines. This has been the central feature of disaster risk financing in India, and it has met the requirements of States for disaster assistance on a predictable basis. The broader impact of these allocations is reflected in improved early warning and preparedness nationally and, consequently, reduced human mortality over the years. However, as disaster risk has increased – both in terms of incidence as well as economic impact – the existing disaster risk financing arrangements appear less than adequate in terms of both source and application.

Aggregate Expenditures on Disasters

8.24 *The total expenditure on disaster response and relief across twenty-eight States between 2011 and 2019 has been Rs. 1,66,702 crore (Table 8.1). A steep jump in annual expenditure from 2015-16 could be explained by the upward revision of the norms of assistance in 2015.*

Table 8.1: Aggregate Expenditure of 28 States on Disasters

(Rs. crore)

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Aggregate States' expenditure on disasters*	14008	11425	16923	18416	32952	27727	15803	29448

* Major Head 2245 + expenditure incurred directly from Public Account

Source: Finance Accounts, CAG

8.25 It is observed that, in addition to the assistance from the SDRF and NDRF, State Governments have also been allocating funds from their budgetary resources for response and relief. State Governments also availed of World Bank loans for supporting larger recovery and reconstruction projects.

Conceptual Framework for Disaster Risk Financing

8.26 These expenditures on response and relief need to be viewed in two ways: one, how they impact public finances, and two, whether they help the people reduce their risk and vulnerability. However, it is also time to recognise that such a huge expenditure should also take poverty and disaster risk into consideration, as these are closely linked.

8.27 In public finance, disasters are looked upon as a contingent liability of the state. Contingent liabilities refer to (government) obligations that are triggered when a potential, but uncertain, future event occurs. The allocations made through the SDRF and NDRF help governments meet their contingent liabilities. However, the existing approach to meeting the contingent liabilities has two weaknesses. First, it is aimed at *meeting* the contingent liabilities, not *reducing* them. Governments should invest in estimating risk exposure and taking appropriate measures to reduce contingent liabilities. Second, the SDRF and NDRF, which function as dedicated reserve funds, are presently the only financial mechanisms for meeting the contingent liabilities. When risk exposure is high and contingent liabilities could increase significantly, multiple instruments and funding windows need to be introduced to meet these liabilities.

8.28 At the community and household level, disaster funds also need to be considered as means of transfer of resources to the people. When people have access to cash, they take several measures to address their welfare losses. They adopt coping strategies in response to disasters, and if they still have resources, they try to recover from the impact and resume their livelihoods. As the size of assistance is generally low, coping with disasters emerges as the primary objective.

8.29 If people need better protection against disasters, they need to build and acquire assets. These assets could include household assets, such as houses or sources of livelihoods, or community assets such as roads, drainage and health centres. Assets provide a sense of well-being and act as a defence against uncertainties and losses associated with disasters. Households with more assets are less likely to experience welfare losses following the occurrence of a disaster event. A disaster assistance strategy, therefore, should not just help people cope with the impact, but should also help them recover from the impact and reduce their risk and vulnerability.

8.30 These two broad conceptual approaches have simultaneously guided our deliberations and helped us frame our recommendations in more forward-looking terms. We envisage that not only should the Union and State Governments have adequate funds to deal with disasters, but these funds should also be sufficiently diversified to support a framework which includes all aspects of disaster management. Risks posed by natural hazards have increased and they need a more comprehensive and balanced response, as compared to the present approach which focuses just on response and relief. Further, the transfer of resources on such a scale should have a clear, discernible impact on poverty and risk which affects households and communities, particularly the poorer sections, all over the country.

Guiding Principles for the FC-XV

8.31 Based on a review of the established practices, both national and international, we are guided by the following four principles.

8.32 First, in all countries with a federal system, while it is the union or federal government which provides disaster assistance, the primary responsibility for disaster management rests with states. Whether it is the United States, Canada or Australia, the federal governments provide the assistance based on a declaration of disaster. In India too, the Union Government has the responsibility for disbursing assistance to the States, either through the NDRF, SDRF or other transfers. SDRF is a well-established mechanism, mandated by the legal provisions of the Disaster Management Act. In view of its long evolution, legal status and operational utility, SDRF should continue as the main vehicle of state resources for disaster management.

8.33 Second, a disaster management cycle consists of several functions – prevention, preparedness, response, mitigation, recovery and reconstruction. A disaster management system, in its infancy, does lay stress on response. However, as it develops further, it advocates other disaster management functions too. The Commission, therefore, having acknowledged the expanding field of disaster management and earmarked financial allocations for different functions, covering both relief and mitigation and provisions made under the Disaster Management Act, had recommended, in its report for 2020-21, the creation of a National Disaster Risk Management Fund (NDRMF) and State Disaster Risk Management Funds (SDRMF) at State level in its first report.

8.34 Third, after subsuming a substantial amount of the National Calamity Contingency Duty (NCCD) into the goods and service tax (GST) and the creation of SDMF and NDMF, the Union Government's fiscal space for disaster management at the national level has reduced significantly. The FC-XIV had recommended a change in the financing pattern of SDRF by the Union and States in the ratio of 90:10 for all States. The Union Government had accepted the recommendation made by the FC-XIV with the modification that contribution of the States to SDRF will continue as before; and that once GST is in place, the recommendation of the FC-XIV on disaster relief would be fully implemented. As the GST introduced in July 2017 has not stabilised, the Union Government decided that its share in SDRF during the award period of FC-XIV shall remain in the same ratio as it was in FC-XIII award period. **Hence, the sharing arrangement recommended by the FC-XIII (25 per cent contribution by all States, except for the North-Eastern and Himalayan (NEH) States which shall contribute 10 per cent) continued and we consider it appropriate to maintain the same arrangement.**

8.35 Fourth, as the system of disaster financing matures, the financial services and instruments for disaster management need to be diversified. Public funds serve a very important purpose in providing predictable support to states. However, these funds are seldom sufficient. We need to recognise the importance of alternative sources of funding and the role that market instruments can play in risk management.

8.36 Guided by these principles, we have made recommendations on all aspects of disaster risk financing. Our first set of recommendations relate to the size and allocation of SDRMF and NDRMF and funding windows for disaster management functions. Recognising some of the challenges posed by emerging risks and vulnerabilities, we have recommended earmarked allocations within the overall allocation.

8.37 We follow it up with recommendations for strengthening systems, guidelines and capacities which need to support the planning and utilisation of resources allocated at the Union and State levels. We believe that a certain level of investment in the governance framework will go a long way in improving the results and outcome in this sector.

8.38 We also follow it up with presenting a set of ideas and innovations which promote market-based instruments of risk management and identify alternative sources of funding. These innovations require further elaboration and due diligence before they are introduced and implemented. However, we believe that it is time to implement these interventions to diversify sources of disaster risk financing and improve the disaster risk management framework in the country.

8.39 Before we present our recommendations, we would like to mention two issues which we have decided not to engage with. Several States have asked for a revision in the norms for assistance provided from SDRF/NDRF now covered under SDRMF/NDRMF. While their request may be justified, such a task is beyond the scope of the Finance Commission. It is the Ministry of Home Affairs which should periodically revise the norms of assistance in consultation with the States. We take note of the fact that the norms are revised periodically, and the practice should continue.

8.40 The existing norms of assistance allow 10 per cent of SDRF to be used for relief assistance for people affected by lightning and other local disasters. In case States are more seriously affected by local disasters, they should bring it to the attention of the Ministry of Home Affairs and NDMA and seek relaxation of the norms. We are satisfied with the existing norms.

National and State Disaster Mitigation Funds

8.41 There is a concept of flexi-fund in development programmes, which allows State Governments to spend 25 per cent of programme resources on implementing mitigation measures. However, in actual practice, these flexi-funds have not been utilised for this. In 2016, the Supreme Court directed the Union Government to set up the NDMF in accordance with Section 47 of the Disaster Management Act. But the NDMF has not been constituted till now. The ministries of Finance and Home Affairs, in their memorandum, as well as the NDMA, have argued for such a fund to be set up without any further delay.

8.42 There is lack of clarity about mitigation in policy and planning discussions. Mitigation refers to "lessening or minimising of the adverse impacts of a hazardous event". It includes both

structural measures (constructing flood embankments and sea walls) as well as non-structural measures (developing building codes and a land use plan) aimed at reducing risks.

8.43 Section 2 (i) of the Disaster Management Act defines 'mitigation' as measures aimed at reducing the risk, impact or effects of a disaster or a potential disaster situation. Hence mitigation could be considered as all related measures, including large scale interventions such as construction of coastal walls, flood embankments, etc. But these are very resource intensive measures which should be pursued through regular development schemes and not from the mitigation fund. **We are of the view that the mitigation fund created should be used for those local level and community-based interventions which reduce risks and promote environment-friendly settlements and livelihood practices.**

8.44 Mitigation, as it is commonly understood and practised in disaster management, is closely related to climate change adaptation. Many interventions such as water resource management, afforestation and livelihood diversification could be considered as helping both disaster mitigation and climate change adaptation. It would, therefore, be desirable to link mitigation to climate change adaptation and use the mitigation fund for supporting adaptation measures as well. At the same time, it should be noted that 'mitigation' is defined differently in climate change policy, where the term is used for the reduction of greenhouse gas emissions that are the source of climate change.

8.45 Given the increasing levels of risks posed by climate change, unregulated urbanisation and over-exploitation of natural resources such as land, water and forests, the idea of a mitigation fund addressing risks and vulnerabilities at the local level has become imperative. Setting up such a mitigation fund, as recommended in our report for 2020-21, will provide a full expression to the objectives of the Disaster Management Act. It would also be in keeping with international practices related to supporting mitigation, along with response.

8.46 **The Commission, taking cognizance of need for mitigation funds at both the national and State levels in accordance with the provisions of the Disaster Management Act, has suggested allocations at these levels**. Mitigation funds should typically provide small grants for community-based local initiatives, pursuing an approach which promotes adjustment with hazards through soft measures, rather than controlling them through hard measures. An indicative list of mitigation activities is provided in Annex 8.2 and the Ministry of Home Affairs, in consultation with NDMA, may issue a detailed list of mitigation activities as part of the guidelines of the Mitigation Fund. The NDMA and SDMA should supervise the National and State Disaster Mitigation Funds as per the provisions of the Act.

Size and Allocation of Disaster Risk Management Funds for States

8.47 One of the key issues before the Finance Commission is the determination of the size of the SDRF and its inter-state distribution. This is an important concern for State Governments as they see the SDRF as the primary source of funds for disaster response. Though the Disaster

Management Act stipulates the constitution of the SDRF, it does not mention the size or source of the fund. The responsibility for determining this, therefore, has been given to the Finance Commission in its ToR. We have now decided to call the basic fund for States as State Disaster Risk Management Fund (SDRMF) which includes both SDRF and SDMF.

8.48 Successive Finance Commissions have pursued an expenditure-based approach to determine the allocation of funds for disaster management to each State. The expenditure-based allocation, however, tends to favour the better-off States, which can allocate resources and show higher expenditures. This gives them a larger base, which allows for even greater percentage increase in future allocations. In contrast, States with a lower initial allocation and expenditure see a lower increase in their allocations. The divergence in the allocations between these groups of States will progressively increase, creating a highly asymmetric situation.

8.49 Several States, which have received lower SDRF allocations, have highlighted this asymmetry arising from the expenditure-driven method. If such an approach persists, it will only aggravate such asymmetry in the inter-state allocation. Successive Finance Commissions have acknowledged the limitations of this approach and have indicated they would prefer a methodology which reflects the risk and vulnerability profile of each State. In fact, the FC-XIV had recommended in its report that such a risk and vulnerability assessment be conducted for the entire country to support the process of allocation. However, an integrated risk and vulnerability assessment at the national level has not yet been approved.

8.50 In view of these concerns, a detailed methodology was worked out which promotes equity and fairness and need-based allocation of funds to States for disaster management. The Commission has used the methodology for determining State-wise allocation for SDRMF in the manner as it had used in its report for 2020-21. It is important to note that this methodology has been the outcome of the deliberations of the Commission with main stakeholders like the Ministry of Home Affairs, NDMA, NITI Aayog, State Governments and UNDP as well as the latter's report on disaster risk financing.

8.51 **This new methodology, which replaces the expenditure-driven methodology, is most inclusive, as it represents a combination of capacity (as reflected through expenditure), risk exposure (area and population) and hazard and vulnerability (risk index).** The new methodology as indicated in the first report is detailed in Annex 8.3 for ready reference.

8.52 Given the high degree of uncertainties amidst the Covid-19 pandemic followed by the long period of lockdown, the Commission anticipates a sharp contraction in the domestic economy. Consequentially, there will be considerable squeeze in the availability of total divisible resources, at least in the near term. Secondly, we had already recommended a substantial increase in the allocation of grants for the total corpus at the State level to Rs. 28,983 crore in 2020-21, compared to Rs. 13,465 crore in 2019-20[3], keeping in view the demands of the mitigation fund that was recommended by us. Thus, the Union share for this amount increased by 115 per cent in 2020-21 against the 2019-20 budget estimates (BE). **The Commission,**

[3] https://www.ndmindia.nic.in/images/gallery/Statewiseallocation_SDRF_2015-2020.pdf

therefore, recommends that allocation for SDRF and NDRF for 2021-22 be retained at the level of 2020-21 and thereafter be set to increase by 5 per cent annually from 2022-23 to 2025-26.

8.53 **The total allocation for disaster management (SDRMF) to the States for the duration of the award period is Rs. 1,60,153 crore (Table 8.2)**. We recommend that the total State allocation for SDRMF be divided into SDRF and SDMF, which together address the full cycle of disaster management needs – response and relief, recovery and reconstruction, preparedness and capacity-building and mitigation.

Table 8.2: Annual Allocation for States for Disaster Management

(Rs. crore)

Year	2021-22	2022-23	2023-24	2024-25	2025-26	Total
Union share	22184	23294	24466	25688	26969	**122601**
States' share	6799	7137	7491	7864	8261	**37552**
Total (Union + States' share)	**28983**	**30431**	**31957**	**33552**	**35230**	**160153**
Percentage increase over previous year	-	5	5	5	5	

8.54 **The SDRF would receive 80 per cent of the total SDRMF, while the SDMF would get 20 per cent of the allocation. Within the SDRF allocation of 80 per cent, there would be three sub-allocations: Response and Relief (40 per cent), Recovery and Reconstruction (30 per cent) and Preparedness and Capacity-building (10 per cent). While the funding windows of SDRF and SDMF are not inter-changeable, there could be flexibility for re-allocation within the three sub-windows of SDRF**. Table 8.3 shows how the overall States allocation will be divided among the SDMF and SDRF, and further three sub-allocations within the SDRF:

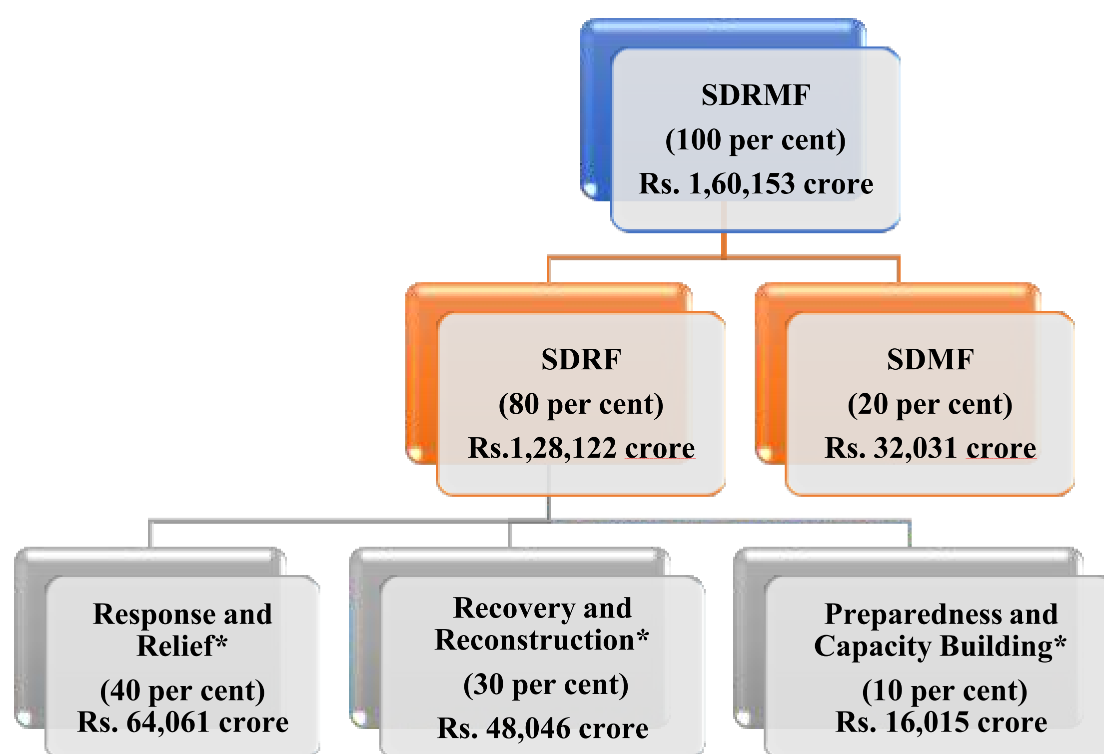
Table 8.3: Distribution of Total States Allocation

(Rs. crore)

Funds (percentage distribution)	Amount
SDMF (20)	32031
SDRF (80)	128122
i) Response and Relief (40)	64061
ii) Recovery and Reconstruction (30)	48046
iii) Preparedness and Capacity Building (10)	16015
Total (SDMF + SDRF) (100)	**160153**

8.55 The State-wise allocations based on the new methodology are provided in Annex 8.4 and Annex 8.5. A snapshot of the sub-categories and earmarked funds for SDRMF recommended by the Commission for the period 2021-26 is depicted in Figure 8.2.

Figure 8.2: Earmarked Funds for SDRMF



** Reallocation within the three sub-windows is recommended.*

Allocation of Funds for National Disaster Risk Management Fund

8.56 The NDRF represents the national disaster reserve, which supplements the SDRF. The NDRF needs to be budgeted and aligned with the SDRF in such a way that it assists States and supplements their SDRF allocations, rather than becoming the main source of disaster assistance.

8.57 The release of funds through the NDRF has been increasing exponentially. During the FC-XII period, the total release through the National Calamity Contingency Fund (NCCF), as it was known then, was Rs. 10,938 crore. During the FC-XIII period, the total release through the NDRF rose to Rs. 17,559 crore, an increase of 61 per cent over the FC-XII cycle. During FC-XIV (2015-20), the NDRF allocation went up to Rs. 57,146 crore, an increase of 225 per cent over the FC-XIII cycle. The projection during the FC-XIV is based on the expenditure incurred during the first three years of its cycle and budgeted expenditure for the last two years of its cycle.

8.58 The NDRF was funded through the proceeds of the NCCD. The NCCD on most of the

commodities has now been subsumed under the GST and is now levied on very few products such as tobacco and crude petroleum. The proceeds of the NCCD, therefore, would not be adequate to fund the NDRF. Hence, it is necessary to make an annual budgetary provision for the NDRMF, into which the NDRF has been subsumed.

8.59 As the provision for the NDRF is linked directly to expenditure, **we recommend a total national allocation of Rs. 68,463 crore for NDRMF for the period from 2021-22 to 2025-26** (Table 8.4), in view of the similar method followed while estimating the size of the SDRMF. In other words, the size of NDRMF for the first year (2021-22) has been kept at the same level of 2020-21 and thereafter, an annual increase of 5 per cent for the rest of the award period has been provided for.

Table 8.4: Proposed Annual National Allocation for Disaster Management

(Rs. crore)

2021-22	2022-23	2023-24	2024-25	2025-26	TOTAL
12390	**13010**	**13660**	**14343**	**15060**	**68463**

8.60 **The Disaster Management Act stipulates two windows of funding at the national level, namely NDRF and NDMF. We have now proposed that these two will fall under the overall amount fixed at the national level called NDRMF. The total allocation for NDRMF should thus be divided among NDRF and NDMF in an 80:20 ratios (Table 8.5).**

Table 8.5: Distribution of Total National Allocation

Funds	Amount (Rs. crore)	Percentage Share
NDMF	13693	20
NDRF	54770	80
Total (NDMF+NDRF)	**68463**	**100**

8.61 **We further suggest that three sub-allocations should be made within the NDRF corpus, similar to the SDRF: Response and Relief (40 per cent); Recovery and Reconstruction (30 per cent); and Preparedness and Capacity-building (10 per cent) (Table 8.6). If required, the Ministry of Home Affairs may examine the need for amending the Disaster Management Act to create such funding windows. While the funding windows for NDRF and NDMF are not interchangeable, there could be flexibility for re-allocation within the three sub-windows of NDRF, subject to the condition that earmarked allocations shall not exceed 10 per cent of the amount earmarked for that sub-window.**

Table 8.6: Windows of NDRF

Windows of NDRF	Amount (Rs. crore)	Percentage Share
Response and Relief	27385	40
Recovery and Reconstruction	20539	30
Preparedness and Capacity Building	6846	10
Total NDRF Corpus	54770	80

8.62 If the NDRMF releases to the States exceed the total budget provision, the Union Government could make additional provision for resources. However, a budget plan for the next five years will help the NDRMF to support States more systematically.

8.63 We recommend that all the Central assistance through the NDRF and NDMF should be on a cost-sharing basis. As the total allocations for the States have registered a significant increase, **there is a case for introducing cost-sharing arrangements on a graded basis, when States request Union assistance through different windows. States should contribute 10 per cent for assistance up to Rs. 250 crore, 20 per cent for assistance up to Rs. 500 crore and 25 per cent for all the assistance exceeding Rs. 500 crore from the NDRF and NDMF**. Such a cost-sharing arrangement would discourage exorbitant demands prepared on the considerations of competitive populism. The graded contribution would also be in keeping with international practice.

Diversifying Funding Windows

Recovery and Reconstruction Facility

8.64 At present, there is no funding window for recovery and reconstruction to support States. State Governments, therefore, have to request the Union Government for assistance. However, the guidelines for the NDRF and SDRF are oriented towards response and relief, and support for recovery and reconstruction is minimal.

8.65 When States are faced with disasters of rare severity, most of them seek loans from the World Bank, with the approval of the Union Government. However, access to such loans depend upon States' overall borrowings. Besides, States cannot approach the World Bank every time they suffer damage and loss because of such disasters.

8.66 In the past, the Planning Commission and Finance Commission have opined that resources for recovery should be allocated through development assistance. In the case of disasters of rare severity, the Union Government would provide a part of resources needed for recovery and reconstruction to States through additional Central allocation. However, with the discontinuation of the distinction between Plan and non-Plan expenditure, there is no such mechanism to support States at present.

8.67 Recovery presents an opportunity to get development activities off the ground as governments and communities spend recovery assistance on rebuilding infrastructure and houses, reviving livelihoods and improving civic services. The present near-total expenditure focus on response and relief does not leave any resources left for recovery. Without recovery, development gets seriously affected, which deepens the incidence of poverty and backwardness. Many States in the northern and eastern parts of the country experience flooding on recurrent basis and, without much recovery, these States tend to lag in development, which contributes significantly to regional imbalances.

8.68 Based on a clear appreciation of the pressing needs to rebuild assets and livelihoods, **we have recommended setting up a Recovery and Reconstruction Facility, both within the SDRF and NDRF, and suggested that 30 per cent of the resources available with these two funds be earmarked for this purpose.** When the resources are used for recovery and reconstruction, these would help people affected by disasters on a long-term basis.

8.69 Assistance for recovery and reconstruction needs to be determined on the basis of an assessment of damage and loss. **Governments do not pay for the entire cost of recovery and reconstruction, and the assistance could be a percentage of the total cost. Recovery and reconstruction is generally a multi-year programme and the assistance needs to be released annually against expenditures**. Further, assistance for recovery and reconstruction needs to be shared between the Union and States. When we apply these filters - needs assessment, recovery assistance on a partial basis, annual releases against expenditures, and cost-sharing between the Union and States - the cost of recovery and reconstruction can be easily managed on a fiscally sustainable basis.

Preparedness and Capacity-building Grants

8.70 **State Governments need to have essential disaster preparedness to respond effectively to disasters. Their institutions and facilities must be equipped and well-functioning to meet the exigencies of a situation**. The FC-XIII had introduced the capacity-building allocation by recommending a grant of Rs. 525 crore, linked to the overall size of the SDRF.

8.71 This capacity-building grant proved useful for States to develop their preparedness levels. Many States used these resources to procure emergency equipment and improve their search and rescue capacities. Though several States asked for the continuation of capacity-building grants, the FC-XIV did not include this in its recommendations and left this issue to be dealt with by the Union and State Governments.

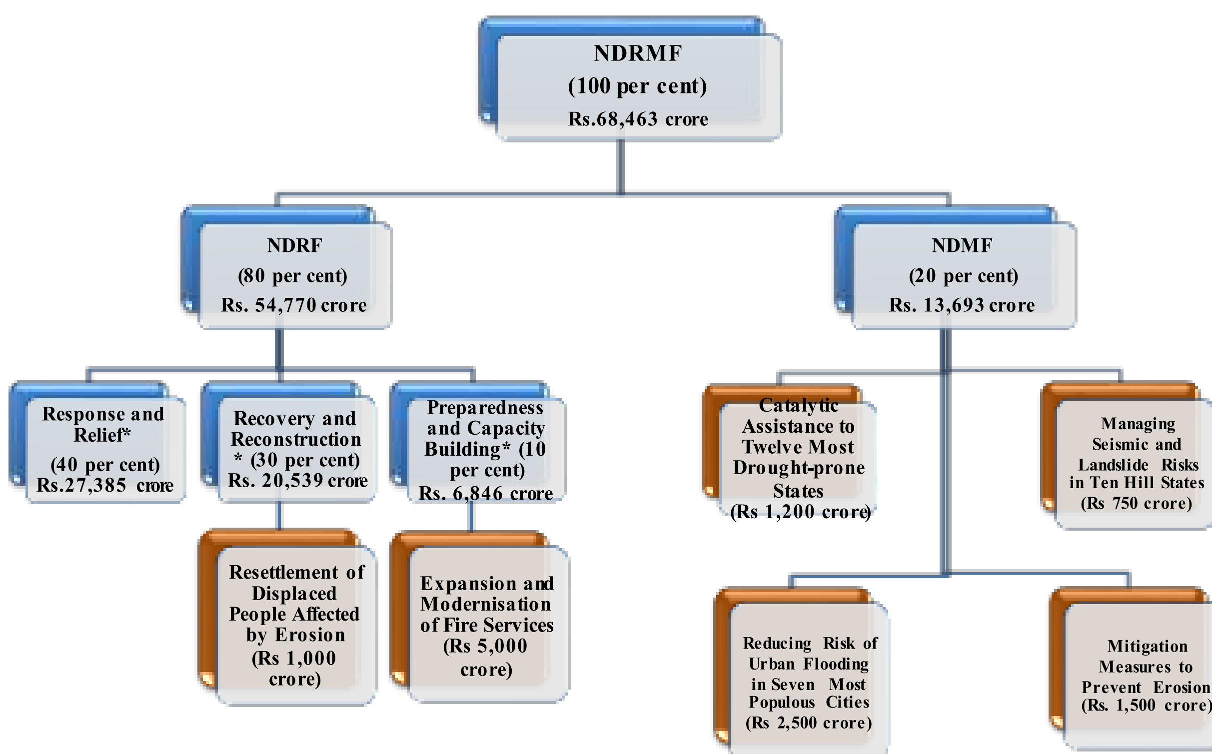
8.72 The preparedness and capacity-building components were included in the guidelines and norms of assistance for the utilisation of SDRF and NDRF, with the State Governments having the flexibility to use 10 per cent of their resources for the procurement of essential search, rescue and evacuation and communication equipment, and 5 per cent on capacity-building activities. In

spite of this flexibility, the claim upon the SDRF was too heavy to allow States to use these resources for equipping their search and rescue teams. The lesson that emerged from such an arrangement is that these resources can be utilised for capacity-building and procurement only if they are earmarked.

8.73 To support the critical institutional, functional and technological components of the disaster management system, it would be essential to earmark allocations for preparedness and capacity-building. **Such an allocation should be 10 per cent of the total State allocation and should be accessed through a sub-window within SDRF. These funds are meant to support the SDMA, SIDM, training and capacity-building activities and emergency response facilities. State Governments would not use these resources for personnel support. It is recommended that a separate set of guidelines be developed for preparedness and capacity-building grants. A similar window of preparedness and capacity-building should be made available within the NDRF, which will largely be used to support national agencies**.

8.74 A snapshot of the sub-categories and earmarked funds for NDRMF recommended by the Commission for the period 2021-26 is depicted in Figure 8.3.

Figure 8.3: Earmarked Funds for NDRMF



** Reallocation within the three sub-windows is recommended, subject to the condition that earmarked allocations under the respective sub-window is duly fulfilled.*

8.75 We recommend six types of earmarked allocations: two under NDRF (Expansion and Modernisation of Fire Services; Resettlement of Displaced People affected by Erosion) and four under NDMF (Catalytic Assistance to Twelve Most Drought-prone States; Managing Seismic and Landslide Risks in Ten Hill States; Reducing the Risk of Urban Flooding in Seven Most Populous Cities; and Mitigation Measures to prevent Erosion). These priorities are listed as follows:

Expansion and Modernisation of Fire Services

8.76 Fire services are the core first responders, particularly in urban areas. They provide a range of services, which include search and rescue, evacuation and immediate medical assistance. Incidents of fire in metropolitan and smaller cities have increased. According to National Crime Records Bureau data, 1,85,383 people lost their lives due to fire accidents between 2010 and 2019. This is an average of fifty-six deaths a day.

8.77 Fire services in the country lack resources and are ill equipped to provide adequate fire safety cover to the population. The NDMA has estimated the extent of deficiency of fire services in the country: fire stations - 97.54 per cent; firefighting and rescue vehicles - 80.04 per cent; and fire personnel - 96.28 per cent. It has recommended for allocation of grants worth Rs. 7,000 crore to States to meet these shortages. Such an investment would be completely justified and timely to save lives and economic losses which are mounting every year. As these resources need to be provided on a cost-sharing basis, we recommend a provision of Rs. 5,000 crore for strengthening fire services at the State level in the next five years. These resources could be allocated through the Preparedness and Capacity-building component of the NDRF. States need to apply for these funds, for which they should contribute 10 per cent of the amount sought. These resources could ideally provide a top-up to the existing programmes.

Catalytic Assistance to Twelve Most Drought-prone States

8.78 Drought is considered to be a silent killer and has a creeping effect. Several States such as Andhra Pradesh, Karnataka, Maharashtra and Rajasthan have suffered drought on a recurrent basis. These States are situated in low rainfall zones (less than 750 millimetres annually) and poor rainfall in successive years seems to have aggravated the intensity of drought. Even States such as Madhya Pradesh and Uttar Pradesh, where the annual rainfall ranges between 750 and 1125 millimetres, have suffered droughts. Small and marginal farmers in these States, which are largely engaged in rain-fed farming, are seriously affected by droughts.

8.79 In view of persistent droughts, widespread agrarian distress and large-scale expenditure on drought relief, it would be critical to establish a long-term drought management mechanism at the State level. While both the Union and State Governments have set up different schemes to mitigate the impact of drought, these interventions have not come together on the ground.

Implemented as they are by different agencies, these schemes have limited impact at the local level.

8.80 States need to develop long-term drought mitigation plans to address the challenges posed by successive droughts. These plans need to include area-specific farming systems, improvements in surface and ground water management, promoting efficiency of water use, agro-forestry schemes and solar energy installations. Each drought-affected district should develop a plan to bring about convergence of these interventions and monitor them on a long-term basis.

8.81 To develop district-level drought mitigation plans, we recommend allocating Rs. 100 crore each to twelve most drought-prone States over five years. These States are: Andhra Pradesh, Bihar, Gujarat, Jharkhand, Karnataka, Madhya Pradesh, Maharashtra, Odisha, Rajasthan, Tamil Nadu, Telangana, and Uttar Pradesh (Table 8.7). It would involve a total allocation of Rs. 1,200 crore over the FC-XV award period (2021-2026). The assistance could be provided through the proposed NDMF.

Table 8.7: Allocation to Drought-prone States for Drought Mitigation

(Rs. crore)

States	Total Allocation
Andhra Pradesh	100
Bihar	100
Gujarat	100
Jharkhand	100
Karnataka	100
Madhya Pradesh	100
Maharashtra	100
Odisha	100
Rajasthan	100
Tamil Nadu	100
Telangana	100
Uttar Pradesh	100
Total	**1200**

Managing Seismic and Landslide Risks in Ten Hill States

8.82 The Himalayas are not only the youngest mountains in the world, they are also among the most seismically active areas. The Indian Seismic Zonation Map classifies this region into Zones IV and V, the highest seismicity zones in India. The States of Himachal Pradesh, Uttarakhand and all the north-eastern States are in these two zones.

8.83 Seismic activities in the region trigger landslides too and both the risks are closely connected. Landslides are also triggered by heavy rains and flooding in the region. The entire Himalayan region experiences landslides on a frequent basis, causing death, destruction and economic disruptions.

8.84 It is critical that the two hill States – Himachal Pradesh and Uttarakhand – and all the eight states in the north-east undertake a mitigation programme to address the earthquake and landslide risks. The mitigation programme implemented over five years will also help these States in developing technical capacities and resources.

8.85 We recommend an allocation of Rs. 750 crore from the proposed NDMF for seismic and landslide risk reduction in the Himalayan region during the next five years. It would include an allocation of Rs. 250 crore each to Himachal Pradesh and Uttarakhand at the rate of Rs. 50 crore per year, and Rs. 250 crore for all the States in the north-east (Table 8.8). The allocation for the north-eastern States could be increased further if they are able to implement the programme and utilise these resources.

Table 8.8: Allocation for Managing Seismic and Landslide Risks in Hill States

(Rs. crore)

States	Annual Allocation	Total Allocation (2021-26)
Himachal Pradesh	50	250
Uttarakhand	50	250
All North-Eastern States		250
Total		**750**

Reducing the Risk of Urban Flooding in Seven Most Populous Cities

8.86 All the major cities in India are heavily affected by floods. The frequency of urban floods has increased, with not a year passing without large parts of some city or the other getting submerged. In December 2015, Chennai was heavily flooded, when the city received a rainfall of 340 mm in the course of just one day. In July 2018, Mumbai received 864.5 mm of rainfall within a week, which was nearly the rainfall for the entire month and in July 2019 over twenty people died due to floods in the city. In both cities, life and economic activity were disrupted as a result.

8.87 While State Governments have sought to address these issues, it requires an approach which brings together urban planning, ecological conservation and disaster management together. State Governments need to support a set of interventions which are implemented by multiple urban agencies working together. In view of the regular incidence of flooding and heavy losses, we recommend that a targeted allocation be made to address urban flooding in seven cities (excluding Delhi), which have a metropolitan area with a population exceeding five million.

These cities are: Mumbai, Chennai, Kolkata, Bengaluru, Hyderabad, Ahmedabad and Pune.

8.88 A similar approach and fund allocation is applicable to Delhi as well. However, since Delhi is a Union Territory (with Legislature), we have not made a separate allocation for it. The Ministry of Finance shall make the requisite fund allocation for Delhi for the award period of this Commission to reduce the risk of urban flooding.

8.89 We recommend that an allocation of Rs. 100 crore per year be made for each of the metros – Mumbai, Chennai and Kolkata – to prepare integrated solutions for flood management (Rs. 1,500 crore over five years). For the next tier of cities – Bengaluru, Hyderabad, Ahmedabad and Pune – an allocation of Rs. 50 crore per year should be made to prevent urban flooding (Rs. 1,000 crore over five years). The total assistance for urban flood management based on the proposed assistance is estimated to be Rs. 2,500 crore during our award period (Table 8.9). This amount may be allocated through the proposed NDMF. These allocations must be made on a cost-sharing arrangement, with the cities contributing 10 per cent of the resources.

Table 8.9: Allocation to Cities for Reducing the Risk of Urban Flooding

(Rs. crore)

Cities	Annual Allocation	Total Allocation (2021-26)
Mumbai	100	500
Chennai	100	500
Kolkata	100	500
Bengaluru	50	250
Hyderabad	50	250
Ahmedabad	50	250
Pune	50	250
Total	**500**	**2500**

Coastal and River Erosion

8.90 Coastal and river erosion can have serious adverse socio-economic consequences. A study conducted by the Space Application Centre (SAC), Ahmedabad, in association with the Central Water Commission (CWC), in May 2014 noted that around 45 per cent of India's coastline is facing erosion. The most telling example of river erosion has been Majuli island in Assam. Considered to be the world's largest riverine island, it is slowly shrinking because of erosion by the Brahmaputra river over decades. Satellite imagery shows the landmass of the island has shrunk from 1,256 square kilometres in 1971 to only 524.2 square kilometres in 2016, which means it has lost more than half of its area during the last forty-five years.

8.91 We have considered two aspects related to erosion: mitigation measures to prevent erosion (under NDMF) and resettlement of displaced people affected by erosion (under NDRF).

i) **Mitigation Measures to Prevent Erosion**

8.92 Coastal erosion, one of the recurring natural hazards, generally occurs as part of the erosion-accretion cycle. It is feared that with the predicted rise in sea levels due to climate change, there will be an increase in the rate of beach erosion as well as loss of coastal properties. In addition, the floods emanating from the Himalayan rivers wreak great annual damage, especially for the people of Assam, Bihar, Uttar Pradesh and West Bengal. Such disasters impede incentives for economic activity in these regions and make it difficult for the inhabitants to break out of their cycles of recurrent damage and poverty. **To reduce the annual flood disasters caused by regular river erosion, major capital works are required for proper upstream river basin management, with gestation spreading over ten to fifteen years. These cannot be accommodated through Finance Commission awards. Therefore, we are persuaded to recommend that such projects should be considered as national priority projects for execution. Only such holistic projects can help address flood mitigation properly. A piecemeal approach will simply witness yearly washing away of river embankments.**

8.93 In order to mitigate the risk of erosion, we recommend an allocation of Rs. 1,500 crore from the proposed NDMF for our award period. States would need to apply for these funds for undertaking erosion mitigation works and NDMA and/or Ministry of Home Affairs may develop suitable norms for this purpose. These allocations must be made on a cost-sharing arrangement, with the States contributing 10 per cent of the resources.

ii) **Resettlement of Displaced People Affected by Erosion**

8.94 The displacement caused by river erosion has taken a regional dimension covering the States of Assam, Bihar, Odisha and West Bengal. Rising sea levels have also threatened habitats. The Sundarbans in West Bengal is a climate hot spot threatened by rising sea water. The coastal fisher-population, who are amongst the most vulnerable communities, suffer loss of life and property as a result of sea erosion.

8.95 Given the magnitude of the problem, we recommend that both the Union and State Governments develop a policy to deal with the extensive displacement of people caused by coastal and river erosion. People must be provided with alternative settlements and they should receive some assistance from the government. To implement this policy, we allocate Rs. 1,000 crore to address the issue of displacement at the national level. State Governments can request the assistance for resettling affected people. Such assistance should be made available through the resources available from the recovery and reconstruction window of the NDRF. However, State Governments should avail these resources on a cost-sharing basis, contributing 10 per cent of the cost of resettlement. Such resettlements should ensure safer sites for the people being resettled.

8.96 **In view of the urgency and importance of these preparedness, risk reduction and recovery priorities at the national level, we recommend Rs. 11,950 crore from different windows of the NDRF and NDMF to address these issues (Table 8.10).** The NDMA should supervise the allocation and utilisation of these resources by framing the guidelines and setting the indicators.

Table 8.10: Summary of Earmarked Allocations

(Rs. crore)

Funding Windows	Earmarked Purpose	Total Allocations (2021-26)
NDRF (Capacity Building)	Expansion and Modernisation of Fire Services	5000
NDRF (Recovery and Reconstruction)	Resettlement of Displaced People affected by Erosion	1000
Sub-total (under NDRF)		**6000***
NDMF	Reducing the Risk of Urban Flooding in Seven Most Populous Cities	2500
NDMF	Catalytic Assistance to Twelve Most Drought-prone States	1200
NDMF	Managing Seismic and Landslide Risks in Ten Hill States	750
NDMF	Mitigation Measures to prevent Erosion	1500
Sub-Total (under NDMF)		**5950****
Grand Total		**11950**

**This amount of Rs. 6,000 crore shall be earmarked out of the total NDRF corpus of Rs. 54,770 crore.*

***This amount of Rs. 5,950 crore shall be earmarked out of the total NDMF corpus of Rs. 13,693 crore.*

8.97 We are of view that the objectives of all the earmarked allocations cannot be achieved unless the projects for which they are meant are implemented without undue delay, so that benefits accrue at the earliest to the target group. Therefore, such projects recommended by us under NDRF and NDMF should be sanctioned in such a manner that these can be completed within the award period of the Commission. **The Commission is also of the view that there shall be no spill-over for the liabilities committed for the projects sanctioned against earmarked allocation beyond the award period (2021-2026) of the Commission.**

Feasibility of District Disaster Response and Mitigation Funds

8.98 There have been consultations with State Governments in the past on the issue of separate district-level funds. State Governments have not supported the idea and suggested that the SDRF can take care of the requirements at the district level as well. Similarly, if the SDMF is constituted, it will take care of mitigation requirements at the district level.

8.99 There are many practical issues that will arise in the case of district-level funds. First, if a district does not experience any disaster, these funds will remain unspent, which will be an inefficient utilisation of resources, which are substantial. Second, the States would find it

difficult to pool resources distributed across districts to respond to a disaster in a particular district or group of districts within that State. Third, the jurisdiction of the State-level funds and district-level funds, which are meant for the same purpose, will overlap and there will always be an issue about how the district-level funds would be spent differently from State-level funds.

8.100 While setting up district-level disaster funds does not seem to be a practical idea, we recommend that State Governments must allocate resources to districts for preparedness and mitigation on an annual basis. Empowering the district administration is essential for improving disaster preparedness at the local level. Without the devolution of resources, the district administration and local governments at the district, taluka and municipal levels would find it difficult to support disaster management preparedness and implementation. State Governments managing the entire fund at the State level is a practice which needs to change.

8.101 State Governments should consider allocating these resources following a methodology that they should evolve. In subsequent allocations, the State Governments may also consider the expenditure incurred by districts under these funds.

Empowering Panchayati Raj Institutions for Disaster Preparedness and Management

8.102 In the present situation, government agencies take sole responsibility for disaster preparedness, rescue, relief and reconstruction activities without providing adequate scope for local participation. Not only has this increased people's dependence on the government machinery but it has also diminished the capacity of local communities to cope with natural disasters. The lack of disaster preparedness and mitigation planning at the local level, especially at the Gram Panchayat level, gives rise to considerable problems in the management of disasters.

8.103 In the event of disasters like floods or earthquake, it takes a while for the full impact to be felt and necessary formalities to be completed before the District Disaster Response Force/ State Disaster Response Force/National Disaster Response Force teams can swing in to action. Meanwhile enormous damage has taken place and people have suffered tremendous loss and faced hardship. Additionally, round the year events like floods, lightning or even local level droughts do not trigger an intervention at the State or Union Government level. It is, therefore, necessary to build adequate capacity at the panchayat level. Thus, the current-top-down approach for disaster management should be suitably corrected and made more effective and efficient by empowering panchayats.

8.104 The Commission, therefore, considers the role of panchayats crucial and necessary in view of their proximity to the local community (including the weaker sections of society) and their ability to enlist people's participation on an institutionalised basis. Their involvement can provide a quick response to disaster events – whether natural or man-made – and also sensitise people to deal with them and minimise their dependence on the government for rescue and relief operations.

8.105 In fact, making panchayats the nodal agency for relief and rehabilitation will result in improved planning, coordination and monitoring, and this will make the overall relief and rehabilitation interventions better. The panchayati raj institutions can play a pro-active role in all stages of disaster management, covering prevention, mitigation, preparedness, response, restoration, rehabilitation reconstruction work.

8.106 The Commission believes that the involvement of panchayats will lead to enhanced effectiveness of activities like rescue operations and arranging temporary shelters; distributing immediate relief in the form of money, food grains, medical care, clothes, tents, vessels, drinking water and other necessities; restoration, rehabilitation and reconstruction efforts of damaged villages and towns; crop protection measures and livestock management; health and sanitation measures; organising health camps and so on. In addition, panchayats can undertake several risk mitigation activities far more effectively. Therefore, some mitigation activities out of the proposed indicative list of activities in Annex 8.2 should be left to the panchayats rather than being taken up by the Union or State Governments.

8.107 The Commission is of the view that State Governments should allocate some reasonable amount out of the allocation made for SDRF and SDMF to districts. These financial mechanisms would strengthen a decentralised approach to disaster management, although, allocating resources to 2,63,028 panchayati raj institutions, comprising 2,55,549 Gram Panchayats, 6,825 Block Panchayats and 654 District Panchayats across 739 districts could be a challenge

Reimbursement to the Ministry of Defence for Expenditure on Disaster Rescue and Response

8.108 The Ministry of Defence renders assistance to the civilian administration for disaster rescue and response. Reimbursement for this expenditure is a major issue of concern. **Normally, the procedure for reimbursement should be resolved between the Ministry of Defence and the Ministry of Home Affairs through mutual consultations. However, as the issue has been referred to the Finance Commission, we recommend the following options:**

(i) Once the requested operation concludes, the unit providing the services submits the bill to the State Government. Upon receipt of this bill, the State Government releases the amount to the local military authority. The State Government can then submit the bill to the Ministry of Home Affairs for reimbursement through the NDRF. The Ministry of Home Affairs then releases the assistance to the State Government as per the norms of assistance included in the guidelines. The armed forces get their reimbursement quickly, and if there is any delay, it is a matter between the State Government and the Ministry of Home Affairs.

(ii) The Ministry of Home Affairs, in consultation with the Ministry of Finance, advances an amount from the NDRF based on average expenditures during previous years to the Ministry of Defence. The total cost incurred on rescue and relief by the

Ministry of Defence is adjusted against this advance at the end of the financial year. This would ensure that the Ministry of Defence has the requisite resources for providing these services.

(iii) Once the requested operations conclude, the local military authority submits the bill to the State Government and gets it countersigned. It then submits the countersigned bill to the Ministry of Defence, which forwards it to the Ministry of Home Affairs, which in turn, will then release the amount through the NDRF to the Ministry of Defence.

8.109 **Both the Union ministries could agree upon any one of these options**.

Strengthening Institutional Capacities and Improving Guidelines

8.110 There is a pressing need to strengthen capacities and systems for managing the NDRF and SDRF at the Union and State levels. At present, funds are released to State Governments, which incur the expenditure, and financial flows are monitored in terms of release and utilisation of funds, with little emphasis on the purpose of utilisation.

Dedicated Capacity for Managing NDRMF and SDRMF

8.111 Given the magnitude of allocations for the NDRMF and SDRMF, **we recommend setting up a dedicated capacity within the Ministry of Home Affairs, Ministry of Finance or NDMA to manage these funds actively. This could be modelled on the lines of Mexico's FONDEN (Fund for Natural Disasters).** Such a capacity with a small staff would carry out the functions of budgeting, release, utilisation, reporting and audit. It would lead to an active management of funds and a greater accountability for allocation, expenditure and reporting. **Such a dedicated capacity would also be helpful in looking beyond the SDRMF and NDRMF and augmenting disaster funding through other sources.**

8.112 We also recommend setting up an online system for the release of NDRMF and SDRMF allocations. It will show the release of SDRMF allocations, expenditures and the outstanding balance for each State online. Such a system would improve the process of adjustment while funds from the Union Government are being released.

Two-stage Assessment for NDRF Allocation

8.113 **We recommend replacing the existing system of assessment of the damages caused by any natural calamity by a two-stage assessment. The first stage should be a smaller assessment, largely to ascertain humanitarian and relief needs. The second assessment should be inter-sectoral and more elaborate, and cover damage, loss and recovery needs.** The Union Government should consider introducing Post-Disaster Needs Assessment (PDNA) as defined in the manual on PDNA produced by the NIDM

(https://nidm.gov.in/PDF/pubs/pdna_manual_vol1.pdf) as the standard methodology for carrying out the assessment following a disaster event.

Developing a Disaster Database

8.114 **We recommend setting up a disaster database as a special initiative. The database should have disaster assessments, the details of allocations and expenditure and preparedness and mitigation plans.** As insurance coverage expands in India, such a database would be extremely helpful in diversifying and improving insurance products and services.

Disbursing Assistance to Women Members of Households

8.115 Given the gender imbalances within households, **we recommend that cash assistance should be transferred to families in a way that women members of the household also get access to the money**. Housing and livelihoods assistance should also be targeted at women. This is an area which requires significant reforms in recognising the legal rights of women and their central role in ensuring the well-being of families.

Development of Guidelines

8.116 **If the new funding windows are being set up, they need to be supported through the development of guidelines.** Once the NDMF and SDMF are set up, they should follow the guidelines for mitigation. Similarly, States should also have guidelines for preparedness and capacity-building. A national recovery framework would guide the States in developing recovery plans. **The NDMA could develop the guidelines and frameworks and organise training around these enabling guidelines.**

NDMA's Leadership Role

8.117 The NDMA should take a leadership role in **developing and maintaining the financial system for disaster management and work closely with the SDMAs.** It needs to play an active role in setting up the Mitigation Fund and the Recovery and Reconstruction facility. These are new mechanisms which require support and nurturing. States need continuous guidance in setting up these windows and effectively using these resources. Without an active champion, these new windows will not be able to yield the expected results.

Outcome Framework

8.118 A greater accountability for the allocation and utilisation of SDRMF and NDRMF resources may be ensured through developing an outcome framework. Such a framework calls

for States' commitments to achieve the Sendai Framework indicators. Some of these include reducing mortality, supporting community recovery and resilience and improving the quality and substance of disaster assistance. **An annual report at the national level may record all the allocations, expenditures, key achievements and results against various indicators developed for the implementation of SFDRR**. The ministries of Finance and Home Affairs and the NDMA may lead a mid-term review of the entire allocations and assess the impact of expenditures through different windows. **The contribution of these allocations to national and state capacities and resources may be evaluated against a set of indicators determined by the NDMA.**

Alternative Sources of Funding

8.119 **The resources provided by the SDRF and NDRF would be insufficient in many situations, and both the Union and State Governments would be constrained to mobilise disaster funding through other sources like reconstruction bonds, contingent credit/stand-by facility with international financial institutions, crowdfunding platforms and corporate social responsibility.** Developing these financial mechanisms and instruments ahead of a contingent situation would help governments identify and select more cost-effective options. **We recommend that the Union and State Governments look at these mechanisms and instruments carefully and consider accessing them when they are faced with disasters.**

Reconstruction Bonds

8.120 In a post-disaster situation, State Governments can issue reconstruction bonds, with a maturity of three to five years, with the approval of the Union Government. People would like to contribute to recovery and reconstruction efforts, and they would prefer to invest in bonds, for reasons other than just financial returns. So the State Governments could issue these bonds with a lower yield. However, the resources raised by these bonds should largely be spent on the construction of productive and social assets.

Contingent Credit/Stand-by Facility with International Financial Institutions

8.121 International financial institutions, the World Bank and the Asian Development Bank (ADB) have been among the most important sources of financial assistance for post-disaster recovery and reconstruction in India. Beginning in 1990, there have been at least nine recovery and reconstruction projects supported by the World Bank with an approximate cost of US$ 2.5 billion across different States.

8.122 If the World Bank and ADB have provided loans for recovery and reconstruction on a regular basis, there could be a long-term arrangement through which the lending operation could be made shorter and easier. Such an arrangement would ensure that if the cost of disaster exceeds

a certain threshold, States could request loans from these institutions with necessary approvals. Such proposals may be considered taking into account the cost of borrowing, knowledge transfer and organisational help.

Crowdfunding Platforms for Disaster

8.123 Crowdfunding is playing an increasingly larger role in mobilising resources for disaster relief and recovery. Campaigns are launched on the internet to raise funds from the public. Communities and organisations with volunteers on the ground ascertain critical needs and create targeted donation pages. Within a matter of hours, a fundraising campaign is launched and a community of fundraisers takes shape.

8.124 Both the Union and State Governments need to recognise the role of crowdfunding and use it when disasters occur. While several crowdfunding platforms come up following a disaster event, a platform set up by the government with specified objectives and an assurance of transparency can attract public contributions on a more significant scale. Setting up a crowdfunding platform would require skills and expertise, which the governments could consider outsourcing. Identifying the right time for crowdfunding, setting up secure payment gateways and ensuring accountability and transparency are the most important considerations for the success of such an initiative. It is an area where both the Union and State Governments together should prepare operational guidelines.

Corporate Social Responsibility Window

8.125 The private sector has been supporting disaster relief and recovery for a long time. However, it can expand its contribution to disaster management by diversifying its engagement. In addition to relief and recovery assistance, it can support an event or campaign to raise awareness, mobilise donations from private sector employees and support crowdfunding. It can provide technological and innovation support for disaster management.

8.126 Incentives for a wider engagement of the private sector could include tax exemption to contributions to the NDRF and SDRF. The FC-XIV had made this recommendation, and this needs to be implemented. We reiterate these recommendations for providing tax exemption for such contributions. Schedule VII of the Companies (Corporate Social Responsibility Policy) Rules 2014 relating to corporate social responsibility states that companies may provide funds for the Prime Minister's Relief Fund or "any other fund set up by the Union Government or the State Governments for socio-economic development and relief". This rule could be used as an enabling provision for the contribution of the private sector to disaster funding windows. The corporate social responsibility rules and tax exemption incentives could be applied more innovatively to improve and diversify private sector support for disaster management.

Insurance and Risk Pooling

8.127 In the past, Finance Commissions have engaged with the provision of insurance for disaster-affected people. However, after due deliberations, they considered insurance as impractical on several grounds. They concluded that it would be cheaper for State Governments to directly provide disaster relief, as is being done presently, instead of going through an insurance intermediary.

8.128 While the Finance Commissions have correctly held these views and hence did not favour an insurance coverage for disasters to be extended to the entire population, there is a strong case for introducing insurance and risk pooling in niche areas, where essential conditions for market-based risk management instruments exist.

8.129 Insurance is feasible and practical when risk pools are large, the data on damage and loss is available and pay-outs could be estimated with reasonable accuracy. An expanded risk pool, which could exist at national or global levels, and quantified risks through a long-term database could be key to the feasibility of insurance services.

8.130 Furthermore, the use of insurance instruments is most efficient for natural perils, which occur infrequently but have high potential impact. The cost of response and recovery for frequently occurring natural hazards (occurring once every five to ten years, depending on the peril) are best absorbed by public funds such as the SDRF and NDRF. However, severe natural hazards occurring every ten to hundred years are best suited to be covered by an insurance policy or catastrophe bond.

8.131 In keeping with these principles, **we propose four insurance interventions, which need to be studied further by the NDMA and the relevant ministries for their feasibility.** These insurance interventions would provide an additional layer of protection to the people. These interventions do not seek to replace the existing public fund mechanisms; rather, they supplement these mechanisms and reinforce protection to the people. However, **these insurance mechanisms need to be introduced with due diligence in partnership with insurance companies**. The proposed insurance mechanisms are discussed below:

National Insurance Scheme for Disaster-related Deaths

8.132 An insurance programme for disaster-related deaths in India could be a feasible intervention for several reasons, and it confers clear benefits upon the families of those who have died. In India, disaster mortality as a proportion to the total population has reduced over the years. Due to improved early warning systems and preparedness as well as better communications, the annual mortality has seen a clear decline. The mortality is expected to decline further, which is a stated policy goal to meet the commitments expressed in the SFDRR.

8.133 On the strength of State-wise disaster mortality data, a national insurance scheme could be set up in partnership with an insurance company. State Governments may join the scheme by

paying insurance premium based on their annual mortality. The Union Government could also contribute to the risk pool. Such insurance premium would generally be less than what State Governments pay by way of ex gratia assistance. In case of deaths, insurance companies would release the pay-out to the affected families at different stages such as one instalment immediately after the death, second instalment after five years, and again after ten years. The insurance company could also make monthly payments to affected families. The insurance scheme could be designed in a way that it essentially works as a social protection scheme. It does not increase the administrative burden on the government, as the responsibility for the pay-out lies with the insurance company.

Synchronising Relief Assistance with Crop Insurance

8.134 Farmers receive assistance in case of crop failure due to disaster events through two sources: SDRF/NDRF release and crop insurance pay-out. Discussions with State Governments showed that the assistance through government sources to a small and marginal farmer ranges from Rs. 3,000 to Rs. 10,000 on an average. While such assistance is helpful to farmers in times of distress, it is not a significant amount. However, if the pay-out from the crop insurance scheme is available at the same time, there is a substantive increase in total assistance. The PMFBY is an effective tool for compensating farmers for crop losses due to natural perils. Its effectiveness would increase considerably if the assessment and pay-out for crop failures is coupled with the SDRF/NDRF assistance.

8.135 We recommend that the Ministry of Agriculture and Farmers' Welfare should take steps through which the synchronisation between the SDRF/NDRF release and crop insurance pay-out could be improved. It would include a common assessment of the area under crops, improved loss assessment methodology and a prompt budget provision for crop insurance.

Risk Pool for Infrastructure Protection and Recovery

8.136 Infrastructure assets are prone to risks of hazards, causing massive damage and loss as seen in recent disasters. As governments are considered the ultimate insurer, there would generally be no insurance coverage for infrastructure protection. When disasters strike, the Union and State Governments release assistance for restoration of infrastructure. However, these resources generally prove inadequate for restoration and reconstruction. As the scale of infrastructure in India increases, the need for their protection would require a major commitment of resources.

8.137 Infrastructure protection could be supported through setting up a national risk pool for infrastructure in partnership with an insurance company. Infrastructure companies within the country could be encouraged to join the risk pool, which will yield the benefit of getting insurance protection against risks as well as the incentive for investing in improved standards and

regulations. When there is damage and loss to infrastructure due to a natural hazard, the risk pool will pay for recovery and reconstruction.

8.138 Setting up a risk pool for infrastructure would be an innovative step and would require partnering with an insurance company. However, it would be more cost effective compared to other risk transfer solutions. As the Union Government has decided to set up the Coalition for Disaster Resilient Infrastructure, setting up a risk pool for infrastructure would be the first step towards seeking risk transfer solutions through market mechanisms.

Access to International Reinsurance for Outlier Hazard Events

8.139 **We recommend exploring an additional layer of protection against extreme hazard events through the international reinsurance market. Such a protection would have a parametric feature, aimed at low-frequency, high-intensity disaster events, and would provide an additional layer of protection through a global risk pool.** The index for such disasters could be defined in terms of magnitude and severity. For example, a great earthquake of magnitude 8 Mw or a super-cyclone could be the trigger for insurance pay-out.

8.140 It would be necessary to procure such an insurance protection through market quotes. Due to the low frequency of disasters and a global reinsurance pool, the premium for a parametric risk protection could be cost effective. International reinsurance companies can bid for protection, based on the magnitude of the hazard and pay-out. It is important that such an insurance protection is cost effective and should be cheaper than other forms of protection.

List of Calamities

8.141 This Commission, like its predecessors, has also examined the requests received from States for inclusion of a number of calamities in the eligible list of disasters for funding support from the SDRF and NDRF. The Commission feels that most of the calamities suggested by the States for inclusion in the list of notified calamities are State-specific or region- specific and can be difficult to quantify, as the scale of severity would vary from region to region.

8.142 The Commission considers that calamities like fire incidents and river and coastal erosion can be tackled efficiently through mitigation efforts. It has, therefore, made an allocation of Rs. 7,500 crore from the NDRMF for this. Of this allocation, Rs. 5,000 crore has been earmarked for strengthening fire services (para 8.77) and Rs. 2,500 crore has been set aside for mitigation measures to prevent erosion and resettlement of displaced people affected by erosion. (paras 8.93 and 8.95).

8.143 The Commission has observed that the list of notified disasters eligible for funding from SDRMF and NDRMF covers the needs of the States to a large extent and thus did not find much merit in the request to expand its scope.

8.144 Man-made disasters and technological disasters (chemical and industrial disasters including radioactive contamination, railway/air accidents), including public health disasters such pandemics/epidemics, which are caused by either negligence/oversight or faulty equipment or even bad weather, may have low chances of occurrence but require high level of funding. The Commission feels that financing of preventive and relief measures for such disasters should be left out of the SDRMF and NDRMF. These disasters may continue to be taken care of by the respective nodal ministry/department. The Union Government may consider financing disaster relief in respect of such disasters as a one-time temporary arrangement from the NDRMF for initial mitigation, as was done at the time of the Covid-19 outbreak provided that funds available with the respective designated ministry/department are not sufficient.

Accounting Norms and Standards

8.145 Mandates relating to operating of the disaster-related funds require the States to transfer their matching share towards the SDRF along with the Union's share received by them. However, some of the States do not make transfers into the public account maintained by them in a timely manner. This results in inadequate funds being available with the States to tackle disasters of a severe nature and they seek additional central assistance (ACA) from the NDRF. States are, therefore, advised to make timely transfers of their matching share under SDRF and SDMF. It is further suggested that since SDRF and SDMF (together now called SDRMF) are non-lapsable corpuses, any balance left under these heads from one Finance Commission award period should be carried forward to the award period of the next Commission.

8.146 The Commission also considers that since the disaster response fund and mitigation fund are different identities, there should be separate accounting heads for each under SDRMF and NDRMF in order to utilise allocation made for response and mitigation efforts. Therefore, the Commission suggests that the Ministry of Home Affairs, in consultation with Department of Expenditure in the Ministry of Finance, take appropriate action to open new accounting heads while formulating the operational guidelines and norms for the SDRMF and NDRMF. Accordingly, sub major heads corresponding to minor heads under MH '1601 - Grants-in-aid from Central Government', MH '2245 - Relief on account of Natural calamities', MH '3601- Grants-in-aid to State Governments', MH- '8121- General and other Reserve Funds' under Reserve Funds Bearing Interest, and MH '8235-General and other Reserve Funds under Reserve Funds Not Bearing Interest should be opened before first instalment of 2021-22 for SDRMF and NDRMF is released. The CGA and Department of Expenditure should ensure that these accounting norms are adhered to. The CAG may appropriately review the adherence to these prescribed accounting practices.

8.147 As per the current practice, 50 per cent of the available balance under SDRF as on April 1 of a financial year, as reported by the Accountant General of the State, is adjusted while calculating the requirement of ACA from the NDRF during severe calamities. However, this does

not capture the contribution (Union as well as States share) made to the SDRF until that period while calculating ACA under NDRF. The contribution made to the SDRF in that financial year is also meant to ensure that States have adequate funds under the SDRF for tackling severe disasters. The Commission is, therefore, of the view that the balance as on April 1 of a financial year and Union and States' contribution of their respective shares made to the SDRF until the latest date should be adjusted while calculating ACA under NDRF and the first charge should be on the SDRF during a severe disaster.

Summary of Recommendations

(I) The ratio of contribution by Union and States to the State-level allocations for disaster management recommended by FC-XIII should be maintained. Thus, States are to contribute 25 per cent of funds of SDRF and SDMF except the NEH States which shall contribute 10 per cent, and the rest is to be provided by the Union Government.

(para 8.34)

(ii) Mitigation Funds should be set up at both the national and State levels, in line with the provisions of the Disaster Management Act. The Mitigation Fund should be used for those local level and community-based interventions which reduce risks and promote environment-friendly settlements and livelihood practices.

(para 8.43 and 8.46)

(iii) Allocation of disaster management funds to SDRMFs should be based on factors of past expenditure, area, population, and disaster risk index (which reflect States' institutional capacity, risk exposure, and hazard and vulnerability respectively). Assuming an annual increase of 5 per cent, we arrive at the total corpus of Rs.1,60,153 crore for States for disaster management for the duration of 2021-26, of which the Union share is Rs. 1,22,601 crore and States share is Rs. 37,552 crore.

(para 8.51, 8.52 and 8.53)

(iv) Total States allocation for SDRMF should be subdivided into funding windows that encompass the full disaster management cycle. Thus, the SDRF should get 80 per cent of the total allocation and the SDMF 20 per cent. The SDRF allocation of 80 per cent should be further distributed as follows: Response and Relief – 40 per cent; Recovery and Reconstruction – 30 per cent; and Preparedness and Capacity-building – 10 per cent. While the funding windows of the SDRF and SDMF are not interchangeable, there could be flexibility for re-allocation within the three sub-windows of SDRF.

(para 8.54)

(v) The allocation for the NDRMF should be based on expenditure in previous years. Assuming an annual increase of 5 per cent, the total national allocation for disaster management is estimated to be Rs. 68,463 crore for the duration of 2021-26.

(para 8.59)

(vi) The allocation for the NDRMF should also be subdivided into funding windows similar to that of States' allocation for disaster management. Hence, the NDRF should get 80 per cent of the total allocation for the NDRMF, with further division into 40 per cent for Response and Relief, 30 per cent for Recovery and Reconstruction and 10 per cent for Preparedness and Capacity-building. The NDMF should be allotted 20 per cent of the total allocation for the NDRMF. If required, the Ministry of Home Affairs may examine the need for amending the Disaster Management Act to create three sub-windows within the NDRF. While the funding window of NDRF and NDMF should be maintained, there could be flexibility for re-allocation within these sub-windows.

(para 8.60 and 8.61)

(vii) To discourage excessive and unsubstantiated demands from States, all Central assistance through the NDRF and NDMF should be provided on a graded cost-sharing basis. States should contribute 10 per cent for assistance up to Rs. 250 crore, 20 per cent for assistance up to Rs. 500 crore and 25 per cent for all assistance exceeding Rs. 500 crore.

(para 8.63)

(viii) A Recovery and Reconstruction Facility should be set up within the NDRF and SDRF. Assistance for recovery and reconstruction is generally a multi-year programme, and the assistance, shared between the Union and States, needs to be released annually against expenditures and only as a percentage of total cost.

(para 8.68 and 8.69)

(ix) State Governments need to have essential disaster preparedness to respond effectively to disasters. Their institutions and facilities must be equipped and well-functioning to meet the exigencies of a situation. The preparedness and capacity-building grants could be used to support the SDMAs, SIDMs, training and capacity-building activities and emergency response facilities. A similar window of preparedness and capacity-building should be made available within the NDRF, which could be used to support national agencies.

(para 8.70 and 8.73)

(x) Major capital works required for proper upstream river basin management (to mitigate annual flood disasters caused by river erosion) with gestation periods of ten to fifteen years cannot be accommodated through Finance Commission award. Therefore, we recommend that such projects should be considered as national priority projects. Only such holistic projects can help address flood mitigation properly. A piecemeal approach will simply result in yearly washing away of river embankments.

(para 8.92)

(xi) There should be six earmarked allocations for a total amount of Rs. 11,950 crore for certain priority areas, namely, two under the NDRF (Expansion and Modernisation of Fire Services and Resettlement of Displaced People affected by Erosion) and four under the NDMF (Catalytic Assistance to Twelve Most Drought-prone States, Managing Seismic and Landslide Risks in Ten Hill States, Reducing the Risk of Urban Flooding in Seven Most Populous Cities and Mitigation Measures to Prevent Erosion).

(para 8.96)

(xii) A streamlined system of payment to the Ministry of Defence by the Ministry of Home Affairs should be institutionalised through mutual consultations. Three options for the system of payment have been outlined.

(para 8.108)

(xiii) In order to strengthen institutional capacities, a dedicated capacity should be set up to supervise the NDRMF and SDRMF and augment disaster funding through other sources. In addition, a disaster database should be developed to help assess the impact of expenditures on different aspects of disaster management. Other interventions such as disbursing assistance to women members of households will make disaster management more effective and efficient. NDMA, as a leading agency in disaster management, needs to be proactive and collaborate with States in pushing the agenda of reforms in disaster management.

(para 8.111, 8.114, 8.115 and 8.117).

(xiv) To improve and streamline the access of Central assistance to the states, the existing system of assessment of the damages caused by any natural calamitiesshould be replaced by a two-stage assessment – an initial humanitarian needs assessment for response and relief assistance and a post-disaster needs assessment (PDNA) for recovery and reconstruction needs.

(para 8.113).

(xv) All the new funding windows need to be supported through development of guidelines, the drawing up of which should be led by the NDMA. (para 8.116)

(xvi) An annual report at the national level may record all the allocations, expenditures, key achievements and results against various indicators developed for the implementation of the SFDRR. The contribution of these allocations to national and State capacities may be evaluated against a set of indicators determined by the NDMA.

(para 8.118)

(xvii) In the event of SDRMF and NDRMF assistance falling short of the required assistance, the Union and States should have recourse to other financial instruments. These instruments are identified as reconstruction bonds, contingent credit/stand-by facility with international financial institutions, crowdfunding platforms and corporate social responsibility.

(para 8.119)

(xviii) Insurance mechanisms, which act as a social safety net and supplement the existing financial mechanisms, need to be introduced in partnership with insurance companies after due diligence is done. These mechanisms are: national insurance scheme for disaster-related deaths, synchronising relief assistance with crop insurance, risk pool for infrastructure protection and recovery, and access to international reinsurance to the outlier hazard events

(para 8.131 and 8.139).

Chapter 9

Pandemic and Beyond: Building Resilience in Health Sector

There is no doubt that India has made some notable gains on the health front since independence. However, the health sector still faces critical challenges like low investment, sharp inter-State variations in the availability of health infrastructure and health outcomes and supply side problems of doctors, paramedics and inadequate number of healthcare centres. In this chapter, we have studied these challenges in detail and worked out a way forward that includes both regulatory recommendations and grants for the health sector. We have recommended grants for critical care hospitals, public health laboratories, Diplomate of National Board courses and training of allied healthcare workforce. This is in addition to the grants for health given through local governments and State-specific grants. The total grants-in-aid support to the health sector over the award period works out to Rs. 1,06,606 crore which is 10.3 per cent of the total grants-in-aid recommended by us. This forms about 0.1 per cent of gross domestic product. The grants for the health sector will be unconditional.

9.1 Para 6(iii) of the Terms of Reference (ToR) requires us to consider "the demand on the resources of the State Governments, particularly on account of financing socio-economic development and critical infrastructure, assets maintenance expenditure, balanced regional development……". Further, para 7 suggests areas where we may propose measurable performance-based incentives for States. Para 7(ii) refers to the "efforts and progress made in moving towards replacement rate of population growth" and para 7(iii) refers to the "achievements in implementation of flagship schemes of Government of India, disaster resilient infrastructure, sustainable development goals, and quality of expenditure". All these have a direct relevance to the health sector and its associated challenges.

9.2 Over the years, India's health sector has been repeatedly identified as one of the most critical areas in need of reform and public investment. However, the pace of progress has been tardy, as is reflected both in the health indices and the poor quality of public health care facilities. Unlike past Commissions, we have consciously decided to devote greater attention and resources to the health sector as it has acquired urgency in the context of the Covid-19 pandemic. The Commission invested a large part of its time and resources in extensive consultations with multiple stakeholders of this sector and this collaborative effort is reflected in the key recommendations in this chapter.

9.3 While the country has made significant progress in some areas like eradication of certain diseases, reduction in total fertility rate (TFR) and infant mortality rate (IMR), it still has quite a

distance to traverse. The Covid-19 pandemic has exposed various fault lines in the country's health sector. Low investment, sharp inter-State variations in the availability of health infrastructure and in health outcomes, supply side problems of doctors, paramedics, hospitals and inadequate number of healthcare centres like primary health care centres (PHCs), sub centres and community health centres (CHCs) are some of the structural challenges that exist. Consequently, we find about 70 per cent of expenditure on health is out of pocket, one of the highest globally. High out of pocket expenditure poses the largest risk to the population living below, and at the margins of, the poverty line. Irrespective of the ability to pay, people in India increasingly seek private health care even for minor illnesses like cold, fever and diarrhoea. Private health care in India is not only expensive but may also lack trained and skilled manpower. People living in rural areas face an additional handicap of location because health care facilities have a significant urban bias. It would not be erroneous to state that even seventy-three years after Independence quality healthcare in India has remained elusive for many.

Health Outcomes: Performance over time

9.4 There is no doubt that India has made some notable gains on the health front since independence. Life expectancy at birth has increased, infant mortality and crude death rates have been greatly reduced, diseases such as smallpox, polio and guinea worm have been eradicated, and leprosy is on the verge of getting eliminated.

9.5 The sex ratio (number of females per 1,000 males) in the country has improved from 933 in 2001 to 943 in 2011. The estimated birth rate declined from 25.8 per 1,000 population in 2000 to 20.4 per 1,000 population in 2016 while the death rate declined from 8.5 per 1,000 population to 6.4 per 1,000 population over the same period. The natural growth rate declined from 17.3 per 1,000 population in 2000 to 14 per 1,000 population in 2016, according to the National Health Profile 2018-19. In recent years, India has made progress in reducing the maternal mortality ratio (MMR) from 556 per 100,000 live births in 1990 to 130 in 2016. The long-prevailing urban-rural divide in institutional births has largely been bridged. Overall, 75 per cent of rural births are now supervised as compared to 89 per cent in urban areas.

9.6 National health programmes have played a crucial role in tackling several serious health concerns. The malarial death rate in India declined to 0.02 deaths per 100,000 population in 2018 from 0.10 deaths in 2001 and the country has achieved the Millennium Development Goal (MDG) of halting and reversing the incidence of tuberculosis (TB) by 2015. There has been significant progress in achieving immunisation coverage through the Universal Immunisation Programme (UIP) which provides protection from six vaccine-preventable diseases.

9.7 While all this reflects significant achievements, it cannot deflect attention from the fact that India lags behind many similarly placed countries. At 130 per 100,000 live births, the MMR is almost double the 2030 Sustainable Development Goal (SDG) target of 70. India ranked 94 out of 107 countries in the Global Hunger Index 2020. Childhood stunting rates of 38 per cent are

among the highest in the world. Data on nutritional outcomes also show that 35.8 per cent of children are underweight and 58.6 per cent are anaemic (Annex 9.1). Since all this has long-term implications for health as well as for learning, employability and economic performance, it is a development challenge of first-order importance.

Table 9.1: Comparison of India with Other Countries in Key Health Outcomes

Country	Population (millions)	Fertility (children per woman)	Life expectancy (years)	Under-five Mortality (per 1,000 live births)	Maternal mortality (per 100,000 births	Child stunting (%)
Bangladesh	167	2.1	72	30	173	36
Brazil	210	1.7	75	14	60	7
China	1,400	1.7	76	9	29	8
India	1,352	2.2	69	37	130	38
Indonesia	267	2.3	71	25	177	36
Malaysia	33	2.0	76	8	29	21
Russia	147	1.8	72	7	17	5
South Africa	59	2.4	64	34	119	27
Sri Lanka	22	2.2	77	7	36	17
Thailand	68	1.5	77	9	37	11
Vietnam	95	2.0	75	21	43	25

Source: World Bank indicators (2011 to 2019)

9.8 There are large inter-State variations in health outcomes. Life expectancy ranges from 65 years in Uttar Pradesh to 75.2 years in Kerala (Annex 9.2). In States like Tamil Nadu and Kerala, the TFR is 1.59 and 1.79 respectively, similar to that in advanced countries, but in States like Bihar and Uttar Pradesh have a TFR of 2.93 and 2.61 respectively. Sample Registration System (SRS) data on IMR (2018) shows the variation is from only four in Nagaland to forty-eight in Madhya Pradesh. Other States with high IMR are Arunachal Pradesh, Assam, Bihar, Chhattisgarh, Meghalaya, Odisha, Rajasthan and Uttar Pradesh. The rate of institutional deliveries in Kerala is 99.8 per cent, while it is only 32.8 per cent in Nagaland. States like Arunachal Pradesh, Assam, Bihar, Jharkhand, Manipur, Meghalaya, Nagaland, Uttar Pradesh and Uttarakhand have a very poor rate of institutional deliveries.

9.9 This disparity is also present in nutritional outcomes. Bihar, Chhattisgarh, Gujarat, Jharkhand, Madhya Pradesh, Rajasthan and Uttar Pradesh have very high proportion of children who are underweight and stunted. States like Haryana, Jharkhand, Madhya Pradesh and Uttar Pradesh have a very high rate of children with anaemia. Hunger Index, India's rank has fallen from 93 in 2015 to 102 in 2019 out of 117 qualifying countries. Such poor nutrition levels also hinder the building up of primary immunity in children. The Union Government launched the Poshan Abhiyan in March 2018 with the objective of building a people's movement for holistic

nutrition. The movement involves inter-sectoral convergence for better service delivery, use of technology (ICT) for real time growth monitoring and tracking of women and children and intensified health and nutrition services.

9.10 These inter-State variation were highlighted in the Health Index contained in NITI Aayog's, *Healthy States, Progressive India,* of June 2019. Among the larger States, the overall score in the index of the best-performing State was more than two and half times that of the overall score of the least-performing State. States also vary in progress towards achieving the SDGs. While Kerala, Tamil Nadu, Maharashtra and Punjab have already achieved the SDG target related to under five mortality rate (U5MR), other States still need significant improvements. There were also significant variations in the changes in the Health Index scores from 2015-16 to 2017-18 across States and Union Territories, indicating different levels of momentum in improving performance. With Covid-19, all these vulnerabilities now risk being magnified, with lasting effects on nutrition, maternal health and children, thereby increasing regional inequities. The pandemic is harming health, social and material well-being worldwide, with the poorest being hit hardest. School closures, social distancing and confinement increase the risk of poor nutrition among children.

9.11 India's health system also fares poorly in terms of providing financial risk protection against catastrophic and impoverishing medical expenses. An estimated 60 million Indians are pushed into poverty each year due to out-of-pocket payments for health. This is a major shortcoming, as ensuring financial protection is one of the key pillars of universal health coverage.

Health Infrastructure: An Assessment of Vulnerabilities

9.12 A crude proxy of the vulnerability of any health system is the availability, distribution and financing of health services, including hospital beds and human resources for health. India is estimated to have a total of 18,99,228 hospital beds (over 60 per cent of which are in the private sector), that is, roughly 1.4 beds per 1,000 population.[1] This is lower than in many comparator countries: China's bed density exceeds four per 1,000; Sri Lanka, the United Kingdom and the United States have around three per 1,000; and in Thailand and Brazil hospital beds exceed two per 1,000 persons.[2] Within India, hospital bed densities are particularly low in Bihar, Odisha, Chhattisgarh, the erstwhile State of Jammu and Kashmir, Jharkhand, Manipur, Madhya Pradesh and Assam. Gujarat, Uttar Pradesh, Maharashtra, Andhra Pradesh, Haryana and Telangana have relatively low densities of public hospital beds, but this is made up by the availability of private beds.

9.13 Beyond hospitals, primary care in the public health system, especially in rural areas, is provided via health outposts (sub centres) that are linked to PHCs and CHCs, several of which

[1] Kapoor, G et al (2020), 'State-Wise Estimates of Current Hospital Beds, Intensive Care Unit (ICU) Beds and Ventilators in India: Are We Prepared for a Surge in COVID-19 Hospitalisations?' https://t.co/zbF5o09d9m #medRxiv.

[2] OECD Health Statistics

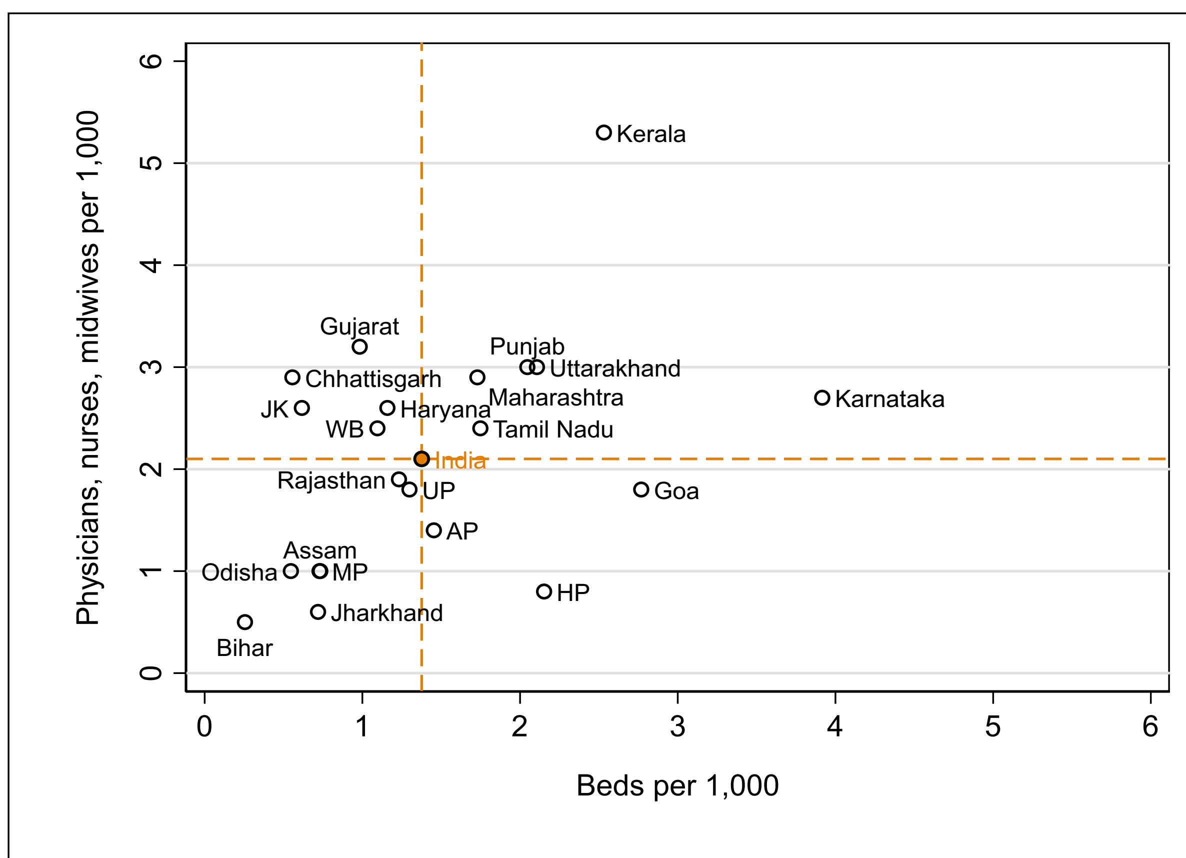
have been or are being upgraded to health and wellness centres (HWCs). The number and distribution of sub centres, PHCs and CHCs in rural areas is based on population norms and there are significant shortfalls, ranging from 23 per cent for sub centres to 28 per cent for PHCs to 37 per cent for CHCs. There is severe deficit of public health facilities in Bihar, Jharkhand, Uttar Pradesh and West Bengal (Annex 9.3).

9.14 In 2018, there were 11.54 lakh registered allopathic medical doctors, 29.66 lakh nurses and 11.25 lakh pharmacists in India. The ratio of doctors and nurses to population is also very low, as compared with the norms set by the World Health Organization (WHO). The doctor to population ratio in India is 1:1,511 against the WHO norm of 1:1,000 and the nurse to population ratio is 1:670 against the norm of 1:300, as the Ministry of Health and Family Welfare (MoHFW) mentioned in its memorandum to us.

9.15 If it is assumed that all allopathic doctors registered with state medical councils are also practising/working in the same State, then a wide variation across States in allopathic doctor to population ratio becomes evident (Annex 9.4). Among the major States, Jharkhand, Chhattisgarh, Uttar Pradesh and Bihar fare very poorly. Among the major States, Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Maharashtra and Uttar Pradesh are way behind others in government doctors to population ratio. The shortfall of nurses is highest in Bihar, Jharkhand, Sikkim, Telangana, Uttar Pradesh and Uttarakhand (Annex 9.5). There is also a significant shortage of all categories of health workforce in government health facilities (Annex 9.6). Seats in medical colleges are highly skewed across States, with two-third of all MBBS seats in the country concentrated in seven States (Tamil Nadu, Kerala, Andhra Pradesh, Telangana, Karnataka, Maharashtra and Gujarat).

9.16 Figure 9.1 shows the variation among States in terms of human resource for health and hospital beds. Rajasthan, Uttar Pradesh, Assam, Madhya Pradesh, Odisha, Jharkhand and Bihar are in a very vulnerable position, with very low ratio of hospital beds and health workforce to population.

Figure 9.1: Human Resource for Health and Hospital Beds per 1000 Persons



Source: World Bank

9.17 The healthcare system faces several challenges which are highlighted in the following paras.

Low Public Health Spending

9.18 The public expenditure (Union and State combined) on health as percentage of GDP in India has been around 1 per cent (Table 9.2).

Table 9.2: Public Health Expenditure

Year	Public expenditure on health as % of GDP
1992-93	1.01#
2003-04	0.99#
2015-16	0.91^
2018-19	0.96^

#Eleventh Five-Year Plan, ^Finance account

9.19 The Eleventh Five-Year Plan (2007-2012) attempted to provide a thrust to the health sector by substantially stepping up public expenditure. It stated that "effort will be made to increase the total expenditure at

the Centre and the States to at least 2 per cent of GDP by the end of the Eleventh Five Year Plan". The Twelfth Five-Year Plan (2012-17) tried to bring both rural and urban health care under the ambit of Universal Health Coverage whereby each person could get assured access to a well-defined set of health care entitlements. However, these targets were clearly not achieved.

9.20 The National Health Policy 2017 (NHP 2017) recommended the ramping up of public health expenditure to 2.5 per cent of GDP by 2025. In 2018-19, this expenditure was only 0.96 per cent of GDP (Figure 9.2).[3] Seventy per cent of public expenditure on health is by the States and only 30 per cent is by the Union Government (Figure 9.3). The aggregate public health expenditure in the country is much less than that of other countries (Figure 9.4).

Figure 9.2: Expenditure on Health as Percentage of GDP

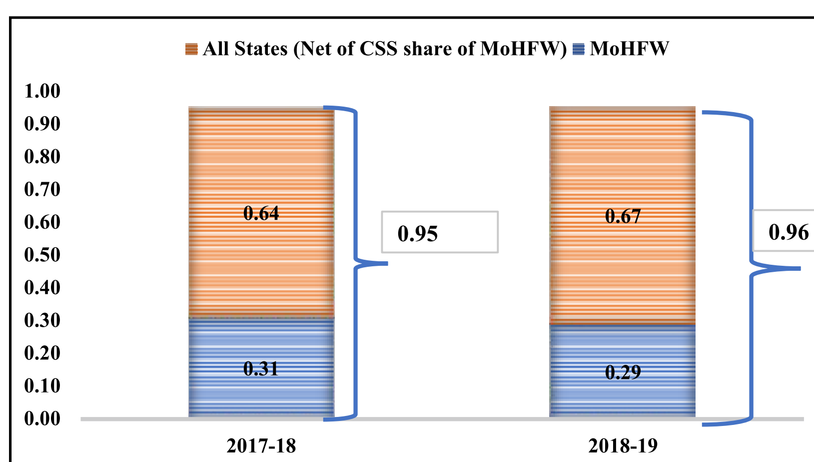
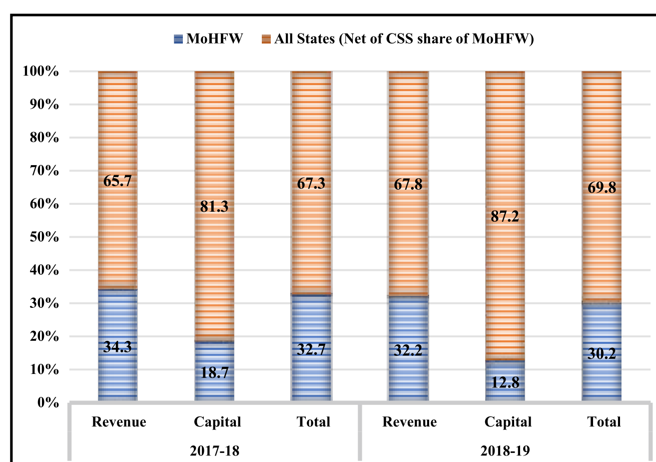


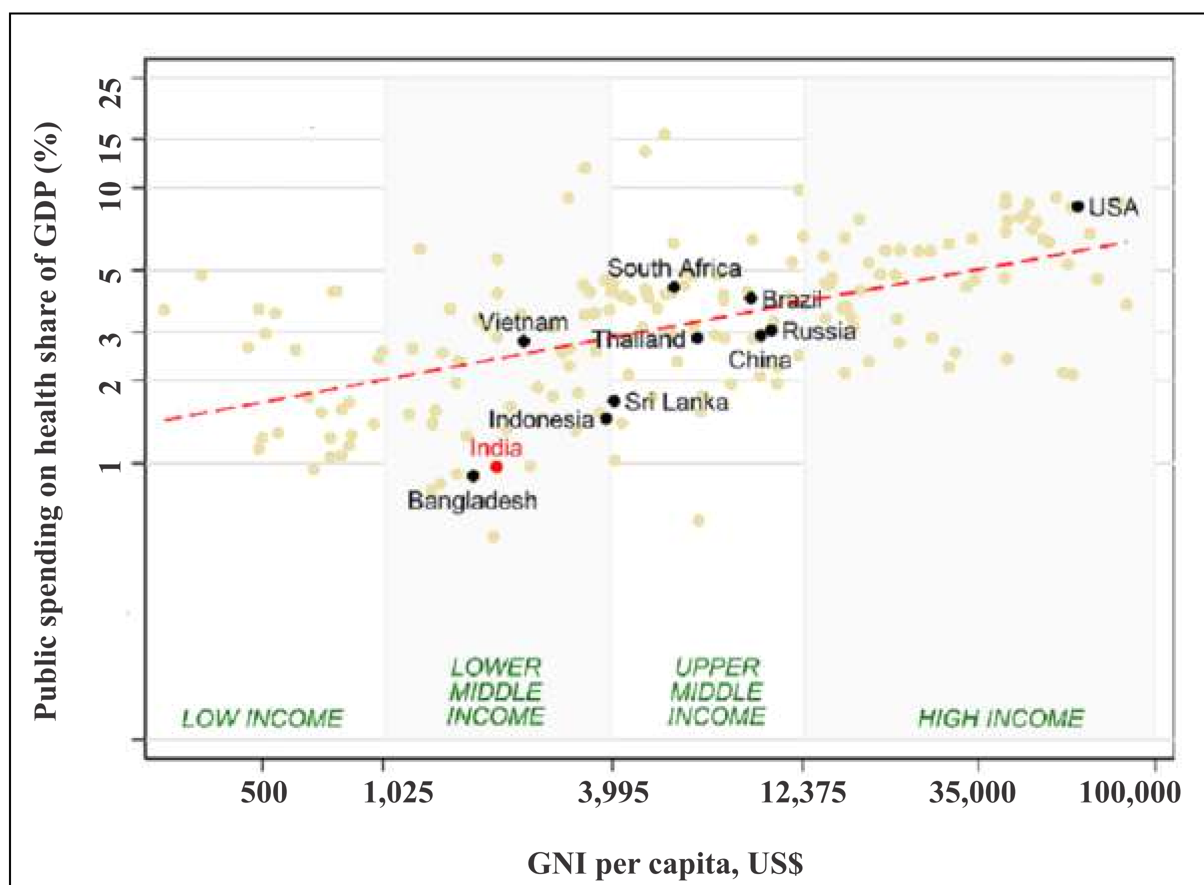
Figure 9.3: Share of Expenditure by Ministry of Health and Family Welfare and States on Health



Source: State Finance Accounts

[3] The 0.96 per cent of expenditure does not include expenditure by the Ministry of Drinking Water and Sanitation (which is now the Department of Drinking Water and Sanitation under the Ministry of Jal Shakti), nutrition component of Integrated Child Development Scheme by the Ministry of Women and Child Development and the mid-day meal scheme of the Ministry of Education, Central Government Health Scheme and health insurance schemes of State Governments employees.

Figure 9.4: Public Spending on Health as Percentage of GDP



Source: World Bank indicators (2011 to 2019)

9.21 The NHP 2017 stated that States' spending on the health sector should be increased to at least 8 per cent of their respective budgets by 2020. In 2018-19, this ratio, on an average, was only 5.18 per cent; it was 6.48 per cent for the North-eastern and Himalayan (NEH) States and only 5.03 per cent for general States. Per capita spending on health, under both revenue and capital heads, is Rs. 1,218 for all States - Rs. 2,256 for NEH States and Rs. 1,148 for general States. There are large inter-State variations in health expenditure. Details are given in Box 9.1.

9.22 While the National Health Policy recommends that expenditure on primary health be increased to two-third of the total health expenditure, it is only 53 per cent. Primary level care has the potential to take care of 90 per cent of healthcare demands. Investment in primary health care, including prevention and health promotion, provides better health and developmental outcomes at a much lower cost. It helps reduce the need for costlier, complex care by preventing illness and promoting general health.

9.23 In order to provide health insurance to vulnerable sections, the Government of India introduced the Ayushman Bharat-Pradhan Mantri Jan Arogya Yojana (PMJAY) in 2018. Covering 50 crore people, it is the biggest healthcare scheme in the world, providing up to Rs. 5 lakh per family per year for secondary and tertiary care hospitalisation. PMJAY will help reduce

expenditure for hospitalisations, which impoverishes people, and will help mitigate the financial risk arising out of catastrophic health episodes. As the scheme matures, there will be a need to fill the supply side gaps to make this a success.

Box 9.1: Inter-State Variations in Spending on Health

Figure 9.5 shows the inter-State variations in terms of per capita spending on health. This is seen to be lowest in Bihar, Uttar Pradesh, Jharkhand, Madhya Pradesh and West Bengal. The inter-State variation is also significant, with the per capita spending of Bihar, Uttar Pradesh and Jharkhand at about half that of Kerala and Tamil Nadu.

Figure 9.6 shows that all States except Meghalaya are spending less than 8 per cent of their budget on the health sector. Punjab, Telangana, Maharashtra, Haryana, Madhya Pradesh, Karnataka, Uttar Pradesh, Andhra Pradesh, Bihar and Nagaland are spending less than 5 per cent of their budget on health.

Figure 9.5: Per Capita Health Expenditure (2018-19)

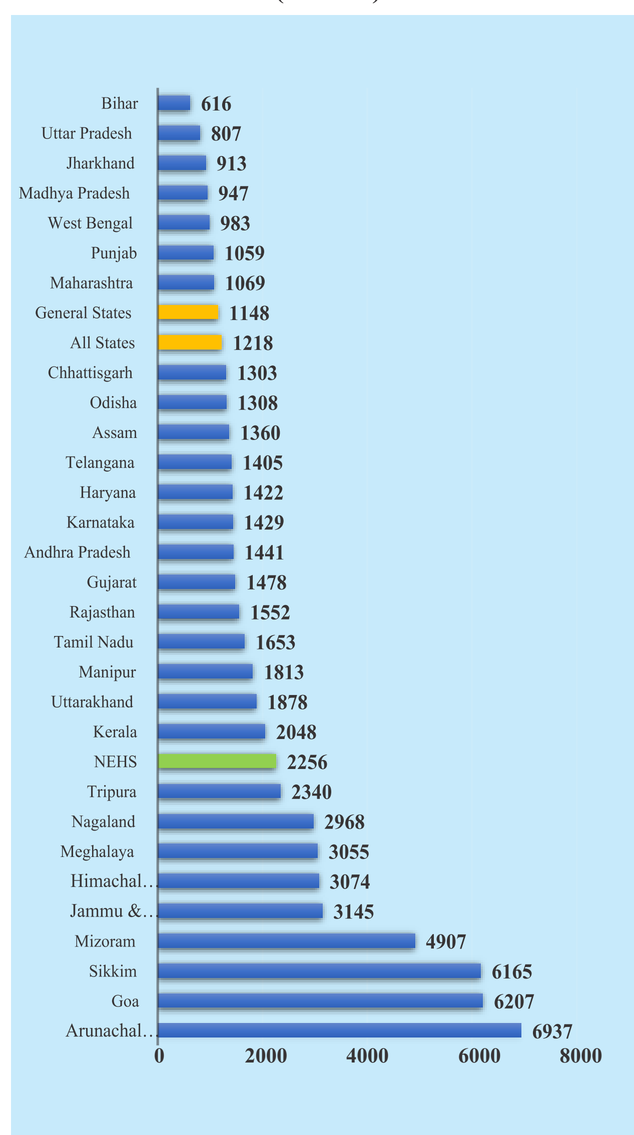
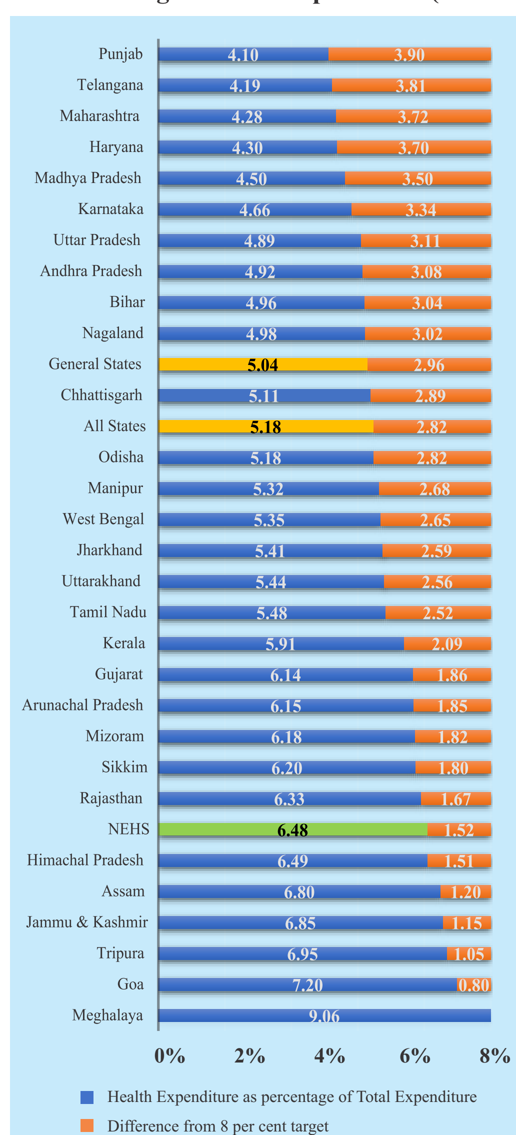


Figure 9.6: Health Expenditure of States as Percentage of Total Expenditure (2018-19)



Other Challenges in India's Healthcare System

9.24 The Covid-19 crisis highlighted the low levels of public spending on health and health infrastructure as well as some key challenges that hinder better progress in health outcomes. Some of them are:

i. an insufficient focus on core public health functions such as disease surveillance and testing;

ii. critical gaps in health infrastructure like sub centres, PHCs, CHCs and human resource for health like doctors, nurses and paramedics;

iii. shortcomings in the quality of care (apart from a select few facilities) despite improvement in access;

iv. inadequate attention to urban health systems and the role of municipalities, which have a key role to play in public health, including air and water pollution, road traffic injuries and pandemic-related vulnerabilities;

v. a government service delivery system which has traditionally focused more on reproductive health and infectious diseases and lesser on non-communicable diseases, which are now the dominant share of the disease burden; and

vi. fragmentation and lack of coordination between different levels and sectors, including a weakly regulated private sector which dominates service provision.

9.25 These overt causes of under-performance are manifestations of more deep-seated issues. Two areas stand out in this context. First, local governance is weak, especially at the sub-district level, where government capacity to deliver is poor, stacking the odds against proficient service delivery in the health sector. Second, demand-side factors, including gender and social norms, compounded by low levels of educational attainment, serve as a major barrier to improving access and quality in health care facility.

9.26 Within the health sector, one major underlying problem is a lack of accountability in the service delivery model. Service delivery has traditionally focused on inputs and infrastructure instead of outputs, outcomes and accountability. This has led to under-performance in government health facilities and the consequent emergence of a large private sector as patients seek care elsewhere. Almost 70 per cent of outpatient utilisation and 58 per cent of all inpatient utilisation now occurs in the private sector, but this is fragmented and largely unregulated. These service delivery challenges are becoming more acute with the epidemiological transition to non-communicable diseases. The health system is not fully equipped to address the growing burden from non-communicable diseases, for which it will need to move from addressing episodic health issues towards the provision of people-centred chronic care. The core of this should be detection and prevention through the primary health care system. Additionally, barriers to individuals seeking care from different levels of health care providers over her/his lifetime need to be removed.

Views of Previous Finance Commissions

9.27 The FC-XII recommended equalisation grants for the health sector amounting to Rs. 5,887 crore to States. It calculated the grants using a two-step normative approach. States which fell short of a normative level of per capita expenditure in health sector were first identified. This gap in expenditure was then filled to the extent of 30 per cent from the average. The FC-XIII recommended State-specific grants for improving health-related physical infrastructure. It also gave a separate performance-based incentive grant amounting to Rs. 5,000 crore for reduction in the IMR.

Views of Union Government

9.28 The MoHFW highlighted the deficit in various areas and sought interventions to strengthen health infrastructure, human resource and pandemic-related preparedness. The memorandum that it submitted indicated the requirement of funds in various areas. A summary of the memorandum is given in Table 9.3. The Ministry also suggested earmarking 10 per cent of the devolution amount proposed by the Finance Commission for the health sector, with at least two-third of this being reserved for primary healthcare. It also requested that a composite health index may be used as an indicator for deciding the performance-based incentives to States/Union Territories and an appropriate weight, not less than 20 per cent, be assigned to this index.

Table 9.3: Memorandum Received from Ministry of Health and Family Welfare (only State share)

	Key element of support	Fund requirement (Rs. crore)		
			Sub-components	Total
1	**Setting-up of medical colleges attached to district hospitals**			**41805**
2	**Training of 1.5 million workforce related to allied health**			**13257**
3	**Starting super speciality blocks under PMSSY**			**5300**
4	**Primary health care**			**513772**
	i Bridging the infrastructure gap in public health facilities including for wellness infrastructure		100310	
	ii Addressing the shortfall in health workforce		177742	
	iii Supporting the national ambulance service		15503	
	iv Support for IT infrastructure for primary healthcare		10733	
	v Support for diagnostic infrastructure to primary healthcare facilities		18471	
	vi Ensuring access to medicines to reduce out of pocket expenditure		134959	
	vii Support to the states to run DNB courses in district hospitals		2723	
	viii Post Covid health sector reforms-		53331	
	(a) Infectious disease/critical care hospitals	*15374*		
	(b) District integrated public health labs	*469*		
	(c) Block level public health units	*5279*		
	(d) Urban HWCs	*24620*		
	(e) Building-less sub centres, PHCs, CHCs	*7589*		
	Total			**574134**

Note: PMSSY – Pradhan Mantri Swasthya Suraksha Yojana
DNB – Diplomate of National Board

Views of State Governments

9.29 The health sector has been extensively covered in all the memoranda from State Governments, which have identified this as the most critical public service responsibility of the governments. Most States have emphasised that the out of pocket expenditure on medical care is very high and is symptomatic of the poor quality of public health services. A recurring theme in almost all the submissions by the States is the understanding that the development of health care institutions and provision of proper health services is indispensable for improving preventive, promotive and curative health of the people of the State and the favourable impact this will have on economic productivity. There is a clear acknowledgement by most States that much greater efforts will be necessary to expand universal health care and that one of the key actions will revolve around an adequate increase in the number of medical personnel. Their availability is not uniform across rural and urban areas within a State and this, in no small measure, is the result of the reluctance of medical personnel to serve in rural and remote areas. This has been identified as one of the biggest constraints in providing affordable basic services.

9.30 A large number of supplementary memoranda of the States were received after the onset of the Covid-19 pandemic. The State Governments have argued that they, on account of being closer to the people, have greater responsibility in combating the virus and its after effects. This would require substantial investments to be made in health infrastructure and providing the enabling environment for businesses to revive. They have, therefore, requested relaxations in targets relating to fiscal deficit and public debt so that critical health-related spending could be quickly done. Most States have acknowledged that they lack the facilities needed to contain and manage rising Covid-19 outbreaks, including the number of doctors, hospital beds, ICUs and quarantine facilities. Many States have also highlighted the link between disasters and the breakdown of health services. They have emphasised the need for an effective response and functional health service following a disaster. The Commission has been requested to consider these factors and also take cognisance of the need to provide for mitigation and containment of such outbreaks while recommending grants for disaster risk management.

Views of FC-XV in the Report for the Year 2020-21

9.31 In our Report for the Year 2020-21, we identified five important initiatives for the health sector that need to be taken, based upon the recommendations of various stakeholders. These included establishment of medical colleges in district hospitals, training of allied healthcare professionals, starting Diplomate of National Board (DNB)[4] courses in private and corporate hospitals, full utilisation of spare infrastructure and facilities in public health facilities and auditing of all medical equipment and diagnostic facilities in public hospitals in order to ensure optimum use.

[4] Diplomate of National Board (DNB) is a medical qualification awarded by the National Board of Examinations (NBE) and is considered equivalent to the postgraduate and post-doctoral programmes offered by the medical colleges in India.

9.32 The impact of malnutrition on the development of the brain, and hence on early education, also prompted us to recommend additional grants of Rs. 7,735 crore to the States for nutrition in our first report.

Stakeholder Consultations

9.33 The Commission engaged in wide consultations on the health sector with various experts and stakeholders, including the MoHFW, State Governments, NITI Aayog, World Bank and the High Level Group on the Health sector. The High Level Group on the Health Sector, under the chairmanship of Dr. R. Guleria, Director, All India Institute of Medical Sciences (AIIMS), had eminent sectoral experts, namely Dr. V.K. Paul, Member NITI Aayog and the acting Chairman, Indian Medical Council, Dr. Devi Shetty, Chairman, Narayana Health City, Dr. Govind Mhaisekar, Vice-Chancellor, Maharashtra University of Health Science, Dr. Naresh Trehan, Medanta City, Dr. Bhabatosh Biswas, professor and head of department of Cardio Thoracic Surgery, R.G. Kar Medical College and Prof. K. Srinath Reddy, President of the Public Health Foundation of India. The Group submitted its report in August 2019, which was annexed to our report of 2020-21. A gist of all the recommendations received from various stakeholders is given at Annex 9.7.

9.34 In addition to the consultations, a study was commissioned on the costs and finances of the PMJAY. This was done by the Institute of Economic Growth. The results indicate that the total costs (Union and States combined) of PMJAY for the five-year period between 2019 and 2023, on the assumption that all the targeted beneficiaries are actually covered, could range from Rs. 28,000 crore to Rs. 74,000 crore in 2019 and go up to between Rs. 66,000 crore and Rs. 1,60,089 crore in 2023, depending on different assumptions related to the notional premiums. The National Health Authority, in its presentation to us stated that the estimated expenditure on PMJAY in 2023 is likely to be Rs 32,220 crore.

India Fights the Pandemic

9.35 The first Covid-19 case in India was detected on 30 January 2020, the same day that WHO declared it a public health emergency of international concern. India had alertly implemented surveillance as early as 17 January, even before the first cases were officially detected. This was followed by a series of travel advisories and restrictions, and efforts to repatriate and quarantine Indian nationals arriving from abroad. The country went into lockdown almost two months later. On 8 June, after ten weeks of lockdown, it started a phased reopening of its economy. At the time of the finalisation of the report, India had 73 lakh confirmed cases and more than one lakh deaths.

9.36 The Government of India took various measures to balance revival of the economy and the need to deal with increasing caseloads and new hotspots. On the health front, the Covid-19 Emergency Response and Health Systems Preparedness Package of Rs. 15,000 crore was

approved by Cabinet on 22 April 2020. This included mainly emergency response components such as development and operations of dedicated Covid facilities with isolation wards and ICUs and the training of health professionals, augmenting testing capacity, procurement of personal protective equipment (PPEs), N-95 masks, ventilators, testing kits and drugs, conversion of railway coaches as Covid Care Centres, strengthening surveillance units and untied funds to the districts for emergency response.

9.37 In addition to this, to counter the economic loss as well as to provide relief to the particular groups who have been adversely affected by the pandemic, the Union Government unveiled a Rs. 20 lakh crore economic stimulus package. This package, called Atmanirbhar Bharat Abhiyaan, was spread over five tranches. In the fifth tranche, the Union Government announced that public expenditure on health will be increased by (a) investing in grass root health institutions and ramping up HWCs in rural and urban areas; (b) setting up of critical care hospital blocks in all districts; and (c) strengthening the laboratory network and surveillance by integrated public health laboratories in all districts and blocks and public health units to manage pandemics. Under the Atmanirbhar Bharat Abhiyan, the country significantly ramped up the number of ventilators and hospital beds for Covid patients as well as the production of N-95 masks, PPE and testing kits. State Governments also took various measures to fight the pandemic. The combined and focused efforts of Union and State/Union Territory Governments have resulted in progressively increased testing across the country aimed at early detection and isolation of Covid-19 positive cases.

9.38 The National Digital Health Mission (NDHM) under the National Health Authority was also launched on 15 August 2020 to implement and facilitate the National Digital Health Blueprint (NDHB). Under this Mission, every Indian will be given a digital health ID which will contain information regarding his illness, medical reports, medicine prescribed and doctor. Each health ID will be linked to a health data consent manager, which will be used to seek the patient's consent and allow for seamless flow of health information. A personal health record will enable monitoring of diseases and efficient analysis of patient data, thus enabling quicker decision-making. Telemedicine is also an integral part of digital health and this mission will help scale up telemedicine in a cost-effective way. It will improve its access and reach and enhance the doctor-patient consultation experience.

9.39 Faced with the unprecedented challenge of Covid-19, the Commission also renewed its engagement with various health sector experts like the MoHFW, World Bank and the High Level Group (HLG) on Health. Based on these discussions, various measures specific to the pandemic were highlighted. These can be divided into three categories: (a) very short-term, (b) short term and (c) medium term. These are summarised below:

a) Very short term

i. Short term management of the pandemic may include measures like rapid testing, wide surveillance with the help of chief medical officers and district magistrates for early identification and isolation of cases and containment of infections to avoid clustering.

ii. Provision of rural mobile health units and supply of equipment like ventilators, PPEs, masks, continuous oxygen supply.

iii. Ensure the supply of efficacious cost-effective medicines, which is critical till a vaccine has been developed.

iv. Final year MD students in various specialties may be awarded certificates of being 'Board Eligible' and allowed to practice in order to meet the immediate need of manpower.

v. Provision for 'flexible money' for the pandemic may be done to help both Union and State Governments.

b) Short term

vi. An 'outbreak management plan' needs to be in place along with creation of more infectious disease/critical care centres and outbreak management centres.

vii. A mechanism to shift health resources like manpower and equipment from one State to another may be created. Crash courses with the help of information technology may be started to train health workers to deal with Covid.

viii. Financing development of a vaccine and provisioning funds to make it available for the masses.

ix. Willing medical colleges may be allowed to run one additional course within their campus with an intake of 100 medical students. The nurses could also be trained and thereafter be allowed to practice as 'nurse practitioners' to prescribe forty-seven basic drugs. A one-year diploma course after MBBS for lab medicine and for ultrasound may be started. Incentives need to be designed for doctors and paramedics to work in the rural areas.

x. National policy and laws on waste disposal to be framed.

c) Medium term

xi. Investment on health to be increased to 2.5 per cent of GDP by 2025, including more investment in PHCs, district hospitals, wellness centres, national ambulance infrastructure and IT infrastructure.

xii. Shortfall in health workforce to be addressed. Primary and wellness health centres should include more MBBS/AYUSH (ayurveda, yoga and naturopathy, unani, siddha and homeopathy) doctors.

xiii. Explore possibilities of covering the remaining 60 per cent of the population under PMJAY.

xiv. Creation of an All India Medical Services on the pattern of the Indian Civil Services. This must receive priority. The All-India Services Act, 1951 has a provision for setting up an Indian Medical and Health Service.

xv. Explore the possibility of implementing a scheme like the National Health Service of the United Kingdom.

Recommendations/Way forward

9.40 We have divided our recommendations into two broad groups: (a) policy recommendations and (b) grants/financial recommendations.

A. Policy Recommendations

9.41 Based upon our discussions, we have realised that certain measures are related to overall regulatory and policy issues that need to be undertaken by the Government for building resilience in this very important sector. Accordingly, we recommend the following:

i. While the Commission has, in subsequent paras, recommended a substantial grant to strengthen the health sector, we expect concurrent efforts by States to enhance their spending on health. **We recommend that the health spending by States should be increased to more than 8 per cent of their budget by 2022**.

ii. There is a renewed focus by both the Union and State Governments on primary healthcare including wellness centres under programmes like PM-Atmanirbhar Swastha Bharat Yojana (PM-ASBY) and PMJAY, which has been magnified in the light of the pandemic. The Commission has also emphasised this by giving the majority portion of health grants for the primary health sector. **We recommend that primary health care should be the number one fundamental commitment of each and every State and that primary health expenditure should be increased to two-thirds of the total health expenditure by 2022.**

iii. In line with the first two recommendations, we expect higher spending by the Union Government towards building a stronger public health sector. As seen earlier, the larger part of the spending on health is done by States. While health remains a State subject, along with enhanced spending by State Governments, the Union Government should also increase its allocation on health. The Union Government should provide adequate support to the requests made by the MoHFW in its memorandum submitted to us (Table 9.3). Accordingly, **we recommend that public health expenditure of Union and States together should be increased in a progressive manner to reach 2.5 per cent of GDP by 2025.**

iv. **Centrally sponsored schemes (CSS) co-financed by the Government of India should be flexible enough to allow States to adapt and innovate. Top-down mandates and strictures on programme implementation are the antithesis of an open-source model. CSS should grant States significant latitude to tailor implementation modalities to local realities.** The new PMJAY programme allows States to co-brand with their own schemes, to choose whether to adopt a trust or insurance mode, to use the Government of India IT system or their own, to adapt the benefit package and eligibility/coverage groups, and so on. The National Health Mission (NHM) has also moved towards greater flexibility.

v. **There is a need to shift the focus of inter-governmental fiscal health financing from inputs to outputs/outcomes while advancing the measurement agenda as an accountability tool. Complementary to the flexibility noted above, the Union Government can shift the focus of CSS and transfers away from line-items and activities and towards outputs and outcomes, with States being empowered to choose their own pathways to achieve results.** Financing can be provided based on bilaterally agreed 'compacts' related to specific objectives (for example, service delivery outputs or specific outcomes) instead of exhaustively discussed implementation plans. To support this approach, the Union Government can support initiatives to enhance data systems, monitoring and evaluation and transparency. One recent example is the NITI Aayog Health Index, which produces an annual report documenting progress among states across twenty-three key health indicators.

vi. While States should take the lead in the design, planning and implementation of key schemes, there are many areas where they should not be starting from scratch or re-inventing the wheel. Medical research, clinical protocols, draft request for proposals/contracts, monitoring and evaluation, surveys, framework contracts for drugs/consumables to achieve lower prices, operational guidelines where appropriate and other inputs would all benefit from a prominent role of the Government of India. States can opt for these inputs where they fit their needs.

vii. **Given the inter-State disparity in the availability of medical doctors, it is essential to constitute an All India Medical and Health Service as is envisaged under Section 2A of the All-India Services Act, 1951. For this purpose, the Union Public Service Commission (UPSC) would need to do annual recruitments, based on the State-wise requisitions by each State Government. We urge the Union Government to implement this proposal in coordination with State Governments.**

viii. **The MBBS curriculum should be restructured to make it competency based. A certain degree of specialisation should be included in the curriculum and the Medical Council of India/National Medical Council (MCI/NMC) should develop small courses on wellness clinic, basic surgical procedures, anaesthesia, obstetrics**

and gynaecology, eye, ENT etc. for MBBS doctors. It should also encourage AYUSH as an elective subject for medicine undergraduates.

ix. **The asymmetric distribution of medical colleges needs to be corrected, as most of them are situated in the western and southern parts of India. All the public health facilities including district hospitals, private sector facilities and corporate hospitals should be utilised for starting specialist DNB courses which will not only enhance the service provisioning but will also ensure the availability of trained human resource.**

x. A number of students aspiring to become doctors choose to take admission in medical colleges in foreign countries. The number of such students rose from 3,438 in 2015 to 12,321 in 2019. There is a need to utilise these foreign medical degree holders in the health system of the country to supplement the existing human resource for health. This may be done by designing a skills-based training programme to improve their knowledge and skills so that they meet the professional competencies required in the screening tests that they have to clear before commencing practice in the country.

xi. **Measures should be taken to assign a larger role to nursing professionals and the concept of nurse practitioner, physician assistant and nurse anaesthetist should be introduced for better utilisation of nursing professionals.** The Allied and Healthcare Professions Bill was introduced in the Rajya Sabha in 2018 and was referred to the Standing Committee in 2019. **The early passage of this legislation should be fast-tracked given its multiplier benefits.**

xii. The NDHM is an imminent revolution with far reaching impact on health for all in the near future and beyond. As part of this Mission, States can adapt these digital health initiatives expeditiously, efficiently and mainstream it in their health endeavours in primary care/home care/facility settings, high-end hospitals as well as public health. This will require support of both public and private health providers. Harnessing new technologies, including artificial intelligence, will optimise resources and secure faster outcomes. We recommend that Union and State Governments together should commit to make available the required resources for NDHM to be an effective mission.

B. Grants/Financial recommendations

9.42 As analysed earlier, India's healthcare system is mired in several challenges and the private sector has failed to fill the critical gap. The pandemic has further highlighted the fact that health must be regarded as a merit good and hence provision of health care services cannot be left to market forces alone. Public health has significant externalities (food and drug regulation, public health action, including health promotion and prevention and surveillance for infectious disease) which require government intervention. Persistent inequities in access and coverage

are a barrier to building India's human capital, and the progress in health indicators and markets do not address the wide regional inequities in health care.

9.43 As the pandemic spread, there has been a significant decline in the delivery of non-Covid essential services, particularly in States with weak health systems, on account of marshalling of all resources for Covid related activities. Health systems across the country were hard put to manage the delivery of both sets of services. Though the private sector provides over 60 per cent of health care in the country, a disproportionately large burden was borne by the government hospitals during the pandemic.

9.44 Covid-19 has shown that significant investments are needed to strengthen the public health system. Without additional funding, the health system will not only fail to respond to outbreaks/disasters and other emergencies but will also be ineffective in delivering other essential services, delaying and disrupting the country's progress towards the achievements of the goals and targets of the NHP 2017 and the SDGs. The pandemic threatens the health standards of the poorest and the weakest and there is a risk of the inequalities being magnified, which will erode India's human capital. Early and sustained efforts are needed to change the trend.

9.45 The pandemic has highlighted the fact that essential public health responses necessary to address to such a crisis were weak. Limited laboratory capacity at all levels meant that functions of testing, case detection, surveillance and outbreak management were compromised and facilities for critical care provision lacked adequate ICUs, isolation beds, oxygen supply and ventilators. Covid-19 also illustrated that despite using the health systems approach to horizontal integration between programmes, much more needs to be done to strengthen convergence between institutions created for vertical disease control programmes and the district and sub-district service delivery systems. There is an immediate need to invest in critical care hospitals and public health laboratories that will address the substantial regional health inequities and help the country be better prepared for future epidemics/pandemics

9.46 Toward this end, it is critically important that primary health care should be at the centre of efforts to improve health and well-being. Primary health care has been proven to be a highly effective and efficient way to address the main causes and risks of poor health and well-being today, as well as handling the emerging challenges that threaten health and well-being tomorrow. There is clear international evidence that quality primary health care reduces total healthcare costs and improves efficiency by reducing hospital admissions. As analysed in earlier sections, there are critical gaps in terms of sub centres, PHCs, CHCs and wellness centres in some States. Our interactions with stakeholders have also drawn our attention to the lack of diagnostic infrastructure in health facilities.

9.47 In addition, as mentioned earlier, many States have been identified with serious shortfall in terms of human resource for health. According to the Rural Health Survey, 2018-19, there is a shortfall of 85.6 per cent of surgeons, 75 per cent of obstetricians and gynaecologists, 87.2 per cent of physicians and 79.9 per cent of paediatricians. Overall, there is a shortfall of 81.8 per cent

specialists at the CHCs, 23 per cent in terms of nursing staff at PHCs and 10 per cent in CHCs in rural areas. Similarly, a shortfall of 22 per cent was seen in PHCs and 21 per cent in CHCs in urban areas.

9.48 While investment in critical care hospitals and health laboratories will provide an immediate intervention to provide crucial services and build resilience against epidemics, pandemics and other infectious diseases, investment in primary health care infrastructure will provide resilience to withstand shocks to the health system in the medium to long term. Investment in specialist and paramedics/nurses courses will help reduce the shortfall in skilled personnel in the medium term. The investment in paramedics training will also provide the skill set for the youth to be employed in this highly productive sector. Our recommendations will also complement the vision of the PMJAY and PM-ASBY and reduce the out of pocket expenditure on health.

9.49 The grants for the health sector are divided into two parts: (i) grants aggregating to Rs. 70,051 crore through local governments and (ii) sectoral grants aggregating to Rs. 31,755 crore to States. We have also recommended State-specific grants for health amounting to Rs. 4,800 crore. **The total grants-in-aid support to the health sector over the award period works out to be Rs. 1,06,606 crore which is 10.3 per cent of the total grants-in-aid recommended by us. This forms about 0.1 per cent of GDP. The grants for the health sector will be unconditional.** We have also tried to front load this support over the award period to help in addressing the immediate requirement of funds due to the ongoing pandemic.

B.1 Health grants through local governments

9.50 Public health forms part of the Eleventh and Twelfth Schedules of the Constitution, thus entailing local governments delivering this function. The National Rural Health Mission (NRHM) provides for the implementation of healthcare programmes through a decentralised system with the involvement of local governments and communities. In fact, rural local governments play a critical role in the planning, implementation and monitoring of the NRHM. The Eleventh Five-Year Plan emphasised the need for greater involvement of local government institutions, right from the village to the district levels, in the public health delivery systems of their respective jurisdictions. The Twelfth Five Year Plan focused on strengthening the initiatives taken in the Eleventh Plan in respect of expanding the reach of healthcare and setting up a system of universal health coverage in India.

9.51 Kerala has established itself as an example where local governments and the staff of public health institutions play a vital role in the effective delivery of healthcare. The Kerala model needs to be emulated in other States as well. Considering this, we feel that adequate grants should be provided to the local governments for public health. Accordingly, **we have recommended health grants aggregating to Rs. 70,051 crore for urban HWCs, building-less sub centres, PHCs, CHCs, block level public health units, support for diagnostic infrastructure for the**

primary healthcare activities and conversion of rural sub centres and PHCs to HWCs. These grants will be released to local governments which will play an important role in providing primary healthcare. Given the importance of health grants to fight the pandemic, we have not put any conditions for release of these grants to the local governments. The details have been explained in Chapter 7 on Empowering Local Governments. The component-wise details are given in Table 9.4:

Table 9.4: Health Grants Through Local Governments

Sub-components	Amount (Rs. crore)
Urban HWCs	24028
Building-less sub centres, PHCs, CHCs	7167
Block level public health units	5279
Support for diagnostic infrastructure to the primary healthcare facilities	18472
Conversion of rural sub centres and PHCs to HWCs	15105
Total	**70051**

B.2 Health sector grants through State Governments

9.52 We have further recognised the need of investing in critical care hospitals and public health laboratories to build resilience in surveillance and fight communicable diseases, epidemics and pandemics in the future. Also, there is a need to boost the number of specialists and paramedics in the country. This can be easily done by using the health facilities available with the States and providing minimum investment for training and medical education. The details of these grants are given in the following paragraphs:

B.2.1. Critical care hospitals

9.53 In the light of the pandemic, we believe that the establishment of critical care hospitals is absolutely essential to build resilience in the country's health systems and ensure preparedness for future epidemics/pandemics. These hospitals will have ICU support, including assured oxygen supply, and requisite infection prevention and control measures. This is also in line with PM-ASBY.

9.54 The MoHFW, in its memorandum, proposed construction of hundred-bedded critical care hospitals in districts with more than 20 lakh population and fifty-bedded hospitals for districts with less than 20 lakh population. **Based upon this proposal, we recommend Rs. 15,265 crore for critical care hospitals. This includes Rs. 13,367 crore for general States and Rs 1,898 crore for NEH States. The inter se distribution of this grant is made on the basis of per capita health expenditure distance method, which is similar to the income distance method**

recommended in the horizontal formula. However, the inter se distribution is made separately for general and NEH States.

9.55 The MoHFW gave an estimated capital cost of Rs. 53 crore for a hundred-bedded hospital and Rs. 28 crore for a fifty-bedded hospital. We believe that the grants States will receive on the basis of the formula explained in the previous para will be sufficient to cover the full capital cost of building 205 hundred-bedded hospitals and 157 fifty-bedded hospitals. The number of hospitals has been capped at the maximum number of districts in a State. The State-wise number of these hospitals as well as recommended grants are given at Annex 9.8.

B.2.2. Strengthening/establishment of Integrated Public Health Laboratories

9.56 Establishment of integrated public health laboratories in all districts is required for strengthening surveillance capacities. This will also strengthen the existing Integrated Disease Surveillance Programme (IDSP) units. The MoHFW proposed a hub-and-spoke model for undertaking laboratory services that would be used in a way that patients would not need to travel to higher level centres to provide samples for laboratory tests. Thus, a district laboratory would serve as the hub for the HWCs in the block, which will be the spokes. This also forms a part of the PM-ASBY.

9.57 **We recommend providing the State's share for building these laboratories. Accordingly, Rs. 469 crore is recommended for this purpose. The remaining share may come from the Union Government as part of the PM-ASBY.** The State-wise and year-wise grants as well as detailed assumptions for calculation of grants as received from MoHFW are given at Annex 9.9.

B.2.3. Training of 1.5 million workforce related to allied healthcare professionals

9.58 After the launch of NRHM in 2005 and NHM in 2012, the Union Government took various steps to reinforce the supply and availability of drugs, diagnostics and equipment. However, the availability of human resources remains a major bottleneck. We feel that addressing this lacuna will not only strengthen healthcare but also provide additional employment opportunities for the skilled youth.

9.59 To address this problem, and given the limited resources, existing district hospitals and sub-divisional hospitals may be used for creating additional infrastructure for training. They will need to be provided funds for this purpose as well as to hire and train the faculty. There are several short-term certificate courses (of six months to one-year duration) which may be easily implemented in these hospitals with minimum investment and by strengthening the existing resources. The faculty hired for training may also work for clinical services. This intervention will, therefore, furnish the much-needed additional manpower in facilities at the district level and below while also building capacity with proven bedside/patient skills. The skilled workforce may

also find gainful employment in the private sector. This intervention is also in line with the Allied and Healthcare Professions Bill, 2018 under consideration.

9.60 The MoHFW gave an estimated fixed cost of Rs. 3 crore per facility, along with variable cost Rs 0.67 crore per course. **Based upon their proposal, we recommend Rs. 13,296 crore for training of the allied healthcare workforce. Out of this, Rs. 1,986 crore will be for NEH States and Rs. 11,310 crore for general States. Based on the number of district and sub-divisional hospitals given by the MoHFW, we have provided Rs. 3 crore per facility for each State. To determine the variable amount for each State, we have used the per capita health expenditure distance method as described in the section on critical care hospitals.** It is estimated that an additional 15 lakh workforce could be skilled in the five years of our award period, with the potential of being absorbed in various public and private healthcare facilities. Year-wise and State-wise summary of these grants along with details of cost as received from the MoHFW is given at Annex 9.10.

B.2.4. Support to States for DNB courses

9.61 India faces a severe shortage of specialists to adequately staff the CHCs and district hospitals in both rural and urban areas. As a strategy to strengthen district hospitals, the Government of India also disseminated guidelines on 'District Hospital Strengthening for Multi-Specialty Care and as a Site of Training Guidelines' in 2017. Additionally, the National Board of Education (NBE) has initiated the DNB programme in district/civil/general hospitals of States under special provisions made for the district DNB programme.

9.62 We feel that there is a need to strengthen district hospitals to serve as knowledge and training hubs for pre-service and in-service training for specialised courses recognised under the NBE, so as to address the issue of specialist shortage in public health facilities. Initiating DNB courses at district hospitals will provide adequate human resource to deliver quality specialised care. By providing the training at district hospitals, monitoring and issues of patient safety will be better ensured, thus reducing overall out of pocket expenditure in accessing specialised care. We expect the States to utilise this fund to build a cadre of additional specialists.

9.63 The MoHFW, in its memorandum, gave the details on starting DNB courses and divided it into two parts:

i. For a 100-199 bedded hospital, DNB courses in two specialities can be initiated with eight seats.

ii. For more than 200-bedded district hospital, in line with NBE guidelines, DNB courses can be initiated in four specialities with sixteen seats.

9.64 Accordingly, **we recommend Rs. 2,725 crore for starting DNB courses in district hospitals.** The State-wise and year-wise table is given at Annex 9.11.

9.65 **It may be noted that all the above grants will be administered by the MoHFW. Though various components have been earmarked, we are cognisant of the fact that some inter-component adjustments within each State's overall share may be required in future years, as per the emerging ground realities. Hence, within each State's respective share, inter-component flexibility is allowed in consultation with the MoHFW. The monitoring mechanism of these grants are detailed in Chapter 10.**

9.66 To summarise, we recommend Rs. 31,755 crore as separate sectoral grants for the health sector to State Governments. The breakup of the grants is in Table 9.5.

Table 9.5: Sectoral Grants for Health

Sub-components	Amount (Rs. crore)
Critical care hospitals	15265
District integrated public health labs	469
Support to the States to run DNB courses in district hospitals	2725
Training of 1.5 million workforce related to Allied health care	13296
Total	**31755**

9.67 In addition, we have recommended Rs. 70,051 crore for the health sector through local governments, which are detailed in Chapter 7 on Empowering Local Governments and Rs. 4,800 crore as part of State-specific grants, which are detailed in Chapter 10 on Performance-based Incentives and Grants.

9.68 We believe that the health grants recommended by us will strengthen the public health system, leveraging existing reforms undertaken over the last few years and envisaging a new generation of reforms to integrate and strengthen health service delivery and public health action.

Summary of Recommendations

9.69 A brief summary of our recommendations is given below:

I. We recommend that health spending by States should be increased to more than 8 per cent of their budget by 2022.

(para 9.41, i)

ii. We recommend that primary health care should be the number one fundamental commitment of each and every State and that primary health expenditure should be increased to two-thirds of the total health expenditure by 2022.

(para 9.41, ii)

iii. We recommend that public health expenditure of Union and States together should be increased in a progressive manner to reach 2.5 per cent of GDP by 2025.

(para 9.41, iii)

iv. Centrally sponsored schemes (CSS) co-financed by the Government of India should be flexible enough to allow States to adapt and innovate. Top-down mandates and strictures on programme implementation are the antithesis of an open-source model. CSS should grant States significant latitude to tailor implementation modalities to local realities.

(para 9.41, iv)

v. There is a need to shift the focus of inter-governmental fiscal health financing from inputs to outputs/outcomes while advancing the measurement agenda as an accountability tool. Complementary to the flexibility noted above, the Union Government can shift the focus of CSS and transfers away from line-items and activities and towards outputs and outcomes, with States being empowered to choose their own pathways to achieve results.

(para 9.41, v)

vi. Given the inter-State disparity in the availability of medical doctors, it is essential to constitute an All India Medical and Health Service as is envisaged under Section 2A of the All-India Services Act, 1951. For this purpose, the Union Public Service Commission (UPSC) would need to do annual recruitments, based on the State-wise requisitions by each State Government. We urge the Union Government to implement this proposal in coordination with State Governments.

(para 9.41, vii)

vii. The MBBS curriculum should be restructured to make it competency based. A certain degree of specialisation should be included in the curriculum and the MCI/NMC should develop small courses on wellness clinic, basic surgical procedures, anaesthesia, obstetrics and gynaecology, eye, ENT etc. for MBBS doctors and encourage AYUSH as an elective subject for medicine undergraduates.

(para 9.41, viii)

viii. The asymmetric distribution of medical colleges needs to be corrected as most of them are located in the western and southern parts of India. All public health facilities including district hospitals, private sector facilities and corporate hospitals should be utilised for starting specialist DNB courses which will not only enhance the service provisioning but will also ensure the availability of trained human resource.

(para 9.41, ix)

ix. Measures should be taken to assign a larger role for nursing professionals and the concept of nurse practitioner, physician assistant and nurse anaesthetist should be introduced for better utilisation of nursing professionals. The early passage of this legislation should be fast-tracked given its multiplier benefits.

(para 9.41, xi)

x. The total grants-in-aid support to the health sector over the award period works out to be Rs. 1,06,606 crore, which is 10.3 per cent of the total grants-in-aid recommended by us. This forms about 0.1 per cent of GDP. The grants for the health sector will be unconditional.

(para 9.49)

xi. We recommend health grants aggregating to Rs. 70,051 crore for urban HWCs, building-less sub centre, PHCs, CHCs, block level public health units, support for diagnostic infrastructure for the primary healthcare activities and conversion of rural sub centres and PHCs to HWCs. These grants will be released to the local governments. Given the importance of health grants to fight the pandemic, we have not put any conditions for release of these grants to the local governments.

(para 9.51)

xii. We recommend Rs. 15,265 crore for critical care hospitals. This includes Rs. 13,367 crore for general States and Rs 1,898 crore for NEH States. The inter se distribution of this grant is made on the basis of per capita health expenditure distance method, which is similar to the income distance method recommended in the horizontal formula. However, the inter se distribution is made separately for general and NEH States.

(para 9.54)

xiii. We recommend Rs. 469 crore for States for building public health laboratories. The remaining share may come from the Union Government as part of PM-ASBY.

(para 9.57)

xiv. We recommend Rs. 13,296 crore for training of the allied healthcare workforce. Out of this, Rs. 1,986 crore will be for NEH States and Rs. 11,310 crore for general States. Based on the number of district and sub-divisional hospitals given by the MoHFW, we have provided Rs. 3 crore per facility for each State. To determine the variable amount for each State, we have used the per capita health expenditure distance method as described in the section on critical care hospitals.

(para 9.60)

xv. We recommend Rs. 2,725 crore for starting DNB courses in district hospitals for overcoming the shortfall of specialists.

(para 9.64)

xvi. All the grants will be administered by the MoHFW. Though various components have been earmarked, we are cognisant of the fact that some inter-component adjustments within each State's overall share may be required in future years, as per the emerging ground realities. Hence, within each State's respective share, inter-component flexibility is allowed in consultation with MoHFW.

(para 9.65)

Chapter 10

Performance-based Incentives and Grants

In this chapter, we address the terms of reference relating to grants-in-aid to States. While doing this, we have linked some grants with performance-based criteria that seek to promote sectors that further national goals. The first grant recommended by us is the revenue deficit grant, which aggregates to Rs. 2,94,514 crore. We have also recommended grants and incentives for various sectors. These fall under four broad themes. The first is social sector where we have focused on health (Rs. 1,06,606 crore) and education (Rs. 10,943 crore). Our second thrust area is agriculture and rural economy where we have focused on incentives for encouraging agricultural reforms (Rs. 45,000 crore) and recommended grants for maintenance of Pradhan Mantri Gram Sadak Yojana roads (Rs. 27,539 crore). Under the third theme, we have focussed on administrative and governance reforms that need greater priority from State Governments. Here, we have provided grants for judiciary (Rs. 10,425 crore), statistics (Rs. 1,175 crore) and incentivisation of aspirational districts and blocks (Rs. 3,150 crore). Under the fourth theme, we have developed a performance-based incentive system for the power sector, which is not linked to grants but opens up an additional borrowing window for States. Besides these, we have recommended State-specific grants aggregating to Rs. 49,599 crore to help States address special needs and overcome cost disabilities.

10.1 Para 4 (ii) of the terms of reference of this Commission 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 by way of grants-in-aid of their revenues under Article 275 of the Constitution for purposes other than those specified in the proviso to clause (1) of that article". Additionally, in a departure from the ToR of previous Commissions, para 5 asks us to examine whether revenue deficit grants be provided at all.

10.2 Another unique feature of the ToR for this Commission is para 7, which states "the Commission may consider proposing measurable performance-based incentives for States, at the appropriate level of Government in the following areas:

i. Efforts made by the States in expansion and deepening the GST tax net;

ii. Efforts and progress made in moving towards replacement rate of population growth;

iii. Achievements in implementation of flagship schemes of Government of India, disaster resilient infrastructure, sustainable development goals, and quality of expenditure;

iv. Progress made in increasing capital expenditure, eliminating losses of power sector, and improving the quality of such expenditure in generating future income streams;

v. Progress made in increasing tax/non-tax revenues, promoting savings by adoption of Direct Benefit Transfers and Public Finance Management System, promoting digital economy and removing layers between the government and the beneficiaries;

vi. Progress made in promoting ease of doing business by effecting related policy and regulatory changes and promoting labour intensive growth;

vii. Provision of grants in aid to local governments for basic services, including quality human resources, and implementation of performance grant system in improving delivery of services;

viii. Control or lack of it in incurring expenditure on populist measures; and

ix. Progress made in sanitation, solid waste management and bringing in behavioural change to end open defecation".

10.3 While firming up our recommendations on grants-in-aid, we studied their nature, categories and size as recommended by previous Commissions. There have broadly been five different categories of grants: (a) revenue deficit grants, (b) grants for local governments, (c) grants for disaster management, (d) sector-specific grants and (e) State-specific grants. Other than the revenue deficit grants, these grants were often conditional and performance-based.

10.4 The overall size of the grants, as a proportion of total transfers, varied from 26.1 per cent under the Sixth Finance Commission (FC-VI) to 7.7 per cent under the FC-VII (Table 10.1). In practice, except for the revenue deficit grants, the actual flow of funds remained below the recommended amount by the end of the award periods of earlier Commissions. This was mainly due to challenges faced in the release of conditional grants. We have recommended grants aggregating to Rs. 10,33,062 crore, which is 19.65 per cent of total recommended transfers to States.

Table 10.1: Share of Grants-in-Aid and Tax Devolution in Total Transfers Recommended by Finance Commissions

Commission	Period	Grants-in-aid		Tax devolution		Total transfers
		Amount (Rs. crore)	% share	Amount (Rs. crore)	% share	Rs. crore
Sixth	1974-79	2510	26.12	7099	73.88	9609
Seventh	1979-84	1610	7.72	19233	92.28	20843
Eighth	1984-89	3769	9.55	35683	90.45	39452
Ninth*	1989-95	11030	9.96	99668	90.04	110698
Tenth	1995-00	20300	8.96	206343	91.04	226643
Eleventh	2000-05	58587	13.47	376318	86.53	434905
Twelfth	2005-10	142640	18.87	613112	81.13	755752
Thirteenth	2010-15	258581	15.15	1448096	84.85	1706677
Fourteenth	2015-20	537353	11.97	3948188	88.03	4485541
Fifteenth (I)	2020-21	201023	19.04	855176	80.96	1056199
Fifteenth(II)	2021-26	1033062	19.65	4224760	80.35	5257822

* Ninth Finance Commission covered six years and additionally provided Plan grants of Rs. 9,000.83 crore (not included above).

10.5 During our deliberations, we concluded that the grants-in-aid can make corrections for cost disabilities and other redistributive requirements which can be addressed only to a limited extent in any devolution formula. Revenue deficit grants also allow States time to adjust to changes in the pattern of tax devolution recommended by Finance Commissions based on the evolving patterns of their assessed needs, ability and performance. Besides, grants-in-aid are more directly targeted and used to equalise the standards of basic social services. We have also tried to link many of our grants with performance-based criteria that seek to promote some sectors that further national goals. We believe that attaching performance criteria to fiscal transfers may enhance transparency, accountability, provide feedback on improving policy formulation and implementation and lead to better monitoring of expenditures. These grants have also helped us to address our wide ranging ToR.

10.6 The first such grant recommended by us is the revenue deficit grant, which allows us to correct for any post-devolution revenue deficit needs of States assessed on a comparable normative basis.

10.7 Besides this, we have also recommended grants and incentives for various sectors. These grants revolve around four main themes. The first is the social sector, where we have focused on

health and education. Both these sectors have faced unprecedented challenges from the Covid-19 pandemic and both provide public services with huge multiplier benefits and significant inter-State externalities. Our second thrust area is the agriculture sector and rural economy, where we have focused on incentives for encouraging agricultural reforms and recommended grants for the maintenance of Pradhan Mantri Gram Sadak Yojana (PMGSY) roads. This emanates from the need to enhance the welfare of rural India, which encompasses two-thirds of the country's population, employs 70 per cent of the total workforce and generates 46 per cent of national income.

10.8 Under the third theme, we have focussed on administrative and governance reforms that often do not get due priority from State Governments. We have recommended grants to strengthen the judiciary, which is the foundation of any peaceful and progressive nation. Also, considering the importance of data and statistics in today's world, we have recommended grants for improvements in statistics. The role of quality statistics and data is very important for any policy making, its implementation and subsequent monitoring. We also believe that incentivising administrative units like districts or blocks, which are below the national average in critical parameters, on the basis of performance (assessed in a transparent manner) can be an effective tool of improvement in governance. Hence, we have recommended grants for aspirational districts and blocks that will be entirely performance-based. The functioning of electricity distribution companies (DISCOMs) have remained a source of strain on State finances and the overall performance of the power sector. Therefore, we have developed a performance-based incentive system for the power sector, which is not linked to grants but opens up an additional borrowing window for States.

10.9 Lastly, we have recommended State-specific grants to help States to meet special burdens or obligations of national concern. These span six broad areas: (a) social needs, (b) administrative governance and related infrastructure, (c) conservation and sustainable use of water, drainage and sanitation, (d) preserving culture and historical monuments, (e) high-cost physical infrastructure and (f) tourism.

10.10 Grants for local governments in keeping with para 4 (iii) of the ToR and for disaster management in terms of para 9 have been dealt with at length in Chapters 7 and 8, respectively. These grants also flow to the States under Article 275 of the Constitution.

Revenue Deficit Grants

10.11 The specific ToR relating to grants-in-aid of earlier Commissions normally mentioned "sums to be paid to the States which are in need of assistance by way of grants-in-aid of their revenues". Para 4 (ii) of the ToR for this Commission, omits the words "which are in need of assistance". Some critics have argued that ToR of all previous Commissions had these words as provided in the Article 275 of the Constitution, which reads: "Such sums as Parliament may by law provide shall be charged on the Consolidated Fund of India in each year as grants-in-aid of

the revenues of such States as Parliament may determine to be in need of assistance, and different sums may be fixed for different States". Further, as mentioned earlier, para 5 of the ToR reads, "The Commission may also examine whether revenue deficit grants be provided at all."

10.12 All Finance Commissions have in the past awarded revenue deficit grants to the States. The Commissions have followed a normative approach to make their assessment and the gap in revenue accounts for the States post devolution was met by recommending revenue deficit grants under Article 275.

10.13 States have given mixed views on the issue of revenue deficit grants. Some States stressed that the gap-filling approach through revenue deficit grants has serious disincentives for tax effort and prudence in expenditure. Hence, these should be discontinued. On the other hand, most of the North-Eastern and Himalayan (NEH) States and few others have argued for continuing with revenue deficit grants. They have cited the stress on State finances on account of the implementation of state-level pay commission awards following the Seventh Central Pay Commission report, implementation of the goods and service tax (GST), interest liabilities on account of Ujjwal DISCOM Assurance Yojana (UDAY) bonds and the discontinuation of Plan grants. The NEH States have also suggested that their relative expenditure on the social sector and/or maintenance of capital assets needs to be higher than others due to topographical conditions and these need to be factored in to the revenue deficit grants. A few States expressed the need for more comprehensive equalisation grants to provide equal levels of services to all citizens.

10.14 We have considered the omission of the words, "which are in need of assistance" in ToR 4 (ii). In this context, we also deliberated the last sentence of ToR 5, which reads, "The Commission may also examine whether revenue deficit grants be provided at all". In our view, ToR 4 (ii) enjoins 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 by way of grants-in-aid of their revenues under Article 275. Article 275(1) itself is very clear that determination of "need of assistance" is paramount in deciding on the principles of grant-in-aid. Article 275 (1) read together with Article 280 (3) (b), in our view, makes it abundantly clear to us that we are obligated to assess the needs of the States on sound principles and determine our recommendations accordingly.

10.15 As done by the previous Commissions, we have applied a normative framework for assessing the own revenues and expenditure requirements of the States. The normative approach, explained in detail in Chapter 4, assesses each State on comparable national standards. Unlike a gap-filling approach that does not make corrections in the fiscal behaviour of the States, this approach ensures that deficiency in fiscal capacity is corrected, but inadequate revenue effort or excessive expenditure is not encouraged. Thus, after the devolution, some States end up with a post-devolution revenue deficit as a result of a vertical imbalance that needs correction because the assessed need is yet to be met. Revenue deficit grants, therefore, ensure that, as per our assessment, at the beginning of each year of the award period, all States start with at least a

revenue balance.

10.16 Also, we believe that any abrupt departure from revenue deficit grants may not be fiscally sustainable as there are issues related to legacy as well as the issue of an adjustment path. Hence, while the recommended revenue deficit grants diminish towards the end of the award period, we considered it unwise and impractical to subject States to a sudden shock of a mismatch between expenditure and the sum of own revenues and tax devolution.

10.17 After considering all relevant issues and careful analysis, we have decided to provide revenue deficit grants to States assessed with a post-devolution deficit.

Assessment of Revenue Deficit Grants

10.18 Based upon the assessment of revenues and expenditures as explained in Chapter 4, pre-devolution revenue deficits have been calculated (Table10.2). The post-devolution revenue deficit, derived from the assessed devolution of taxes based upon the horizontal devolution formula explained in Chapter 6, is in Table 10.3. The States which still show a revenue deficit have been recommended revenue deficit grants.

10.19 **We have recommended revenue deficit grants of Rs. 2,94,514 crore over our award period for seventeen States** (Table 10.4). These States are Andhra Pradesh, Assam, Haryana, Himachal Pradesh, Karnataka, Kerala, Manipur, Meghalaya, Mizoram, Nagaland, Punjab, Rajasthan, Sikkim, Tamil Nadu, Tripura, Uttarakhand and West Bengal. As can be seen from this table, the revenue deficit grants are on a declining path and the number of qualifying States declines from seventeen in 2021-22, the first year of our award, to six in 2025-26, the last year of the award. The total revenue deficit grant amount is also on a declining path, from Rs. 118,452 crore in the first year to Rs. 13,705 crore in the last year.

Table 10.2: Pre-Devolution Revenue Deficit/Surplus

(Rs. crore)

Deficit (+)/Surplus (-)

State	2021-22	2022-23	2023-24	2024-25	2025-26
Andhra Pradesh	43910	40198	36054	29445	20040
Arunachal Pradesh	8989	9361	9831	10340	10981
Assam	26977	27807	28705	29194	28950
Bihar	62323	64711	67731	71444	71984
Chhattisgarh	19206	19253	19721	19945	18327
Goa	2021	1353	582	-390	-1991
Gujarat	14281	10179	2958	-6427	-23688
Haryana	7330	1564	-5301	-14363	-27178
Himachal Pradesh	15715	15458	14900	14031	12159
Jharkhand	14688	14778	15027	15349	13798
Karnataka	25650	19348	12233	1724	-17508
Kerala	32569	27277	20618	11644	-1538
Madhya Pradesh	32797	32062	31108	28800	24259
Maharashtra	24584	17909	6976	-6022	-37198
Manipur	7240	7556	8007	8407	8837
Meghalaya	6330	6652	7038	7293	7528
Mizoram	5083	5278	5596	5762	5949
Nagaland	8304	8699	9138	9397	9750
Odisha	20614	19927	19334	17674	13891
Punjab	21982	21513	20515	18919	14122
Rajasthan	49565	49010	48472	46237	40564
Sikkim	3233	3283	3348	3370	3335
Tamil Nadu	29068	18291	5607	-10312	-34187
Telangana	-2155	-9151	-16609	-27376	-40801
Tripura	9209	9610	10011	10419	10553
Uttar Pradesh	112740	113509	112596	109944	100038
Uttarakhand	15135	15328	15440	15387	14091
West Bengal	67153	68702	70371	71026	68892
Total of States (Deficit)	**686696**	**648616**	**601917**	**555751**	**498048**
Total of States (Surplus)	**-2155**	**-9151**	**-21910**	**-64890**	**-184089**

Table 10.3: Post-Devolution Revenue Deficit/Surplus

(Rs. crore)
Deficit (+)/Surplus (-)

State	2021-22	2022-23	2023-24	2024-25	2025-26
Andhra Pradesh	17257	10549	2691	-8458	-23368
Arunachal Pradesh	-2582	-3511	-4653	-6115	-7864
Assam	6376	4890	2918	-102	-4601
Bihar	-3918	-8976	-15186	-22756	-35897
Chhattisgarh	-3232	-5708	-8366	-11964	-18216
Goa	-521	-1475	-2600	-4005	-6131
Gujarat	-8625	-15302	-25714	-39001	-60993
Haryana	132	-6444	-14312	-24600	-38901
Himachal Pradesh	10249	9377	8058	6258	3257
Jharkhand	-7092	-9450	-12235	-15623	-21672
Karnataka	1631	-7371	-17832	-32433	-56625
Kerala	19891	13174	4749	-6385	-22185
Madhya Pradesh	-18902	-25449	-33606	-44720	-59939
Maharashtra	-17019	-28371	-45100	-65185	-104953
Manipur	2524	2310	2104	1701	1157
Meghalaya	1279	1033	715	110	-699
Mizoram	1790	1615	1474	1079	586
Nagaland	4557	4530	4447	4068	3647
Odisha	-9207	-13246	-17994	-24734	-34676
Punjab	10081	8274	5618	1995	-5260
Rajasthan	9878	4862	-1205	-10200	-24070
Sikkim	678	440	149	-264	-827
Tamil Nadu	2204	-11593	-28020	-48515	-77938
Telangana	-15999	-24551	-33938	-47063	-63347
Tripura	4546	4423	4174	3788	2959
Uttar Pradesh	-5405	-17917	-35290	-58066	-92374
Uttarakhand	7772	7137	6223	4916	2099
West Bengal	17607	13587	8353	568	-11799
Total of States (Deficit)	**118452**	**86201**	**51673**	**24483**	**13705**
Total of States (Surplus)	**-92502**	**-179364**	**-296051**	**-470189**	**-772335**

Table 10.4: Grants-in-aid for Revenue Deficit

(Rs. crore)

State	2021-22	2022-23	2023-24	2024-25	2025-26	2021-26
Andhra Pradesh	17257	10549	2691	Nil	Nil	30497
Assam	6376	4890	2918	Nil	Nil	14184
Haryana	132	Nil	Nil	Nil	Nil	132
Himachal Pradesh	10249	9377	8058	6258	3257	37199
Karnataka	1631	Nil	Nil	Nil	Nil	1631
Kerala	19891	13174	4749	Nil	Nil	37814
Manipur	2524	2310	2104	1701	1157	9796
Meghalaya	1279	1033	715	110	Nil	3137
Mizoram	1790	1615	1474	1079	586	6544
Nagaland	4557	4530	4447	4068	3647	21249
Punjab	10081	8274	5618	1995	Nil	25968
Rajasthan	9878	4862	Nil	Nil	Nil	14740
Sikkim	678	440	149	Nil	Nil	1267
Tamil Nadu	2204	Nil	Nil	Nil	Nil	2204
Tripura	4546	4423	4174	3788	2959	19890
Uttarakhand	7772	7137	6223	4916	2099	28147
West Bengal	17607	13587	8353	568	Nil	40115
Total of States	**118452**	**86201**	**51673**	**24483**	**13705**	**294514**

Performance-based Incentives and Grants

10.20 We held detailed deliberations with reference to the nine points given in para 7 of the ToR to firm up our recommendations on performance-based incentives and grants for the 2021-26 period. Some of our views in the light of international experience on conditional and performance based fiscal transfers have been summarised in Chapter 2. Our deliberations and recommendations are elaborated in the following paras.

10.21 The idea of performance-based incentives is a time-tested approach and previous Finance Commissions have made recommendations in three broad categories: (a) incentives/rewards within the devolution formula, (b) performance-based grants and (c) other incentives.

10.22 In the horizontal formula for devolution of taxes, the relative collection of income tax by States remained a consistent criterion for distribution of income tax from the FC-I to the FC-IX. The FC-X introduced 'tax effort' as one of the criteria for distribution of income tax. The FC-XI, FC-XII and FC-XIII used 'fiscal discipline' as one of the parameters for distribution of taxes.

These acted as a reward/incentive for States to enhance revenues and become fiscally prudent. The FC-XIII gave performance-based grants, such as incentives for reduction in infant mortality rate, improvement in the delivery of justice, issuing unique IDs, and improvement of statistical systems at the State and district level. Commissions also gave performance grants to local governments.

10.23 Besides these, there have been other incentives like the Fiscal Reform Facility recommended by the FC-XI which incentivised elimination/reduction in revenue deficits. The FC-XII recommended the Debt Consolidation and Relief Facility which incentivised better debt management and formed the basis of the fiscal responsibility and budget management (FRBM) legislations of States. The FC-XIV incentivised the States for additional debt facility on fulfilling certain conditions related to fiscal performance.

10.24 The Union Government, in its memorandum, stated equalisation and efficiency as two objectives for having performance-based incentives for States:

i. The incentives with equalisation as an objective should ensure that people living in different States have access to the same level of basic services such as roads, education, sanitation etc.

ii. The other incentives with efficiency objectives should broadly ensure that economically efficient decisions are rewarded and that the focus is on long-run sustainability of policies as opposed to the short-run imperatives of the political cycle.

10.25 The memorandum from the Union Government also suggested some possible ways of quantifying performance of States and furnished an illustrative list of indicators that can be used for this purpose. It mentioned that the detailing and refinement of incentives can be done by Ministries/Departments in consultation with the States and under the overall guidance of the NITI Aayog.

10.26 Some States supported performance-based incentives in a few of the areas listed in para 7 of the ToR. They expressed the view that States should be incentivised to perform better in fiscal as well as other socio-economic parameters and together move towards a sustainable development path. States with low total fertility ratios have supported the idea of incentivising the States on this criterion.

10.27 A few States cautioned that the measurement of performance may become very subjective. They were not sure how performance would be measured or which methodology would be scientific, objective and consistent for application across all States. Some States noted that in a large country like India, any uniform prescription – a 'one size fits all' approach – is likely to be inappropriate because of the diversity of issues needing attention across the States. With the varied socio-economic backgrounds of States, adhering to all these conditionalities may seriously hold back the implementation of development programmes.

10.28 Some of the States opposed the reference in para 7 (viii) to 'control or lack of it in incurring expenditure on populist measures' as an area to incentivise. Many States stressed that the categorisation of schemes into populist and non-populist cannot be done objectively, as development requirements differ from State to State. Further, they argued that elected sovereign governments are accountable to the people of the State and they, rather than the Finance Commission, should have the prerogative of deciding the welfare schemes.

Our Approach

10.29 We have identified the following main principles while proposing measurable performance-based incentives for States:

i. as far as feasible, incentives should be outcome-based transfers;

ii. the outcome-based indicators should be fixed against each incentive through the use of credible and verifiable data, ideally with the attributes of being objective, reliable, universal, consistent, actionable, simple, and not subject to manipulation;

iii. the incentives must be sufficient in size to induce the desired outcomes; and

iv. incentives ought to reward a combination of both achievements in absolute terms as well as percentage changes in recent years, in order to balance the long-term efforts of advanced States and short-term efforts of more laggard States.

10.30 We mentioned in our Report for the Year 2020-21 that the Commission will consider providing performance-based incentives in various areas. We have made recommendations for many of these areas for our award period of 2021-26. We have classified them in four themes, as stated earlier. Some relate to flagship schemes of the Government of India and New India 2022 and are essential for the overall economic development of the country. Some of them are long pending reforms which fall within the domain of State Governments and, hence, their cooperation and coordination is needed to bring about the change. These are discussed in detail in following paras:

A. Social Sector

A.I Health Sector

10.31 The Covid-19 pandemic highlighted long-pending challenges in the health sector and risks compounding many vulnerabilities, especially of child undernourishment and mortality. These have been discussed in detail in Chapter 9 and grants aggregating to Rs. 31,755 crore have been recommended. In addition, grants for health through local governments aggregating to Rs. 70,051 crore have also been recommended in Chapter 7. We have also recommended State-specific grants for health amounting to Rs. 4,800 crore. The total grants-in-aid support to the

health sector works out to be Rs. 1,06,606 crore which is 10.3 per cent of the total grants-in-aid recommended by us. The grants for the health sector will be unconditional. We have also tried to front-load this support over the award period to help in addressing immediate needs due to the ongoing pandemic.

A.II Education Sector

School Education

10.32 India enjoys an unprecedented demographic advantage as more than 65 per cent of its population is in the working age group and the average age of population is twenty-nine years. Education is a key area that will help in harnessing this demographic dividend, which is expected to last for the next two decades and contribute significantly to economic development.

10.33 India spends about 3 per cent of its gross domestic product (GDP) on education, which is much below the average of developed countries. About 84 per cent of total expenditure on education is done by the States. Besides low investment, the education system faces various challenges such as poor learning outcomes, inadequate teacher training, teacher vacancies and absenteeism and an ineffective regulatory regime. The accountability measures are still weak at various places. There are large inter-State variations in educational performance. For example, literacy levels of States vary from 61.8 per cent in Bihar to 94 per cent in Kerala. The pupil-teacher ratio is very poor in States like Bihar, Haryana, Jharkhand and Uttar Pradesh,

10.34 The Government of India approved the National Education Policy in July 2020 (NEP 2020). This seeks to address many of the above challenges related to the foundational pillars of access, affordability, equity, quality and accountability. It proposes the revision and revamping of all aspects of the education structure, including its regulation and governance, to create a new system that is aligned with the aspirational goals of twenty-first century education, while building upon India's traditions and value systems. Complementing these efforts of the government, we decided, after detailed deliberations, that States should also be incentivised to improve pre-primary and broader school education.

10.35 Various parameters for defining the key performance indicators were discussed with the Ministry of Education (MoE), NITI Aayog and other subject area experts. The MoE informed us that it publishes an annual Performance Grading Index (PGI) of States which is based on seventy parameters covering five domains: (a) learning outcomes and quality, (b) access, (c) infrastructure and facilities, (d) equity and (e) governance processes. The comprehensive index captures all the major education-related indicators. Within these, we have focused on ten key indicators to incentivise States. These mainly relate to learning and equity outcomes.

10.36 A prime area of concern that remains, even after providing access to basic education, is the poor learning outcomes of school children. Accordingly, we have selected a few learning outcomes measured by the PGI and accorded a weight of 60 per cent to them. Another area which deserves attention is the education of girls, which is a critical determinant not only of age of

marriage, age of first pregnancy, total fertility and child health and nutrition but also the raising of the next generation of Indian citizens. We have also noted the educational gaps between rural and urban areas and between general and scheduled caste, scheduled tribes and minorities students. To address these, we have chosen some of the equity outcome indicators within PGI with an overall weightage of 40 per cent. This sub-set of the PGI is given at Annex 10.1.

10.37 **We recommend grants of Rs. 4,800 crore (Rs. 1,200 crore each year) from 2022-23 to 2025-26 for incentivising States to enhance educational outcomes based upon the above mentioned indicators.**

10.38 **We recommend incentivising six States each year as under:**

- **i. Category I: Rs. 200 crore incentive per year per State to be given to three States which secure the top three ranks in PGI.**
- **ii. Category II: Rs. 200 crore incentive per year per State to be given to three States which show the highest improvement in PGI score over the previous year.**

10.39 Over the award period, a State can only be awarded once in Category I and once in Category II, with the condition that it cannot be awarded for both categories in the same year. When a State cannot be awarded on account of any of these conditions, then the next best State in that category will be awarded. The grant will be released based upon the recommendation of the MoE. The performance grant received by the State will be utilised by the education department for enhancing educational outcomes and not diverted for use by any other department by the State.

Higher Education

10.40 To translate the demographic advantage into a productive dividend, it is important that higher education is also geared towards higher employment and entrepreneurial opportunities. The major challenges that the country faces in higher education include disparities in access, employability, research and innovation, faculty vacancies, capacity building, multiple regulatory agencies, large number of affiliated institutions and lack of flexibility in curricula. These challenges arise not only because of limited resources and funding but also to the absence of a forward looking policy framework. Also, the Covid-19 pandemic has necessitated alternative modes of delivering quality education wherever the traditional and in-person modes of education are not possible. There is also a dearth of professional courses in regional languages, which is a hindrance for many coming from rural areas. Considering this, we have recommended grants for higher education in two sub-categories: (a) promotion of online education, and (b) development of professional courses in regional languages.

10.41 The situation arising out of the Covid-19 pandemic, when institutions are closed, has increased the demand for online education. **We recommend grants of Rs. 5,078 crore for promotion of online education through the development of massive open online courses**

(MOOCs), direct-to-home (DTH) content development, digital classrooms and provision of devices (laptop/tablet) for 25 lakhs students belonging to socially and economically weaker sections of society. The inter se distribution between States has been made on the basis of the 2011 Census population. The details of distribution of devices may be worked out by the respective States in consultation with the MoE.

10.42 We also believe that the issue of access and the rural-urban divide in higher education may be addressed through encouraging teaching and learning material and pedagogy in the vernacular languages. There is a need to start professional courses in regional languages as 70 per cent of the people in India live in rural and tribal areas without access to quality education in English language. At present, it has been found that students from these backgrounds are diffident about opting for professional courses as they are offered in English only. Also, some of those who do take it up drop out mid-stream. After consultations with various stakeholders, **including the MoE, we recommend that two colleges in every State – one medical and one engineering – convert the learning material and pedagogy of their professional courses/ programmes into the recognised regional language (matribhasha) of the concerned State.** This is also in line with the NEP 2020 that attempts to revive the focus on regional languages in the country. **We have adopted the same cost norms as suggested by the Ministry and accordingly recommend Rs. 38 crore per State for five years amounting to a total of Rs. 1,065 crore for the development of professional courses in regional languages over the period 2021-26.**

10.43 The component-wise details of grants for higher education are given in Table 10.5. **Thus, for online learning and development of professional courses in regional languages (matribhasha) for higher education in India we recommend Rs. 6,143 crore. This grant will be administered by the MoE.** The State-wise and year-wise grants are given in Annex 10.2.

Table 10.5: Component-wise Disaggregation of Grants for Higher Education

(Rs. crore)

Year	Online Education				Development of professional courses in regional languages	Total
	MOOCs development	DTH	Device	Digital classrooms		
2021-22	68	3	449	400	213	1133
2022-23	83	5	463	413	213	1177
2023-24	129	13	477	427	213	1259
2024-25	148	14	492	436	213	1303
2025-26	91	11	505	451	213	1271
Total	**519**	**46**	**2386**	**2127**	**1065**	**6143**

B. Agriculture Sector and Rural Infrastructure

B.I Incentives for Agriculture Reforms, Self-Reliance, Export and Sustainability

10.44 The agriculture sector continues to dominate the Indian economy with 17.7 per cent share in gross value added (2019-20) and 44 per cent share in total workforce in the country.[1] The sector also assumes importance for the attainment of Sustainable Development Goals (SDG) 2030, addressing the issues of hunger and nutrition, greenhouse gas emissions and environment quality and also as a significant determinant of natural resource sustainability.

10.45 During the last three decades, agricultural output has grown at a trend growth rate of 3 per cent per year and it shows acceleration during the recent decade to 3.60 per cent. On the other hand, population growth rate, has been decelerating and reached a level of just 1.1. per cent. Further, while agri-food production has projected to maintain almost the same growth rate, population growth will further decelerate. This is creating mismatch between growth in domestic output and demand, with the latter not keeping pace with the former.

10.46 India is now surplus in many commodities and needs foreign markets to sell surplus domestic production to prevent a sharp fall in farm prices. This requires improved efficiency in production and better logistics. The growth rate in agriculture so far has been largely driven by output price support and input subsidies. These cause serious distortions in the output market and have led to the unsustainable use of natural resources. The most serious stress is felt on water resources, as half of the observation wells in the country show serious decline in the groundwater table. There are reports of farmers not getting remunerative prices for some crops as markets are not very competitive. Land lease laws in the country are such that they neither allow expansion of operational holdings nor encourage exit from farming. The net result has been that agriculture suffers from poor competitiveness, low production efficiency, unsustainable use of natural resources and low returns to farmers.

10.47 The main reason for the current state of agriculture is the absence of required policy reforms and missing development initiatives. In our first report for the year 2020-21, we had recommended that States will be eligible for financial incentives if they enact and implement all features of three new Acts prepared by the Ministry of Agriculture and NITI Aayog: (a) Model Agricultural Produce and Livestock Marketing (APLM) Act, (b) Model Contract Farming Act and (c) Model Agricultural Land Leasing Act.

10.48 It is pertinent to mention that out of these three policy reforms recommended by us, the Union Government has passed two Acts – (a) The Farmers Produce Trade and Commerce (Promotion and Facilitation) Act 2020 and (b) The Farmers (Empowerment and Protection) Agreement on Price Assurance and Farm Services Act 2020. We feel that with these two laws already in place, there is no need for the Commission to incentivise States to adopt the Model APLM Act and the Model Contract Farming Act. However, the Model Agricultural Land Leasing Act still remains on our agenda.

[1] Agriculture refers to crops, livestock, fishery and forestry.

10.49 Keeping these developments in mind, we held wide-ranging consultations with experts including the Ministry of Agriculture and Farmers Welfare, to formulate our view on the agriculture-related performance-based incentives for States. In this endeavour, we had the following objectives: (a) to use the challenges created by the Covid-19 pandemic as an opportunity; (b) to create mechanisms that ensure the sustainable performance of agriculture; (c) to enable smallholders and tenant farmers raise their income; (d) to promote demand-based production; (e) to incentivise increases in exports to match rising surplus production; and (f) to boost the agri-food processing sector.

10.50 After intense deliberations, we have selected four areas and parameters for performance-based incentives covering policies, investments, development initiatives and outcomes:

i. land lease reforms,

ii. sustainable and efficient water use in agriculture,

iii. export promotion, and

iv. contribution towards Atmanirbhar Bharat.

10.51 Each parameter is assigned an equal weight of 25 per cent. A summary of these parameters along with the goal and target underlying them are presented in Table 10.6.

Table 10.6: Parameters, Targets and Weights for Performance-Based Grants for Agricultural Reforms

S. no.	Purpose	Target/goal	Weight 1-100
1	Land lease reforms	Create legal provisions for liberalisation and recognition of agricultural land lease.	25
2	Sustainable and efficient use of water in agriculture	Maintain and augment groundwater stock and check the fall in the water table.	25
3	Export promotion for surplus disposal and better returns to farmers	Increase in exports of the agriculture sector	25
4	Atmanirbhar Bharat in oilseeds, pulses and wood and wood based products	Doubling of growth in output of three commodities over the average growth rate during 2011-12 to 2017-18	25

Land Lease Reforms

10.52 As mentioned earlier, the liberalisation of land lease was among the three policy reforms highlighted in our report for 2020-21. The incidence of leasing of agricultural land is rising but the lessee, or tenant who leases agricultural land, is not recognised, as the leasing agreements are largely informal.

10.53 More than 40 per cent of cultivated land is under leased tenancy in a few States. Such cultivators work in an insecure environment as they are not recognised by law and are deprived of benefits of government schemes such as the Pradhan Mantri Kisan Samman Nidhi (PM-KISAN) and institutional credit. A committee constituted by NITI Aayog went into details of this issue and proposed a model agricultural land lease law for adoption by the States. NITI Aayog also attempted to persuade States to legislate land lease laws, using the draft as a model. At present Madhya Pradesh and Uttarakhand have partially adopted the model law. Uttar Pradesh has passed an Act to amend its Revenue Code and created a provision for leasing of land by a landlord to any person, firm, company, partnership firm, trust, society, or any other legal entity for a period of fifteen years for agriculture or for setting up solar energy plants. This innovative approach meets the objective of the model land lease law circulated by NITI Aayog.

10.54 **We recommend that States may appropriately amend their land-related laws on the lines of NITI Aayog's model law to allow short-term and long-term lease of agricultural land both for agricultural purpose as well as for agro-industry, logistics for agricultural trade and supply chains.**

Sustainable and Efficient Water Use

10.55 India faces serious and rising stress in its water resources. Groundwater levels are falling at an alarming rate in large parts of the country and 600 million people already face high to extreme water stress. Despite the rising gap between the demand and supply of water, India's policies and practices encourage profligate use of water. The agriculture sector uses about 90 per cent of total water used in the country and still half of the area under agriculture remains rainfed. We use far more water compared to most other major agricultural countries to produce the same quantity of output. The reason for this is that farmers follow flood irrigation, as water supply to agriculture and power supply to extract water for agriculture is free in many States and highly subsidised in other States.

10.56 There are at least three ways to reduce and rationalise water use in agriculture. First, replace free or subsidised power supply for agriculture with direct benefit transfers (DBT) so power supply to agriculture is adequately charged. This will lead to judicious use of water and some shift away from water guzzling crops. Second, encourage and spread new technologies, such as drip, sprinkler, sensor-based irrigation to get more crop per drop. Third, conserve and harvest rainwater to increase the availability of surface as well as of groundwater. The net effect of all these measures can be captured from changes in the groundwater table which is regularly monitored by the Central Groundwater Board under the Ministry of Jal Shakti. Accordingly, **we recommend incentive-based grants to States that maintain and augment groundwater stock and put a check on any fall in the water table.**

Export Promotion

10.57 India is a net agri-food exporting country and exports 7 per cent of its domestic production. Indian agriculture has reached a stage where growth in domestic demand is lagging behind the growth in domestic production, leading to a rise in the surplus in the domestic market. The fraction of domestic production available for export will continue to rise in the next decade. Despite being the second highest agricultural producer in the world, India's share in the global market is just 2.5 per cent. India has enormous headroom for growing agricultural exports. Recognising this, the Government of India issued the Agriculture Export Policy in December 2018 which aims to double, by 2022, the level of agricultural exports from the level achieved in 2017. We propose to use this target as an indicator for our award for export performance of a State.

10.58 Recognising the importance of exports for Indian agriculture and farmers, we constituted a High Level Expert Group (HLEG) to suggest policy changes and strategy to give a transformative push to farm exports. After reviewing global trade flows, food and agriculture trends, successful case examples in India and overseas, review of select value chains, as well as wide-ranging consultations with governments, experts, industry, farmers and commodity boards, the HLEG made significant and pragmatic recommendations for doubling agricultural exports.[2] Some of these are:

i. Focus on twenty-two crop value chains (including two for import substitution) that have a potential to nearly double India's net exports in the medium term. Of these, target seven value chains that are an early must-win (rice, shrimp, spices, buffalo meat, fruits and vegetables for exports; and vegetable oil and wood for import substitution). Given their diversity, these can serve as lighthouses for other value chains in the next phase.

ii. Support these agri-value chains holistically through a cluster approach by addressing key enablers on both the supply side and demand side. This will increase farm productivity, improve quality, ensure regulatory compliance, enhance cost efficiency and boost competitiveness, while continuing with efforts to improve market access.

iii. The value chain clusters must be anchored by private sector value chain players to ensure market orientation through value added products.

iv. States must lead this effort by building comprehensive plans for developing the value chain clusters of the focus commodities.

v. The Union Government will have a key role to play in enabling execution of these plans. Building trade relationships and negotiating treaties with importing countries will naturally be in the Union's domain. It will also have to make and/or support investments in infrastructure at the air and sea ports, national highways, and warehouses in the importing countries, and also build 'Brand India' in destination markets.

[2] Details can be seen in HLEG report at: https://fincomindia.nic.in/ShowContentOne.aspx?id=27&Section=1

vi. A central body should be set up as an Empowered Committee comprising representatives of all stakeholder groups and State Governments with a dedicated secretariat. Inter-ministerial offices like Principal Secretary of the Prime Minister's Office or Member (Agriculture) of NITI Aayog could provide monitoring oversight to this set-up.

vii. The high cost of logistics affects the competitiveness of our agriculture exports and this needs to be addressed through appropriate policy measures.

10.59 The HLEG believes that the recommended approach will boost India's agriculture exports from US$ 40 billion to US$ 70 billion in a few years after implementation, while attracting estimated investment to the tune of US$ 8-10 billion across inputs, infrastructure, processing and demand enablers. The additional exports could result in the creation of seven to ten million jobs along the value chain, besides contributing to higher farmer incomes. Keeping these suggestions in mind, **we recommend using growth in agricultural exports as a target indicator for award for export performance of a State.**

Contribution Towards Atmanirbhar Bharat

10.60 Recently, considerable emphasis has been given to making India self-reliant through Make in India. Agriculture, being the largest sector of the Indian economy, has to play a significant role in achieving the goal of Atmanirbhar Bharat. Despite the rising stock and surplus in some commodities, and large unused land, India has a sizable deficit in other agricultural commodities.

10.61 The Green Revolution, focussing on wheat and rice, created strong disadvantage for the production of pulses and oilseeds crops in the country. Moreover, the availability of pulses in global market is also very limited, leaving little scope for large scale imports. As a result, per capita domestic availability of pulses has declined from 69 grams per person per day in 1961 to less than 55 grams in recent years. Pulses are a major source of protein and nutrition for a large number of Indians and the decline in its per capita availability has led to undernutrition and malnutrition. More than 60 per cent of India's domestic demand for vegetable oil is met from imports, valued at Rs. 69,000 crore. Similarly, the country is meeting 40 per cent of its non-fuel timber requirement from imported wood and wood products, valued at Rs. 42,000 crore in 2018-19 making it the second highest agri-import commodity after vegetable oil.[3]

10.62 The country has vast tracts of barren lands devoid of vegetative cover, with serious economic and environmental implications. State laws on felling of trees and transit of produce of trees and setting up of wood-based industries are major hurdles to raising trees outside forests and producing wood on private lands. A change in the regulatory focus, in the form of relaxation in regulations relating to felling of trees and their transport and on wood-based industries, will encourage growing of valuable tree species on private lands. **We recommend increasing production of oilseeds, pulses and wood and wood-based products as an indicator to make**

[3] *Handbook of Statistics on Indian Economy,* Reserve Bank of India

India self-reliant in pulses, edible oils and wood and wood products.

10.63 One of the performance criteria presented in Table 10.6, namely the enactment of the model agricultural land lease law, is a one-time policy measure. A State is eligible to get one-fifth of the earmarked incentive for the State on the notification of the new law during our award period (2021-26). Other parameters involve step-wise annual progress. These will be quantified on an annual basis to arrive at the amount of performance-based incentive. The methodology for estimating performance-based grants to States and actual indicators to measure extent of performance are presented in Annex 10.3.

10.64 **We recommend that Rs. 45,000 crore be kept as performance-based incentives for all the States for carrying out agricultural reforms during the award period. Its distribution among States, based on gross value added (GVA) in agriculture (average of actuals for 2018-19 and our projections of 2019-20) in each State, is given in Annex 10.4. NITI Aayog will be the nodal agency for monitoring and reporting progress of the indicators in each State and recommend the release of performance-based reward on the basis of annual assessment.**

Distribution of Residual Fund

10.65 It is likely that a few States may not be able to meet all the four goals/targets for getting the full amount of the performance-based grant for agriculture. This will leave some amount of performance grants unused at the end of five years. We recommend that this unused amount be distributed among those States which earned an aggregate score of at least 25 per cent. The share of each of the eligible States will be determined on the basis of their relative share in the total agricultural GVA of all the eligible States.

10.66 **This performance grant should be used only for infrastructure and activities related to the development of agriculture and allied sectors by the States.**

B.II Maintenance of PMGSY Roads

10.67 Para 6 (iii) of the ToR says that 'While making its recommendations, the Commission shall have regard, among other considerations, to: …..the demand on the resources of the State Governments, particularly on account of financing socioeconomic development and critical infrastructure, assets maintenance expenditure……'.

10.68 Rural roads are recognised as catalysts for rural development and critical for poverty alleviation. The PMGSY was launched in December 2000 to provide all-weather connectivity to eligible habitations. To date, 6.32 lakh km road length has been constructed, which is close to a quarter of the rural road network. This huge asset demands a recurring and steady stream of funds for maintenance.

10.69 Rural roads often witness manifold increase in traffic volume and need constant

upgradation. PMGSY introduced the concept of a five-year guarantee period for the maintenance of roads. As of date, 1.63 lakh km roads (25.8 per cent) are within this guarantee period, which leaves 4.69 lakh km of road (74.2 per cent) due for renewal/upgradation. While the routine maintenance of roads is provided for by State Governments in the original cost, the increasing liability of the post guarantee period maintenance is becoming a challenge. After the change in funding pattern of Centrally sponsored schemes (CSS), post 2015, the financial burden of States has increased and most are unable to provide funds for maintenance and upgradation of roads. This financial stress has increased after the Covid-19 pandemic and, over time, it is essential that the States meet this need fully from their own sources.

10.70 The Ministry of Rural Development (MoRD) has informed us that the total asset value of PMGSY roads constructed so far is about Rs. 3.16 lakh crore. These roads will undergo rapid deterioration if periodic maintenance is not carried out. The cost of such maintenance is approximately Rs. 12-15 lakh per km in plain areas and Rs. 14-17 lakh per km in the hilly areas. At the present construction cost of Rs. 0.6 crore per km, the total replacement value of the 4.69 lakh km of roads now in the post five-year period is roughly Rs. 2.81 lakh crore. The Ministry requested us to provide a grant of Rs. 73,142 crore to the States for the roads that are likely to fall in the post-five-year category during our award period.

10.71 We feel that it is extremely important to provide for maintenance of the PMGSY roads at the end of the five-year maintenance contract period. We have taken the projected expenditure on maintenance of roads from the MoRD for a period of five years and recommend grants to cover a part of the maintenance cost. We have covered a higher proportion of the total maintenance cost for NEH States considering that they face greater challenges in maintaining their road infrastructure. Until the States are fully able to meet these costs, for the general States we have provided for 25 per cent of the projected cost of maintenance, and the total grant works out to Rs. 14,743 crore. Similarly, for the NEH States we have provided for 90 per cent of the projected cost of maintenance, and the total grant works out to Rs. 12,796 crore.

10.72 **Thus, for our award period, we recommend Rs. 27,539 crore for the maintenance of PMGSY roads for the years 2021-26, out of which Rs. 14,743 crore is for the general States and Rs. 12,796 crore is for the NEH States. This amount is expected to cover about 2.21 lakh km of roads that fall in the post five-year maintenance period. This grant will be administered by the MoRD. The State-wise and year-wise details are given at Annex 10.5.**

C. Governance and administrative reforms

C.I Judiciary

10.73 An efficient justice delivery system is a central component in implementing the SDG Goal no. 16, that is, peace, justice and strong institutions. During our consultations with the Department of Justice in the Ministry of Law and Justice, we were informed that State Governments did not provide adequately for strengthening the judicial system even after the enhanced tax devolution following the recommendations of the FC-XIV.

10.74 Latest data show that the district and subordinate courts across the country are still grappling with about 3.20 crore pending cases, causing inordinate delays in justice delivery. Two-thirds of the prison population are under-trial prisoners who continue to be incarcerated due to disproportionate delay in trials. Delays and pendency of economic cases are also mounting and this is taking a toll on the economy in terms of stalled projects, mounting legal costs, contested tax revenues and reduced investment.

10.75 The Department of Justice sent a proposal for Rs. 19,312 crore for all States to build fast-track courts, special fast-track courts for cases under the Protection of Children from Sexual Offences (POCSO) Act and appropriate facilities in court complexes. After detailed deliberations, **we recommend grants of Rs. 10,425 crore for fast-track courts for speedier justice delivery in cases of heinous crimes, civil cases of marginalised people, property cases that are over five years old and economic offences as well as special fast-track courts for POCSO cases.** The Department gave an approximate cost of Rs. 82.50 lakh per court per year for starting new fast-track courts as well as running existing fast-track courts. Based upon this cost, 2,530 fast track courts may be started and maintained for five years. We recommend that preference should be given to fast-track court for POCSO cases. The number of fast track courts proposed for each State is based upon the crime rate mentioned in the National Crime Records Bureau data of 2018.

10.76 We are convinced that grants for judiciary recommended by this Commission would aid in ensuring essential infrastructure to facilitate early disposal of cases in several important areas, which would improve the efficiency of the justice delivery system. This will benefit both the society at large and the economy. The State-wise grants are given in Annex 10.6. This grant will be administered by Department of Justice in the Ministry of Law and Justice.

C.II Statistics

10.77 Reliable statistics are absolutely essential for any policy making, implementation and subsequent monitoring. The Ministry of Statistics and Programme Implementation (MoSPI) submitted a detailed proposal to enhance the system of statistical data collection and their dissemination. The proposal contains the expectations from the States for the next five years along with a broad implementation strategy as well as recommendations for State-wise grants. We are convinced that incentivising States for producing robust statistics in a timely manner will go a long way in effective policy making in times to come.

10.78 The grants for statistics for the States have a fixed and a variable grant. A quantum of fixed grants of Rs. 1 crore per district is recommended for all States to support their basic statistical operations. An additional quantum of variable grants is being provided to the States on the basis of two criteria. These are: (a) the level of statistical capacity and development; and (b) the utilisation capacity, based on past expenditure on statistical activities. The statistical capacity and development of a State is assessed on parameters such as existing manpower, status of

compilation of district domestic product, index of industrial production, consumer price index, participation in the National Sample Survey/Annual Survey of Industries and other published statistical exercises. Based on the scores assigned to States on the selected parameters, they have been categorised into three groups and variable grants per district have been recommended for each.

10.79 Based on the scores, the categorisation of States into three groups and proposed quantum of variable grant per district are in Table 10.7. State-wise details are given in Annex 10.7.

Table 10.7: Categories of States for Variable Grants for Statistics

Group	Average score based on total of available indicators	Proposed quantum of variable grant per district	Name of States
I	Greater than or equal to 0.70	Rs. 50 lakh	Andhra Pradesh, Gujarat, Karnataka, Kerala, Odisha, Tamil Nadu, Telangana, Uttar Pradesh, West Bengal (9)
II	Greater than or equal to 0.5 but less than 0.70	Rs. 75 lakh	Assam, Haryana, Himachal Pradesh, Maharashtra, Manipur, Mizoram, Rajasthan, Sikkim (8)
III	Less than 0.5	Rs. 1 crore	Arunachal Pradesh, Bihar, Chhattisgarh, Goa, Jharkhand, Madhya Pradesh, Meghalaya, Nagaland, Punjab, Tripura, Uttarakhand (11)

10.80 We have accepted, after deliberations with experts, the broad outline of the expected activities proposed by MoSPI which is given in Table 10.8. However, this list of indicators is suggestive and may be revised and finalised by MoSPI in consultation with States.

Table 10.8: List of Milestones for Variable Component of Statistics Grants

Milestone	Activities related to the milestone	Release of additional resources/funds (within envelope)
1.	• Compilation and **annual release** of district domestic product (DDP) • Compilation and **monthly release** of State index of industrial production and consumer price index • State monitoring framework for SDGs and **dynamic updating** with National SDG Dashboard	33.33 per cent of variable component
2.	• Participation in NSS surveys and release of estimates at the sub-**State/district levels** within one year of completion of survey; • Using technology for data capture (computer assisted personal interviewing (CAPI) mode), validation and processing.	33.33 per cent of variable component
3.	• Implementing **dynamic updating** of proposed National Business Register • Innovations for improvements in administrative statistics like establishment and household registries; land records, etc. • Dynamic updating with the national integrated information portal being developed by MoSPI	33.33 per cent of variable component

10.81 The variable grants amounting to Rs. 498 crore are based upon the fulfilling of all of the three milestones above. This amount is equally spread across three years, 2023-24 to 2025-26. To avail one-third of this amount in a year, States have to fulfil any one of the three milestones in year 2023-24. In year 2024-25, one of the remaining two milestones should be fulfilled to get another one-third amount and the last milestone should be fulfilled in year 2025-26 to get the remaining amount. The order of completion of these milestones is not specified. The variable component of the grants to be given to States will be based upon the recommendations of MoSPI, which will administer the grant.

10.82 **We recommend total grants to the States, with fixed and variable components, of Rs. 1,175 crore from 2022-23 to 2025-26 for improving the quality of statistics. We also recommend that, initially, the fixed grant of the total allocation, amounting to Rs. 677 crore, which is unconditional, may be released in 2022-23. The remaining variable component of Rs. 498 crore may be disbursed equally over the remaining three years starting 2023-26, based on achievements of milestones against a list of activities as explained before. Both the**

fixed and variable grant will be utilised by the States' statistics department only. The year-wise and State-wise details are given at Annex 10.8. This grant will be administered by MoSPI.

C.III Development of Aspirational Districts and Blocks

10.83 The 'Transformation of Aspirational Districts' programme was initiated by NITI Aayog to expeditiously improve the socio-economic status of 112 relatively underdeveloped districts across the country, that were identified on the basis of certain social and economic development criteria. Driven primarily by the States and instituted for the States, this initiative focuses on the strengths of each district, and identifies the attainable outcomes for immediate improvement, while measuring progress and ranking the selected districts. The three core principles of the programme are: convergence (of Union and State Schemes), collaboration (among citizens and functionaries of Union and State Governments, including district teams) and competition among districts. It focuses on five main themes: health and nutrition, education, agriculture and water resources, financial inclusion and skill development and basic infrastructure, which have a direct bearing on the quality of life and productivity of citizens.

10.84 The Union Government, in its memorandum, has emphasised the need to incentivise aspirational districts through an improvement in key performance indicators developed by NITI Aayog. The baseline ranking for the aspirational districts is based on forty-nine indicators across five sectors: (a) health and nutrition (30 per cent weightage); (b) education (30 per cent); (c) agriculture and water resources (20 per cent); (d) financial inclusion and skill development (10 per cent); and (e) basic infrastructure (10 per cent). We also held extensive consultations with NITI Aayog, and received a formal request for supporting this programme.

10.85 We studied the proposal and held detailed discussions. Based upon our deliberations, we have come to the conclusion that incentivising administrative units like districts or blocks, which are below the national average in critical parameters, on the basis of performance in a transparent manner can be an effective tool of improvement in governance. Such incentives give rise to healthy competition among different units, thereby improving the impact of a scheme/policy across different sectors. The ensuing competition among different public delivery units should lead to greater adoption of innovative and best practices.

Aspirational Districts

10.86 **We recommend Rs. 500 crore over the five-year award period for incentivising aspirational districts.** The performance of a district would be measured on the basis of a performance matrix consisting of selected key performance indicators (KPIs) over a given period of time. The KPIs will be formulated and finalised by NITI Aayog in consultation with States. Based upon this index, ten districts would be selected for a yearly performance grant of Rs. 10 crore each, subject to the following conditions:

i. Districts will receive such an amount only once in the 2021-26 period. If the same district also ranks among the best ten districts, it would receive a certificate, but the allocation would be provided to the next best district observing similar conditionality.

ii. NITI Aayog will define a minimum benchmark of performance that districts will have to achieve to avail the award/grant.

iii. The amount would be in the nature of untied funds and districts would have the flexibility of choosing the projects/activities subject to a negative list to be drawn up by NITI Aayog to ensure that this fund is utilised for critical needs of the district.

iv. Every district that has secured the performance grant would have to get its proposed plan of action and activities approved by a nodal officer designated for this purpose by the State Government and would send such a plan of action to NITI Aayog. The plan has to be developed in consultation with the district and State Government.

10.87 The guiding principles for selection of KPIs and assessment of performance of a district are:

i. To the extent possible, KPIs should be outcome-based indicators. Only very critical process indicators, which are directly linked to flagship schemes of the Union Government, are to be included.

ii. KPIs must be relevant to all districts in India.

iii. Evaluation of performance would be based on an independent survey done by a third party selected through an open competitive process.

Administrative Blocks

10.88 The experience with aspirational districts has been extremely encouraging and NITI Aayog has now proposed that the focus should be on the administrative block as a unit of targeted intervention. We have examined the proposal of NITI Aayog for incentivising blocks in aspirational districts and are in agreement with the proposal. **We recommend that 10 per cent of the blocks in the aspirational districts of each of the concerned States would be selected every year from 2021-22 to 2025-26 on the basis of their performance using an identified performance matrix. These blocks would be rewarded an amount of Rs. 5 crore each. Since there are 915 administrative blocks in the 112 aspirational districts, about 100 blocks, spread over the States that have aspirational districts, would be covered every year. This will translate into an amount of Rs. 2,500 crore for incentivising blocks over the five-year award period. The performance grant will be subject to the following conditions:**

i. A block will receive such performance grant only once in a period of 2021-26. If the same block secures rank among the first blocks in another year, it would receive a certificate but the allocation would be provided to next best block observing similar conditionality.

ii. NITI Aayog will define a minimum benchmark of performance that blocks will have to achieve to avail the award/grant.

iii. The grant would be in the nature of untied funds and the district concerned would have the flexibility of choosing the projects/activities subject to a negative list prescribed by NITI Aayog. While finalising the list of activities /projects, the critical needs of blocks would be given priority.

iv. Every block that has secured a performance grant would get the proposed plan of action/activities approved by the District Administration.

10.89 The guiding principles of selection of KPIs for the evaluation of blocks would be the same as for aspirational districts. However, given the specific priorities, the list of indicators for assessing 10 per cent of the best performing blocks in a State would be State-specific. NITI Aayog would work with each State to arrive at a set of indicators for selecting top 10 per cent of the blocks in each State.

10.90 In order to ensure that competition among districts and among blocks remains fair and transparent, independent third party surveys on a sample basis should be conducted once a year in each district. The performance measurement would be based on the results of these surveys. NITI Aayog should engage agencies for conducting these surveys through competitive bidding. **We recommend Rs. 150 crore for capacity building and surveys in 112 districts and 915 blocks over a period of five years.**

10.91 After completion of the project, districts and blocks would forward utilisation certificates of activities undertaken through State Government to the Union Government.

10.92 Accordingly, **we recommend Rs. 3,150 crore for incentivising aspirational districts and blocks for a period of five years from 2021-22 to 2025-26.** This grant will be administered by NITI Aayog. A summary is given in Table 10.9.

Table 10.9: Requirement of Funds for Aspirational Districts and Blocks

S. No.	Particulars	Yearly	Cumulative for five years (2021 - 2026)
		(Rs. crore)	(Rs. crore)
1	Performance grant to ten best performing aspirational districts (out of 112) @ Rs. 10 crore every year	100	500
2	Performance grant to best performing 100 blocks @ Rs. 5 crore every year	500	2500
3	Surveys and capacity building in all 112 aspirational districts and 915 blocks	30	150
	Total	630	3150

D. Power Sector Reforms

10.93 Para 7(iv) of our ToR enjoins us to consider measurable performance-based incentives for States that have made "progress in increasing capital expenditure, eliminating losses of power sector, and improving the quality of such expenditure in generating future income streams". The power sector has its distinct but interrelated segments of generation, transmission and distribution. The Electricity Act, 2003 provided a framework for the development of the sector by promoting competition, ensuring transparency, rationalising electricity tariffs, distancing government from regulatory responsibilities and protecting consumer interest. It succeeded in bringing investment from the private sector in generation and transmission and resulted in huge augmentation of generation and transmission facilities.

10.94 However, functioning of distribution companies (DISCOMs) have remained a source of strain on State finances and the overall performance of the power sector. In most States, the improvements in the distribution segment are incomplete. This segment has been the weakest link in the entire value chain and has long faced questions of financial sustainability on account of below-cost tariffs to different consumer groups, the supply of un-metered, free electricity to agriculture, States not providing the promised subsidies to the utilities, high aggregate technical and commercial (AT&C) losses and poor regulatory governance. The issue of inadequate revenue realisation and significant functional inefficiencies remain. These factors have weakened the finances of State utilities, lowered the ability to attract private investment in the sector and resulted in heavy reliance upon government support for both investment and working capital. The consequence has been pressure on State finances as well as on the viability of the upstream segments of the power sector, lender banks and financial institutions and, ultimately, acting as a brake on the entire economy.

10.95 Over the past twenty years, a number of reform initiatives have been taken to create incentives to increase metered supply, strengthen transmission and distribution systems and reduce losses. These reform measures have included schemes that offered funding for capital investment and made the terms of financing more attractive for States achieving targets of loss reduction. Some of the key reform initiatives have been the Accelerated Power Development and Reform Programme (APDRP), the Restructured-APDRP, Integrated Power Development Scheme, Financial Restructuring Plan and Ujjwal DISCOM Assurance Yojana (UDAY). These reform measures, generally, had a marginal impact on the functioning of the DISCOMs, though some States have shown improvement.

10.96 In our report for 2020-21, we had noted that we would consider recommending annual financial incentives for top performing States in the power sector. The targets suggested were based on certain broad parameters such as: (a) achieving the reduction targets of AT&C losses, (b) achieving the reduction targets of average cost of supply (ACS) and average revenue realised (ARR) gap, (c) open access to trade and industry to meet their power needs from sources other than the State utilities and (d) to implement direct cash transfers for all consumers eligible for subsidy in a State. We, in our first report, had also urged the Ministry of Power to develop, in

consultation with the States, a monitorable performance index within 2020-21, with State-wise targets and a clear roadmap.

10.97 Since State Governments are the sole owners of an overwhelming majority of the distribution utilities, their financial position is directly affected by the financial health of the utilities. The State Governments have been lending to the power sector specially to fund capital expenditure of transmission companies and DISCOMs, and also to cover their mounting financial losses. In addition to direct lending, State Governments have been providing support to State DISCOMs in the form of grants and subsidies. During the 2014-19 period, States, on an average, have spent 6.6 per cent of their budget on power. State Governments also provide guarantees for the borrowings of DISCOMs from financial institutions. Given that State Governments are guarantors, these resultant contingent liabilities are a risk to State finances, owing to the large outstanding debt and rising losses of DISCOMs. The aggregate losses (after including the subsidy received) for all the utilities increased from Rs. 33,594 crore in 2017-18 to Rs. 61,360 crore in 2018-19.

10.98 The outstanding debt of State Governments as a proportion of gross state domestic product (GSDP) stood at 25.3 per cent as on 31 March 2019. On the same date, the stock of borrowings of DISCOMs, which are not part of the outstanding debt of the States, stood at 2.5 per cent of GDP. The stock of borrowings of DISCOMs of seven States, where its incidence is the highest, averaged 5 per cent of their GSDP. Apart from the rising debt stock, the DISCOMs have also reported liabilities - both financial and non-financial - worth 1.9 per cent of GSDP and payables on account of purchase of power and fuel worth about 1.1 per cent of GSDP on 31 March 2019. This impacts the comprehensive debt profile of the States. The known vulnerabilities of DISCOMs in their commercial operations and their shadow on State finances have compelled us to address the problems in a manner that will create incentives for States to comprehensively reform their power sector.

10.99 The power sector has also been severely impacted by the Covid-19 pandemic and there has been a significant drop in power consumption. During the period April-June 2020 the consumption of power declined by 18.3 per cent on a year on year basis. More importantly, there has been a steeper fall in industrial and commercial consumption, two major revenue earners for the DISCOMs. There is clearly a longer-term impact of the Covid-related slowdown on electricity offtake impacting power demand and, hence, revenues.

10.100 As discussed earlier in the report, the pandemic has had a serious negative impact on the resources of both the Union and State Governments. As a consequence, States urgently require additional resources to address the effects of the pandemic and maintain the standards of service delivery to public. To enhance the resources of the State Governments, the Union Government provided an additional borrowing limit of up to 2 per cent of GSDP in the year 2020-21. Out of this 2 per cent, 0.25 per cent was linked to power reforms. To avail of 0.25 per cent of additional borrowing, States are required to undertake reforms in the year 2020-21, on the lines of the parameters we recommended in our first report:

i. For reduction in AT&C losses in a State as per targets, an additional borrowing limit of 0.05 per cent of its GSDP has been allowed.

ii. For reduction in the ACS-ARR gap in a State as per targets, an additional borrowing limit of 0.05 per cent of its GSDP has been allowed.

iii. For introduction of DBT to all farmers in a State in lieu of free electricity given to them, an additional borrowing limit of 0.15 per cent of its GSDP has been allowed. To become eligible, the State is required to (a) formulate the DBT scheme and (b) implement this scheme in at least one district by 31 December 2020.

10.101 The measures taken by the Union Government in the course of addressing the pandemic have already set in motion a process of incentivising the States to improve the distribution sector. These, along with the proposed amendments to the Electricity Act 2003 and the likely approval of the New Tariff Policy, will further provide momentum to the reform agenda. We believe that these measures need to be continued as the attendant structural reforms are expected to be completed over the next four-five years.

10.102 We had, in our report for 2020-21, indicated our approach for designing a forward looking performance incentive for improvement in the power sector for top performing States. There is clear recognition amongst all stakeholders that a number of steps are required to be taken by all the States and the DISCOMs under them to enable the power sector to become the engine of growth. These include eliminating cross subsidies, expanding metered supply, implementing DBT for transfer of subsidy, reducing ACS-ARR gaps as well as AT&C losses. We also recognise that fresh capital investment is required for last-mile improvements in supply infrastructure. Underlying all these, in our opinion, is the need to increase power demand to give a spurt to the economy and target improvement in the revenue realisation of DISCOMs. Making the increase in revenue realisation the central focus of our approach will also trigger removal of functional and operational inefficiencies that have plagued the distribution sector. Therefore, keeping in view the impact of the pandemic on both demand side and supply side factors in the power sector and on State finances, we considered various options that would provide States with a liquidity cushion to implement structural improvements in the finances of DISCOMs and simultaneously introduce governance improvements. In designing our performance incentive, we also factored in the responsibility of the State Governments and their accountability towards the tax-payers and citizens.

10.103 **Accordingly, we recommend an extra annual borrowing space for the States, of the magnitude of 0.50 per cent of their GSDP for each of the first four years of the award covering the period 2021-22 to 2024-25, based on certain performance criteria in the power sector.** As the DISCOMs' operational efficiency is important to the extended debt profiles of States, we recommend linking this window of additional borrowing space to certain specified measures to improve this operational efficiency. We have made this intervention forward looking, with targeted year-on-year improvements during the 2021-25 period that can be calibrated and

assessed before States are rewarded. We further recommend that for States that achieve the threshold level in terms of performance, the extra borrowing can be used for capital expenditure to upgrade distribution infrastructure.

10.104 We had extensive discussions with a large number of stakeholders and received numerous suggestions on the incentive system that could be set in place to align the interests of the State Government with those of the distribution utilities. Some of the indicators suggested included implementation of corporate governance practices in DISCOMs, implementation of a public private partnership model, procurement of power through tariff-based competitive bidding, smart metering with prepaid facility, commitment to fulfill renewable purchase obligations and switch to DBT for the transfer of subsidy to agricultural and other consumers.

10.105 In the course of our deliberations, we noted that the absence of up-to-date audited accounts is a problem in some of the DISCOMs. Most of them are registered under the Companies Act, 2013 and are required to file their consolidated financial statements as per a mandated schedule. Unless and until proper audited accounts are available, the financial implications of performance cannot be measured. This will make the incentive structure potentially susceptible to gaming. We, therefore, recommend as an entry level condition, that for a State to become eligible for this extra borrowing, it should ensure and certify that all DISCOMs in the State have up-to-date audited accounts. This implies that in determining the eligibility of a State in year (t), all the DISCOMs in the State should have filed their consolidated financial statements for the financial year (t-1) as per the statutory requirements. Unless this condition is fulfilled by all the DISCOMs of the State for the accounts of the previous financial year, the State will not be eligible for the additional borrowing. This entry level condition will only apply for the borrowings in the years from 2022-23 onwards. We expect that this entry level condition will instil discipline and actual performance will get captured to accurately reflect the ACS-ARR gap.

10.106 In our final choice of indicators, we have restricted the number of key indicators that will reflect the outcome of the reforms to four. In order to maintain continuity, we chose to continue with all the three indicators that have been mandated by the Ministry of Finance for the year 2020-21: (a) reduction in AT&C losses; (b) reduction in ACS-ARR gaps; (c) reduction in payment of cash subsidy by adopting DBT. These had also been identified by us in our first report. We have expanded the third indicator to include the reduction in tariff subsidy as a percentage of revenue from the sale of power. This will measure the extent to which State Governments are providing subsidy to the power sector.

10.107 The objective of reform should be to ensure a sustained increase in electricity consumption in the country, with DISCOMs in a position to improve their off-take of power. The three performance indicators address this core concern. Underlying the three indicators should be an incentive to increase the sale of metered energy, for which revenue has actually been collected. Non metered supply poses a challenge for accurate measurement and raises the possibility of including figures that do not actually represent increased energy off take but merely a juggling of transmission and distribution (T&D) losses. For DBT to succeed, the consumption of electricity

by a user needs to be measured and this is only possible with increasing metered supply. The subsidy through DBT will thus get automatically captured. Supply of energy that is not metered or supplied free gets excluded unless there is an up-front payment of subsidy. We have, therefore, added a fourth indicator that looks at per capita consumption of units through metered supply that yield actual revenue. In this, subsidies on the demand side made through DBT will get included as it will reflect actual revenue generation for power sold. But subsidies and supply side transfers that are given through State budgets for unmetered supply will be excluded because it will not reflect actual consumption, as it can also involve unmetered supplies to sectors like agriculture.[4] The availability of up-to-date audited accounts will enable the capture of this vital information central to the four performance indicators identified. Therefore, in making assessment of the performance of the States, the demand side subsidy for metered supply can automatically be identified for inclusion just as supply side subsidy transfers from State Governments can be identified for exclusion. Once the primary focus of States and DISCOMs shifts to the core activity of making the power sector viable and financially stable, it is expected that there will be an incentive for reducing both AT&C losses and supply side subsidies for free supply. The incentive under this component will include both high achievement in percentage terms as well as an increase in absolute number of units. This, in our opinion, will enable the incentive mechanism to cater to both consistent higher performance as well as improvement by laggard states. Unlike past reforms that focused on inputs, our reforms are linked to measurable outcomes and therefore more likely to succeed. Table 10.10 summarises the indicators along with their weights.

[4] A demand side subsidy is a subsidy directed to the consumer, whereas a supply side subsidy is a subsidy directed to the service provider.

Table 10.10: Matrix for Evaluation of Performance of States

	Purpose	Indicator	Measure	Unit	Weightage
1.	Timely submission of audited statements, including consolidated financial statements	Submission of consolidated financial statements of previous financial year	Submission before due date	As per statutory requirement	Entry level condition
2.	Sustained increase in electricity consumption	Per capita consumption of units through metered supply that yields actual revenue. This will include subsidies made through DBT as they reflect actual revenue for power sold. It will exclude subsidies and supply side transfers made through State budget for all types of unmetered supply	Annual percentage increase	Percentage increase	20
			Annual absolute increase	Increase in absolute units	15
3.	Overall operational efficiency	AT&C losses	Annual percentage reduction	Percentage reduction	20
4.	Overall operational efficiency	ACS-ARR gap	Paise /kWh of energy sale	Percentage reduction	20
5.	Reduction of cash subsidy and overall reduction of subsidy	Subsidy payment by DBT	Annual percentage increase	Percentage increase	15
		Tariff subsidy booked as a percentage of revenue from sale of power	Annual Percentage reduction	Percentage reduction	10

10.108 The Ministry of Power (MoP) will be the nodal department for monitoring progress of the indicators and will submit its annual assessment and recommendation to the Ministry of Finance. At the beginning of the financial year, by the month of May, an agreed plan by way of a memorandum of understanding (MoU) between the State Government and MoP will become the base for measuring the eligibility for the incentive borrowing for the next year. For the first year

(2021-22), the past performance can be used. The final decision to grant an extra 0.50 per cent of GSDP as additional borrowing to the State will be taken by the Ministry of Finance, based upon the recommendation of the MoP.

10.109 There may be some States that avail of this additional borrowing window but the finances of the DISCOMs continue to deteriorate. There needs to be a strong disincentive for this. We recommend that a State that does not achieve a certain minimum level of performance, as per the MoU, after having availed of this additional borrowing facility, should be penalised by adjustment of the borrowing undertaken for the power sector from the normal borrowing limit of the State for the following year. The MoP, in consultation with the Ministry of Finance, will work out the details of this mechanism well in advance so that the States are aware of the consequences of poor performance.

10.110 Over the award period of this Commission, we anticipate that the suggested measures will lead to a significant increase in demand for electricity accompanied with increased revenue realisations by DISCOMs, reductions in the operational parameters such as AT&C losses and the ACS-ARR gap. This will have a direct impact on the finances of the DISCOMs and will be reflected in improved financial indicators, such as the reduction in annual losses and total liabilities of the DISCOMs and an increase in their net worth. This will reduce the dependence of DISCOMs on State support and will be reflected both in terms of the annual subsidy outgo from the Consolidated Fund of the State and also the reduction in the total borrowings (and grants) of the DISCOMs from the State Governments.

Other Sector-specific Grants Proposed in Report for 2020-21

10.111 In our report for 2020-21, we had also identified certain sectors for performance-based incentives and grants – nutrition, pre-primary education, railways, police training and housing, enhancing trade including exports and promotion of tourism.

10.112 We recommended a grant for nutrition amounting to Rs. 7,735 crore for the States. The decision was based upon the persisting levels of malnutrition among vulnerable children, pregnant women and lactating mothers (especially in relatively less developed States) that forms a key part of the global hunger index. Various studies confirm that malnutrition has a severe impact on the brain development of children. The amount that we recommended was in addition to the grants allocated by the Union Government under CSS. However, the explanatory memorandum released by the Government of India stated that 'the Commission may review this recommendation as a part of its overall proposal of measurable performance-based incentives for States as per the TOR, in the main report.' In response, we reiterate the urgent need of higher allocation of resources to address persisting acute and chronic undernutrition and hunger and **recommend that the nutrition of children and pregnant and lactating mothers be accorded the highest priority by Government of India through the Integrated Child Development Scheme.**

10.113 In our report for 2020-21, we mentioned that we will examine the feasibility and potential effectiveness of a performance-based incentive related to exports, including its design. We have recommended incentive grants to promote agri-exports in the section on incentives for agricultural reforms earlier in this Chapter. Also, the Union Government recently decided to provide incentives to States by providing additional borrowing limit conditional to 'ease of doing business reform,' among other things. Hence, we believe that separate grants for incentivising exports may not be required at this stage.

10.114 The Ministry of Railways, in its memorandum, projected a significant requirement of funds for on-going works for the next five years. This essentially outlined the requirement of funds for completing the on-going works for State Governments (on cost sharing basis), national projects and for other plan heads (rolling stock, level crossing, signal and telecom and electrification etc.). During our meeting with the Ministry of Railways, we were informed that certain on-going projects related to new lines, gauge conversion and doubling of the railway track lines are being taken up jointly with the States on cost sharing basis. There are thirty-eight such projects where the States are unable to pay their share of the project cost. These projects are, at present, stalled at different stages of implementation, and the current investments are proving to be infructuous. **Hence, it is recommended that the Union Government may put forward an arrangement to ensure completion of these projects at the earliest.**

10.115 We also mentioned in our report that we will consider providing grants for police housing and training. In this respect, after our deliberations, we have recommended such grants for some States, as part of State-specific grants, based upon their submissions to us.

10.116 In our report for 2020-21, we also stated that the Commission will consider recommending performance incentive grants for States to promote tourism. The ongoing pandemic has had a disproportionate impact on the tourism sector and it will take some time for normalcy to return. Any performance incentive in this period of uncertainty would not serve its purpose and we have, therefore, desisted from recommending any incentives for this sector. However, we have recommended grants to some States for specific tourism projects, based on their submissions to us, as part of State-specific grants given in the next section.

State-Specific Grants

10.117 While we agree that most of the funds devolved to States should be untied, formula-based devolution cannot finely target State-specific disabilities, needs and priorities. State-specific grants may help overcome special needs and cost disabilities of States that could not be covered under the formula-based devolution and other sector- specific grants. Hence, grants (including revenue deficit grants, sector-specific grants and State-specific grants) should be optimally combined to maximise the impact of fiscal transfers.

10.118 We requested the States to send their views on our ToR, identify areas requiring support and give their proposals. Though the States largely expressed preference for untied and formula-

based grants, they also submitted proposals for State-specific grants that covered the administrative, revenue and development functions of the State. After going through each of these proposals, we are inclined to recommend State-specific grants to meet some special obligations of regional and national concern. These grants fall under six broad themes: (a) social needs, (b) administrative governance and related infrastructure, (c) conservation and sustainable use of water, drainage and sanitation, (d) preserving culture and historical monuments, (e) high-cost physical infrastructure and (f) tourism. **We recommend State-specific grants of Rs. 49,599 crore during our award period (Table 10.11). A summary of the list of schemes along with the allocated amounts is given at Annex 10.9. Further details of each of the schemes are placed in Annex 10.10.**

Table 10.11: State-wise and Year-Wise Distribution of State-specific Grants

(Rs. crore)

State	2021-22	2022-23	2023-24	2024-25	2025-26	2021-26
Andhra Pradesh	0	460	460	690	690	2300
Arunachal Pradesh	0	80	80	120	120	400
Assam	0	275	275	413	412	1375
Bihar	0	453	453	680	681	2267
Chhattisgarh	0	332	332	498	498	1660
Goa	0	140	140	210	210	700
Gujarat	0	572	572	858	858	2860
Haryana	0	400	400	600	603	2003
Himachal Pradesh	0	284	284	426	426	1420
Jharkhand	0	260	260	390	390	1300
Karnataka	0	1200	1200	1800	1800	6000
Kerala	0	220	220	330	330	1100
Madhya Pradesh	0	353	353	530	529	1765
Maharashtra	0	550	550	825	825	2750
Manipur	0	180	180	270	270	900
Meghalaya	0	160	160	240	240	800
Mizoram	0	140	140	210	210	700
Nagaland	0	105	105	158	157	525
Odisha	0	355	355	533	532	1775
Punjab	0	310	310	464	461	1545
Rajasthan	0	464	464	697	697	2322
Sikkim	0	100	100	150	150	500
Tamil Nadu	0	440	440	660	660	2200
Telangana	0	472	472	709	709	2362
Tripura	0	175	175	263	262	875
Uttar Pradesh	0	699	699	1049	1048	3495
Uttarakhand	0	320	320	480	480	1600
West Bengal	0	420	420	630	630	2100
Total	**0**	**9919**	**9919**	**14883**	**14878**	**49599**

General Conditions for State-specific Grants

10.119 The following conditions shall apply with regard to the State-specific grants recommended above:

i. **No funds from any of the State-specific grants may be used for payment of government-owned land. Wherever additional land is required to be acquired from private parties for the project/construction, the State-specific grants may be used for such compulsory acquisition payments, subject to a ceiling of 50 per cent of such land acquisition cost for new greenfield projects. However, for brownfield projects where the infrastructure is complete and functional, the State-specific grants would be for productivity enhancement and reaping externalities of scale. In such brownfield projects, the additional expenditure is primarily on land acquisition (such as airport runway extension); therefore, there need not be any such ceiling for utilisation of the State-specific grant. To expedite the execution of all projects, land acquisition payments as above made in 2021-22 would be eligible for retroactive funding in 2022-23 from the State-specific grants.**

ii. The phasing of the State-specific grants given in Table 10.11 is only indicative; States may communicate to the Union Government their required phasing along with the timeline and benchmarks of physical progress to be achieved. After review, the grant may be released in a maximum of two instalments in a year. However, no grants would be released in 2021-22.

iii. Accounts shall be maintained and utilisation certificates/statements of expenditure should be submitted as per General Finance Rules, 2017 for a particular year before release of the next instalment.

Monitoring of Grants

10.120 To ensure that the objectives for which the grants have been recommended are achieved, it is desirable that the States put a robust review and monitoring mechanism in place. **We recommend that every State should constitute a high level committee for reviewing and monitoring the proper utilisation of State-specific and sector-specific grants. This committee may be headed by the Chief Secretary with the Finance Secretary and the secretaries/heads of relevant departments as members.** The committee should meet at least once a quarter to review the utilisation of the grants and to issue directions for mid-course correction, as necessary.

10.121 The committee should be responsible for monitoring both financial and physical targets and for ensuring adherence to the specific conditionalities in respect of each sector-specific and State-specific grant, wherever applicable. In the year 2021-22, the committee will ensure the preparation of estimates/detailed project report, timelines, deliverables, monitoring mechanism

of the outcomes and overall viability of each project. Thereafter, at the beginning of each year, the committee may approve the projects to be undertaken in each sector for that year, quantify the targets, both in physical and financial terms, and lay down the time period for achieving specific milestones. This committee will also act as the recommendatory body for grants to the Government of India.

10.122 **We recommend that the progress of these projects also be reviewed annually by a committee headed by the Chief Minister with the State Finance Minister and the State ministers concerned as members.**

10.123 We have no doubt that the States themselves would be committed to timely and qualitative implementation of the projects/schemes for which we have provided grants. **We recommend that no conditionalities, other than what we have prescribed, should be imposed by the Union Government for release or utilisation of the grants.**

10.124 States must have flexibility in deciding the basket of projects to be undertaken within each sector, in framing the time schedule for various stages of these projects and in reprioritising within this basket of projects, if necessary.

10.125 **To summarise, after considering all relevant aspects, we have recommended grants-in-aid amounting in aggregate to Rs. 10,33,062 crore.** A year-wise summary of performance based incentives and grants is given in Table 10.12.

Table 10.12: Year–wise Total Grants and Incentives

(Rs. crore)

S.no.	Components	2021-22	2022-23	2023-24	2024-25	2025-26	2021-26
1	**Revenue Deficit grants**	118452	86201	51673	24483	13705	294514
2	**Local governments grants**	80297	84703	87181	92087	92093	436361
3	**Disaster management grants**	22184	23294	24466	25688	26969	122601
4	**Sector-specific grants**	12346	23729	24773	33062	36077	129987
i	*Sectoral grants for Health*	*4767*	*6211*	*6368*	*6527*	*7882*	*31755*
ii	*School Education*		*1200*	*1200*	*1200*	*1200*	*4800*
iii	*Higher Education*	*1133*	*1177*	*1259*	*1303*	*1271*	*6143*
iv	*Implementation of agricultural reforms*		*7500*	*7500*	*15000*	*15000*	*45000*
v	*Maintenance of PMGSY roads*	*3731*	*4249*	*5565*	*6151*	*7843*	*27539*
vi	*Judiciary*	*2085*	*2085*	*2085*	*2085*	*2085*	*10425*
vii	*Statistics*	*0*	*677*	*166*	*166*	*166*	*1175*
viii	*Aspirational districts and blocks*	*630*	*630*	*630*	*630*	*630*	*3150*
5	**State-specific grants**	0	9919	9919	14883	14878	49599
	Total	**233279**	**227846**	**198012**	**190203**	**183722**	**1033062**

10.127 A statement indicating total transfers to the States is given in Table 10.13.

Table 10.13: Total Transfers Recommended by FC-XV

(Rs. crore)

States	Share in Central Taxes & Duties	Post Devolution Revenue Deficit	Local Governments	Disaster management	Health	PMGSY roads	Statistics	Judiciary	Higher Education	Agriculture	State Specific	Total Grants-in-Aid (sum of col.3 to 12)	Total Transfers (sum of column 2 & 13)
1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*	*13*	*14*
Andhra Pradesh	170976	30497	18063	6183	877	344	19	295	250	4209	2300	63037	234013
Arunachal Pradesh	74227	0	1618	1382	133	1508	49	20	48	107	400	5265	79492
Assam	132152	14184	10934	4268	2161	3103	57	610	171	748	1375	37611	169763
Bihar	424926	0	35577	7824	3223	1694	77	960	483	1720	2267	53825	478751
Chhattisgarh	143938	0	10368	2387	588	911	54	200	146	917	1660	17231	161169
Goa	16307	0	609	63	56	0	5	15	50	63	700	1561	17868
Gujarat	146938	0	22163	7316	1070	330	51	310	298	2818	2860	37216	184154
Haryana	46177	132	9066	2715	695	128	40	300	146	1696	2003	16921	63098
Himachal Pradesh	35064	37199	3049	2258	377	2222	21	50	70	247	1420	46913	81977
Jharkhand	139712	0	12322	3138	1014	966	48	275	179	677	1300	19919	159631
Karnataka	154077	1631	21877	4369	1233	398	45	295	299	2290	6000	38437	192514
Kerala	81326	37814	12554	1738	607	113	20	405	181	1086	1100	55618	136944
Madhya Pradesh	331642	0	28367	10059	2340	2109	102	690	349	4587	1765	50368	382010
Maharashtra	266877	0	41391	17803	2710	613	63	1240	520	3285	2750	70375	337252
Manipur	30251	9796	1277	234	191	1193	28	30	54	101	900	13804	44055
Meghalaya	32403	3137	1385	363	187	544	23	30	54	86	800	6609	39012
Mizoram	21124	6544	713	259	115	546	14	15	48	86	700	9040	30164
Nagaland	24039	21249	1038	228	153	372	23	10	51	124	525	23773	47812
Odisha	191297	0	15752	8865	962	1949	45	425	218	1271	1775	31262	222559
Punjab	76343	25968	10305	2736	902	230	43	145	156	1966	1545	43996	120339
Rajasthan	254583	14740	27172	8186	1186	1618	57	460	332	3301	2322	59374	313957
Sikkim	16393	1267	360	279	100	484	7	5	45	41	500	3088	19481
Tamil Nadu	172329	2204	25526	5637	1002	506	47	250	347	2632	2200	40351	212680
Telangana	88806	0	13111	2483	624	255	46	245	189	1665	2362	20980	109786
Tripura	29912	19890	1580	378	265	502	17	85	55	228	875	23875	53787
Uttar Pradesh	757879	0	67160	10685	6150	1465	114	1825	893	5334	3495	97121	855000
Uttarakhand	47234	28147	4181	5178	728	2322	25	70	83	277	1600	42611	89845
West Bengal	317828	40115	30393	5587	2106	1114	35	1165	428	3438	2100	86481	404309
Total	**4224760**	**294514**	**427911**	**122601**	**31755**	**27539**	**1175**	**10425**	**6143**	**45000**	**49599**	**1016662**	**5241422**

Note: (1) Amounts under 'Share in Central taxes and duties'-Column 3 are indicative and actual amounts will vary with the size of the divisible pool over the five year award period; (2) An amount of Rs.16,400 crore is not included in the total Grants-in-aids figure in column13. This comprises of three grants (a) School Education (Rs.4,800 crore), (b) Grants for aspirational districts and blocks (Rs.3,150 crore) and (c) Local Bodies grants for (i) Incubation of new Cities (Rs. 8,000 Crore) and (ii) National Data Centre (Rs. 450 Crore)

Summary of Recommendations

A summary of our recommendations is given below:

i. We recommend total revenue deficit grants of Rs. 2,94,514 crore over our award period for seventeen States.

(para 10.19)

ii. We recommend grants of Rs. 4,800 crore (Rs 1,200 crore each year) from 2022-23 to 2025-26 for incentivising the States to enhance educational outcomes . The performance grant received by the State will be utilised by the education department for enhancing educational outcomes and not diverted for use by any other department by the State.

(para 10.37 and 10.39)

iii. We recommend Rs. 6,143 crore for online learning and development of professional courses in regional languages (matribhasha) for higher education in India.

(para 10.43)

iv. We recommend that Rs. 45,000 crore be kept as performance-based incentive for all the States for carrying out agricultural reforms during the award period.

a. We recommend that States may appropriately amend their land-related laws on the lines of NITI Aayog's model law to allow short-term and long-term lease of agricultural land both for agricultural purpose as well as for agro-industry, logistics for agricultural trade and supply chains.

b. We recommend incentive-based grants to States that maintain and augment groundwater stock and put a check on any fall in the water table.

c. We recommend using growth in agricultural exports as a target indicator for the award on export performance of a State.

d. We recommend increasing production of oilseeds, pulses and wood and wood-based products as an indicator to make India self-reliant in pulses, edible oils and wood and wood products.

e. This performance grant for agriculture should be used only for infrastructure and activities related to the development of agriculture and allied sectors by the States.

(para, 10.54, 10.56, 10.59, 10.62, 10.64 and 10.66)

v. We recommend Rs. 27,539 crore for maintenance of PMGSY roads for the years 2021-26, out of which Rs. 14,743 crore is for the general States and Rs. 12,796 crore is for the NEH States.

(para 10.72)

vi. We recommend grants of Rs. 10,425 crore for fast-track courts for speedier justice delivery in cases of heinous crimes, civil cases of marginalised people, five-year-old property cases and economic offences as well as special fast-track courts for POCSO cases.

(para 10.75)

vii. We recommend total grants to the States, with the fixed and variable components, of Rs. 1,175 crore from 2022-23 to 2025-26 for improving the quality of statistics. We also recommend that, initially, the fixed grant of the total allocation, amounting to Rs. 677 crore, which is unconditional may be released in 2022-23. The remaining variable component of Rs. 498 crore may be disbursed equally over the remaining three years starting 2023-26, based on achievements of specified milestones. Both the fixed and variable grants will be utilised by the statistics department only.

(para 10.82)

viii. We recommend Rs. 3,150 crore for incentivising aspirational districts and blocks for a period of five years from 2021-22 to 2025-26.

(para 10.92)

ix. We recommend an extra annual borrowing space for the States, of the magnitude of 0.50 per cent of their GSDP for each of the first four years of the award covering the period 2021-22 to 2024-25, based on certain performance criteria in the power sector.

(para 10.103)

x. We recommend that the nutrition of children and pregnant and lactating mothers may be accorded the highest priority by Government of India through the Integrated Child Development Scheme.

(para 10.112).

xi. We recommend that the Union Government may put forward an arrangement to ensure completion of the pending railways projects at the earliest.

(para 10.114).

xii. We recommend State-specific grants of Rs. 49,599 crore during our award period for social needs, administrative governance and related infrastructure, conservation and sustainable use of water, drainage and sanitation, preserving culture and historical monuments, high-cost physical infrastructure and tourism.

(para 10.118)

xiii. No funds from any of the State-specific grants may be used for payment of government-owned land. Wherever additional land is required to be acquired from private parties for the project/construction, the State-specific grants may be used for such compulsory acquisition payments, subject to a ceiling of 50 per cent of such land acquisition cost for new greenfield projects. However, for brownfield projects where the

infrastructure is complete and functional, the State-specific grants would be for productivity enhancement and reaping externalities of scale. In such brownfield projects, the additional expenditure is primarily on land acquisition (such as airport runway extension); therefore, there need not be any such ceiling for utilisation of the State-specific grant. To expedite the execution of all projects, land acquisition payments as above made in 2021-22 would be eligible for retroactive funding in 2022-23 from the State-specific grants

(para 10.119, i)

xiv. We recommend that every State should constitute a high level committee for reviewing and monitoring the proper utilisation of State-specific and sector-specific grants. This committee may be headed by the Chief Secretary with the Finance Secretary and the secretaries/heads of relevant departments as members. We recommend that the progress of these projects also be reviewed annually by a committee headed by the Chief Minister with the State Finance Minister and the State ministers concerned as members.We recommend that no conditionalities, other than what we have prescribed, should be imposed by the Union Government for release or utilisation of the grants.

(para 10.120, 10.122 and 10.123)

Chapter 11

Defence and Internal Security

In keeping with the terms of reference, the Commission examined the need and urgency to step up outlay on the capital requirements for defence and internal security, identified additional resources and deliberated on the desirability of a separate mechanism for such funding. The Commission examined the capital expenditure projections of the Ministry of Defence as well as of the Ministry of Home Affairs for internal security. After examining all the aspects, we have recommended the constitution of a dedicated Modernisation Fund for Defence and Internal Security to bridge the gaps between the projected budgetary requirement and budget allocation for capital expenditure on defence and internal security. This will be a non-lapsable fund under the Public Accounts and will have four sources of incremental funding: (i) transfers from the Consolidated Fund of India; (ii) disinvestment proceeds of defence public sector enterprises; (iii) proceeds from monetisation of surplus defence land; and (iv) proceeds of receipts from defence land likely to be transferred to State Governments and for public projects in future. The Fund shall have the standard notified rules for its administration, public reporting and audit by the Comptroller and Auditor General. We also recommend that the Ministry of Defence should take immediate measures to innovatively bring down the salaries and pension liabilities and reduce its dependence on defence imports, with a specific roadmap.

11.1 Defence and internal security are the paramount needs of any country and catering to it adequately is a critical sovereign function involving substantial fiscal resources. These are considered to be among the primary charges on the nation's tax resources. In view of the complex and evolving spectrum of security challenges, modernisation of the defence and internal security apparatus is a continuous process, based on threat perception, operational challenges and technological advances. Unlike previous Finance Commissions, our unique terms of reference (ToR) mandated us to give special focus on examining the defence and internal security needs of the country. Para 6 (ii) of the original ToR enjoins us to consider the demands on the resources of the Union Government on account of, among others mentioned, defence and internal security. Para 9A of the additional terms of reference notified on 29 July 2019 mandate us to examine "whether a separate mechanism for funding of defence and internal security ought to be set up, and if so, how such a mechanism could be operationalised".

11.2 In view of the above, we considered all aspects of the issue, including relevant Constitutional provisions, views of Constitutional experts, demands of the sector on resources due to fast-evolving technological changes, geo-political complexities and sector-specific dynamics in procurement, including the synchronisation of the flow of funds with the

procurement cycle. We constituted a special group in order to address the ToR.[1] We also considered the written submissions of some of the States and of the Ministries of Defence, Home Affairs and Finance.

Constitutional Provisions

11.3 Article 51 (a) of the Directive Principle of State Policy stipulates that the State shall endeavour to promote international peace and security. Article 51A lists the Fundamental Duties of every Indian citizen, and clauses (c) and (d) of this Article state that every citizen has a duty to uphold and protect the sovereignty, unity and integrity of India and to defend the country and render national service when called upon to do so. Article 246 (1) provides exclusive power to Parliament to make laws on defence and internal security related matters enumerated in the relevant entries in List I (Union List) of the Seventh Schedule. In addition, Article 355 explicitly states that it is the duty of the Union to protect every State against external aggression and internal disturbance and to ensure that the government of every State is carried on in accordance with the provisions of the Constitution.

11.4 `Public order' and 'Police' are the first and second entries respectively in the List II (State List) of the Seventh Schedule. This bestows on State Governments the primary responsibility of maintaining law and order, preventing, detecting and investigating crime and prosecuting criminals. On the other hand, Entry 2 A of the Union List I empowers the Union Government to deploy any armed force of the Union or any other force subject to the control of the Union in aid of civil power. The Union Government, thus, supplements the efforts of the States in the maintenance of law and order. It also provides financial assistance to States for modernisation of their police forces in weaponry, communication, equipment, mobility, training and other infrastructure. Further, intelligence inputs are regularly shared by the central security and intelligence agencies with the law enforcement agencies of States to prevent crime and law and order related incidents. In addition, various matters related to public order and police are so closely intertwined with emerging areas of internal security, insurgency, terrorism, cyber security and other elements of external aggression that the subject of internal security becomes the collective responsibility of both Union and State Governments.

11.5 This summarises the Constitutional roles of the Union and the State Governments in preserving external and internal security and the intricate relationship between them. Both of them cannot work in water tight compartments and preserving security is a continuum of roles and responsibilities of both in the federal system.

Analysis of Defence Expenditure

11.6 Defence expenditure has, over time, been characterised by a higher share of revenue

[1] The details of the constitution of the group and meetings are given in Volume II of the Report (Annex 1.18 and 1.35)

expenditure, huge pension bills and lower capital expenditure with high dependence on import of defence equipment. It has become imperative to review the structure of defence expenditure in order to ensure greater predictability and stability in the flow of adequate funds for its capital needs and to find ways to reduce growth in revenue expenditure, especially rising pension outlays.

11.7 The Ministry of Defence (MoD) has the highest allocation among all Union ministries. Over the last ten years, the defence budget has shown a trend growth rate of 9.6 per cent. Within this, revenue expenditure has grown at 11 per cent and capital expenditure at only 6.1 per cent (Table 11.1). The higher growth of revenue expenditure is mainly on account of rising outlays on defence pension, which has increased at the rate of 15.7 per cent.

Table 11.1: Analysis of Total Defence Expenditure (Revenue and Capital)

(Rs. crore)

Financial Year	Defence revenue expenditure	As % of GDP	As per cent of revenue expenditure of Union Govt	Defence capital expenditure	As % of GDP	As % of capital expenditure of Union Govt	Total defence expenditure (revenue + capital)	As % of GDP	As % of total expenditure of Union Govt
2011-12	144147	1.65	12.6	69526	0.80	43.8	213673	2.45	16.4
2012-13	158545	1.59	12.8	72097	0.73	43.2	230642	2.32	16.4
2013-14	173912	1.55	12.7	80222	0.71	42.7	254134	2.26	16.3
2014-15	201929	1.62	13.8	83076	0.67	42.2	285005	2.29	17.1
2015-16	210306	1.53	13.7	83614	0.61	33.0	293920	2.13	16.4
2016-17	260067	1.69	15.4	91484	0.59	32.1	351551	2.28	17.8
2017-18	284273	1.66	15.1	95431	0.56	36.3	379704	2.22	17.7
2018-19	303657	1.60	15.1	99802	0.53	32.4	403459	2.13	17.4
2019-20 RE	333449	1.63	14.2	115371	0.56	33.1	448820	2.20	16.6
2020-21 BE	352823	1.57	13.4	118555	0.53	28.8	471378	2.10	15.5
TGR (%) (2011-21)	**11.0**			**6.1**			**9.6**		

Notes: 1. Defence revenue expenditure includes defence services revenue, defence misc.(civil) revenue and defence pensions.

2. Defence capital expenditure includes capital outlay and defence misc. (civil) capital.

3. TGR = trend growth rate

11.8 Although as a proportion of gross domestic product (GDP), total defence expenditure has decreased between 2011-12 and 2018-19 (from 2.5 per cent to 2.1 per cent), the proportion of total defence expenditure in total Union Government expenditure has increased from 16.4 per cent to 17.4 per cent during the same period. This is also in the background of a decline in total Union Government expenditure from 14.9 per cent of GDP in 2011-12 to 12.2 per cent of GDP in 2018-19. The increase is largely accounted for by defence revenue expenditure which rose from

12.6 per cent of the Union Government's revenue expenditure in 2011-12 to 15.1 per cent in 2018-19 on account of higher outgo on salaries and pensions, with the implementation of revised pay scales following the recommendations of the Seventh Central Pay Commission. On the other hand, the share of defence capital expenditure in the total capital expenditure of the Union Government has declined from 43.8 per cent to 32.4 per cent during the same period.

Review of Defence Capital Outlay

11.9 Defence capital outlay includes expenditure on the purchase of defence equipment, weaponry, aircraft, naval ships, land and the cost of construction of roads and bridges in border areas. Capital outlay on defence in 2020-21 (BE) is Rs. 1.14 lakh crore, which accounts for 24.1 per cent of the total defence budget (including defence pension). This indicates a decline since 2011-12, when the capital outlay was 31.8 per cent of total defence budget. Similarly, between 2011-12 and 2018-19, capital outlay as a proportion of total Union Government expenditure declined from 5.2 per cent to 4.1 per cent, and as a proportion of GDP from 0.8 per cent to 0.5 per cent. (Table 11.2).

Table 11.2: Capital Outlay of Defence Services

(Rs. crore)

Financial Year	BE	Actual	Annual growth (%)	Actual as % of BE	Capital outlay as % of GDP	Capital outlay as % of total Union expenditure	Capital Outlay as % oftotal defence expenditure*
2011-12	69199	67902	9.4	98.1	0.8	5.2	31.8
2012-13	79579	70499	3.8	88.6	0.7	5.0	30.6
2013-14	86741	79125	12.2	91.2	0.7	5.1	31.1
2014-15	94588	81887	3.5	86.6	0.7	4.9	28.7
2015-16	94588	79958	-2.4	84.5	0.6	4.5	27.2
2016-17	86340	86371	8.0	100.0	0.6	4.4	24.6
2017-18	86529	90445	4.7	104.5	0.5	4.2	23.8
2018-19	94011	95231	5.3	101.3	0.5	4.1	23.6
2019-20 RE	103394	110394 (RE)	15.9	106.8	0.5	4.1	24.6
2020-21 BE	113734	113734 (BE)	3.0		0.5	3.7	24.1
TGR (%) (2011-21)		5.7 %					

* Total defence expenditure include defence pension.
TGR = trend growth rate

11.10 A key feature of defence capital expenditure is the dependence on imports. According to the Stockholm International Peace Research Institute, India was the fourth-largest importer of defence goods and services in 2018. Imports of military hardware result in the country losing out on the multiplier effects on the economy as well as on spin-offs in terms of technical and scientific inventions and innovations, which domestic production will result in. Furthermore, the dependence on foreign suppliers for military hardware not only entails huge expenditure on imports, but also makes national security vulnerable to vagaries of supply during emergencies. There has been a recent thrust for indigenous production of defence equipment but it needs to be matched with predictability and stability in the flow of adequate resources for capital investment as part of overall strategy of defence modernisation.

Expenditure on Pensions

11.11 Defence pensions cover payment of service pension, gratuity, family pension, disability pension, commuted value of pension and leave encashment for retired personnel of the three services and also employees of ordnance factories. Defence pension, as a proportion of total defence allocation, has risen from 17.6 per cent to 28.4 per cent between 2011-12 to 2020-21 (BE). It has grown at trend growth rate of 15.7 per cent in the last ten years (2011-2021) against 9.6 per cent growth in the entire defence sector. As a proportion of GDP, it increased from 0.4 per cent to 0.6 per cent and as a proportion of revenue expenditure of the Union Government expenditure from 3.3 to 5.1 per cent (Table.11.3).

Table 11.3: Defence Pension Expenditure

Financial Year	Defence pension (in Rs. crore)	Percentage of defence expenditure*	Percentage of GDP	Percentage of revenue expenditure of Union Government
2011-12	37569	17.58	0.43	3.3
2012-13	43368	18.80	0.44	3.5
2013-14	45500	17.90	0.41	3.3
2014-15	60450	21.21	0.48	4.1
2015-16	60238	20.49	0.44	3.9
2016-17	87826	24.98	0.57	5.2
2017-18	92000	24.23	0.54	4.9
2018-19	101775	25.23	0.54	5.1
2019-20 RE	117810	26.25	0.58	5.0
2020-21 BE	133825	28.39	0.60	5.1
TGR(%) (2011-21)	15.7			

* Total defence expenditure include defence pension.
TGR = trend growth rate

11.12 From 2016-17 onwards, consequent to the implementation of the Seventh Central Pay Commission award and the One Rank One Pension (OROP) scheme for defence services employees, the defence pension expenditure has started growing at a faster rate than the capital outlay on defence services. As the overall resources were limited, this increase in defence pension expenditure impacts the availability of funds for defence modernisation.

Analysis of Expenditure on Internal Security

11.13 The budget for the Ministry of Home Affairs (MHA) constituted 4.8 per cent of the total expenditure of the Union Government in 2018-19. Of the total budget expenditure of MHA for 2018-19, 81.7 per cent is on the police, 12.5 per cent is on grants made to Union Territories and 5.8 per cent is on miscellaneous items such as disaster management, rehabilitation of refugees and migrants, census and Cabinet.

Expenditure on Police and Central Armed Police Forces

11.14 In 2015-16, of the total expenditure of Rs. 80,000 crore by the MHA, 79 per cent (Rs. 63,000 crore) was spent on the police (which includes the Central Armed Police Forces (CAPFs)[2] and Delhi Police). In 2018-19, out of a total expenditure of Rs.1.12 lakh crore by MHA, 82 per cent (Rs. 92,000 crore) was spent on police. In 2020-21, 63 per cent of the budget allocation of Rs. 1.67 lakh crore for MHA has been allocated for the police. The decline in the share of the police in the expenditure of the Ministry is mainly because the allocation for Jammu and Kashmir and Ladakh is now routed through the MHA budget in 2020-21, following the reorganisation of the erstwhile state of Jammu and Kashmir into two Union Territories of Jammu and Kashmir and Ladakh.

11.15 The CAPFs are estimated to receive a total allocation of Rs. 78,000 crore in 2020-21 (BE). This accounts for 74 per cent of the expenditure on police. Table 11.4 shows the distribution between revenue and capital expenditure for total police and seven CAPFs between 2015-16 and 2020-21(BE).

[2] The seven Central Armed Police Forces (CAPFs) are: Assam Rifles, Border Security Force, Central Industrial Security Force, Central Reserve Police Force, Indo-Tibetan Border Police, National Security Guard and Sashastra Seema Bal

Table 11.4: Total Police and CAPFs Expenditure

(Rs. crore)

Years	Police Expenditure			Share of revenue expen diture %	Share of capital expen diture %	of which expenditure on CAPFs			Share of revenue expen diture %	Share of capital expen diture %
	Revenue	Capital	Total			Revenue	Capital	Total		
2015-16	54280	9055	63335	85.7	14.3	43935	734	44669	98.4	1.6
2016-17	64203	8851	73054	87.9	12.1	51529	946	52475	98.2	1.8
2017-18	71352	10535	81887	87.1	12.9	56801	1206	58007	97.9	2.1
2018-19	82209	9484	91693	89.7	10.3	66507	1164	67671	98.3	1.7
2019-20 (RE)	93455	9748	103203	90.6	9.4	74687	1482	76169	98.1	1.9
2020-21 (BE)	95398	9846	105244	90.6	9.4	76414	1473	77887	98.1	1.9
TGR %	**12.4**	**1.7**	**11.1**			**12.2**	**14.7**	**12.3**		

Note: 1. Police expenditure includes expenditure on CAPFs, modernisation of police, Delhi Police, police infrastructure, IB and border infrastructure

11.16 Though the budget allocations on police have increased at a nominal rate of 11.1 per cent during the 2015-16 to 2020-21(BE) period, this has been largely on account of revenue expenditure, which has grown at a rate of 12.4 per cent, while the growth of capital expenditure has been only 1.7 per cent. Capital expenditure is for procurement of machinery and equipment and motor vehicles, whereas revenue expenditure is on items such as salaries, arms and ammunition and clothing. The share of revenue expenditure in police grants has progressively increased from 85.7 per cent to about 90.6 per cent from 2015-16 to 2020-21(BE) while the share of the capital expenditure has declined from 14.3 per cent to 9.4 per cent.

Views of the Union Government

Ministry of Defence

11.17 In its memorandum, the Ministry of Defence (MoD) sought adequate funding through alternate sources in order to meet its increasing requirements. It pointed out that budgetary allocations, which have declined over the years, are inadequate to fund large defence acquisitions. Further, reallocation of resources and appropriation from other budget heads like health, education and infrastructure create their own set of problems. Hence, the Ministry represented, a separate and dedicated funding mechanism for capital expenditure will provide assurance of availability and predictability in the flow of funds and this will help to plan and build strategic defence capabilities.

11.18 For the award period 2021-26, the MoD has estimated that, going by current trends, it will

receive an allocation of Rs. 9.01 lakh crore for capital outlay and this is based on a growth rate of 16 per cent. However, the defence plan projection on the capital account is Rs. 17.46 lakh crore for the same period. As a result, the projected shortfall is Rs. 8.45 lakh crore. (Table 11.5)

Table 11.5: Estimated Shortfall in Allocations for Defence Services

(Rs. crore)

Heads	2021-22	2022-23	2023-24	2024-25	2025-26	Total 2021-26
Capital expenditure						
Defence plan projection	286058	314663	346130	380743	418817	1746411
Allocation (estimated)	131054	152022	176346	204562	237291	901275
Shortfall (estimated)	155004	162641	169784	176181	181526	845136
Revenue expenditure						
Defence plan projection	323556	357529	387919	428650	465086	1962740
Allocation (estimated)	223237	238863	255584	273474	292618	1283776
Shortfall (estimated)	100319	118666	132335	155176	172468	678964

Source: MoD note dated 25 August 2020

Allocation (estimated) - Revenue projections grown @ 7 per cent per annum and capital projections @ 16 per cent per annum over 2020-21(BE).

11.19 The MoD stated that if the projections made in the defence plan for committed liabilities on on-going capital acquisitions are taken into account, along with the new acquisitions planned, the three services would substantially run short of funds in the coming years. It was further highlighted that there is a total shortfall (on both revenue and capital accounts) of Rs. 7,37,357 crore in the Ministry's defence plan projections for the three forces for the period 2017-18 to 2020-21.

11.20 The Ministry drew attention to the fact that consistent shortfalls in the defence budget over a long period has resulted in serious capability gaps, compromising the operational preparedness of the services. Consequently, they have to resort to ad-hoc mechanisms such as postponement of a few procurements and delaying payments, resulting in high carry forward of unmet requirements and committed liabilities. Therefore, there is an urgent need to explore new, multiple and dedicated avenues of raising resources to infuse additional funds for modernisation and technological upgradation of the country's defence capabilities.

11.21 The MoD has suggested several options for funding defence modernisation:

i. carving out a certain portion of the shareable pool for defence and internal security before the vertical devolution;

ii. monetisation of defence land;

iii. a defence or national security cess;

iv. defence bonds;

v. making the profits that accrue to defence public sector enterprises (DPSEs) and ordnance factories from defence exports available exclusively for defence purposes;

vi. proceeds from the disinvestment of DPSEs;

vii. augmentation of defence receipts by reimbursement of expenditure incurred on Humanitarian Aid and Disaster Relief, aid to State and civil authorities and United Nations missions;

viii. one-time lump-sum grants to the defence services by re-appropriation of underutilised heads across various demands of grants by the Ministry of Finance; and

ix. exemption from levy of statutory duties like customs duty, goods and services tax (GST) and integrated GST on the purchase and acquisitions by the services.

Ministry of Home Affairs

11.22 In its memorandum and subsequent submissions, the MHA highlighted inadequate allocations by both Union and State Governments for internal security and stressed on the need for earmarking a higher allocation for this. Though the budget allocations have increased at a nominal rate of 11-12 per cent, this has been largely on the revenue account and allocations for capital expenditure have remained almost stagnant. The share of revenue expenditure in police grants has increased progressively from 78 per cent in 2009-10 to about 90 per cent in 2020-21, while the share of capital expenditure has shrunk from 22 per cent to 10 per cent during this period. The Ministry also drew attention to the fact that the scheme for Assistance to States for Modernisation of Police Forces, which is capital intensive, is also significantly under-funded.

11.23 The capital allocation by the MHA is largely for development of police infrastructure, border infrastructure and provisioning schemes. The funds for police infrastructure cater to the capital requirements of the CAPFs and cover construction of buildings for offices, residences and the like. Border infrastructure relates to the construction of border out-posts, observation towers, border fencing and border roads. Provisioning requirements comprise procurement of arms, machinery and equipment such as night vision devices, hand-held thermal imagers and unmanned aerial vehicles as well as communication equipment, which are required by the CAPFs for their operational requirements.

11.24 Like the MoD, the MHA also emphasised the need for increase in outlays with greater degree of predictability in allocations. At the same time, it pointed out that the increased devolution to States did not result in any incremental increase by State Governments in their allocations to the police. Thus, the MHA felt that there is a definite need for a separate mechanism for funding of internal security, as the Ministry did not have many alternative sources for funding,

such as sale of surplus land. It requested the Commission to recommend a sectoral grant over our five-year award period, as indicated in our Report for the Year 2020-21. The Ministry sought a specific purpose grant of Rs. 63,385 crore for internal security over the five-year award period, based on the shortfall between budgetary projections and allocations for capital heads for CAPFs and other organisations of MHA as well as for the Scheme for Modernisation of Police Forces. It also suggested that this provision may be allocated in the form of a separate fund, distinct from any allocation for defence, as States have a shared responsibility for internal security.

11.25 The projected revenue and capital expenditure for police over the five years of our award period is given in Table 11.6.

Table: 11.6: Projections for Police (Union Government)

(Grant 48-Police)

(Rs. crore)

Heads	2021-22	2022-23	2023-24	2024-25	2025-26
Revenue	105240	121026	139180	160057	184066
Capital @	12969	14803	16485	18054	20301
Total	118209	135829	155665	178111	204367

@ Includes Central sector expenditure on schemes.

Source: MHA email dated 1 September 2020

Ministry of Finance

11.26 The Ministry of Finance (MoF) stated that defence expenditure is entirely the responsibility of the Union Government as it is a Union List subject. However, States also enjoy the benefits of peace within the country and security at the national borders. Economic growth and development in States will not be possible without these two fundamental sovereign functions being satisfactorily carried out. Hence there is merit in recognising expenditure on defence as the first charge on the tax resources of the Union. It further stated that the Union Government's requirements for the defence sector are an inviolable priority. It is imperative that defence expenditure keeps pace with the security challenges facing the country. Defence expenditure grew at 9.1 per cent during the award period of the Fourteenth Finance Commission (FC-XIV) period (2015-2020) and the Ministry projected an annual average growth rate of 10.3 per cent during the award period of the FC-XV.

11.27 The Ministry has acknowledged that it may not be possible for the Commission to set aside expenditure on defence from the pool of shareable taxes, but it urged that the imperative of defence expenditure be recognised while considering the requirements of the Union. With heavy capital expenditure being incurred by the MoD in the last ten years, the burden of maintenance of defence acquisitions is going to increase the demand for revenue expenditure in the coming years.

11.28 The MoF further stated that defence planning and capability building is a lengthy process which requires long term commitment of funds. Consistent increase in the capital outlay on defence services is required for aircraft and aero-engines, heavy and medium vehicles, other equipment, research and development and other special projects of the defence services.

11.29 In the context of internal security, the MoF has stated that though 'public order' and 'police' are the responsibilities of States, Article 355 of the Constitution enjoins the Union to protect every State against external aggression and internal disturbances. The expectation from the Union Government is much more than strictly required under Constitutional or legal provisions. Given the limited capacities of States to invest in police modernisation and special projects, there is need for the Union Government to provide a thrust for training, capacity building and modernisation to increase the capacity of the State police forces.

11.30 Areas affected by left-wing extremism, the North East and Jammu and Kashmir are the three main theatres of internal security challenges. The Union Government's support through the deployment of forces, enhancing the capacities of the State police and a number of developmental interventions have helped bring about a steady improvement in the security scenario over the years. This supportive role of the Union Government needs to continue.

Views of the States

11.31 Some of the States expressed their views on a separate mechanism for funding of defence and internal security. They have suggested that any likely recommendation for financing a separate mechanism for funding of defence and internal security should not result in a reduction in the size of the divisible pool. The allocation of funds for defence and internal security is the responsibility of the Union Government, which can make the necessary allocation from within its own share of the divisible pool, non-shareable resources such as non-tax revenues, borrowings and non-debt capital receipts. If the Commission carves out this expenditure head from within the divisible pool, there may be reduction of resources allocated to the States. They further stressed that the Union may, without any prejudice to the States, create a non-lapsable fund from the resources within the Consolidated Fund of India and not by attempting to shrink the divisible pool.

Views of Constitutional Experts on Sovereign's Role on Security

11.32 We are acutely aware that, within the given Constitutional framework, there are complex questions involving on the role of governments (both the Union and the States) and citizens in defence and internal security. We studied the opinions of Constitutional experts obtained by previous Finance Commissions in this regard. We also sought the opinion of Shri. K. Parasaran, former Attorney General of India and this guided us in our approach. A gist of his opinion is provided in Box 11.1.

Box 11.1: Opinion of Shri K Parasaran

The legal opinion by Shri. Parasaran has emphasised that the sovereign power must always bear in mind that a depleted treasury will prejudice the defence of the nation against external aggression and its ability to contain internal disturbances. He referred to Article 355 and cited a Supreme Court order:

"*In the Constitutional scheme of things, it is very clear that while considerable autonomy and functional prerogatives have been accorded to State Governments, nevertheless clearly greater powers and prerogatives over a complex range of all - encompassing subjects are vested with the Union because the latter bears the first and final responsibility for the performance of the fundamental sovereign function of any political state-maintenance of robust security environment. A contextual construction of a provision in the Constitution of India would show that the sovereign function of maintenance of national security is squarely vested with the Union." (Pragyasingh Chandrapalsingh Thakur vs State of Maharashtra, 2014 (1), Bom CR (Cri) 135)*

Further quoting Article 51 (a) and Article 51A(c) and (d), Shri. Parasaran has averred that "citizens are expected to cooperate with the measures taken by the State towards securing defence and internal security." Additionally, the legal opinion stated that the Supreme Court has observed that the duty of every citizen of India is the collective duty of the State.

From the above, two inferences are made: "first, upholding India's sovereignty, including by ensuring adequate defence and internal security is the duty of the Union with a corresponding duty of various States and the citizens to cooperate with the Union and States in this task. Second, though the fulfillment of this duty is a shared responsibility (State understood as all citizens put together and all its agencies), the Union under Article 355 is specifically obliged to protect States against external aggression and internal disturbance. Thus the Union has been vested with a specific constitutional directive to ensure defence of India and national security."

Deliberations of the Group Constituted on Defence and Internal Security

11.33 This Group was constituted to hold focussed deliberations on the main reference whether a separate mechanism for funding of defence and internal security ought to be set up, and if so, how such a mechanism could be operationalised. The Group, after careful consideration of all aspects related to the needs, available resources and medium term projections of capital investment for defence modernisation, examined the proposals of the MoD and MHA.

11.34 It was recognised that the requirement of resources for defence has increased significantly due to the advances in technology and weapon systems, use of unconventional tools of warfare and threat of conflicts on multiple fronts. It was also agreed that even as the challenges have grown, there has been a decline in allocations to the defence forces. Defence planning and capability building requires long term commitment of funds. To facilitate realistic planning which is aligned with the likely resource availability, certain predictability/certainty in budgetary allocations is essential.

11.35 Complex procurement procedures and insufficient availability of funds over a prolonged period of time have resulted in shortages in critical defence equipment. The requirement of the

armed forces for modernisation can be meaningfully met if there is certainty in the commitment of financial support to it in the form of dedicated fund, based on approved modernisation plans, at least for a five year-period on a continuing basis.

11.36 The objective of such a modernisation fund would be to bridge the gap between the actual requirement for specified purposes (like acquisition of equipment for modernisation) and the allocation in a given year. Thus, it would supplement the annual budgetary allocation, whenever required. This would help in eliminating the prevailing uncertainty in providing adequate funds for various defence capability development and infrastructure projects.

11.37 In view of this, the Group recommended the creation of a non-lapsable Defence Modernisation Fund. An integral part of such a non-lapsable fund is to have a specific source of funds. The Group deliberated the merits and demerits of operating the fund outside the Public Account, as the MoD had proposed. It was felt that if a special purpose vehicle administers such a fund, then there is no need to have non-lapsable system. After considering all aspects and views of the MoF, the Group recommended operating such a fund through the Public Account of India, within the norms of Parliamentary procedures on approval of annual demands of grants.

11.38 The MoD has proposed Rs. 55,000 crores as the annual size of the fund. The basis for estimating this amount is the average gap between projection and allocation of funds for the capital segment during the last five years (Table. 11.7).

Table.11.7: Projection and Allocation of Funds for Capital Investments in Defence Services

(Rs. crore)

Year	Projection	Allocation	Shortfall
2016-17	121930	78587	43343
2017-18	132872	86488	46384
2018-19	172203	93982	78221
2019-20	170904	110394 (RE)	60510
2020-21	175702	113734 (BE)	61968
Total	773611	483185	290426
Average	154722	96637	58085

Source: MoD's Base Paper dated 16 July 2020 and ID note dated 25 August, 2020 submitted to FC-XV

11.39 The Group also considered the different options proposed by the MoD for funding of the defence modernisation fund as elaborated in para 11.21. After considering all these options, the Group felt that many of these proposed sources of funding would interfere with the Constitutional mandate of the Finance Commission in the distribution of the shareable pool of Central taxes

between the Union and the States, or amount to shifting or reshuffling of resources. The Group felt that the creation of the non-lapsable fund could be done through additional resource mobilisation. These could be in the form of levy of a moderate cess on direct taxes and import duty, cess on petrol and diesel, disinvestment proceeds of DPSEs and monetisation of surplus land.

11.40 To raise additional resources, the MoD suggested three major sources of land which can be considered for monetisation: (a) land available after the closure of military farms; (b) abandoned air fields and camping grounds, and (c) encroached land for which efforts should be made to recover the cost of the land. The financial details worked out by the MoD are as follows:

(i) Approximately 20,000 acres of land in use by military farms can be offered to other Union Government departments, State Governments and public sector entities.

(ii) Approximately 749 acres of land costing Rs. 2,216 crore have been sought for public projects.

(iii) Approximately 1,243 acres of defence land are under encroachment, including by State Government agencies. The estimated cost is about Rs. 10,000 crore.

(iv) Abandoned air fields and camping grounds of approximately 8,000 acres of land.

(v) Approximately 1,559 acres of land worth Rs. 18,836 crore is being used by State Governments for which working permission has been accorded.

11.41 The MoD further stated that a gestation period of seven to eight years has been assumed for the true realisation of the proceeds from monetisation of defence land. The realisation of funds from such monetisation was assumed at approximately Rs. 18,000 crore - Rs. 10,000 crore from realisation of proceeds from encroached land and Rs. 8,000 crore from public projects such as roads, flyovers and road over bridges, airports, railway lines and metro rail. The MoD estimated that Rs. 10,000 crore can be realised through this mechanism during this Commission's award period. The year-wise details are given in Table 11.8.

Table 11.8 Annual Incremental Accrual of Resources

(Rs. crore)

	2021-22	2022-23	2023-24	2024-25	2025-26	Total
Amount estimated	1000	1500	2000	2500	3000	10000

Source: MoD's Base Paper dated 27 July 2020 submitted to FC-XV

11.42 The Group discussed the matter and recommended that the Ministry should endeavour to monetise this surplus land with a clear action plan to realise the targeted sums annually, so that the full proceeds can be utilised through the non-lapsable defence fund.

11.43 The MoD assessed that approximately Rs. 5,000 crore per year can be realised through disinvestment of DPSEs. The Group felt that this amount could also become part of the proposed fund.

Approach

11.44 We carefully considered the opinion of Constitutional experts and the deliberations of the Group constituted by us. We noted that upholding India's sovereignty, including by ensuring adequate defence and internal security, is the duty of the Union and the States, and citizens had a corresponding duty to cooperate with the Union in this task. Secondly, though the fulfilment of this duty is a shared responsibility (State understood as all citizens put together and all its agencies), the Union under Article 355 is specifically obliged to protect States against external aggression and internal disturbance. Thus, the Union has been vested with a specific constitutional directive to ensure the defence of India and national security.

11.45 In their assessment of Union finances, earlier Finance Commissions as well as this Commission have examined the requirements of defence on revenue account in detail. However, financing capital expenditure on defence has never been addressed nor provided for in the assessments on the demand on the resources of the Union. Such requirements have been left to be met from the borrowings, as in the case of other types of capital investment. We recognise the ultimate and final responsibility of the Union Government in this regard. At the same time, considering the need and urgency to step up investment in financing defence capital requirements, we acknowledge the need to identify additional resources and the desirability of a separate mechanism for such funding.

11.46 It needs to be recognised also that in the inter-governmental transfer system, as per our Constitutional design, there is a flow of transfers from Union to States, but there is no mechanism for a reverse flow. We also recognise the Constitutional principles that preclude us from pre-empting any amount from the divisible pool of resources. Further, keeping in view our recommendation and approach for simplification of tax structures and reduction of dependence on cesses and surcharges suggested in our Report, we have also desisted from recommending any new or additional cess or surcharge for this purpose which would have accrued to the Union Government as an additional source of revenue.

11.47 We have inferred on the basis of our consultations and analysis that capital expenditure on defence, unlike other investments in social and economic sectors, does not result in remunerative returns. It provides, "the basis for the first and foundational sovereign function of any political state – the maintenance of a robust security environment."[3] By its nature, it falls in the category of committed expenditure of the Union Government.

11.48 In making our recommendations to identify additional resources for this requirement, we

[3] Pragyasingh Chandrapalsingh Thakur v State of Maharashtra, 2014 (1) Bom CR (Cri) 135

have looked at the totality of the transfer system, comprising of multiple channels within the framework of fiscal consolidation. Finance Commissions since the FC-XI have adopted an approach based on fiscal consolidation and bench-marked indicative total transfers from the Union. In the past, there were Finance Commission transfers through devolution and grants and transfers through the Planning Commission. Additionally, there were Centrally sponsored schemes (CSS). At present, the transfers comprise primarily Finance Commission transfers and transfers through CSS.

11.49 The FC-XI had recommended an overall cap on transfers to States from all sources as a key consideration towards fiscal consolidation. As it noted, "we have set a notional limit on the overall revenue transfers taking into account the legitimate needs of the Union to meet its revenue expenditure liabilities." For this the gross revenue receipts of the Union Government were taken as a bench mark. Gross revenue receipts comprise tax revenues and non-tax revenues, and excludes non-debt capital receipts (primarily disinvestment proceeds). FC-XII, FC-XII and FC-XIV have all followed the approach, but with varying benchmark levels. Table11.9 gives the size of devolution and recommended transfers from gross revenue receipts. However, it is important to keep in mind that the limits have been exceeded almost continuously since 2006-07[4].

Table 11.9: Indicative Transfer Limits from Gross Revenue Receipts (in percentage)

Finance Commission	Devolution from the divisible pool	Indicative transfer limit from GRR from all sources	Actual transfers during the relevant period
Eleventh (2000-2005)	29.50	37.50	34.96
Twelfth (2005-2010)	30.50	38.00	47.39
Thirteenth (2010-2015)	32.00	39.50	48.22
Fourteenth (2015-2020)	42.00	49.00	49.10

11.50 Keeping in view the extant strategic requirements for national defence in the global context, we have, in our approach, re-calibrated the relative shares of Union and States in gross revenue receipts by reducing our grants component by 1 per cent. This will enable the Union to set aside resources for the special funding mechanism that we have proposed in the subsequent paragraphs. Based on our assessment of the gross revenue receipts of the Union Government for the entire award period of 2021-22 to 2025-26, in nominal terms, this dispensation may leave Rs. 1.53 lakh crore with the Union Government. However, in our scheme as indicated in Table 11.10, the overall indicative transfers to the States may remain at the level of the FC-XIV period to address the needs and expectations of the States.

[4] Detailed analyses of the expenditure are contained in the Report of the Thirteenth Finance Commission, Report of the Fourteenth Finance Commission and Chapter 3 of this Report.

Table 11.10: Transfers as Percentage of Gross Revenue Receipts

Gross Revenue Receipts	FC-XIV*	FC-XV
Revenue deficit grants	1.81	1.92
Disaster Risk Management	0.45	0.80
Grants to local governments to States	2.43	2.85
Sector-specific grants	0.00	0.85
State specific grants	0.00	0.32
FC grants to States	4.68	6.74
Tax devolution	30.59	27.55
Total FC- grants + devolution	**35.27**	**34.29**
Non-FC grants (excluding GST Compensation)	12.81	12.82
GST compensation	2.08	4.02
Aggregate transfers (including GST compensation)	50.16	51.13
Aggregate transfers (excluding GST compensation)	49.10	49.08

*FC-XIV ratios are calculated based on provisional actuals of 2019-20 and actuals for other years.

11.51 We recommend that the total amount of Rs. 1.53 lakh crore, as calculated on an annual basis in Table 11.11 should be earmarked for additional investment in defence capital expenditure and for capital expenditure on internal security. We are also of the view that there should be a separate mechanism that satisfies the principles of non-lapsability and incrementality and the proposed fund is meant for such specific purpose, along with dedicated resources of an incremental nature. We, therefore, recommend that this amount should go into a specifically created non-lapsable fund and expenditure out of that fund will be governed as described later.

Table 11.11: Indicative Amount for Investment in Defence and Internal Security Capital Fund

(Rs. crore)

Years	Assessed GRR	Annual Indicative Amount
2021-22	2429405	24294
2022-23	2684208	26842
2023-24	2999062	29991
2024-25	3381073	33811
2025-26	3841639	38416
Total	15335387	153354

11.52 Among the various options proposed by the MoD and deliberated upon by the Group constituted for this purpose, we have identified the following:

(i) The MoD has substantial surplus land at its disposal. Monetisation of this can generate substantial resources if there is an effective and robust framework for the identification, valuation and disposal of such land. We, therefore, recommend that the MoD should, at the earliest, put in place a mechanism for generating additional resources from monetisation of land, including payments for defence land likely to be transferred to State Governments and for public projects in the future.

(ii) We have also considered whether the proceeds of disinvestment of DPSEs should go as general non-debt capital receipts into the Consolidated Fund or should the amount be made available for defence capital investment. Taking into account the wide gap between the requirement and availability of funds, we are of the view that the proceeds of disinvestment of DPSEs should also be part of the non-lapsable fund.

11.53 Taking cognizance of all these factors, we made following specific and general recommendations on defence and internal security for our five-year award period:

Specific Recommendations

11.54 **The Union Government may constitute, in the Public Account of India, a dedicated, non-lapsable fund, Modernisation Fund for Defence and Internal Security (MFDIS), to bridge the gap between projected budgetary requirements and budget allocation for defence and internal security. This may be called *Rashtriya Suraksha Naivedyam Kosh* or any other appropriate name. The proceeds of the fund will be utilised for the following three purposes:**

(i) capital investment for modernisation of defence services;

(ii) capital investment for CAPFs and modernisation of state police forces, as projected by MHA; and

(iii) a small component as welfare fund for our soldiers and para-military personnel.

The fund shall have the standard notified rules for its administration, public reporting, and audit by the Comptroller and Auditor General.

11.55 We expect that the Union Government will provide the identified amounts for each year, as specified in Table 11.11, in the Union Budget on an annual basis. We suggest a suitable budget line may be opened for "Investment in MFDIS (*Rashtriya Suraksha Naivedyam Kosh*)" (or any other appropriate name) specifically for this amount that will be made available as an additionality, over and above the normal budgetary capital outlay for defence. In the second stage, the amount will be transferred to the Public Account.

11.56 **This Fund will have four specific sources of incremental funding:**

(i) transfers from Consolidated Fund of India;

(ii) disinvestment proceeds of DPSEs;

(iii) proceeds from the monetisation of surplus defence land, including realisation of arrears of payment for defence land used by State Governments and for public projects and cost recovered of encroached land; and

(iv) proceeds of receipts from defence land likely to be transferred to State Governments and for public projects in future.

The total indicative size of the proposed MFDIS over the period 2021-26 is Rs. 2,38,354 crore.

11.57 From the above, we expect that an estimated additional amount, as given year-wise in Table 11.12, to become available over the five-year of our award period:

Table 11.12: Annual Targets for the Proposed MFDIS

(Rs. crore)

S. No.	Sources of Revenue	Amount to be used for	2021-22	2022-23	2023-24	2024-25	2025-26	Total 2021-26
1	Transfers from Consolidated Fund (para 11.51)	**Defence & Internal Security**	24294	26842	29991	33811	38416	**153354**
2	Disinvestment proceeds of DPSEs	**Defence**	7000	7000	8000	9000	9000	**40000**
3	Monetisation of defence lands*	**Defence**	6000	7000	8000	9000	10000	**40000**
4	Payments for defence land likely to be transferred to State Governments and for public projects in future	**Defence**	400	600	900	1300	1800	**5000**
5	**Gross Total**		**37694**	**41442**	**46891**	**53111**	**59216**	**238354**

* Includes realisation of arrears of payment for defence land used by State Governments and for public projects and cost recovered of encroached land.

11.58 **The maximum size of the recommended fund is Rs. 51,000 crores per annum. Any amount exceeding the same shall be deposited into the Consolidated Fund.**

11.59 **This amount shall be maintained in the Public Account and shall be operated through the extant procedures for operating such accounts.**

11.60 **The unutilised amount from the normal budgetary allocations to the MoD and MHA for capital expenditure shall not be part of the Fund and should be governed as per the principles of the annual budget process.**

11.61 **The MoD would have exclusive rights over the use of the amounts deposited in the Fund from the sources of revenue mentioned at serial no. 2, 3 and 4 in Table 11.12. The MHA will only be permitted to use the fund that is earmarked for it from the source of revenue mentioned at serial no. 1 of Table 11.12. The amount proposed for capital expenditure towards internal security for five years is Rs. 50,000 crore and the year-wise amount is given in Table 11.13. Out of this Rs. 50,000 crore, the MHA will allocate Rs. 500 crore for redeveloping/improving the residential facilities for police personnel in Delhi. This would be augmented by Rs. 100 crore per annum for improved communication systems and technology upgradation of the police personnel.**

Table 11.13: Amount Earmarked for Internal Security from the Proposed MFDIS During the Award Period of FC-XV

(Rs crore)

	2021-22	2022-23	2023-24	2024-25	2025-26	Total
Amount earmarked for internal security	8000	9000	10000	11000	12000	50000

11.62 **The fund may be operated by a suitably empowered High Powered Committee (HPC) notified by the Union Government. This may be headed by the Cabinet Secretary and consist of the Secretaries of Defence, Home and Expenditure and the Chief of Defence Staff.** The Committee will also monitor the entire mechanism to ensure realisation of targeted annual proceeds, assess the service-wise annual needs and make allocations to them. It shall also monitor the conditions mentioned by us for operating such Fund.

11.63 Apart from this, **the HPC would also allocate Rs. 1,000 crore per annum for the welfare of families of defence and CAPF personnel who sacrifice their lives in frontline duties.** As this is more in the nature of a humanitarian support, we would suggest simple processes and procedures that would enable this amount to be quickly placed at the disposal of the heads of the services in respect of defence forces and heads of the CAPFs engaged in internal security for disbursal.

General Recommendations

11.64 **We also expect that over the next year or two (medium-term), the Union Government will review its existing expenditures and rationalise and re-prioritise them to**

focus on certain key sectors and interventions with nation-wide externalities, defence and internal security. This will reduce pressures on the revenue account of the Union to enable higher capital expenditure within the available fiscal space.

11.65 **Due to overall fiscal constraints, the MoD should also take immediate measures to innovatively bring down the salaries and pension liabilities.**

11.66 **The MoD has been examining various possibilities of reforms in defence pension, as deliberated by relevant Parliamentary Committees. These are:**

- **i. bringing service personnel currently under the old pension scheme into the New Pension Scheme (NPS) or a separate NPS for the armed forces;**
- **ii. increasing the retirement age of personnel below officer ranks to a reasonable level;**
- **iii. transfer of retired personnel to other services, like the paramilitary forces, after active service of a certain duration; and**
- **iv. resettlement of ex-servicemen through skill development courses.**

We recommend that the MoD take appropriate reform measures, without losing much time, on these lines or any other innovative approach, in order to ensure the growth of defence pensions are at par with non-defence pensions.

11.67 **We also recommend that the MoD shall reduce its dependence on defence imports with a specific roadmap by corresponding enhancement in indigenous production at a faster rate.** The Ministry shall prepare and implement a time-bound action plan in this regard and MoF outlays for defence expenditure should incentivise such a roadmap. By the end of 2025-26, the endeavour of the MoD should be that not more than 30 per cent of defence capital outlay is through foreign vendor imports.

Summary of Recommendations

i. The Union Government may constitute in the Public Account of India, a dedicated non-lapsable fund, Modernisation Fund for Defence and Internal Security (MFDIS), to bridge the gap between projected budgetary requirements and budget allocation for defence and internal security. This may be called *Rashtriya Suraksha Naivedyam Kosh* or any other appropriate name. The proceeds of the fund will be utilised for the following three purposes:

- (a) capital investment for modernisation of defence services;
- (b) capital investment for CAPFs and modernisation of state police forces as projected by MHA; and

(c) a small component as welfare fund for our soldiers and para-military personnel.

The fund shall have the standard notified rules for its administration, public reporting, and audit by the CAG.

(para 11.54)

ii. This Fund will have four specific sources of incremental funding:

a. transfers from the Consolidated Fund of India;

b. disinvestment proceeds of DPSEs;

c. proceeds from the monetisation of surplus defence land, including realisation of arrears of payment for defence land used by State Governments and for public projects and cost recovered of encroached land; and

d. proceeds of receipts from defence land likely to be transferred to State Governments and for public projects in future.

The total indicative size of the proposed MFDIS over the period 2021-26 is Rs. 2,38,354 crore.

(para 11.56/Table 11.12)

iii. The maximum size of the recommended fund is Rs 51,000 crore per annum. Any amount exceeding the same shall be deposited into the Consolidated Fund. This amount shall be maintained in the Public Account and shall be operated through the extant procedures for operating such accounts. The unutilised amount from the normal budgetary allocations to the MoD and MHA for capital expenditure shall not be part of the Fund and should be governed as per the principles of the annual budget process.

(para 11.58, 11.59 and 11.60)

iv. The MoD would have exclusive rights over the use of the amounts deposited in the Fund from the specified sources of revenue mentioned at serial no. 2, 3 and 4 in Table 11.12. The MHA will only be permitted to use the fund that is earmarked for it from the source of revenue mentioned at serial no.1 of Table 11.12. The amount proposed for capital expenditure towards internal security for five years is Rs. 50,000 crore and the year-wise amount is given at Table 11.13. Out of this Rs. 50,000 crore, the MHA will allocate Rs. 500 crore for redeveloping/improving the residential facilities for police personnel in Delhi. This would be augmented by Rs. 100 crore per annum for improved communication systems and technology upgradation of the police personnel.

(para 11.61/Tables 11.12 and 11.13)

v. The fund may be operated by a suitably empowered High Powered Committee (HPC) notified by the Union Government. This may be headed by the Cabinet Secretary and consist of the Secretaries of Defence, Home and Expenditure and the Chief of Defence Staff. The HPC would also allocate Rs. 1,000 crore per annum for the welfare of families of the defence and CAPF personnel who sacrifice their lives in frontline duties.

(para 11.62 and 11.63)

vi. We also expect that over the next year or two (medium-term), the Union Government will review its existing expenditures and rationalise and re-prioritise them to focus on certain key sectors and interventions with nation-wide externalities, defence and internal security. This will reduce pressures on the revenue account of the Union to enable higher capital expenditure within the available fiscal space.

(para 11.64)

vii. Due to overall fiscal constraints, the MoD should also take immediate measures to innovatively bring down the salaries and pension liabilities.

(para 11.65 and 11.66)

viii. We also recommend that MoD shall reduce its dependence on defence imports with a specific roadmap by corresponding enhancement in indigenous production at a faster rate.

(para 11.67)

Chapter 12

Fiscal Consolidation Roadmap

Fiscal consolidation has been one of the guiding principles of India's economic policy and macro-economic management. Successive Finance Commissions have analysed the road map and challenges for consolidation and laid down the steps for achieving it. Our terms of reference also mandate us to recommend a fiscal consolidation road map. We start with the background, including the terms of reference of the Commission relevant to this Chapter. We then summarise the views expressed on the subject by previous Finance Commissions, Union and State Governments and the Reserve Bank of India. Next, we review the current status of deficit and debt of the Union and State Governments as well as their consolidated position. Based on all the above, we discuss our approach and delineate a road map for debt and deficit of the Union and State Governments in the next five years. While doing this, we recognise upfront the immediate resource requirements for fighting the pandemic, the demands on government budgets for stimulating the economy and the need to gradually consolidate the debt position of the general government in the latter half of our award period. Given the tentative nature of the economic outlook, we recommend that this issue should be revisited forthwith, once the needs of essential health expenditures to tackle the pandemic and its aftermath, as well as the pace of economic recovery become clearer.

Background

12.1 Para 5 of the Commission's terms of reference (ToR) enjoins us to review the current status of the finance, deficit, debt levels, cash balances and fiscal discipline efforts of the Union and the States. We are also mandated to recommend a fiscal consolidation roadmap for sound fiscal management, taking into account the responsibility of the Union Government and State Governments to adhere to appropriate levels of general and consolidated government debt and deficit levels, while fostering higher inclusive growth in the country, guided by the principles of equity, efficiency and transparency.

12.2 Further, para 6 requires us to consider, among other things, the demand on the resources of the Union Government, particularly on account of defence, internal security, infrastructure, railways, climate change, commitment towards administration of Union Territories without legislature, and other committed expenditure and liabilities; and the demand on the resources of the State Governments, particularly on account of financing socio-economic development and critical infrastructure, assets maintenance expenditure, balanced regional development and impact of the debt and liabilities of their public utilities.

12.3 The ongoing Covid-19 pandemic and the resultant economic contraction have

significantly changed the magnitude of demands on the resources of the Union and State Governments. We have done an assessment of the requirements to meet these demands in Chapters 4 and 9 of this Report. This assessment also forms the basis of our approach and recommendations on the fiscal roadmap of the general government.

Views of Previous Finance Commissions

12.4 Even when explicitly not part of their ToR, all Finance Commissions, starting with the Second, have dealt with State debt issues. From the FC-VI onwards, review of the States debt became a part of the ToR. Up to the FC-VIII, while reviewing State debt positions, Finance Commissions estimated the non-Plan capital gap of States to suggest debt relief measures, with particular reference to Central loans to States. From the FC-IX onwards, the debt position was reviewed as a whole and corrective measures were suggested. The ToR for the FC-X asked it to suggest corrective fiscal measures, keeping in view the financial requirement of the Union Government. ToRs from the FC-XI onwards have mandated Commissions to consider the long-term sustainability of debt.

12.5 The FC-XII recommended the Debt Consolidation and Relief Facility for States, with the condition that they could avail of it if they enacted a fiscal responsibility legislation that prescribes specific annual deficit reduction targets in order to ultimately eliminate the revenue deficit and reduce the fiscal deficit to 3 per cent of GSDP. It recommended discontinuing the role of the Union Government in lending to the States, and also suggested setting up of a sinking fund for the amortisation of loans, and guarantee redemption funds for the discharge of the States' obligations under guarantees.

12.6 The FC-XIII recommended that the Union should achieve a revenue surplus by 2014-15 and that States with zero revenue deficit or surplus in 2007-08 should maintain those levels while other States should eliminate the revenue deficit by 2014-15. A fiscal deficit target of 3 per cent of GSDP was recommended for all States, but with different target dates for general States and North-Eastern and Himalayan (NEH) States. For 2014-15, it set a combined debt to gross domestic product (GDP) target of 68 per cent for the general government, split into 44.8 per cent for the Union and 24.3 per cent for the States. It also recommended: (a) aligning the National Small Savings Fund (NSSF) to the market rate of interest and resetting interest rates on NSSF loans to States subject to certain conditions; (b) conditional write-off of specified loans given by the Union to the States; and (c) an independent review and monitoring, to be instituted by the Union Government, of the implementation of its own fiscal responsibility and budget management process.

12.7 The FC-XIV recommended a ceiling on the fiscal deficit at 3 per cent of GDP from 2016-17 up to 2019-20 for the Union Government. For all States, the fiscal deficit targets and annual borrowing limits were anchored to an annual limit of 3 per cent of GSDP. However, States could get flexibility on this on the primary condition that there is no revenue deficit in the year in which

borrowing limits are to be fixed and in the immediately preceding year. Once this condition is met, a 0.25 per cent flexibility over and above the 3 per cent ceiling was allowed if the debt-GSDP ratio was less than or equal to 25 per cent in the preceding year. Another 0.25 per cent flexibility was allowed on fulfilling the condition that the interest payments are less than or equal to 10 per cent of the revenue receipts in the preceding year. Moreover, if a State was not able to fully utilise its sanctioned borrowing limit of 3 per cent of GSDP in any particular year, this un-utilised borrowing amount (calculated in rupees) could be availed only in the following year but within the award period. It also recommended that State Governments be excluded from the operations of the NSSF, with effect from 1 April 2015.

12.8 The FC-XIV made detailed recommendations on the fiscal responsibility framework:

i. The Union Government may amend its Fiscal Responsibility and Budget Management (FRBM) Act, 2003 to reflect the fiscal roadmap, omit the definition of effective revenue deficit and mandate the establishment of an independent fiscal council to undertake ex-ante assessment.

ii. The Union Government may take expeditious action to bring into effect Section 7A of the FRBM Act for the purposes of ex-post assessment.

iii. 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.

iv. Both the Union and State Governments may report extended public debt as a supplement to the budget document, keeping in mind the importance of risks arising from guarantees, off-budget borrowings and accumulated losses of financially weak public sector enterprises.

Views of the States

12.9 Many States argued that uniform and inflexible fiscal rules undermine the fiscal autonomy of the States and lead to decline in their development expenditure. To deal with the Covid-19 pandemic, many States have requested us to relax the norms relating to fiscal deficit and debt and allow them to raise more financial resources during our award period. Some of them also urged us to recommend raising the ways and means accommodation to them during the award period.

12.10 A few States felt that the enforcement of fiscal rules is not symmetrical between the Union and the States. While the States are subject to annual borrowing limits fixed by the Union based on fiscal adjustment path/FRBM limits, there is no such mechanism to enforce fiscal discipline on the part of the Union. In the adoption of fiscal targets, there should be uniform treatment for the Union and the States. The Union Government amended its FRBM Act and dispensed with the revenue deficit target altogether. But borrowing targets of the States are set with reference to the revenue deficit.

12.11 Many States requested that we avoid the imposition of any condition under Article 293(3) of the Constitution. Net budgetary borrowing ceilings for the States are already fixed by the Government of India at the beginning of every fiscal year as per the fiscal deficit target specified in the FRBM Act. Specifying further conditions restrains entitled borrowings and the fiscal space of the States.

12.12 A suggestion was made to permit States to breach the FRBM borrowing limits in the event of a shortfall in tax devolution. It was also suggested that States should be allowed a higher debt ceiling of at least 30 per cent of GSDP, because under the debt target of 20 per cent of GSDP, many of them would have to keep fiscal deficit below 3 per cent of GSDP. There were also proposals for building in escape clauses for States under the FRBM framework.

12.13 Most North-eastern States maintained that private investment is totally absent in their region in critical sectors like power, road, network, airport, etc. They suggested that some relaxation under the FRBM Act for higher borrowings to finance capital outlays may be considered for them.

12.14 Another demand is that the States may be allowed prematurely to retire their high cost debt (such as under NSSF) based on existing market dynamics. This will allow States to refinance their loans at lower interest rates and decrease their debt servicing cost.

12.15 Some States argued that the combined debt target may be different if the implicit nominal GDP growth changes, as compared to the implicit growth assumption of 11 per cent per annum that was used for deriving the 60 per cent target. Fiscal deficit and debt targets should be made consistent. Since the fiscal deficit limits for both the Union and the States are currently 3 per cent, capping the total debt at 20 per cent of GDP for the aggregate of States is unwarranted.

12.16 At times, some States have to take recourse to market borrowing just to avail of their full borrowing limit and this leads to excessive cash balances. They proposed that we may incentivise the States to avoid this by recommending the carry forward of the unutilised borrowing limit to the succeeding years within the award period. This will also provide the required flexibility to the State Governments to adopt a counter-cyclical fiscal policy. Countercyclical fiscal space can be created also through relaxation of fiscal targets in times of slow growth, institution of a budget stabilisation fund to build up buffers and fixation of a range of targets instead of fixed targets.

Views of the Union Government

12.17 The Union Government submitted that this Commission should define 'debt' consistently and clearly for both the Union and the States, against the current situation where different documents use different definitions of debt. It suggested the adoption of the definition used in the Status Paper on Government Debt, with inclusion of fully-serviced bonds and other extra-budgetary resources and deduction of multilateral/bilateral loans taken on the States' account on back-to-back basis for computing the Union's debt and liabilities. It also said that State's

liabilities to the Union need to be excluded from general government debt to avoid double counting.

12.18 The Union Government urged the Commission to incentivise States to amend their FRBM acts to bring the debt-GDP ratio to 20 per cent of their GSDP by 2024-25, by linking its transfers to fulfilment of this goal.

12.19 It was suggested that the States should also strive for a robust borrowing programme by integrating their financial management systems with Accountant General's and Reserve Bank of India's (RBI) financial system. **The State Governments may explore the formation of independent public debt management cells (PDMCs) similar to the one at the Union Government level.**

12.20 The Union Government requested us to define what is permissible as States' borrowing and prescribe that any liability taken outside permissible sources of borrowing should be prohibited. It also requested us to recommend a reporting system for any such borrowings. It held that the Union Government should have the authority to regulate market borrowings of a State, if the latter is found to be raising unauthorised off-budget borrowings.

12.21 The Union Government also felt that we should not recommend revenue deficit grants for any State, since all major States have adequate revenue raising powers to meet legitimate expenditure. Only the States which are not using their fiscal powers or were fiscally mismanaged in the past or have undertaken excessive debt and are running populist schemes fail to generate enough resources to meet their expenditure. Some of the hill states which may be fiscally unsustainable can be helped by way of specific grants.

12.22 In the revised memorandum, the Union Government expressed difficulty in projecting fiscal deficit and debt because of the uncertainty caused by the Covid-19 pandemic. It preferred to follow a glide path for reducing fiscal deficit, while also keeping the following steps in mind:

i. maintaining transparency in the market borrowing programme by effective dissemination of the borrowing calendar to investors;

ii. conducting investor interaction with other stakeholders regularly;

iii. creating benchmarks of desired tenors by issuing sizeable volumes to enhance investor participation and liquidity;

iv. elongating the maturity profile of the debt portfolio and building a smooth yield curve;

v. issuing a variety of instruments that help investors manage their portfolio efficiently; and

vi. continuing with the rationalisation of interest rates on small savings schemes and other instruments like provident fund and special securities in line with the interest rates prevailing in the economy.

Views of the Reserve Bank of India

12.23 The RBI wanted the States to pursue an active debt management strategy similar to that followed by the Union, in terms of buyback, switches and non-standard issuances towards consolidation of outstanding debt. Passive consolidation involves issuing a few new securities and reissuing them repetitively until they reach a cap. The buyback of securities will not only help in consolidation but will also reduce the cost of borrowings. The buyback and switches are undertaken for the purpose of bringing down elevated redemption pressures in the near term.

12.24 The RBI felt that oversupply of State development loans (SDLs) in the market needs to be dis-incentivised in the interest of all stakeholders, including States. SDLs have not been able to attract foreign portfolio investors due to lack of financial information on the States. Regular disclosure of the financial position of the States and their credit rating will help broaden the investor base. **Credit rating will also reinforce fiscal discipline and lead to better pricing of SDLs. The States should define and disclose contingent liabilities transparently, estimate them and assess the risks associated with them.**

12.25 The surplus cash balances of the States have increased over a period of time. Investing these balances in Intermediary Treasury Bills (ITBs) leads to negative spreads in the form of interest rate differential between market borrowings and the returns on the ITBs. Avenues for States to invest their surplus in short maturities other than treasury bills are limited. Thus, States may be allowed to invest in cash management bills of the Government of India through a non-competitive route as a measure to minimise the negative carry of the States to the maximum possible extent.

12.26 The RBI felt that the **States should build more avenues for short-term borrowings other than ways and means advances/overdraft (WMA/OD) facility, which has monetary policy implications.** Such a facility may help States meet the temporary mismatches in their revenue flows without any limits at market-determined cost.

Review of the Current Position

FRBM Framework

12.27 The FRBM Act, as amended in 2018, defines the debt of the Union Government to include: (a) its outstanding liabilities on the security of the Consolidated Fund of India, including external debt valued at current exchange rates; (b) the outstanding liabilities in the public account of India; and (c) such financial liabilities of any body corporate or other entity owned or controlled by it, which the Government is to repay or service from the annual financial statement, reduced by the cash balance available.

12.28 On the operational details of fiscal targeting, the Act specifies the following:

(i) The Union Government shall: (a) take appropriate measures to limit the fiscal deficit up to 3 per cent of GDP by 31 March 2021; (b) endeavour to ensure that the general

government debt does not exceed 60 per cent and the Union Government debt does not exceed 40 per cent of GDP by the end of 2024-2025; and, (c) not give additional guarantees with respect to any loan on the security of the Consolidated Fund of India in excess of 0.5 per cent of GDP in any financial year.

(ii) Annual fiscal deficit target can be exceeded in a year, but by not more than 0.5 per cent of GDP, on specified grounds. In such instances, a statement explaining the reasons thereof and the path of return to the annual prescribed targets shall be laid before both Houses of Parliament.

(iii) If any deviation is made in meeting the obligations under the Act, owing to unforeseen circumstances, the Finance Minister will make a statement in both Houses of Parliament explaining the reasons for the deviation and the remedial measures proposed.

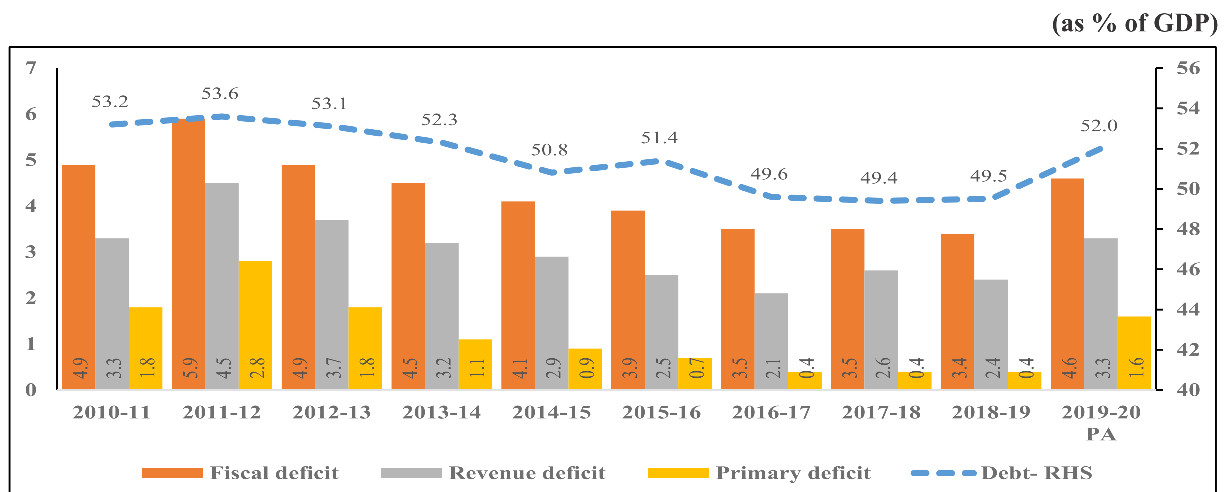
12.29 About half the States amended their FRBM Acts between 2015 and 2018, consequent to the award of the FC-XIV, generally aligning their debt and deficit targets to the Commission's recommendations. Most of the State Governments have their fiscal deficit targets fixed at or below 3 per cent of GSDP. The borrowings by States are governed by the Article 293 (3) of the Constitution that stipulates that State Governments cannot take any loan without the consent of the Union Government, if any part of a loan either given to the State by the Union Government or guaranteed by the Union is still outstanding.

Debt and Deficits of the Union

12.30 During the entire period of our review, from 2010-11 to 2019-20, the fiscal deficit of the Union Government remained above the target prescribed under the FRBM Act. As Figure 12.1 shows, the fiscal deficit reached its peak level of 5.9 per cent of GDP in 2011-12 and improved to 3.4 per cent in 2018-19. However, with slowing economy and declining tax revenue collection, fiscal deficit worsened to 4.6 per cent of GDP in 2019-20.

Figure 12.1 : Union Government Fiscal Indicators

(as % of GDP)



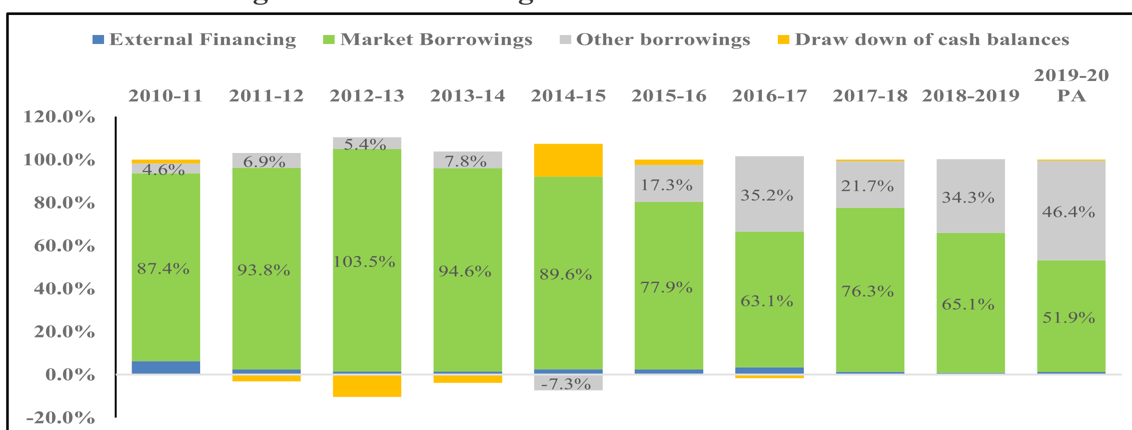
Source : Union Budget

12.31 During the period of our review, 70 per cent of the fiscal deficit of the Union was accounted for by the revenue deficit, leaving just 30 per cent of the net borrowing available for capital expenditure purposes. The primary deficit has shown a declining trend from 2.8 per cent of GDP in 2011-12 to 0.4 per cent in 2018-19. However, in 2019-20, it spiked to 1.6 per cent of GDP.

12.32 The debt-GDP ratio of the Union improved from 53.2 per cent in 2010-11 to 49.4 per cent in 2017-18 before again deteriorating to 52 per cent in 2019-20 (Figure 12.1). As per the definition of Central Government debt in the amended FRBM Act, the outstanding debt has been adjusted for external debt at current exchange rates. The debt in 2019-20 also includes stock of EBRs, which are to be fully serviced from the Union Budget[1]. This was reported for the first time in the Union Budget 2019-20 presented in July 2019.

12.33 A significant change in the composition of the financing of the Union's fiscal deficit was noticed during the period under review. The proportion of market borrowing in financing reached a peak level of 103.5 per cent of the fiscal deficit in 2012-13 and then gradually declined to reach just 51.9 per cent of fiscal deficit in 2019-20 (Figure 12.2). This would impact the overall cost of finance and the maturity profile of the Union Government's debt stock.

Figure 12.2: Financing of Fiscal Deficit of the Union



Source : RBI for the years till 2018-19 and CGA for 2019-20 PA

12.34 Apart from the reported EBR, the Union Government has been resorting to off-budget financing in the form of deferment of expenditure to the following year. The details of such off-budget financing are presented in Chapter 3 paragraph 3.51. The stock of EBR on account of fertilizer subsidies as of March 2020 was around Rs. 40,000 crore.

12.35 In the case of the food subsidy, in order to cover the shortfall in the budget allocation, the Union Government asks the Food Corporation of India (FCI) to resort to a number of instruments such as bonds, unsecured short-term loans as well as loans from the NSSF. The outstanding stock of NSSF loans to FCI as of March 2020 was Rs. 3.2 lakh crore.

[1] As defined in para 4 of MTFP 2019-20, fully serviced means principal and interest both paid through Annual Financial Statement. This may be at variance with the 'Central Government Debt' defined under FRBM Act, 2003.

Debt and Deficits of the States

12.36 At an aggregate level, the States have maintained their fiscal deficit below the target of 3 per cent of GSDP for most of the years in our review period, except 2015-16 and 2016-17. This slippage was on account of the Ujjwal DISCOM Assurance Yojana (UDAY) scheme, under which States were to take over certain part of DISCOM debt stock on their own balance sheets. This is reflected in higher fiscal deficit in those years.

12.37 The pressure on the States' fiscal position has been rising, as can be seen from the rising primary deficit of the States. The States' primary deficit in 2010-11 was 0.6 per cent of aggregate GSDP, and then rose to 2 per cent in 2016-17 before improving to around 1 per cent in the 2019-20 budget estimates of the States.

12.38 The total debt of the States declined to 22.8 per cent of GSDP in 2013-14 and then rose to 25.9 per cent in 2016-17 due to the impact of UDAY and remained stable at that level for three years. In 2019-20, it has been budgeted to rise sharply to 27.3 per cent of GSDP. Actual outturn of outstanding debt at the end of 2019-20 might be higher than this due to the slowing of the economy and expected tax revenue shortfall.

Table 12.1: Revenue Deficit (+)/Surplus (-) of the States

Indicators	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20 RE
Number of States with revenue deficit	10	6	6	11	15	10	10	10	10	15
Revenue deficit as % of all-State GSDP*	0.59	0.40	0.38	0.48	0.84	0.56	0.77	0.65	0.68	1.00
Number of States with revenue surplus	18	22	22	17	14	19	19	19	19	13
Revenue surplus as % of all-State GSDP*	-0.63	-0.69	-0.60	-0.38	-0.45	-0.51	-0.49	- 0.50	-0.55	-0.23
Aggregate revenue deficit/surplus as % of all-State GSDP	-0.04	-0.29	-0.22	0.10	0.39	0.04	0.28	0.15	0.13	0.77
Aggregate fiscal deficit as % of all-State GSDP	2.4	2.0	2.1	2.3	2.9	3.2	3.6	2.5	2.5	3.2

** revenue deficit refers to aggregate revenue deficit of States that had revenue deficit and revenue surplus refers to aggregate revenue surplus of States that had revenue surplus.*

Source : Finance Accounts and MoSPI

Note: Total number of States during 2010-11 to 2013-14 is twenty-eight because Telangana was not a separate State. The number of States in 2019-20 is twenty-eight because Jammu & Kashmir ceased to be a State.

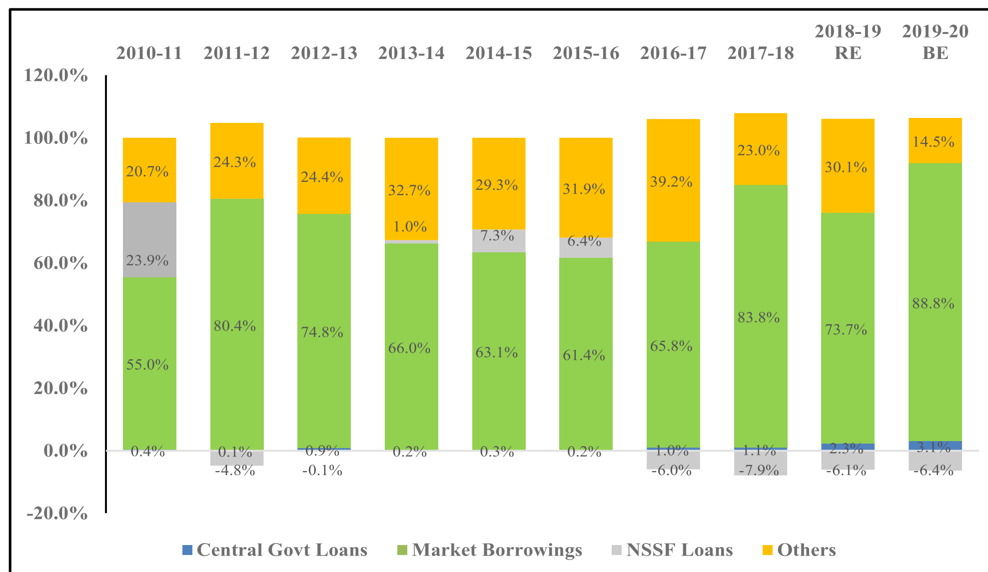
12.39 The revenue deficit of the States at an aggregate level is expected to be 0.77 per cent of

GSDP in 2019-20. During our review period, the aggregate revenue deficit has shown two clear trends. One, the States in the aggregate are in revenue deficit consistently since 2013-14. Two, before that, they reported revenue surplus for three consecutive years.

12.40 Table 12.1 provides a disaggregated picture of the deficits of States. A majority of States remained revenue surplus during the entire period of review. Among the large States, Bihar, Gujarat, Karnataka, Madhya Pradesh, Odisha and Uttar Pradesh have reported revenue surplus in all the years under review. Andhra Pradesh (post re-organisation), Haryana, Kerala, Punjab and West Bengal have reported revenue deficit in all the years. Tamil Nadu and Rajasthan have reported revenue deficit in the last seven years.

12.41 Figure 12.3 depicts the financing pattern of the fiscal deficit of the States. The proportion of market borrowing in financing has been fluctuating during our review period. However, it remains the major source of financing. States have, on the whole, significantly reduced their deficit financing through NSSF securities. This also gets reflected in the reduction in the share of NSSF securities in the total aggregated liabilities of the States to 8 per cent in 2019-20 from 27 per cent in 2010-11. Central loans to States now constitute only 4 per cent of total aggregate liabilities, as compared to 8 per cent in 2010-11.

Figure 12.3: Financing of the States' Fiscal Deficit



Source : Based on RBI's Handbook of Statistics on Indian Economy, 18 Sep 2020

12.42 During our review period, many States have resorted to financing of public expenditure through EBRs or off-budget borrowings. This has been noted by the CAG, in its reports on finances of State Governments. However, due to the general lack of reporting of such EBRs, we are unable to factor them into our calculations.

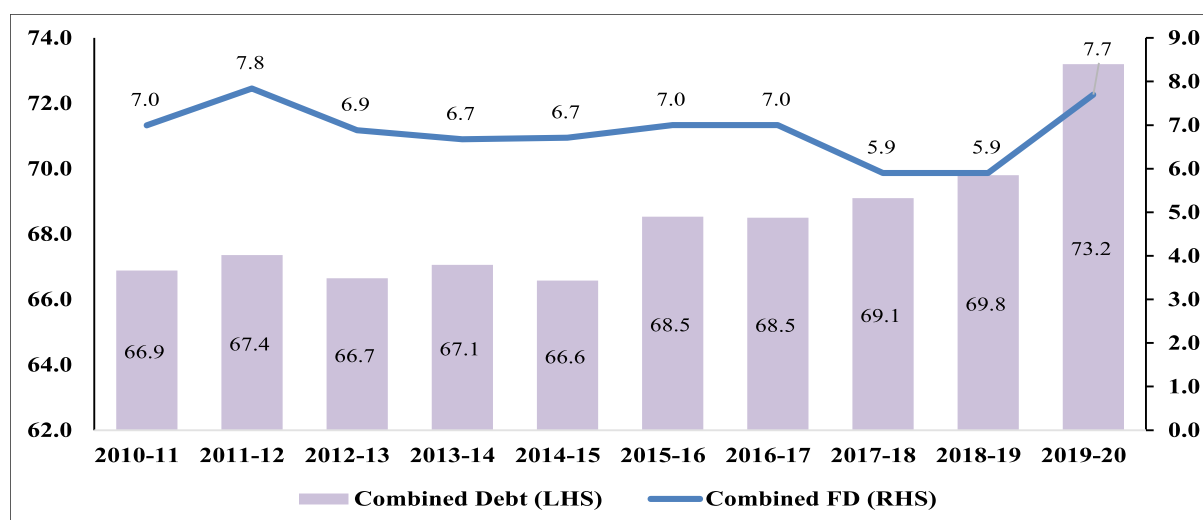
Review of Debt and Deficit of the General Government

12.43 The Union Government amended the FRBM Act through the Finance Act 2018. In the reformed FRBM framework, the focus is on limiting general government debt. It mandates the Union Government to endeavour to ensure that the general government debt does not exceed 60 per cent of GDP. We have adjusted inter-governmental transactions while consolidating at the general government level. These inter-governmental transactions included the stock of Central loans to the States, the stock of NSSF securities and Treasury Bills held by the State Governments.

12.44 The combined fiscal deficit of the general government during the review period reached the peak of 7.8 per cent of GDP in 2011-12 and was estimated to be around 7.7 per cent in 2019-20 (Figure 12.4).

Figure 12.4: General Government Debt and Deficit

(as % of GDP)



Source : Union Budget and Finance Account and our estimates

12.45 The debt-GDP ratio of the general government remained above the target of 60 per cent throughout our review period. It remained stable at around 66 per cent during the 2010-11 to 2014-15 period. Later, due to the implementation of the UDAY scheme, it breached the 68 per cent mark and remained above that level. Debt-GDP ratio saw a significant jump of more than 3 percentage points in 2019-20 due to the slowing of the economy and the shortfall in tax revenues. Both in terms of direction and quantum, combined debt during 2015-20 period did not follow the fiscal roadmap prescribed by the FC-XIV.

12.46 In the consolidated debt, ratio of debt of the Union to the States changed from 70:30 observed during the 2010-15 period to 67:33 in the last five years. At the general government level, conditions for debt sustainability - nominal growth of GDP being higher than nominal interest rate - was being met during the review period.

Path of Fiscal Consolidation for the Union Government

12.47 There are many competing considerations that exert considerable pressure on the finances of the Union Government. The balance of these considerations determined our deficit and debt path for the Union Government.

12.48 While assessing the revenue expenditure of the Union and the State Governments, we adopted normative principles with the objective of opening up space for higher allocations on health and other urgent expenditure needs and of ensuring fiscal sustainability in the medium term. We expect that the discipline that we have envisaged is strictly observed in the provision for salaries and allowances, other establishment-related expenses, pensions and subsidies. However, there are inescapable compulsions related to: (a) interest liabilities of the Union, which accounted for 29 per cent of its revenue expenditure in 2018-19 and which faces an upward pressure due to elevated borrowing requirements in the first half of our award period; (b) requirement to fund the upkeep of defence assets adequately; and (c) need to support important national priorities like health, science and technology and external affairs. Balancing the considerations of discipline, prudence and adequacy, we have pegged the trend growth rate of the own revenue expenditure of the Union Government at 6.9 per cent during our award period vis-a-vis 9.5 per cent growth during the 2015-16 to 2019-20 period.

12.49 We have also maintained that **since the overall responsibility of macro-fiscal balance rests with the Union Government, it should support the budgets of State Governments and local governments generously in the next five years.** However, the responsibility of balancing budgets of States lies primarily with their governments. We have explained our position and cautionary observations on the persistent revenue deficits run by many State Governments in Chapter 10 on grants-in-aid. However, considering the need to manage the transition smoothly, we have recommended support to seventeen State budgets with revenue deficit grants, mostly in the first three years. We have also recommended grants to State Governments for important sectors like health, education, rural roads and agricultural reforms.

12.50 We have also increased the grants for disaster risk management from 0.45 per cent of the gross revenue receipts of the Union Government during 2015-16 to 2019-20 to 0.80 per cent during 2021-22 to 2025-26. Likewise, the grants to the local self-governments have been stepped up from 2.43 per cent of the gross revenue receipts to 2.85 per cent. Overall, our recommendation for grants to the State Governments is estimated at 6.74 per cent of the gross revenue receipts of the Union Government, as compared to 4.68 per cent in the case of the FC-XIV.

12.51 Another major component of the revenue account of the Union Government is the schematically-tied transfers to State Governments, prominently by way of Centrally sponsored schemes (CSS). We have examined the issue of CSS in detail. The following are the findings and recommendations from our analysis:

(i) In February 2017, the Union Government indicated that, for aligning the schemes with the financial resources cycle of the Union and State Governments, ongoing schemes

would be co-terminus with the Finance Commission cycles. This meant that the continuation of the schemes would be contingent on outcome review, fresh appraisal and approval. To eliminate overlap of activities/objectives, the fresh proposal for continuation of the scheme was required to reflect a clear convergence architecture with other similar schemes of the Union.

(ii) Till recently, there seemed to be confusion about the number of existing CSS, indicating the complexity of the entire structure. The Department of Expenditure, Ministry of Finance, has recently drawn up a list of 131 CSSs. The Union Budget 2020-21 shows that fifteen of the thirty umbrella CSS account for about 90 per cent of the total allocation under CSS. Many umbrella schemes have, within them, a number of small schemes, some of them with negligible allocations.

(iii) It is important to gradually stop the funding for those CSS and their sub-components which have either outlived their utility or have insignificant budgetary outlays not commensurate to a national programme. There should also be a minimum threshold funding size for the approval of a CSS. This will help both the Union and the State Governments to focus on "the continuing imperative of the national development programme" as mentioned in our ToR. It will also help the participating Governments to ensure that the rights-based schemes are adequately funded.

(iv) There are two pre-conditions for carrying out this task.

(a) **The first is to fix a threshold amount of annual appropriation below which the funding for a CSSs may be stopped. Below the stipulated threshold, the administrating department should justify the need for the continuity of the scheme.**

(b) **The second requirement is to conduct an independent evaluation of all the CSS. We understand that the Department of Expenditure had asked NITI Aayog to conduct a third-party evaluation of all the CSS. This task should be completed within a stipulated timeframe. Further, the flow of monitoring information should be regular and should include, apart from routine statements of financial and physical progress, credible information on output and outcome indicators.**

(v) Clarity and stability in the share of the Union Government in CSS is important for the fiscal arithmetic of the States. **The funding pattern of the CSSs should be fixed upfront in a transparent manner and should be kept stable.**

12.52 We have assessed that keeping the aggregate size of the schematic transfers from the Union to the States at the FC-XIV levels (12.81 per cent of the gross revenue receipts) will be adequate to work around the above-recommended framework. We have made this provision in our projections of the revenue expenditure of the Union.

12.53 All the above, coupled with the loss of the gross revenue receipts base because of the steep

contraction in 2020-21 and the need for public expenditure for economic recovery, exerts significant upward pressure on the revenue account of the Union Government. The summary impact of the afore-mentioned developments is that the revenue deficit of the Union Government cannot be eliminated by 2025-26. This also means that it is impossible to pursue the FRBM path of fiscal deficit of 3 per cent of GDP even by 2025-26, unless the economy gains a greater momentum than expected. From the assessment of the Union finances in Chapter 4, it is clear that a 3 per cent fiscal deficit will not cover the revenue account imbalance till 2024-25 and will barely cover it in 2025-26. What makes the balance difficult is also the estimated deceleration in the non-debt capital receipts, including interest receipts and divestment proceeds, from 0.5 per cent of GDP during the FC-XIV period to 0.4 per cent during our award period.

12.54 Considering the macro-stabilisation function of the Union Government, the space for counter-cyclical investment spending cannot be allowed to shrink because of compulsions on the revenue account, including that of supporting the budgets of the State and local governments. The increased requirement of defence capital spending is an added compulsion. The following indicative fiscal path will bring the space for capital expenditure of the Union during 2021-22 to 2025-26, close to the levels of the FC-XIV period, relative to the GDP.

Table 12.2: Indicative Deficit and Debt Path for the Union Government

(% of GDP)

	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Revenue deficit	5.9	4.9	4.5	3.9	3.3	2.8
Fiscal deficit	7.4	6.0	5.5	5.0	4.5	4.0
Total liabilities	62.9	61.0	61.0	60.1	58.6	56.6

12.55 The debt to GDP ratio of the Union Government is projected to increase substantially in 2020-21 (Table 12.2) on account of two factors – the estimated contraction of nominal GDP by 6 per cent and the increase in the fiscal deficit to GDP ratio owing to a sharp contraction in revenues amidst heightened expenditure needs. As GDP growth and revenues pick up in subsequent years, relieving the pressure on fiscal deficit, the debt to GDP ratio of the Union gradually declines.

12.56 The numbers presented in Table 12.2 are based on our assessment of GDP growth and the revenue and expenditure path of the Union Government presented in Chapter 4. Considering the uncertainty in the economic outlook and revenue path of the Union Government for the next five years, Table 12.3 considers a range of possibilities for the fiscal deficit for the Union. The range of deficits presented in the table reflects the uncertainty about the impact of the pandemic on the economy, its implications for the revenues of the Union and the resource requirements for fighting the pandemic and for stimulating the economy. The upper and lower limits, 0.5 percentage point of GDP above and below the assessed terminal year deficit, lends flexibility to fiscal targeting of the Union, depending on the course of economic recovery. We have used the

middle range of fiscal deficit in Table 12.3 for the calculation of the liabilities of the Union Government presented in Table 12.2.

Table 12.3: Range of Union Government's Fiscal Deficit

(% of GDP)

	2021-22	2022-23	2023-24	2024-25	2025-26
In case economic recovery is slower than assessed	6.5	6.0	5.5	5.0	4.5
If our macro-economic assessment holds	6.0	5.5	5.0	4.5	4.0
In case economic recovery is faster than assessed	6.0	5.5	5.0	4.0	3.5

Path of Fiscal Consolidation for the State Governments

12.57 The capital expenditure of all States as a proportion of GDP was 2.6 per cent during the 2011-2019 period, while the revenue deficit was 0.1 per cent and fiscal deficit was 2.7 per cent. Based on our calculations of the revenue gap of States after taking into account the own revenue receipts and tax devolution, we have recommended a total revenue deficit grant of Rs. 2,94,514 crore for seventeen States from 2021-22 to 2025-26. In principle, once the estimated revenue deficit is taken care of with a matching provision for revenue deficit grant, the whole borrowing space under fiscal deficit is available for capital spending. It is from this perspective that we approached the issue of the net borrowing limit (gross borrowing minus repayment) of the State Governments.

12.58 **While fixing the borrowing limit for States in absolute amounts, one important issue is the size of GSDP in the year under consideration (year 't'), because the GSDP data certified by the National Statistical Office (NSO) is only available with a lag of at least two years**. To overcome this difficulty, the FC-XIV recommended a practical method: "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.".

12.59 This is a time-tested methodology which **we also recommend without any change, with the caveat that the NSO should provide estimates of GSDP to the Department of Expenditure for this purpose. In the interest of transparency, we recommend that the NSO may publish this information.**

12.60 The borrowing limit for the year 2020-21 has already been decided. The Government of India had indicated that the States' net borrowing ceiling for 2020-21 was fixed initially at Rs. 6.41 lakh crore, following the extant method for arriving at the GSDP and the borrowing limit. Responding to the demands by the States for an increase in the borrowing limit from 3 per cent in 2020-21 in view of the unusual fiscal pressures, the Government of India stepped up the borrowing limits of States from 3 per cent to 5 per cent for the year. Of the additional 2 per cent, 0.5 per cent was unconditional and the remaining 1.5 per cent was conditional. Out of the conditional component, 1 per cent of the GSDP is to be given in 4 tranches of 0.25 per cent, with each tranche linked to specified reform actions related to distribution of electricity, universalisation of the One Nation One Ration card scheme, ease of doing business and revenues of urban local bodies. The remaining 0.50 per cent is permissible if milestones are achieved in at least three out of the four reform areas. We assessed that as States are generally revenue-stressed in the current year, most of them may avail of the additional borrowing facility offered to them in varying degrees. Hence, we expect that the all-State fiscal deficit will be around 4.5 per cent of the aggregate GSDP.

12.61 Following the recommended methodology for GSDP projection mentioned earlier, the GSDP growth rate for the year 2021-22 will be determined by the observed GSDP growth rates in the years 2017-18, 2018-19 and 2019-20. It is more than likely that FRBM-mandated 3 per cent of GSDP (worked out using these growth rates for 2021-22) will be lower than the borrowing room of 5 per cent of GSDP available to the States in 2020-21. In order to avoid a sudden drop in the resource availability to the States, **we recommend that the normal net borrowing limit of State Governments for the year 2021-22 may be fixed at 4 per cent of GSDP**.

12.62 In line with the recommended methodology, the GSDP growth rate for the year 2022-23 will be determined by the observed GSDP growth rate in the years 2018-19, 2019-20 and 2020-21, assuming that the growth rate for 2020-21 becomes available at the stage of fixing the borrowing limit for that year. The contraction in 2020-21 will depress the average growth of the aforesaid three years with adverse impact on the net borrowing limits of States. The steeper the contraction for a State in 2020-21, the higher will be such impact on the borrowing limit. **Considering this, we recommend that the normal net borrowing limit of State Governments for the year 2022-23 may be fixed at 3.5 per cent of GSDP.**

12.63 The impact of the contraction in 2020-21 will continue to be present in the borrowing limits of the States for the years 2023-24 and 2024-25 also. However, this impact is likely to be counterbalanced by the sharp recovery in growth projected for 2021-22. Hence, **we recommend that the normal net borrowing limit to the State Governments for the three-year period of 2023-24 to 2025-26 may be fixed at 3 per cent of GSDP.**

12.64 **If a State is not able to fully utilise its sanctioned borrowing limit, as specified above, in any particular year during the first four years of our award period (2021-22 to 2024-25), it will have the option of availing this unutilised borrowing amount (calculated in rupees) in any of the subsequent years within our award period.**

12.65 Based on these assumptions, we have worked out the debt path for States, as presented in Table 12.4. Since all estimated revenue deficits are met by equivalent provision of revenue deficit grant, the revenue surpluses run by the States are reflected by the negative numbers on revenue deficit presented in the table. The State debt in aggregate tapers off gradually after 2022-23. This is similar to the pattern in the debt path of the Union shown in Table 12.2. The State-specific indicative debt paths are given in Annex 12.1.

Table 12.4: Indicative Deficit and Debt Path for State Governments

(% of GSDP)

	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Revenue deficit*	-0.1	-0.5	-0.8	-1.2	-1.7	-2.5
Fiscal deficit	4.5	4.0	3.5	3.0	3.0	3.0
Total liabilities	33.1	32.6	33.3	33.1	32.8	32.5

* negative values indicate surplus and positive values indicate deficit

Note: While arriving at the total liabilities of States for the year 2021-22, an aggregate fiscal deficit of 3.5 per cent of GSDP is taken because some States may not avail of the full unconditional net borrowing space of 4 per cent

Incentive-based Extra Borrowing Space for the States

12.66 The ToR of the Commission enjoins us to consider measurable performance-based incentives for States that have made progress in, among other things, eliminating losses of the power sector. In most of the States, the functioning of distribution companies (DISCOMs) has remained a source of strain on State finances, despite the initiatives in the past including UDAY.

12.67 As on 31 March 2019, the stock of borrowings of DISCOMs stood at 2.5 per cent of GDP. This is not reported as part of the State liabilities. However, State Governments are the sole owners of an overwhelming majority of the distribution utilities. Apart from the rising debt stock, the DISCOMs have also reported liabilities – both financial and non-financial -worth 1.9 per cent of GSDP and payables on account of purchase of power and fuel worth about 1.1 per cent of GSDP. This means that the debt profile of the States changes if we extend the definition of their debt to include DISCOMs debt also.

12.68 We had, in our Report for 2020-21, noted that we would consider recommending annual financial incentives in the power sector for top performing States. Out of the 2 per cent extra borrowing space offered by the Union Government to State Governments, 0.25 per cent was

linked to power reforms, on the lines of the parameters indicated by us in our Report for 2020-21. Considering the centrality of the financial strength of DISCOMs to the soundness of State finances, we have recommended an additional borrowing space of 0.5 per cent of GSDP for States, during the four-year period 2021-22 to 2024-25. This is a conditional borrowing space - the recommended modalities for availing this borrowing space is detailed in Chapter 10 relating to our recommendations on grants in aid.

12.69 The upper limit of fiscal deficit presented in Table 12.5 assumes that States will avail fully of the extra unconditional borrowing room recommended for them in 2021-22 and 2022-23 as well as the incentive-based extra borrowing space given for the power sector during 2021-22 to 2024-25. However, given the revealed preference of many States to borrow less than the available borrowing space, they may revert to their normal borrowing pattern below 3 per cent of their GSDP from 2021-22. In this scenario, the all-State average of fiscal deficit in 2021-22 and 2022-23 can also be around 3 per cent of GSDP. Table 12.5 gives a possible range of all-State deficit as percentage of GSDP from 2021-22 to 2025-26.

Table 12.5: Range of all-State Fiscal Deficit under the Recommended Space for Borrowing

(% of GSDP)

	2021-22	2022-23	2023-24	2024-25	2025-26
Upper limit- (If all States use the full borrowing space available)	4.5	4.0	3.5	3.5	3.0
Lower limit- (States, on an average, reach the current FRBM limit)	3.0	3.0	3.0	3.0	3.0

General Government Deficit and Debt

12.70 The general government deficit and debt profile, presented in Table 12.6, combines the calculations presented for the Union and the States separately in the previous tables and figures, with two differences. First, Table 12.6 presents the calculations for States as percentage of GDP while Table 12.1 and Table 12.4 presented them as percentage of all-State GSDP. Secondly, while combining the debt of the Union and the States to arrive at the consolidated debt, we have netted inter-governmental transactions to avoid double-counting.

Table 12.6: Indicative Deficit and Debt Path for the General Government

(% of GDP)

	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Revenue deficit-Union	5.9	4.9	4.5	3.9	3.3	2.8
Revenue deficit-States	-0.1	-0.4	-0.8	-1.1	-1.6	-2.4
Revenue deficit-combined	5.8	4.5	3.7	2.8	1.7	0.4
Fiscal deficit-Union	7.4	6.0	5.5	5.0	4.5	4.0
Fiscal deficit-States	4.2	3.3	3.3	2.8	2.8	2.8
Fiscal deficit-combined	11.6	9.3	8.8	7.8	7.3	6.8
Total liabilities-Union	62.9	61.0	61.0	60.1	58.6	56.6
Total liabilities-States	31.1	30.7	31.3	31.1	30.9	30.5
Netting (*)	4.2	3.4	2.7	2.1	1.7	1.4
Total liabilities-combined	89.8	88.3	89.6	89.1	87.8	85.7

(*) The items netted include the stock of Union Government loans to the States, the stock of NSSF securities and Treasury Bills held by the State Governments.

12.71 Reflecting the patterns in the Union and State debt relative to GDP, the combined debt also increases steeply in 2020-21 and then declines gradually. **The combined debt exhibits a smooth downward trajectory during the last three years, that is, 2023-24 to 2025-26.**

12.72 There are risks on the downside to the calculations on the debt path of the general government presented in Table 12.6. First, we made our calculations based on the middle range of fiscal deficit of the Union Government given in Table 12.3 and the numbers used for arriving at the total liabilities of the State Governments in Table 12.4. In the event that the Union or the States prefer to stimulate the economy with greater investment spending, or if the health and recovery needs of fighting the pandemic stay elevated beyond mid-2021, they may prefer to borrow close to the maximum limit available. Second, we have not considered possible demands on the budget of the Union on account of the recapitalisation of the financial system. This is because our discussions indicated that the requirements and choice among the different options of recapitalisation will depend on an assessment of the depth of the impact of the Covid-19 pandemic on the financial system. Third, to make our stand clear, we are not including or quantifying the debt implications of borrowing for managing the GST compensation for States. The fiscal deficit and debt path worked out by us from 2020-21 to 2025-26 excludes the borrowing that the States or the Union may do under any arrangement worked out between the Union and the States, consequent upon decisions in the GST Council. Finally, if GDP growth falters in the later part of our award period, there will be a threat to the sustainability of debt of the

general government in many ways. Hence, it is important that the additional fiscal space that we have recommended for the first part of our award period is utilised well to protect and improve productive capacity.

Off-budget and Contingent Liabilities and Fiscal Rules

12.73 We have noted that the off-budget financing of budgetary expenditures has proliferated in the last five years. The Union Government has started disclosing off-budget liabilities to the extent that such liabilities are repaid and serviced from the annual financial statement. There is still a significant amount of off-budget expenditure that is subject to subtle interpretations of the law and escape the calculations of deficit and debt. In the case of the many State Governments, despite efforts, we have not been able to arrive at tenable numbers of such liabilities. There is virtually no such disclosure in the budget documents and accounts of States.

12.74 Our position on off-budget liabilities, as stated elsewhere, is that these obligations need to be cleared in a time-bound manner, but the resources for doing so cannot be found from the regular inflow of tax and non-tax revenues. For this purpose, additional resources should be mobilised by the respective governments, including through monetisation of assets.

12.75 Detailed analysis revealed that there is a substantial portion of implicit contingent liabilities, outside the framework of standard guarantees that can eventually devolve heavily on the State Governments. We also found that the risk profile of these implicit liabilities is varied. The State-specific amounts are also very different relative to their budget size and GSDP. It is important to analyse the breadth of these liabilities. However, for the present, we recommend that governments at all tiers may observe strict discipline by resisting any further additions to the stock of off-budget transactions and contingent liabilities which is against the norms of fiscal transparency and detrimental to fiscal sustainability. **One very important purpose of our recommendation for higher borrowing limit to the Union and State Governments is to foster transparency and to avoid build-up of non-transparent liabilities.**

12.76 The amendments carried out in 2018 to the FRBM Act were based on the findings of the Report of the FRBM Review Committee of 2017. The slowdown of the economy thereafter, accentuated by the Covid-19 pandemic, has changed the configuration of real GDP growth, interest rates, interest-growth differential, net financial savings of the household sector, saving-investment balance and the need for external financing. **In view of the uncertainty that prevails at the stage that we have done our analysis, as well as the contemporary realities and challenges, we recognise that the FRBM Act needs a major restructuring and recommend that the time-table for defining and achieving debt sustainability may be examined by a High-powered Inter-governmental Group. This High-powered Group can craft the new FRBM framework and oversee its implementation. It is important that the Union and State Governments amend their FRBM Acts, based on the recommendations of the Group, so as to ensure that their legislations are consistent with the fiscal sustainability framework put in place.** This is why we have termed the debt path we have worked out as 'indicative', while addressing the ToR to recommend a fiscal consolidation roadmap for sound fiscal management.

Summary of Recommendations

12.77 The fundamental principles that we have kept in mind while arguing out our case for fiscal consolidation are the following:

(i) The macro-stabilisation function of prudently supporting the State budgets to help them overcome the current crisis rests with the Union Government. However, the responsibility of balancing the budgets of State Governments lies primarily with those Governments themselves.

(para 12.49)

(ii) The current strain on the revenues of the Union and State Governments calls for strict discipline in revenue expenditure, opening up space for higher allocations on health and other urgent expenditure needs while ensuring fiscal sustainability in the medium term.

(para 12.48)

(iii) It is important that all committed expenditures and developmental expenditures are met from the augmented borrowing space recommended for the Union and the State Governments, without resort to off-budget or any non-transparent means of financing for any expenditures.

(para 12.75)

(iv) The Union Budget 2020-21 shows that fifteen of the thirty umbrella CSS account for about 90 per cent of the total allocation under CSS. Many umbrella schemes have, within them, a number of small schemes, some of them with negligible allocations. A threshold amount of annual appropriation should be fixed below which the funding for a CSSs may be stopped. Below the stipulated threshold, the administrating department should justify the need for the continuation of the scheme. As the life cycle of ongoing schemes has been made co-terminus with the cycle of Finance Commissions, the third-party evaluation of all CSS should be completed within a stipulated timeframe. The flow of monitoring information should be regular and should include credible information on output and outcome indicators. The funding pattern of the CSSs should be fixed upfront in a transparent manner and should be kept stable.

(para 12.51)

(v) For the State Governments, we have recommended that the normal limit for net borrowing may be fixed at 4 per cent of GSDP in 2021-22, 3.5 per cent in 2022-23 and be maintained at 3 per cent of GSDP from 2023-24 to 2025-26 . The term 'normal' is used to clarify that we have not accounted for any additional borrowing to be done by the State Governments to manage the shortfall in GST compensation to them, or the incentive-based additional borrowing space that we have recommended for power sector reforms in Chapter 10.

(para 12.61 to para 12.63)

(vi) If a State is not able to fully utilise its sanctioned borrowing limit as specified above, in any particular year during the first four years of our award period (2021-22 to 2024-25), it will have the option of availing this unutilised borrowing amount (calculated in rupees) in any of the subsequent years within our award period.

(Para 12.64)

(vii) We recommend that for the purpose of assigning State-specific borrowing limits as a proportion of GSDP for a given fiscal year, the estimates of GSDP published by the NSO should be used according to the procedure detailed in paragraphs 12.58 and 12.59.

(viii) We have assessed that, given the compulsions on the revenue account of the Union Government, including of lending support to the budgets of sub-national governments, they may have to follow an elevated path of fiscal deficit with a terminal year (2025-26) target of 4 per cent of the GDP.

(para 12.54 and Table 12.2)

(ix) With the recommended path for the fiscal deficit of the Union and the State Governments, we have shown that the consolidated debt of the general government will have a downward trajectory during 2023-24 to 2025-26. The differentiated debt to GSDP path of the State Governments for 2021-26 is outlined at Annex 12.1.

(para 12.65, 12.70 to 12.72 and Table 12.6)

(x) In view of the uncertainty that prevails at the stage that we have done our analysis, as well as the contemporary realities and challenges, we recognise that the FRBM Act needs a major restructuring and recommend that the time-table for defining and achieving debt sustainability may be examined by a High-powered Inter-governmental Group. This High-powered Group can craft the new FRBM framework and oversee its implementation. It is important that the Union and State Governments amend their FRBM Acts, based on the recommendations of the Group, so as to ensure that their legislations are consistent with the fiscal sustainability framework put in place.

(para 12.76)

(xi) Disclosure of the financial positions of the States and their credit rating will help in broadening the investor base. Credit rating will also reinforce self-discipline on the fiscal front and lead to better pricing of SDLs. The States and the Union should define contingent liabilities transparently, estimate them and assess the risks associated with them.

(para 12.24)

(xii) State Governments may explore formation of independent public debt management cells which will chart their borrowing programme efficiently.

(para 12.19)

(xiii) States should have more avenues for short-term borrowings other than the WMA/OD facility provided by RBI, which has monetary policy implications. Such a facility may help States in meeting the temporary mismatches in their revenue flows at market-determined cost.

(para 12.26)

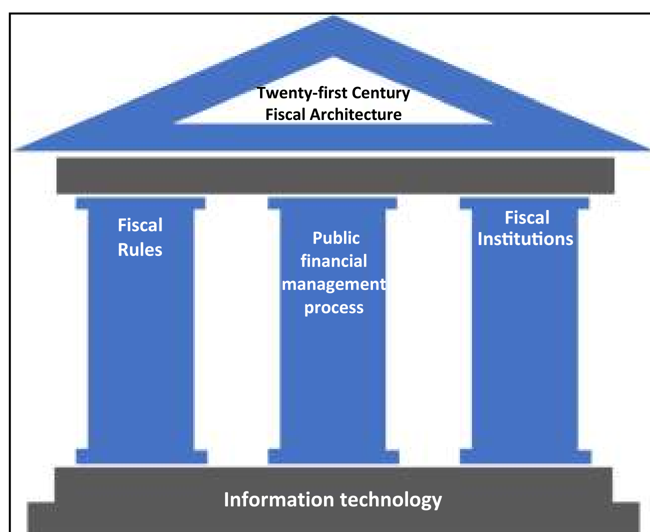
Chapter 13

Fiscal Architecture for Twenty-First Century India: Fiscal Rules, Financial Management and Institutions

This chapter defines the steps to bring India's fiscal architecture to twenty-first century international standards. The need for this has become even more imperative, given the strain on public finances as a result of the Covid-19 pandemic crisis.

We believe that if India wants to achieve its full potential for economic growth and development over the medium term, it has to improve the quality and efficiency of public spending and financial management across all levels of government.

India's twenty-first century fiscal architecture should be built on three mutually-reinforcing pillars:



- *fiscal rules across all levels of government which set the institutional and budgetary framework for fiscal sustainability;*
- *a public financial management system which provides complete, consistent, reliable and timely reporting of the fiscal indicators that are part of the first pillar; and*
- *an independent assessment mechanism so as to provide assurance and advice on the working of the other two pillars.*
- *This chapter, accordingly, recommends that all levels of government move steadily in this direction, with a mix of institutional reforms and the use of modern technology.*

13.1 Para 5 of the terms of reference (ToR) specifically mandates us to address issues related to the future fiscal architecture for India. As discussed in earlier chapters, these issues arise in the context of recommending a fiscal consolidation roadmap for sound fiscal management, guided by the principles of equity, efficiency and transparency. We have also been asked to assess the need

to improve the quality of public spending and to promote savings by adopting the public financial management system (ToR 7 (iii), (iv) and (v)). The ToR also include the option to propose measurable performance-based incentives for achieving these savings at the appropriate levels of government.[1]

13.2 Raising the quality and efficiency of public spending is a critical challenge for India, given overall resource constraints. The strain on public finances from the Covid-19 crisis, especially the need for reprioritising expenditures and financing the health and infrastructure response, accentuates the importance of ensuring that public financial management policies, processes and systems adopt best practices. There is considerable evidence of the high costs of inefficiencies in fiscal management, especially for key health and education outcomes. Studies highlight that with improved efficiency, States could, on average, raise their output indicators by 30 per cent with the same level of inputs.[2] There is also clear correlation with higher capacity and better governance stemming from improved public financial management practices. Thus, the quality of public financial management[3] has direct implications for the delivery of public services and sustaining economic growth.

13.3 International experience confirms that a public financial management system with strong budget institutions are critical to the delivery of effective fiscal outcomes and the overall path to fiscal consolidation.[4] Thus, improving public financial management would raise intended programme outcomes and the quality of service delivery, release public and private resources for productive sectors and catalyse sustainable growth. In particular, reprioritising public expenditure during the current Covid crisis becomes essential as government resources are constrained. At the same time, international experience also confirms that financial crises have frequently been triggered by the realisation of risks stemming from ineffective surveillance at all levels of government, especially from sub-national governments and extra budgetary borrowing of the 'public sector'.

13.4 These factors have special implications for all levels of the government. Many of the key economic, social and environmental challenges are in the purview of the States and local governments. The costs of inefficiencies in fiscal and financial management are becoming more important as the volume of untied resources available to the States have risen and these have highlighted the need for intensifying public financial management reforms to raise the quality of development expenditure and overall public investment management. With States accounting for roughly half of India's general government fiscal deficit, the strength of States' fiscal rules legislations and their consistency with the amended Fiscal Responsibility and Budget

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[1] These may include: conditional transfers, requiring States to adopt specific public financial management practices and standards and performance as a prerequisite for specific transfers; and capacity-building grants to assist states acquire the skills and technical assistance needed to implement specific reforms.

[2] Mohanty, Ranjan Kumar & Bhanumurthy, N.R., 2018. "Assessing Public Expenditure Efficiency at Indian States," Working Papers 18/225, National Institute of Public Finance and Policy. https://www.nipfp.org.in/media/medialibrary/2018/03/WP_2018_225.pdf

[3] public financial management refers to the set of laws, rules, systems and processes used to mobilise revenue, and allocate and account for the use of public funds, and has four main objectives – fiscal discipline, allocative efficiency, operational efficiency and accountability.

[4] Schwartz, Gerd, Manal Fouad, Torben Hansen, and Geneviève Verdier, eds. September 2020. Well Spent: How Strong Infrastructure Governance Can End Waste in Public Investment. Washington, DC: International Monetary Fund.

Management (FRBM) Act, 2003 of the Union Government are also important to ensure the sustainability of public finances and macro-economic stability.

13.5 This will mean strengthening budgetary institutions at all levels of government to better anchor the framework for inter-governmental reform, meet policy priorities as efficiently as possible and deliver better development outcomes. Building India's fiscal architecture towards these ends is central to the future of India's fiscal federalism.

13.6 This chapter is organised as follows. In the context of best international practice and experience, it first reviews the implementation of India's fiscal rules and the adequacy of the supporting institutional framework for its effective implementation as well as the implications for the States. Within the institutional framework, it then looks at the links between these fiscal rules and public financial management, on the one hand, and the need for an independent institution to monitor compliance and assess underlying macroeconomic and budgetary forecasts, on the other. In short, having a fiscal rule raises the bar on the needed strength of the underlying public financial management processes and institutions. Finally, the chapter recommends the institutional way forward to gain consensus for and implement the three pillars that constitute the best practice fiscal architecture for Twenty-First Century India.

Fiscal Rules

International Experience

13.7 Many G-20 countries have set fiscal rules, including at sub-national levels, with the objective of strengthening budget institutions and management practices as well as their accountability. These rules have evolved over time, trying to balance credibility with flexibility. Overall, well designed and well implemented fiscal rules have helped contain a deficit bias, strengthen market credibility of the commitment to fiscal sustainability and allowed counter-cyclical fiscal management. By increasing the predictability of fiscal policy, they have helped lower output volatility and raise sustainable growth.

13.8 However, the challenge with fiscal rules is at least two-fold. One, to ensure that the rules are well designed. Two, to ensure that the public financial management systems and institutions allow the rules to be well monitored and implemented. Unless both challenges can be met, fiscal rules can quickly lose their relevance and credibility.

13.9 With respect to the first challenge on the design of fiscal rules, a broader "second generation fiscal framework" has become apparent in the past decade following the global financial crisis of 2008 and is characterised by greater flexibility and enforcement mechanisms:

i. Countries are now increasingly adopting more than one fiscal rule to better balance credibility (the need to create a fiscal anchor) with flexibility (the need to respond to economic shocks). One challenge with having multiple rules, however, is that they can sometimes be internally inconsistent and complex to monitor, verify and communicate.

ii. Hence, the second-generation fiscal rules typically rely on `escape clauses' or

equivalent mechanisms (using structural deficits) to create flexibility. These were generally incorporated after the global financial crisis (prior to which many existing fiscal rules did not have escape clauses), along with enhancements of specific monitoring, enforcement, communication, and transparency mechanisms. In most cases, countries are already using the flexibility in their fiscal rules to deviate or suspend the rules in response to the Covid pandemic. For example, the European Union activated the general escape clause to suspend the adjustment that member states have to do to meet their fiscal targets.

iii. Countries also often adopt "automatic correction mechanisms" which specify in advance how deviations from the rule will be handled. This is now a requirement for European Union countries that have signed the "Fiscal Compact." Other escape clauses impose limits on how long fiscal policy can deviate from the targets in the rule, including specifying the nature of the plan to return to the rule, with publication of the supporting medium-term fiscal strategy.

13.10 With respect to the second challenge on monitoring, countries with successful fiscal rules have also implemented overarching public financial management laws to ensure that these systems were sufficiently developed to support the fiscal rules. International evidence is clear that countries with weak public financial management systems and weak budget procedures were unable to monitor and effectively control fiscal targets and rules.

India's Fiscal Rule: Challenges in Implementation

13.11 Compared with other emerging market countries, India was relatively early in its adoption of fiscal rules through the enactment of the FRBM Act in 2003, mirrored by the successive adoption of fiscal responsibility legislation by all the States[5]. Since then, through a number of amendments, the Union has updated the FRBM Act, adopted multiple fiscal indicators as target indicators, added direct rules on the Union and the General Government debt ceilings, clarified the escape clauses, made the Medium Term Expenditure Framework (MTEF) statement mandatory for the Union, and tried to bring India into the second generation of fiscal rules (changes to the FRBM Act in 2018 are contained in Box 13.1).

13.12 However, challenges in implementing these fiscal rules remain, as the underlying public financial management system meets only a fraction of best practice standards. The majority of the practices affecting budget formulation, execution and reporting are still without sufficient legislative strength; they are, instead, governed by a multiplicity of constitutional provisions, executive rules, orders and manuals. These have been replicated at the State level, but without consistency in framework and practices across levels of government, resulting in marked differences in the extent to which the Union and the States have progressed (Annex 13.1).

[5] Only Karnataka's Fiscal Responsibility Act of 2002 predates the FRBM Act, 2003 of the Union Government

Box 13.1: Recent Amendments to FRBM Act, 2003

The major amendments made through the Finance Act 2018 in the FRBM Act are;

- Government debt became the primary anchor, with the fiscal deficit as the key operational target. The fiscal deficit was to be reduced to 3 per cent of gross domestic product (GDP) by the end of financial year 2020-21.
- Achieving the General Government debt target of 60 per cent of GDP and Central Government debt target of 40 per cent by the end of financial year 2024-25.
- The scope of 'Central Government Debt' has been expanded to include the total outstanding liabilities on the security of the Consolidated Fund of India and Public Accounts plus financial liabilities of any body, corporate, or other entity owned or controlled by the Central Government, which the Government is to repay or service from the Annual Financial Statement.
- Widening of grounds (escape clauses) on which the Union Government is allowed to breach the deficit targets, including national security, act of war, national calamity, collapse of agriculture, structural reforms and decline in real output growth. However, any deviation from the fiscal deficit target shall not exceed one-half per cent of GDP.
- In case of an increase in real output growth of a quarter by at least 3 percentage points above its average of the previous four quarters, reduce the fiscal deficit by at least one-quarter per cent of GDP in a year.

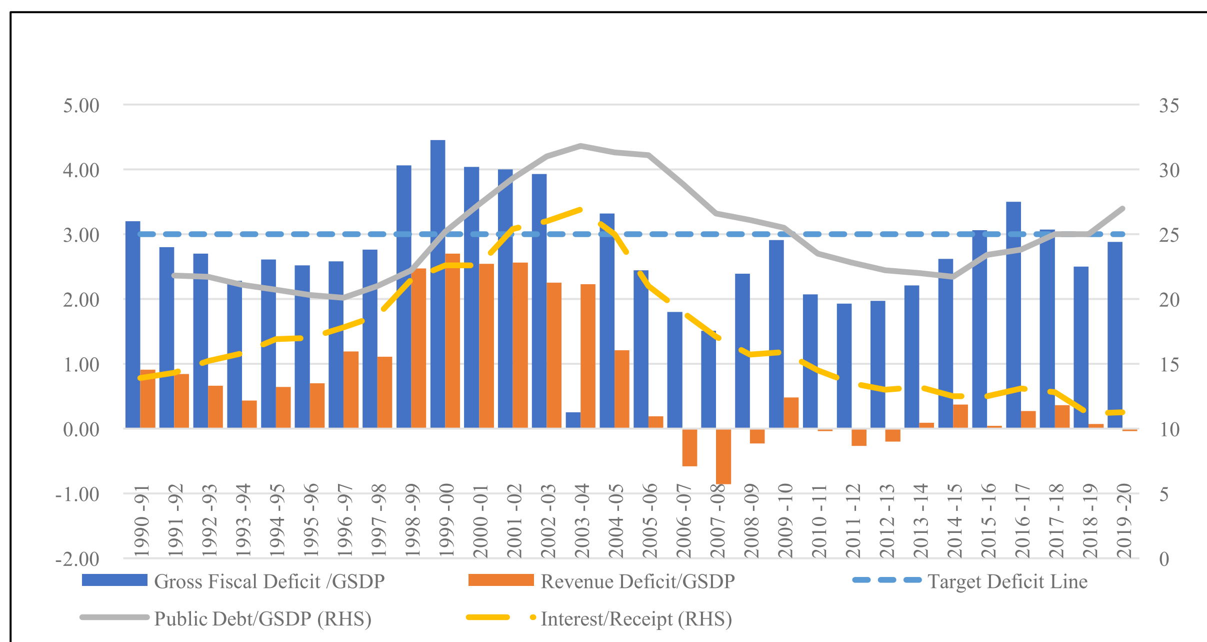
13.13 As a result, there are significant inconsistencies and gaps in the public financial management framework that affect the consistency, comprehensiveness and reliability of fiscal statistics across all levels of government.[6] In addition, the fiscal deficit defined in the revised FRBM Act (as the balance of operations incurring into the Consolidated Fund of India) falls short of the new debt ceiling that covers a broader definition of accounts and implementing agencies that deliver public services on behalf of the government. In practice, this has led to the fiscal rules being effectively circumvented, in particular by the use of public sector entities for off-budget fiscal operations, inconsistent budget classification and accounting practices (and the misclassification of revenues and expenditures) and the use of the public accounts for budgetary purposes.

13.14 The absence of an independent fiscal institution to assess and evaluate the fiscal plan as well as performance and forecasts published by governments (as is now the reality in many advanced and emerging market countries) has also further diminished the capacity to monitor compliance. Thus, target dates have been periodically shifted, escape clauses have been modified and compliance to the FRBM Act continues to reflect the discretion of the government. Most

[6] A summary review of such gaps in the existing public financial management system is given in Annex 13.2, with greater differences across the States that still needs to be fully assessed.

States have not legislated their outstanding debt targets and their MTEFs have not been developed consistently to reflect their strategic budgeting and planning. As a result, after early improvement in fiscal consolidation following the enactment of fiscal rules, the deficits of many States have recently been on a rising trajectory (Figure 13.1).

Figure 13.1: Indian States' Aggregate Fiscal Positions (in per cent)



Source: Finance Accounts of States and RBI Database.

Note: 2019-20 is budget estimates

13.15 Recent reports of the Comptroller and Auditor General (CAG) on the Union Government's compliance with the FRBM Act list many of the mismatches between the Act's provisions and reported outcomes. These involve the use of one-off measures to enable compliance, such as deferring payments, raising off-budget financing[7], and the transfer of funds from the Consolidated Fund to the Public Accounts in case of some states which risk distorting the assessment of fiscal activity. Similar observations have also been made in the CAG's reports on State Finances published every year for all the States.

13.16 More fundamentally, the challenge remains of strengthening budget institutions as a whole, and the underlying public finance and accountability architecture. This involves updating the coverage and availability of critical fiscal data across levels of government to be commensurate with the FRBM rules. As we discuss later in this Chapter, this is essential also to build market discipline which will supplement the role of fiscal rules in strengthening fiscal discipline.

[7] Report of the Comptroller and Auditor General of India on Compliance of the Fiscal Responsibility and Budget Management Act, 2003 for the year 2016-17, Report No. 20 of 2018. In the absence of a legislation or accounting standards, material circumvention in financial reporting does not influence the audit opinion of the CAG on the finance accounts.

13.17 Principal among the challenges is that India does not compile or monitor consistent general government fiscal aggregates on a timely basis.[8] Against this, the number of countries providing general government data has nearly doubled in past decade.[9] This reflects the reality that India's fiscal reporting systems at the Union and the State levels are not aligned with international practice, despite the last four Finance Commissions making specific recommendations on the implementation of public financial management reforms (Annex 13.3).

13.18 From the recommendations of previous Finance Commissions, three themes stand out: (a) strengthening the budgetary process and the performance orientation of budgets; (b) moving towards the adoption of accrual accounting; and (c) standardising and consolidating key fiscal and financial information across Union and State Governments and local bodies, including all "other liabilities" such as from off-budget borrowing and accumulated losses from State-owned enterprises. This last point is particularly important given the difficulties in assembling a comprehensive, coherent set of fiscal data for the States and the third tier of government that allows for in-depth analysis of policy options.

13.19 To address this issue, a central lesson from international experience is to define the public financial management framework for India and its constituents, strengthen budgetary institutions at key stages of the fiscal process, prescribe the accounting standards and precise definitions for target fiscal indicators and ensure consistency of the fiscal rules across all levels of government. The lack of progress in these areas continues to distort the alignment of the budget and expenditures with government policy priorities, hinders effective expenditure control, raises the public costs of inefficiency on fiscal management and creates opportunities for creative accounting and biased forecasts.

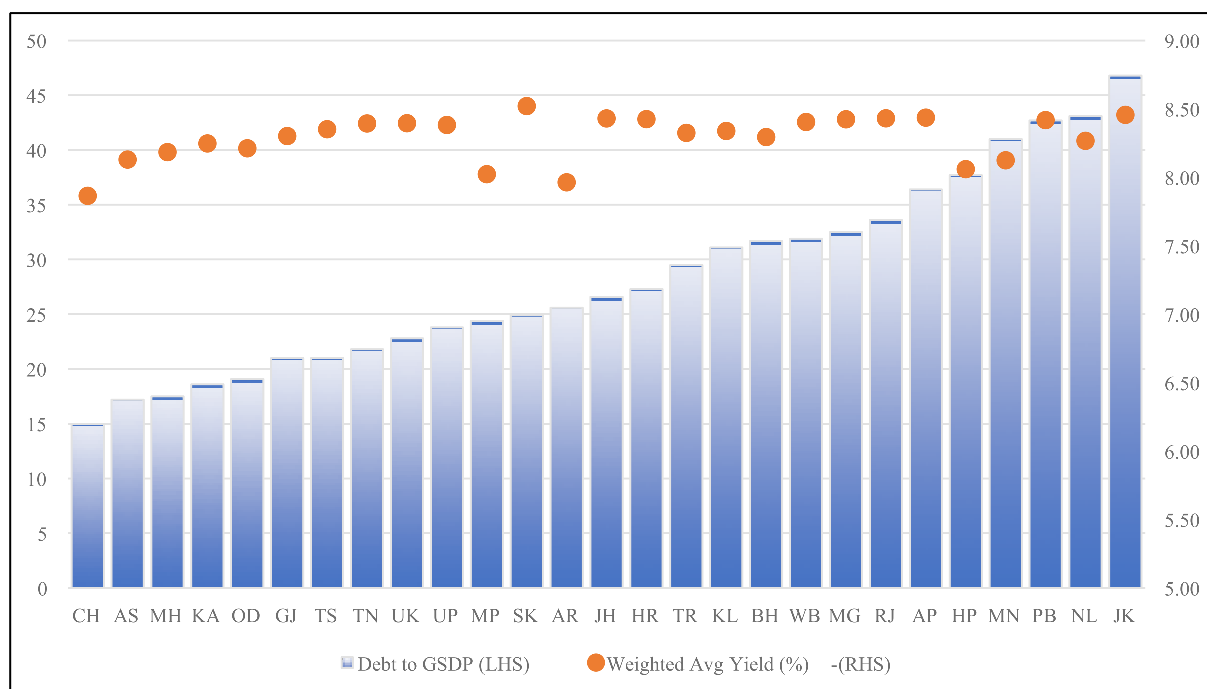
13.20 Looking ahead, public financial management reforms at the sub-national level should be consistent with reforms at the Union Government level, in terms of a clear framework, ensuring consistent and well defined targets and accounting standards, timely, comprehensive and reliable reporting of sub-national fiscal operations and strengthening automatic deviation correction mechanisms and sanctions for non-compliance. In particular, the sub-national reforms should seek to define sub-national debt targets that are consistent with general government debt reduction targets. These objectives will also require consistent updates to individual State fiscal responsibility legislations.

13.21 This approach not only seeks to ensure the internal consistency of the rules at the Union and the States levels, but also provide more incentives to strengthen sub-national revenue collection, make borrowing a function of repayment capacity and better capture differences in the States' financial conditions. This is a critical issue given the growing need to build market financing for the States and the third tier, especially the municipalities.

[8] The CAG does prepare a combined revenue and finance account (CFRA) for the Union and the States, but it is not in accessible format and it is published after a considerable time lag.

[9] A good example of high frequency and detailed sub-national government data is Brazil, where fiscal data on deficits and debt are available at quarterly intervals and disaggregated below the sub-national government level.

Figure 13.2: Challenges of Market Discipline in the States (2018-19)



Source: Reserve Bank of India

13.22 As of now, despite periodic efforts by the Reserve Bank of India (RBI) to increase the transparency of States' market borrowing, there is virtually no correlation between the States' fiscal metrics and its borrowing costs (Figure 13.2). This is because of expectations of implicit sovereign guarantees which result in moral hazard, despite the Union having stopped intermediating in the raising of borrowings by States. Building sustainable market finances for the States and local governments clearly requires reliable and consistent information on their finances on a timely basis, as discussed below. International evidence demonstrates that the strength of fiscal institutions, as discussed later in this chapter, helps improve credit rating and reduce credit costs.

Public Financial Management Reforms

13.23 The challenges faced in implementing India's fiscal rule are testimony to the lack of a public financial management system that mirrors and supports India's fiscal responsibility legislations and allows the debt consolidation roadmap to be met with equity, efficiency and transparency (as specified in para 5 of our ToR). Over the decades, India has tried to adapt international best practices toward this end and has successively committed to meeting related international standards in the public financial management system, but comprehensive coverage remains distant, as significant gaps continue to exist.

13.24 Among the weakest links in fiscal management is linking the fiscal rule (and overall fiscal strategy) to budget process and implementation within and across different tiers of government - mainly, how well the MTEF is integrated with the bottom-up costing of programs and budgets prepared by the line departments in the Union Government and the States.

13.25 Consistent with international experience, this section details four overarching objectives of public financial management and goes on to recommend the reforms necessary to bring the system to international standards, while improving the quality of spending and promoting public savings (Figure 13.3):

Figure 13.3: Objectives of Public Financial Management System

i. **Aggregate fiscal discipline:** budget formulation and execution in accordance with the defined fiscal policy objectives and consistent with fiscal rules.

ii. **Strategic budgeting and planning:** the ability to implement policy priorities through the strategic allocation of resources.

iii. **Operational efficiency:** delivering intended policy outcomes in an efficient manner through a robust system of budget execution.

iv. **Accountability and transparency:** important cross-cutting dimensions to ensure comprehensive, accurate and timely fiscal information is available, and oversight institutions (both internal and external) and mechanisms are in place for public consultation and engagement.

Aggregate Fiscal Discipline

Fiscal Coverage and Reporting

13.26 Building on the definition of 'Central Government Debt' in the amended FRBM Act, the Union and State accounts should include debts of all government entities and agencies/corporations that deliver public services on behalf of the Union or State Governments, including all autonomous bodies, parastatals, and extra-budgetary funds at the Union and State levels. This is critical, given the recognised need to ensure that all such bodies without independent revenue streams are part of government fiscal operations and of fiscal reporting of

deficit and debt.

13.27 **Appropriate amendments may, therefore, also be taken up by the States in their respective fiscal responsibility legislations to ensure consistency with the amended Union Government FRBM Act and, in particular, with the definition of debt.**

13.28 In this context, while the Union and many of the States have enacted laws regulating the issue of explicit guarantees and their inclusion in debt reporting, a complete reporting mechanism of explicit and implicit guarantees (due to government being the majority shareholder) is not yet in place. **Hence, the Government Accounting Standards and Advisory Board (GASAB), building on its continuing work, is best placed to develop accounting standards for financial reporting and disclosures of broader 'public debt', which can form the basis for a reporting framework for contingent liabilities, along with standard norms for recognising the risk of such liabilities arising for the Union and the States after following due process.**

13.29 Such consistency will allow the Union Government to take necessary measures to extend fiscal coverage and reporting to cover the consolidated general government accounts and, separately, also, to the public sector borrowing requirement.[10]

13.30 These reforms, supported by a modernisation of the budget and account code classification (chart of accounts)[11], would also allow Governments to move towards adopting the internationally acceptable Government Finance Statistics Framework, consistent with the international commitments made.

Macroeconomic and Fiscal Forecasting

13.31 Union and State Governments should regularly publish, along with the underlying assumptions and methodology, medium-term macroeconomic and fiscal forecasts and link the fiscal targets to the forward macroeconomic projections. Fiscal forecasts should systematically identify the impact of all new revenue and expenditure policies – with a consolidated view of fiscal policy initiatives across ministries and levels of government. This framework should be integrated with each Finance Commission report to provide rolling multi-year expenditure limits.

13.32 The Union and the State Governments should strive to improve the accuracy and consistency of such macroeconomic and fiscal forecasting by using the latest techniques and developing the technical capacities of personnel involved in the forecasting and budgeting process.

[10] Public sector borrowing requirement refers to the total net borrowings of the general government and public sector enterprises owned or controlled by Union and State Governments. It includes the borrowing of the public sector to arrive at the borrowing space left for the private sector to borrow.

[11] For example, one such set of recommendations are in the report of the Committee Constituted to Review the List of Major and Minor Heads of Accounts (LMMHA) of Union and States headed by C. R. Sundaramurti

Strategic Budget and Planning

13.33 The Union and many of the States present the medium-term policy statements (medium term fiscal policy or MTFP and MTEF) as part of the budget, as prescribed in their respective fiscal responsibility legislations. The Union and some State Governments also produce outcome budget documents. However, underlying budgetary processes to plan for the medium-term and measure budget performance have not been reformed or changed. Hence, there is a misalignment between the annual budget exercise, medium-term planning and outcome budgets. Thus, it is essential to adopt performance-based budgeting practices. For example, capital investment projects are generally spread over many years. However, in the annual budgetary exercise, expenditure is appropriated only for the year, with many projects being left incomplete or delayed due to the non-allocation or inadequate allocation of funds in subsequent years. Meanwhile, new capital commitments are taken up, disregarding the adequacy of fiscal space to accommodate new projects. Such an approach towards project and programme investments is highly inefficient, as often the benefits of the investment cannot be realised even after capital spending has taken place.

13.34 To correct the misalignment in strategic budgeting, a medium-term budget and debt framework should be published, building on the reliable and rolling three-year MTEF and the annual MTFP statement. The frameworks should confirm that the projected tax provisions and expenditure programmes enable the fiscal targets to be met in a sustainable manner, without special one-off measures in annual budgets to meet the gap.

Performance Orientation of Budgets

13.35 Integrate performance information (defining outcomes and output indicators and targets) for high priority programmes in the budget documentation of the Union and States for decision-making and the legislative process. This will strengthen transparency and accountability in budget presentation, approval and execution.

13.36 Moving towards performance or programme-based budgets will require changes in the present budget and account code classification (chart of accounts). This should result in consistent programme and economic classification, which can also be adaptable to include future changes in programmes or schemes.[12] This will help integrate programme spending with intended outcomes and shift the focus of legislature oversight to the outcomes of the programmes. The Union Government has already announced its intention to synchronise Centrally sponsored schemes (CSS) with the Finance Commission cycle. Similarly, States may also like to synchronise their own schemes and programmes with their resource allocation cycles. In **addition, periodic evaluations and mid-term spending reviews could be built in for high**

[12] Many committees in the past have recommended changes in the Chart of Accounts (LMMH). Those may be looked into and appropriately implemented.

priority programmes by the Union ministries and State Governments in collaboration with the Ministry of Finance.

Operational Efficiency

13.37 Improved transparency of assumptions and outside scrutiny will build the accuracy of revenue forecasting and avoid revenue outturns significantly different from budget projections. This will limit the number and purpose of supplementary budgets with explicit accounting and financial reporting requirements for special purpose and extra budgetary financing vehicles. Both factors would increase budget credibility and lift the generally weak Public Expenditure and Financial Accountability (PEFA) ratings of many States.[13]

13.38 Though the Treasury Single Account (TSA) has been implemented at both the Union and the State levels, many States continue to borrow even while holding large cash balances in bank accounts held by government-controlled entities. **Therefore, we recommend to strengthen cash management practices for each State and the Union Government through the more comprehensive Treasury Single Account (TSA) mechanism. This will allow a more effective management of cash, including of government entities and agencies, and special purpose vehicles that are financing government activity.**

Transparency and Accountability

13.39 Fiscal transparency not only contributes to sound economic management and effective policy formulation, but it also helps in strengthening budgetary practices and improving accountability. Transparency is the key ingredient for leveraging the full potential of a sound public financial management system.

Availability of Public Information

13.40 **All the data and information related to Union and State fiscal operations, such as pre-budget and related policy statements, and mid-year reviews, should be made available to the public in a reliable, timely and comparable manner.** This would allow wider understanding and appreciation of the Union and State budgetary process. Technology can be used to create a single and transparent portal with all such information available as per the National Data Sharing and Accessibility Policy (NDSAP) of the Government of India.

13.41 **There is also room to improve the timeliness of audited financial reports of governments, ensuring they are prepared within six months of the year-end and audited**

[13] PEFA is a methodology for assessing public financial management performance. It identifies ninety-four characteristics (dimensions) across thirty-one key components of public financial management (indicators) in seven broad areas of activity (pillars). For details on methodology refer to PEFA Framework for assessing public financial management (PEFA Secretariat 2016). The RBI has recently assessed States' performance on select PEFA indicators and noted that twenty-three States had a rating below B, i.e. C or D on the indicator of aggregate expenditure and revenue out-turns, pointing to the need to establish baselines for States' performance and monitoring and possibly incentivising improvement using the PEFA framework for assessment.

within nine months, with specific responsibilities for maintaining such timelines assigned at each stage of preparation of audited financial statements.

13.42 The CAG which is mandated to carry out the role of accounts compilation and finalisation for almost all the States, as well as being the auditor of both the Union and the States, is already in the process of establishing common fiscal data standards. This would eventually ensure availability of standardised data through a public web portal for granular level fiscal statistics of the Union and the States, both for historic audited fiscal data, as well as high frequency fiscal data for the current year in downloadable database formats.

Fiscal Accounting

13.43 Consistent with international practice, and the recommendations of successive Finance Commissions, **we recommend that a time-bound plan should be prepared for the phased adoption of standard-based accounting and financial reporting for the Union and the States, while the eventual adoption of accrual-based accounting is being considered.**

13.44 One of the primary concerns of the Commission is maximising reliability, accessibility, consistency and timeliness of the financial reporting across all levels of government. Use of information technology can provide a solution to this problem. Many States have developed Integrated Financial Management Systems (IFMS)[14] for managing financial operations in a very efficient and secure way. However, there are issues of the comprehensiveness and coverage of such systems as well as the ability to talk to other systems. **We urge the Union and States to prepare IT protocols and a comprehensive plan to allow for data sharing and aggregation across all levels of government at the earliest.**

Comprehensive Public Financial Management: The Way Forward

13.45 Moving in this direction will not be easy. India has tried, over time, to take individual and incremental reforms to successive parts of the public financial management system. These have generally been stand-alone in nature, focusing on particular (and dispersed) dimensions of public financial management that have been difficult to integrate and sustain. There is, therefore, a need to evolve and agree on a comprehensive public financial management reform strategy for both the Union and the States, recognising the need for policy, regulatory and institutional reforms and leveraging technology to drive these reforms. Within this comprehensive strategy, there is still room to move ahead incrementally in a sequenced manner, provided the reform initiatives are carefully integrated and coordinated across all levels of government. International experience

[14] IFMS is an IT-based solution which provides platform for public financial management processes including budget formulation, execution (e.g. budgetary control, cash management, treasury operations), accounting, auditing, reporting; and integrates them with other functionalities like e-procurement, payroll or human resources management, debt management etc. IFMS is used as a generic name for any system which is defined as above. However, IFMS must be distinguished from Management Information System (MIS).

[15] Most large emerging market (South Africa, Brazil, and Indonesia), and advanced countries (Australia, Canada, the UK, and OECD countries) have established public financial management Legislations.

points to the rising number of large emerging and advanced countries with modern and comprehensive public financial management laws[15], that set out the quality and standards for the entire public financial management cycle, and confirm the need for overarching reform of India's public financial management system to align it with its peers.

13.46 It is well-recognised that a strong public financial management system is an essential aspect of the institutional framework for effective public service delivery – both are closely associated with poverty reduction and economic growth. Countries with strong and accountable public financial management systems tend to deliver services more efficiently, effectively and equitably, and regulate markets more efficiently and fairly. In this sense, good public financial management is a necessary building block for most development outcomes.

13.47 The Constitution of India provides a public financial management framework at a fairly high level.[16] This is supported by various statutes, subordinate legislations, guidelines, manuals, government orders and so on instituted at different points in time, with some of them going back to the pre-independence period. While many reforms have been initiated, they have been largely standalone, and primarily driven by the use of information technology such as direct benefit transfer (DBT) and Financial Management Information System. Thus, the underlying public financial management structure is piecemeal, has not yet seen significant reforms and does not have a comprehensive legislative framework backing it.

13.48 More recently, Covid-19 has inflicted incalculable social, economic and structural damage globally and has brought to surface the fault lines in the fiscal and public financial management architecture of many countries. This crisis has also highlighted the need for expenditure prioritisation and more efficient resource allocation.

13.49 In this context, the need for public financial management reforms in India arises from three very compelling arguments:

i. To bridge the gap between the high-level public financial management framework in the Constitution and the detailed guidelines, rules, regulations and manuals and, thereby, codify the principles and processes, while providing them statutory strength.

ii. To enable a review and rationalisation of the existing rules and regulations, some of which date back to the pre-independence era and make them internally consistent between the Union and the States.

iii. To build a more resilient public finance framework with capacity to better manage and mitigate future shocks.

[16] The main articles dealing with this are Articles 112 to 117, and 202 to 207 that provide 'Procedure in Financial Matters'.

Box 13.2: Key Elements of Public Finance Management Reforms in India

Both for the Union and the States, the critical gaps and reform priorities in the public financial management framework include:

- Strengthening the fiscal responsibility framework and ensuring that the FRBM Act is fully supported by the institutional framework for public financial management at different levels of government.
- Building fiscal reporting by aligning the public investment programmes of the Union and the States, wherever applicable, through a medium-term prioritisation of programmes and projects, within a medium-term expenditure framework.
- Ensuring the fiscal strategy and fiscal risk exercises, that are already part of the FRBM Act, are closely aligned with the annual budget exercises of the Union and the States.
- Ensuring uniformity in the definition of fiscal indicators and the standard reporting framework of the Union and States.
- Building outcome budgeting by linking the budget with performance in terms of outputs and outcomes, by modernising and enabling the underlying budget structures and processes.
- Key enabling elements towards outcome-based budgeting include: (a) adoption of an outcome-oriented stance to budgeting by reforming the budget classification and chart of accounts; (b) according legislative appropriation at the programme level instead of 'object head'; (c) allowing freedom to the executive to move funds within pre-defined rules; and (d) introducing a practice of 'carry over' for flexibility to pay for expenditure incurred till the last day of the financial year during a pre-defined window in the next financial year.
- Enhanced and standard based financial reporting: The essence of reforms in financial reporting are (a) to bring government accounting in line with internationally accepted accounting and reporting standards by standard setting by an independent accounting standards body and providing for progressive implementation, including the transition from cash to accrual based accounting; (b) strengthening executive ownership over the maintenance of accounts; and (c) setting clear timelines for production of accounts, completion of audit and tabling before the Legislature.
- Bringing appropriate legislative oversight on these and related public financial management functions based on consensus among all stakeholders
- Such a public financial management framework in India would bring clarity to the roles and responsibilities of various functionaries and entities, fill the gaps in accountability, enhance the oversight by the legislature and civil society and strengthen the areas of fiscal responsibility, budget management, and financial management, including accounting and reporting. Such an overarching framework, with legislative strength, would improve accountability and transparency and, thereby, improve governance.
- These elements would "*address issues related to the future fiscal architecture for the country guided by the principles of equity, efficiency and transparency*".

13.50 **Therefore, we recommend a comprehensive framework with essential elements of public financial management for consideration and deliberation by all the stakeholders (Box 13.2). This framework needs to be developed further in consultation with the States and other relevant stakeholders, and the nature of its implementation agreed upon. We believe that such a public financial management framework, if implemented, would bring India's second pillar of its fiscal architecture to global best practices in the twenty-first century. One such overarching legal framework, prepared by independent domain experts, is placed on our website for future reference.**

Fiscal Institutions

13.51 Our review of international experience suggests that there is also high correlation between establishing fiscal rules and setting up independent fiscal councils, the number of which has tripled since 2005. The evidence confirms that they have complemented each other in assessing and monitoring fiscal policy, ensuring the effective implementation of fiscal rules and strengthening fiscal performance. In particular, evidence points out that adequate external and independent scrutiny makes for better compliance with fiscal rules through their influence on the accuracy of budget forecasts. In many countries, fiscal councils are also helping meet the growing need for better coordination between the centre and the states, and the consistency of the fiscal targets across levels of government. Overall, fiscal councils constitute the third pillar of fiscal architecture.

13.52 While there is variation in the institutional models of fiscal councils internationally, there is broad agreement on critical factors to ensure their good functioning. Among these factors, effective independence and non-partisanship are perceived as being essential to the success of fiscal councils, underpinned by a clear legal framework that ensures they have a statutory footing, with provisions relating to leadership, resources, mandate and functions, publications and access to information. Regarding their independence, a clear model is that of the stand-alone United States Congressional Budget Office (CBO, which has legal separation from the executive and parliament, whereas the United Kingdom's Office for Budget Responsibility (OBR) has a dual line of responsibility to the executive and the parliament, although it is a legally separate entity with its own oversight board. About a third of today's fiscal councils are independent bodies based in parliament, with a stronger focus on assisting parliamentary oversight of the budget. It is uncommon for fiscal councils to be housed within the executive, in national audit offices, or the central bank (partly reflecting the different skill sets involved).

13.53 In India, despite the recommendations of successive Finance Commissions and other bodies to go in this direction, progress has lagged. As a result, as discussed earlier, institutional gaps have persisted in the production, collation, coordination and publication of fiscal data, as well as in independently reviewing fiscal projections and the medium-term budgetary framework across levels of government.

13.54 Among its recommendations in these areas, the Thirteenth Finance Commission (FC-XIII) had proposed that the Union Government should institutionalise independent review and monitoring of its own FRBM process. In this context, the 2015 amendment to the Rules under FRBM Act, 2003 incorporated a set of provisions requiring the CAG to periodically review the implementation of the FRBM Act. However, this is being done as a periodic post-facto review. What is required is continuing ex-ante monitoring and assessment of the internal consistency of revenue, expenditure, and deficit targets, under the fiscal responsibility legislations of the Union and the State Governments, and their effective implementation. These could be among the key functions of a fiscal council.

13.55 The FC-XIV had also made a strong case for legally institutionalising an independent fiscal institution.[17] The case was emphasised recently by the FRBM Review Committee and by the National Statistical Commission.

13.56 **We recommend the establishment of an independent Fiscal Council with powers to access records as required from the Union as well as the States. The fiscal council would have only an advisory role clearly separated from enforcement, which is the prerogative of the other organs of the government.**

13.57 Based on international experience, some indicative functions of the proposed fiscal council can be:

(i) providing multi-year macro-economic and fiscal forecasts;

(ii) evaluating fiscal performance vis-à-vis targets across levels of government;

(iii) assessing the appropriateness and consistency of fiscal targets in the States;

(iv) carrying out an independent assessment of long-term fiscal sustainability;

(v) assessing fiscal policy statements by governments under fiscal responsibility legislations;

(vi) advising on the conditions for using escape clauses under fiscal responsibility legislations;

(vii) policy costing of new measures with significant fiscal implications;

(viii) providing analytical support to the Finance Commissions, including at the State levels; and

(ix) publication of all their reports and underlying methodologies.

13.58 The mandate of a fiscal council could be broadened to cover not only the production of macroeconomic and fiscal forecasts to inform the budget, but also to advise on setting and recalibrating fiscal targets and rules at national and sub-national levels, as well as monitoring

[17] The FV-XIV also advocated the case for performance grants for Gram Panchayats and municipalities to promote the availability of reliable data on local bodies' receipt and expenditure through audited accounts; and, for the urban local bodies, publication of information on provision of basic services.

compliance with such targets and rules. The fiscal council can also work towards improving the quality of fiscal statistics at all levels of government.

Moving Ahead

13.59 The real challenge in establishing these pillars of the fiscal architecture lies in motivating, launching and sustaining such coordinated institutional reforms. **Toward this end, the Ministry of Finance could launch the process of stakeholder consultations and prepare a time-bound plan for the implementation of comprehensive public financial management reforms at all levels of government. Such consultation could bring together all the relevant stakeholders like the Finance departments of States, CAG of India (and subordinate field offices of Accountant General in States), Controller General of Accounts, Reserve Bank of India and technical research bodies working in the area of public financial management systems. Such a process could also become part of the discussion agenda of existing forums of Union-State consultations, such as the Inter-State Council or the governing council of NITI Aayog.**

13.60 The objective would be to put in place a consultative process to promote deliberation and awareness of the reform agenda with the publication of regular reports on implementation. Publication of information on the progress of reforms and benchmarking of progress across States will facilitate third-party review and scrutiny from interested non-governmental organisations, thereby exercising pressure to sustain reform.

13.61 International experience suggests that major reforms such as these may typically take several years for completion of all of its elements. Regular monitoring will help decision-makers keep track of reforms over time. It will also help track progress and performance across States. Hence, there is need of an institutional mechanism driving budgetary and public financial management reforms in a coordinated, transparent and inclusive way across levels of government to deliver consistency, transparency and accountability.

Summary of Recommendations

I. Appropriate amendments may, therefore, also be taken up by the States in their respective fiscal responsibility legislations to ensure consistency with the amended Union Government FRBM Act and, in particular, with the definition of debt. (*Para 13.27*)

ii. The Government Accounting Standards and Advisory Board (GASAB), building on its continuing work, is best placed to develop accounting standards for financial reporting and disclosures of broader 'public debt', which can form the basis for a reporting framework for contingent liabilities, along with standard norms for recognising the risk of such liabilities arising for the Union and the States after following due process. (*Para 13.28*)

iii. The Union and the State Governments should strive to improve the accuracy and consistency of such macroeconomic and fiscal forecasting by using the latest techniques and developing the technical capacities of personnel involved in the forecasting and budgeting process. (*Para 13.32*)

iv. Strengthen cash management practices for each State and the Union Government through the more comprehensive Treasury Single Account (TSA) mechanism. This will allow a more effective management of cash, including of government entities and agencies, and special purpose vehicles that are financing government activity. (*Para 13.38*)

v. All the data and information related to Union and State fiscal operations, such as pre-budget and related policy statements, and mid-year reviews, should be made available to the public in a reliable, timely and comparable manner. (*Para 13.40*)

vi. There is also room to improve the timeliness of audited financial reports of governments, ensuring they are prepared within six months of the year-end and audited within nine months, with specific responsibilities for maintaining such timelines assigned at each stage of preparation of audited financial statements. (*para 13.41*)

vii. A time-bound plan should be prepared for the phased adoption of standard-based accounting and financial reporting for the Union and the States, while the eventual adoption of accrual-based accounting is being considered. (*Para 13.43*)

viii. A comprehensive framework with essential elements of public financial management for consideration and deliberation by all the stakeholders. This framework needs to be developed further in consultation with the States and other relevant stakeholders, and the nature of its implementation agreed upon. We believe that such a public financial management framework, if implemented, would bring India's second pillar of its fiscal architecture to global best practices in the twenty-first century. (*Para 13.50*)

ix. The establishment of an independent Fiscal Council with powers to access records as required from the Union as well as the States. The fiscal council would have only an advisory role clearly separated from enforcement, which is the prerogative of the other organs of the government. (*Para 13.56*)

x. The Ministry of Finance could launch the process of stakeholder consultations and prepare a time-bound plan for the implementation of comprehensive public financial management reforms at all levels of government. (*Para 13.59*)

Chapter 14
Summary of Recommendations

Pandemic Times: Analysis for the Future 2021-26

1. We have treated the expenditures arising out of current transactions separately from the accumulated liabilities of extra-budgetary transactions. We quote from our report for 2020-21, "Outstanding extra-budgetary liabilities need to be clearly identified and eliminated in a time-bound manner with transparent reporting of deficit and debt as provided in the amended FRBM Act of 2018". We reiterate this statement. The liability of the accumulated burden needs to be fully met and will need additional resources beyond our projections to be mobilised by the Union Government, through administrative and governance reforms that will release scarce resources for clearing outstanding liabilities. We expect that the Union Government will draw up an appropriate plan for introducing such measures that will ensure repayments in a time-bound manner. As we have factored in the entire current expenditure requirements of the Union and State Governments for the award period, they should not take further recourse to any extra budgetary resources.

(para 4.43 to 4.48)

2. Our analysis and projections at different stages were affected by inconsistent accounting of receipts and expenditure that made it very difficult to ensure comparability of the base level of expenditure and revenue across States. It is important that these accounting differences are ironed out forthwith to facilitate comparison of important components of State Government expenditure and consistent State level fiscal analysis and the aggregation with the Union's accounts.

(para 4.79)

Resource Mobilisation

3. The pandemic has given rise to two competing considerations in the short to medium term. First, there is the need for sizeable resources for the general government to deal successively with the increased demands for health interventions and medical infrastructure, income generation programmes and fiscal support for economic revival. Second, the sharp contraction in economic activity has adversely affected revenue collection, especially tax revenues. This fiscal predicament has been described as a 'scissors effect' in Chapter 2. Fully meeting the estimated tax gap could result in a 5 percentage point improvement in the tax-GDP ratio from its level of 16 per cent in 2019-20 over the medium term. But this would happen only with significant improvement in governance of tax administration across the three tiers of government. The changes required to close the tax gap are both administrative/operational and tax policy-related. In the ensuing section, our recommendations are arranged in three segments; (a) administrative/operational changes, (b) tax policy changes and (c) other changes that will help achieve the full potential.

(para 5.42)

Administrative/Operational Changes

4. The IT platform of GST needs to be rectified forthwith and strict compliance ensured with the timelines of filing GST returns, which should lead to seamless invoice-matching and identification of frauds. This should also facilitate regular flow of consistent data on turnovers, output GST, input tax credits and net collections, with possible degree of disaggregation to facilitate scrutiny, analysis and feedback to policy.

(para 5.8 to 5.10)

5. The unit level information from GSTN should help in expanding the breadth of direct taxes. Tax authorities need to overcome technical impediments and operationalise the tax information system efficiently. (Action by Union and the States)

(para 5.8 to 5.10 and annex 5.1)

6. States will need to step up field efforts for expanding the GST base and for ensuring compliance, commensurate with their field strength and infrastructure for VAT and GST collection. (Action by States).

(para 5.26)

7. With the help of information from GST returns, the increasing number of formal transactions and the trail of bank transactions, the direct tax administration should track individual proprietorships and partnerships more effectively (Income Tax – Action by Department of Revenue, Government of India).

(para 5.15)

8. Closer co-ordination should be ensured between agencies involved in TDS and TCS, filers of withholding tax and information filers for various financial transactions to trace assessees not filing returns. (Income Tax – Action by Department of Revenue, Government of India).

(para 5.17)

9. To reduce excessive dependence on income tax on salaried incomes, it is important to expeditiously expand coverage of provisions relating to TDS and TCS to more transactions and incomes, which will leave behind an audit trail that acts as a deterrent to tax evasion. (Income Tax – Action by Department of Revenue, Government of India).

(para 5.15 to 5.17)

10. Another issue that calls for urgent departmental resolution, irrespective of revenue consequences, is the disputed direct taxes. Timely clarifications and removal of doubts by authorities, review and improvement in the quality of orders passed and conduct of multi-year audits as against the current single-year audit will help stem the origin of disputes. The constitution of an apex body at the highest level in the CBDT and CBIC to clarify all matters of interpretation will help ensure consistency and uniformity across jurisdictions. The data on disputes should be maintained on a case-wise basis, facilitating analysis of cases and drawing of lessons for the future. (Income Tax—Action by Department of Revenue, Government of India).

(para 5.22 to 5.24)

11. At the State Government level, stamp duty and registration fees have large untapped potential. States should integrate computerised property records with registration of transactions and capture market value of properties. State Governments should also streamline their methodology of property valuation to yield regular and realistic updating of property values. This will also help property taxation at the third tier of government. (Stamp duty and registration fees-Action by State Governments).

(para 5.27 to 5.31)

Tax policy changes

12. The inverted duty structure between intermediate inputs and final outputs present in the GST for many items should be resolved by streamlining its multiple rate structure. This can be corrected even without the weighted effective tax rate going up, with a salutary impact on net revenue collections of the general government. (GST—Appropriate recommendations by Union and the States for action by the GST Council).

(para 5.7)

13. Efficiency gains can be similarly reaped in customs duty collections by reducing its multiple rate structure: (a) broad banding of industrial finished products on MFN basis; (b) broad banding for intermediate industrial products and industrial raw materials on MFN basis; (c) streamlining and reducing non-tariff barriers; and (d) continuing with zero rating of imports, to facilitate exports for global value chains. The changes at (a) to (c) above may be made in calibrated fashion. (Customs Duty—Action by Department of Revenue, Government of India).

(para 5.13)

14. The myriad exemptions under different direct tax laws that breeds tax evasion, especially by the richer groups, will need to be reduced. Incentives leading to ambiguous interpretations and evasion will need to be eliminated. The concessions given to perquisites also need to be reviewed comprehensively. The threshold limits may be kept at the current level for some time to build stability in the tax regime and to ensure greater predictability and better tax planning for the taxpayer. (Income Tax—Action by Department of Revenue, Government of India).

(para 5.15, 5.16 and 5.21)

15. The Union Government may initiate action for a Constitutional amendment to effect a change that enables periodic revision of the limits of professions tax upon the recommendations of the President of India, after taking into cognisance a recommendation to this effect by the Finance Commission. (Action by Department of Revenue, Government of India).

(para 5.36 to 5.41)

Institutional and tax policy changes that will help achieve the full potential

16. It is important to restore the revenue neutrality of the GST rate, which was compromised by the multiple rate structure and several downward adjustments of rates. The rate structure can be rationalised by merging the rates of 12 per cent and 18 per cent. The system can be operated

with a three-rate structure of a merit rate, standard rate and demerit rate. Efficiency and revenue gains require that exemptions be minimised. (GST—Appropriate recommendations by the Union and the States for action by the GST Council).

(para 5.10 and Box 5.1)

17. Over-reliance on consumption-based taxes by the general government, which reduces the progressivity of the tax system, should be reduced by widening the net of income and asset-based taxation. Different tiers of the Government should review their Constitutional entitlements to income and asset-based taxation and assess the feasibility of each untapped tax power, so that the erosion of the tax base and evasion of tax payments can be halted. Wherever inadequate devolution of taxation powers hinders resource mobilisation at the third tier of Government, especially in asset-based taxes, such devolution should be immediately undertaken and local administrative capacity strengthened.

(Annex 5.2)

Towards Cooperative Federalism: Balancing Equity and Efficiency

18. We recommend retaining the vertical share of 41 per cent of the divisible pool of taxes for the States during the award period of this Commission.

(para 6.29)

19. To arrive at the inter se shares of States in the devolution, we have retained the horizontal devolution formula recommended in our report for the year 2020-21.

(para 6.41)

20. On horizontal devolution, while we agree that the Census 2011 population data better represents the present need of States, to be fair to, as well as reward, the States which have done better on the demographic front, we have assigned a 12.5 per cent weight to the demographic performance criterion.

(para 6.54)

21. The horizontal formula and the weights attached to the criteria are summarised in Table 6.4.

(para 6.57)

22. For the period 2021-22 to 2025-26, the inter se shares of States in the net proceeds of the taxes (divisible pool) as recommended by this Commission, based on the methodology described are given in Table 6.5.

(para 6.58)

Empowering Local Governments

23. The total size of the grant to local governments should be Rs. 4,36,361 crore for the

period 2021-26. We favour a fixed amount rather than a proportion of the divisible pool of taxes to ensure greater predictability of the quantum and timing of fund flow.

(para 7.60)

24. Of these total grants, Rs. 8,000 crore is performance-based grants for incubation of new cities and Rs. 450 crore is for shared municipal services**.** A sum of Rs. 2,36,805 crore is earmarked for rural local bodies, Rs. 1,21,055 crore for urban local bodies and Rs. 70,051 crore for health grants through local governments.

(para 7.61, 7.62 and 7.93)

25. For inter se distribution among States for rural and urban local bodies, weightage of 90 per cent should be given to population and 10 per cent to the area of the State. The grant to each State is detailed at Annex 7.4.

(para 7.62 and 7.93)

26. We recommend that all States which have not done so, must constitute SFCs, act upon their recommendations and lay the explanatory memorandum as to the action taken thereon before the State legislature on or before March 2024. After March 2024, no grants should be released to a State that has not complied with the Constitutional provisions in respect of the SFC and these conditions. The MoPR will certify the compliance of all Constitutional provisions by a State in this respect before the release of their share of grants for 2024-25 and 2025-26.

(para 7.58)

27. The entry level condition for rural and urban local bodies availing any grants due to them is having both provisional and audited accounts online in the public domain. States will receive grants for those rural and urban local bodies that have their provisional accounts for the previous year and audited accounts for the year before the previous, available online.

(para 7.76 to 7.78, 7.95 and 7.96)

28. For urban local bodies, apart from the entry level condition of having both provisional and audited accounts online in the public domain, after 2021-22, fixation of minimum floor for property tax rates by the relevant State followed by consistent improvement in the collection of property taxes in tandem with the growth rate of State's own GSDP will be an additional mandatory pre-condition.

(para 7.95 to 7.99, 7.101 and 7.102)

29. To supplement the resources needed to fulfil national priorities, 60 per cent of the grants to rural local bodies should be tied to supporting and strengthening the delivery of two categories of basic services: (a) sanitation and maintenance of ODF status; and (b) drinking water, rain water harvesting and water recycling.

(para 7.84 and 7.85)

30. Urban local bodies have been categorised into two groups, based on population, and different norms have been used for flow of grants to each, based on their specific needs and aspirations. For cities with million-plus population (Million-Plus cities), 100 per cent of the

grants are performance-linked through the Million-Plus Cities Challenge Fund (MCF). Basic grants are proposed only for cities/towns having a population of less than a million.

(para 7.104,7.105 and 7.128)

31. Category I cities (urban agglomerations with a population of more than one million) will be treated as a single unit for monitoring of performance indicators of ambient air quality and service level benchmarks. One-third of the total MCF of each city is earmarked for achieving ambient air quality. The balance two-third of the city-wise MCF is earmarked for achieving service level benchmarks for drinking water (including rainwater harvesting and recycling) and solid waste management. For drinking water (including rainwater harvesting and recycling) and sanitation and solid waste management criteria under service level benchmarks, the MoHUA shall act as the nodal ministry for determining the eligible urban local bodies.

(para 7.111 to 7.127)

32. Sixty per cent of the basic grants for urban local bodies in non-Million-Plus cities should be tied to supporting and strengthening the delivery of: (a) sanitation and solid waste management and attainment of star ratings as developed by the MoHUA; and (b) drinking water, rain water harvesting and water recycling.

(para 7.130 and 7.131)

33. We recommend that for the five-year award period (2021-22 to 2025-26) grants should go to all the three tiers of panchayati raj institutions.Since no resident of India should be denied a share of the local body grants, these should be distributed to even those areas which are not required to have panchayats (Fifth and Sixth Schedule areas and Excluded Areas) for augmenting their resources to provide basic services by similar local level bodies.

(para 7.63 to 7.68)

34. State Governments, while deciding the share of basic grant among various urban local bodies in cities other than Million-Plus cities, shall make allotment of grants (only under basic grants) on a per capita basis for the Cantonment Boards falling within the State.

(para 7.133 and 7.134)

35. The grants recommended by us for rural local bodies and non-Million-Plus cities shall be released in two equal instalments each year in June and October after ascertaining the entry level benchmarks and other requirements recommended by us. The States shall transfer grants-in-aid to the local bodies within ten working days of having received them from the Union Government. Any delay beyond ten working days will require the State Governments to release the same with interest as per the effective rate of interest on market borrowings/State Development Loans for the previous year.

(para 7.135)

36. Since health grants are meant for addressing the gaps in primary health infrastructure, the allocations would not be on a per capita basis for States or for local governments. Based on the MoHFW proposal, the recommended year-wise State-wise fund allocation for this purpose is provided at Annex 7.10. The MoHFW shall closely coordinate with respective State Governments and work out a mechanism for flow and utilisation of these health grants and also

involve panchayati raj institutions at all three levels by entrusting them with the responsibility to supervise and manage the delivery of health services in a phased manner. No conditions or directions other than those indicated in para 7.147 should be imposed either by the Union or the State Governments, or any authority, for releasing the grants for health.

(para 7.136 to 7.147)

37. A sum of Rs. 8,000 crore is recommended to States as grants for incubation of new cities and Rs. 450 crore for facilitating shared municipal services.

(para 7.148 to 7.154)

38. Since the ceiling for professions tax has not been revised for the last three decades, it is time that the relevant amendment to the Constitution is carried out on a priority basis.

(para 7.155 and 7.156)

Disaster Risk Management

39. The ratio of contribution by Union and States to the State-level allocations for disaster management recommended by FC-XIII should be maintained. Thus, States are to contribute 25 per cent of funds of SDRF and SDMF except the NEH States which shall contribute 10 per cent, and the rest is to be provided by the Union Government.

(para 8.34)

40. Mitigation Funds should be set up at both the national and State levels, in line with the provisions of the Disaster Management Act. The Mitigation Fund should be used for those local level and community-based interventions which reduce risks and promote environment-friendly settlements and livelihood practices.

(para 8.43 and 8.46)

41. Allocation of disaster management funds to SDRMFs should be based on factors of past expenditure, area, population and disaster risk index (which reflect States' institutional capacity, risk exposure and hazard and vulnerability respectively). Assuming an annual increase of 5 per cent, we arrive at the total corpus of Rs.1,60,153 crore for States for disaster management for the duration of 2021-26, of which the Union share is Rs. 1,22,601 crore and States share is Rs. 37,552 crore.

(para 8.51, 8.52 and 8.53)

42. Total States allocation for SDRMF should be subdivided into funding windows that encompass the full disaster management cycle. Thus, the SDRF should get 80 per cent of the total allocation and the SDMF 20 per cent. The SDRF allocation of 80 per cent should be further distributed as follows: Response and Relief – 40 per cent; Recovery and Reconstruction – 30 per cent; and Preparedness and Capacity-building – 10 per cent. While the funding windows of the SDRF and SDMF are not interchangeable, there could be flexibility for re-allocation within the three sub-windows of SDRF.

(para 8.54)

43. The allocation for the NDRMF should be based on expenditure in previous years. Assuming an annual increase of 5 per cent, the total national allocation for disaster management is estimated to be Rs. 68,463 crore for the duration of 2021-26.

(para 8.59)

44. The allocation for the NDRMF should also be subdivided into funding windows similar to that of States' allocation for disaster management. Hence, the NDRF should get 80 per cent of the total allocation for the NDRMF, with further division into 40 per cent for Response and Relief, 30 per cent for Recovery and Reconstruction and 10 per cent for Preparedness and Capacity-building. The NDMF should be allotted 20 per cent of the total allocation for the NDRMF. If required, the Ministry of Home Affairs may examine the need for amending the Disaster Management Act to create three sub-windows within the NDRF. While the funding window of NDRF and NDMF should be maintained, there could be flexibility for re-allocation within these sub-windows.

(para 8.60 and 8.61)

45. To discourage excessive and unsubstantiated demands from States, all Central assistance through the NDRF and NDMF should be provided on a graded cost-sharing basis. States should contribute 10 per cent for assistance up to Rs. 250 crore, 20 per cent for assistance up to Rs. 500 crore and 25 per cent for all assistance exceeding Rs. 500 crore.

(para 8.63)

46. A Recovery and Reconstruction Facility should be set up within the NDRF and SDRF. Assistance for recovery and reconstruction is generally a multi-year programme, and the assistance, shared between the Union and States, needs to be released annually against expenditures and only as a percentage of total cost.

(para 8.68 and 8.69)

47. State Governments need to have essential disaster preparedness to respond effectively to disasters. Their institutions and facilities must be equipped and well-functioning to meet the exigencies of a situation. The preparedness and capacity-building grants could be used to support the SDMAs, SIDMs, training and capacity-building activities and emergency response facilities. A similar window of preparedness and capacity-building should be made available within the NDRF, which could be used to support national agencies.

(para 8.70 and 8.73)

48. Major capital works required for proper upstream river basin management (to mitigate annual flood disasters caused by river erosion) with gestation periods of ten to fifteen years cannot be accommodated through Finance Commission award. Therefore, we recommend that such projects should be considered as national priority projects. Only such holistic projects can help address flood mitigation properly. A piecemeal approach will simply result in yearly washing away of river embankments.

(para 8.92)

49. There should be six earmarked allocations for a total amount of Rs. 11,950 crore for certain priority areas, namely, two under the NDRF (Expansion and Modernisation of Fire Services and Resettlement of Displaced People affected by Erosion) and four under the NDMF

(Catalytic Assistance to Twelve Most Drought-prone States, Managing Seismic and Landslide Risks in Ten Hill States, Reducing the Risk of Urban Flooding in Seven Most Populous Cities and Mitigation Measures to Prevent Erosion).

(para 8.96)

50. A streamlined system of payment to the Ministry of Defence by the Ministry of Home Affairs should be institutionalised through mutual consultations. Three options for the system of payment have been outlined.

(para 8.108)

51. In order to strengthen institutional capacities, a dedicated capacity should be set up to supervise the NDRMF and SDRMF and augment disaster funding through other sources. In addition, a disaster database should be developed to help assess the impact of expenditures on different aspects of disaster management. Other interventions such as disbursing assistance to women members of households will make disaster management more effective and efficient. NDMA, as a leading agency in disaster management, needs to be proactive and collaborate with States in pushing the agenda of reforms in disaster management.

(para 8.111, 8.114, 8.115 and 8.117)

52. To improve and streamline the access of Central assistance to the states, the existing system of assessment of the damages caused by any natural calamity should be replaced by a two-stage assessment – an initial humanitarian needs assessment for response and relief assistance and a post-disaster needs assessment (PDNA) for recovery and reconstruction needs.

(para 8.113)

53. All the new funding windows need to be supported through development of guidelines, the drawing up of which should be led by the NDMA.

(para 8.116)

54. An annual report at the national level may record all the allocations, expenditures, key achievements and results against various indicators developed for the implementation of the SFDRR. The contribution of these allocations to national and State capacities may be evaluated against a set of indicators determined by the NDMA.

(para 8.118)

55. In the event of SDRMF and NDRMF assistance falling short of the required assistance, the Union and States should have recourse to other financial instruments. These instruments are identified as reconstruction bonds, contingent credit/stand-by facility with international financial institutions, crowdfunding platforms and corporate social responsibility.

(para 8.119)

56. Insurance mechanisms, which act as a social safety net and supplement the existing financial mechanisms, need to be introduced in partnership with insurance companies after due diligence is done. These mechanisms are: national insurance scheme for disaster-related deaths, synchronising relief assistance with crop insurance, risk pool for infrastructure protection and recovery, and access to international reinsurance to the outlier hazard events

(para 8.131 and 8.139)

Pandemic and Beyond: Building Resilience in Health Sector

57. We recommend that health spending by States should be increased to more than 8 per cent of their budget by 2022.

(para 9.41, i)

58. We recommend that primary health care should be the number one fundamental commitment of each and every State and that primary health expenditure should be increased to two-thirds of the total health expenditure by 2022.

(para 9.41, ii)

59. We recommend that public health expenditure of Union and States together should be increased in a progressive manner to reach 2.5 per cent of GDP by 2025.

(para 9.41, iii)

60. Centrally sponsored schemes (CSS) co-financed by the Government of India should be flexible enough to allow States to adapt and innovate. Top-down mandates and strictures on programme implementation are the antithesis of an open-source model. CSS should grant States significant latitude to tailor implementation modalities to local realities.

(para 9.41, iv)

61. There is a need to shift the focus of inter-governmental fiscal health financing from inputs to outputs/outcomes while advancing the measurement agenda as an accountability tool. Complementary to the flexibility noted above, the Union Government can shift the focus of CSS and transfers away from line-items and activities and towards outputs and outcomes, with States being empowered to choose their own pathways to achieve results**.**

(para 9.41, v)

62. Given the inter-State disparity in the availability of medical doctors, it is essential to constitute an All India Medical and Health Service as is envisaged under Section 2A of the All-India Services Act, 1951. For this purpose, the Union Public Service Commission (UPSC) would need to do annual recruitments, based on the State-wise requisitions by each State Government. We urge the Union Government to implement this proposal in coordination with State Governments.

(para 9.41, vii)

63. The MBBS curriculum should be restructured to make it competency based. A certain degree of specialisation should be included in the curriculum and the MCI/NMC should develop small courses on wellness clinic, basic surgical procedures, anaesthesia, obstetrics and gynaecology, eye, ENT etc. for MBBS doctors and encourage AYUSH as an elective subject for medicine undergraduates.

(para 9.41, viii)

64. The asymmetric distribution of medical colleges needs to be corrected as most of them are situated in the western and southern parts of India. All public health facilities including district hospitals, private sector facilities and corporate hospitals should be utilised for starting specialist

DNB courses which will not only enhance the service provisioning but will also ensure the availability of trained human resource.

(para 9.41, ix)

65. Measures should be taken to assign a larger role for nursing professionals and the concept of nurse practitioner, physician assistant and nurse anaesthetist should be introduced for better utilisation of nursing professionals. The early passage of this legislation should be fast-tracked given its multiplier benefits.

(para 9.41, xi)

66. The total grants-in-aid support to the health sector over the award period works out to be Rs. 1,06,606 crore, which is 10.3 per cent of the total grants-in-aid recommended by us. This forms about 0.1 per cent of GDP. The grants for the health sector will be unconditional.

(para 9.49)

67. We recommend health grants aggregating to Rs. 70,051 crore for urban HWCs, building-less sub centre, PHCs, CHCs, block level public health units, support for diagnostic infrastructure for the primary healthcare activities and conversion of rural sub centres and PHCs to HWCs. These grants will be released to the local governments. Given the importance of health grants to fight the pandemic, we have not put any conditions for release of these grants to the local governments.

(para 9.51)

68. We recommend Rs. 15,265 crore for critical care hospitals. This includes Rs. 13,367 crore for general States and Rs 1,898 crore for NEH States. The inter se distribution of this grant is made on the basis of per capita health expenditure distance method, which is similar to the income distance method recommended in the horizontal formula. However, the inter se distribution is made separately for general and NEH States.

(para 9.54)

69. We recommend Rs. 469 crore for States for building public health laboratories. The remaining share may come from the Union Government as part of PM-ASBY.

(para 9.57)

70. We recommend Rs. 13,296 crore for training of the allied healthcare workforce. Out of this, Rs. 1,986 crore will be for NEH States and Rs. 11,310 crore for general States. Based on the number of district and sub-divisional hospitals given by the MoHFW, we have provided Rs. 3 crore per facility for each State. To determine the variable amount for each State, we have used the per capita health expenditure distance method as described in the section on critical care hospitals.

(para 9.60)

71. We recommend Rs. 2,725 crore for starting DNB courses in district hospitals for overcoming the shortfall of specialists.

(para 9.64)

72. All the grants will be administered by the MoHFW. Though various components have been earmarked, we are cognisant of the fact that some inter-component adjustments within each State's overall share may be required in future years, as per the emerging ground realities. Hence, within each State's respective share, inter-component flexibility is allowed in consultation with the MoHFW.

(para 9.65)

Performance-based Incentives and Grants

73. We recommend total revenue deficit grants of Rs. 2,94,514 crore over our award period for seventeen States.

(para 10.19)

74. We recommend grants of Rs. 4,800 crore (Rs. 1,200 crore each year) from 2022-23 to 2025-26 for incentivising the States to enhance educational outcomes. The performance grant received by the State will be utilised by the education department for enhancing educational outcomes and not diverted for use by any other department by the State.

(para 10.37 and 10.39)

75. We recommend Rs. 6,143 crore for online learning and development of professional courses in regional languages (*matribhasha*) for higher education in India.

(para 10.43)

76. We recommend that Rs. 45,000 crore be kept as performance-based incentive for all the States for carrying out agricultural reforms during the award period.

a. We recommend that States may appropriately amend their land-related laws on the lines of NITI Aayog's model law to allow short-term and long-term lease of agricultural land both for agricultural purpose as well as for agro-industry, logistics for agricultural trade and supply chains.

b. We recommend incentive-based grants to States that maintain and augment groundwater stock and put a check on any fall in the water table.

c. We recommend using growth in agricultural exports as a target indicator for the award on export performance of a State.

d. We recommend increasing production of oilseeds, pulses and wood and wood-based products as an indicator to make India self-reliant in pulses, edible oils and wood and wood products.

e. This performance grant for agriculture should be used only for infrastructure and activities related to the development of agriculture and allied sectors by the States.

(para 10.54, 10.56, 10.59, 10.62, 10.64 and 10.66)

77. We recommend Rs. 27,539 crore for maintenance of PMGSY roads for the years 2021-26, out of which Rs. 14,743 crore is for the general States and Rs. 12,796 crore is for the NEH States.

(para 10.72)

78. We recommend grants of Rs. 10,425 crore for fast-track courts for speedier justice delivery in cases of heinous crimes, civil cases of marginalised people, five-year-old property cases and economic offences as well as special fast-track courts for POCSO cases.

(para 10.75)

79. We recommend total grants to the States, with the fixed and variable components, of Rs. 1,175 crore from 2022-23 to 2025-26 for improving the quality of statistics. We also recommend that, initially, the fixed grant of the total allocation, amounting to Rs. 677 crore, which is unconditional may be released in 2022-23. The remaining variable component of Rs. 498 crore may be disbursed equally over the remaining three years starting 2023-26, based on achievements of specified milestones. Both the fixed and variable grants will be utilised by the statistics department only.

(para 10.82)

80. We recommend Rs. 3,150 crore for incentivising aspirational districts and blocks for a period of five years from 2021-22 to 2025-26.

(para 10.92)

81. We recommend an extra annual borrowing space for the States, of the magnitude of 0.50 per cent of their GSDP for each of the first four years of the award covering the period 2021-22 to 2024-25, based on certain performance criteria in the power sector.

(para 10.103)

82. We recommend that the nutrition of children and pregnant and lactating mothers may be accorded the highest priority by Government of India through the Integrated Child Development Scheme.

(para 10.112)

83. We recommend that the Union Government may put forward an arrangement to ensure completion of the pending railways projects at the earliest.

(para 10.114)

84. We recommend State-specific grants of Rs. 49,599 crore during our award period for social needs, administrative governance and related infrastructure, conservation and sustainable use of water, drainage and sanitation, preserving culture and historical monuments, high-cost physical infrastructure and tourism.

(para 10.118)

85. No funds from any of the State-specific grants may be used for payment of government-owned land. Wherever additional land is required to be acquired from private parties for the project/construction, the State-specific grants may be used for such compulsory acquisition payments, subject to a ceiling of 50 per cent of such land acquisition cost for new greenfield projects. However, for brownfield projects where the infrastructure is complete and functional, the State-specific grants would be for productivity enhancement and reaping externalities of scale. In such brownfield projects, the additional expenditure is primarily on land acquisition (such as airport runway extension); therefore, there need not be any such ceiling for utilisation of the State-specific grant. To expedite the execution of all projects, land acquisition payments as

above made in 2021-22 would be eligible for retroactive funding in 2022-23 from the State-specific grants.

(para 10.119, i)

86. We recommend that every State should constitute a high level committee for reviewing and monitoring the proper utilisation of State-specific and sector-specific grants. This committee may be headed by the Chief Secretary with the Finance Secretary and the secretaries/heads of relevant departments as members. We recommend that the progress of these projects also be reviewed annually by a committee headed by the Chief Minister with the State Finance Minister and the State ministers concerned as members. We recommend that no conditionalities, other than what we have prescribed, should be imposed by the Union Government for release or utilisation of the grants.

(para 10.120, 10.122 and 10.123)

Defence and Internal Security

87. The Union Government may constitute in the Public Account of India, a dedicated non-lapsable fund, Modernisation Fund for Defence and Internal Security (MFDIS), to bridge the gap between projected budgetary requirements and budget allocation for defence and internal security. This may be called *Rashtriya Suraksha Naivedyam Kosh* or any other appropriate name. The proceeds of the fund will be utilised for the following three purposes:

(a) capital investment for modernisation of defence services;

(b) capital investment for CAPFs and modernisation of state police forces as projected by MHA; and

(c) a small component as welfare fund for our soldiers and para-military personnel.

The fund shall have the standard notified rules for its administration, public reporting and audit by the CAG.

(para 11.54)

88. This Fund will have four specific sources of incremental funding:

a. transfers from the Consolidated Fund of India;

b. disinvestment proceeds of DPSEs;

c. proceeds from the monetisation of surplus defence land, including realisation of arrears of payment for defence land used by State Governments and for public projects and cost recovered of encroached land; and

d. proceeds of receipts from defence land likely to be transferred to State Governments and for public projects in future.

The total indicative size of the proposed MFDIS over the period 2021-26 is Rs. 2,38,354 crore.

(para 11.56/Table 11.12)

89. The maximum size of the recommended fund is Rs 51,000 crore per annum. Any amount exceeding the same shall be deposited into the Consolidated Fund. This amount shall be maintained in the Public Account and shall be operated through the extant procedures for

operating such accounts. The unutilised amount from the normal budgetary allocations to the MoD and MHA for capital expenditure shall not be part of the Fund and should be governed as per the principles of the annual budget process.

(para 11.58, 11.59 and 11.60)

90. The MoD would have exclusive rights over the use of the amounts deposited in the Fund from the specified sources of revenue mentioned at serial no. 2, 3 and 4 in Table 11.12. The MHA will only be permitted to use the fund that is earmarked for it from the source of revenue mentioned at serial no.1 of Table 11.12. The amount proposed for capital expenditure towards internal security for five years is Rs. 50,000 crore and the year-wise amount is given at Table 11.13. Out of this Rs. 50,000 crore, the MHA will allocate Rs. 500 crore for redeveloping/improving the residential facilities for police personnel in Delhi. This would be augmented by Rs. 100 crore per annum for improved communication systems and technology upgradation of the police personnel.

(para 11.61/Tables 11.12 and 11.13)

91. The fund may be operated by a suitably empowered High Powered Committee (HPC) notified by the Union Government. This may be headed by the Cabinet Secretary and consist of the Secretaries of Defence, Home and Expenditure and the Chief of Defence Staff. The HPC would also allocate Rs. 1,000 crore per annum for the welfare of families of the defence and CAPF personnel who sacrifice their lives in frontline duties.

(para 11.62 and 11.63)

92. We also expect that over the next year or two (medium-term), the Union Government will review its existing expenditures and rationalise and re-prioritise them to focus on certain key sectors and interventions with nation-wide externalities, defence and internal security. This will reduce pressures on the revenue account of the Union to enable higher capital expenditure within the available fiscal space.

(para 11.64)

93. Due to overall fiscal constraints, the MoD should also take immediate measures to innovatively bring down the salaries and pension liabilities.

(para 11.65 and 11.66)

94. We also recommend that MoD shall reduce its dependence on defence imports with a specific roadmap by corresponding enhancement in indigenous production at a faster rate.

(para 11.67)

Fiscal Consolidation Roadmap

95. The macro-stabilisation function of prudently supporting the State budgets to help them overcome the current crisis rests with the Union Government. However, the responsibility of balancing the budgets of States lies primarily with their governments.

(para 12.49)

96. The current strain on the revenues of the Union and State Governments calls for strict discipline in revenue expenditure, opening up space for higher allocations on health and other urgent expenditure needs while ensuring fiscal sustainability in the medium term.

(para 12.48)

97. It is important that all committed expenditures and developmental expenditures are met from the augmented borrowing space recommended for the Union and the State Governments, without resort to off-budget or any non-transparent means of financing for any expenditures.

(para 12.75)

98. The Union Budget 2020-21 shows that fifteen of the thirty umbrella CSS account for about 90 per cent of the total allocation under CSS. Many umbrella schemes have, within them, a number of small schemes, some of them with negligible allocations. A threshold amount of annual appropriation should be fixed below which the funding for a CSS may be stopped. Below the stipulated threshold, the administrating department should justify the need for the continuation of the scheme. As the life cycle of ongoing schemes has been made co-terminus with the cycle of Finance Commissions, the third-party evaluation of all CSS should be completed within a stipulated timeframe. The flow of monitoring information should be regular and should include credible information on output and outcome indicators. The funding pattern of the CSS should be fixed upfront in a transparent manner and should be kept stable.

(para 12.51)

99. For the State Governments, we have recommended that the normal limit for net borrowing may be fixed at 4 per cent of GSDP in 2021-22, 3.5 per cent in 2022-23 and be maintained at 3 per cent of GSDP from 2023-24 to 2025-26. The term 'normal' is used to clarify that we have not accounted for any additional borrowing to be done by the State Governments to manage the shortfall in GST compensation to them, or the incentive-based additional borrowing space that we have recommended for power sector reforms in Chapter 10.

(para 12.61 to 12.63)

100. If a State is not able to fully utilise its sanctioned borrowing limit as specified above, in any particular year during the first four years of our award period (2021-22 to 2024-25), it will have the option of availing this unutilised borrowing amount (calculated in rupees) in any of the subsequent years within our award period

(para 12.64)

101. We recommend that for the purpose of assigning State-specific borrowing limits as a proportion of GSDP for a given fiscal year, the estimates of GSDP published by the NSO should be used according to the specified procedure.

(para 12.58 and 12.59)

102. We have assessed that, given the compulsions on the revenue account of the Union Government, including of lending support to the budgets of sub-national governments, they may have to follow an elevated path of fiscal deficit with a terminal year (2025-26) target of 4 per cent of the GDP.

(para 12.54 and Table 12.2)

103. With the recommended path for the fiscal deficit of the Union and the State Governments, we have shown that the consolidated debt of the general government will have a downward trajectory during 2023-24 to 2025-26. The differentiated debt/ GSDP path of the State Governments for 2021-26 has also been outlined by us at Annex 12.1.

(para 12.65, 12.70 to 12.72 and Table 12.6)

104. In view of the uncertainty that prevails at the stage that we have done our analysis, as well as the contemporary realities and challenges, we recognise that the FRBM Act needs a major restructuring and recommend that the time-table for defining and achieving debt sustainability may be examined by a High-powered Inter-governmental Group. This High-powered Group can craft the new FRBM framework and oversee its implementation. It is important that the Union and State Governments amend their FRBM Acts, based on the recommendations of the Group, so as to ensure that their legislations are consistent with the fiscal sustainability framework put in place.

(para 12.76)

105. Disclosure of the financial positions of the States and their credit rating will help in broadening the investor base. Credit rating will also reinforce self-discipline on the fiscal front and lead to better pricing of SDLs. The States and the Union should define contingent liabilities transparently, estimate them and assess the risks associated with them.

(para 12.24)

106. State Governments may explore formation of independent public debt management cells which will chart their borrowing programme efficiently.

(para 12.19)

107. States should have more avenues for short-term borrowings other than the ways and means advances and over draft (WMA/OD) facility provided by RBI, which has monetary policy implications. Such a facility may help States in meeting the temporary mismatches in their revenue flows at market-determined cost.

(para 12.26)

Fiscal Architecture for Twenty-First Century India: Fiscal Rules, Financial Management and Institutions

108. Appropriate amendments may, therefore, also be taken up by the States in their respective fiscal responsibility legislations to ensure consistency with the amended Union Government FRBM Act and, in particular, with the definition of debt.

(para 13.27)

109. The Government Accounting Standards and Advisory Board (GASAB), building on its continuing work, is best placed to develop accounting standards for financial reporting and disclosures of broader 'public debt', which can form the basis for a reporting framework for

contingent liabilities, along with standard norms for recognising the risk of such liabilities arising for the Union and the States after following due process.

(para 13.28)

110. The Union and the State Governments should strive to improve the accuracy and consistency of such macroeconomic and fiscal forecasting by using the latest techniques and developing the technical capacities of personnel involved in the forecasting and budgeting process.

(para 13.32)

111. Strengthen cash management practices for each State and the Union Government through the more comprehensive Treasury Single Account (TSA) mechanism. This will allow a more effective management of cash, including of government entities and agencies, and special purpose vehicles that are financing government activity.

(para 13.38)

112. All the data and information related to Union and State fiscal operations, such as pre-budget and related policy statements, and mid-year reviews, should be made available to the public in a reliable, timely and comparable manner.

(para 13.40)

113. There is also room to improve the timeliness of audited financial reports of governments, ensuring they are prepared within six months of the year-end and audited within nine months, with specific responsibilities for maintaining such timelines assigned at each stage of preparation of audited financial statements.

(para 13.41)

114. A time-bound plan should be prepared for the phased adoption of standard-based accounting and financial reporting for the Union and the States, while the eventual adoption of accrual-based accounting is being considered.

(para 13.43)

115. A comprehensive framework with essential elements of public financial management for consideration and deliberation by all the stakeholders. This framework needs to be developed further in consultation with the States and other relevant stakeholders, and the nature of its implementation agreed upon. We believe that such a public financial management framework, if implemented, would bring India's second pillar of its fiscal architecture to global best practices in the twenty-first century.

(para 13.50)

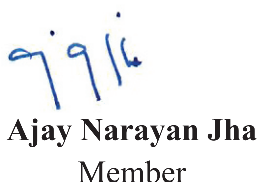
116. The establishment of an independent Fiscal Council with powers to access records as required from the Union as well as the States. The fiscal council would have only an advisory role clearly separated from enforcement, which is the prerogative of the other organs of the government.

(para 13.56)

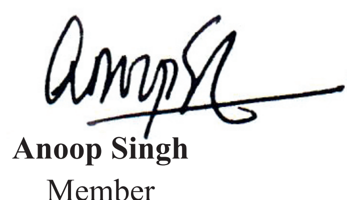
117. The Ministry of Finance could launch the process of stakeholder consultations and prepare a time-bound plan for the implementation of comprehensive public financial management reforms at all levels of government.

(para 13.59)

N.K. Singh
Chairman

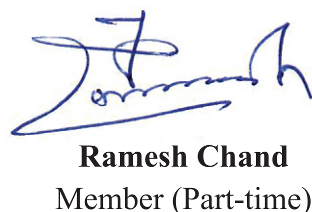


Ajay Narayan Jha
Member



Anoop Singh
Member

Ashok Lahiri
Member



Ramesh Chand
Member (Part-time)

New Delhi
30 October, 2020

I wish to record my deep appreciation of the outstanding support, domain knowledge and sustained dedication of all the Members of the Commission. This report is a joint endeavour, with each Member contributing immeasurably. The intense deliberations supported by their experience and areas of specialty were of immense value to the Commission, especially helping it to address a somewhat challenging set of terms of reference given to us by the President. Their valuable advice and their unstinted commitment are gratefully acknowledged.

I also want to put on record my deep appreciation of the valuable contributions made on multiple fronts by Shri Arvind Mehta, Secretary to the Commission. He provided strength and leadership and coordinated the activities of the Commission with experience and skill, enabling us to complete our task within the stipulated timeframe. He also contributed actively to the deliberations of the Commission on key issues. In this endeavour, he was supported by a

dedicated team of professionals and other members of the staff which anchored the work of the Commission and took it to its fruition. I gratefully acknowledge the contribution of Shri Mukhmeet Singh Bhatia, Additional Secretary, who brought to the table his past experience and analytical understanding of complex issues, particularly his contribution to the Volume III dedicated to the Union Government. Shri Ravi Kota, Joint Secretary, combined valuable experience of the States with his sophisticated understanding of several constitutional issues, making a meaningful contribution not only to the Commission's work but particularly to Volume IV, which concerns the States. Shri Antony Cyriac, Economic Advisor has been a pillar of strength to the Commission through his analytical and technical support, which contributed significantly to our work. He exhibited excellent domain understanding in modelling and in assessment of public finances in these uncertain times. Ms. Maushumi Chakravarty, Media Advisor has been a very valuable participant for all the media outreach of the Commission.

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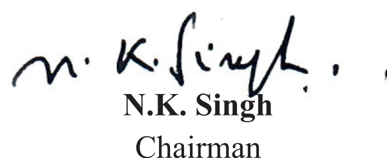

N.K. Singh
Chairman

New Delhi
30 October, 2020