Continuity with Change: Approach of the Fifteenth Finance Commission

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Abstract

The two latest Finance Commissions – the Fourteenth Finance Commission (FC-XIV) and the Fifteenth Finance Commission (FC-XV)– mark a break from the past. The paper explores the structural shift in federal finances with the abolition of the Planning Commission and contemporaneous circumstances that shaped the approach of the FC-XV and examines the intersections and divergence, continuity and change, with FC-XIV in terms of its treatment of and approach to the three core issues of vertical and horizontal devolution, grants-in-aid to the States and transfers to local governments. It argues that the pervasive impact of the pandemic has shaped the recommendations of FC-XV in several ways without compromising on the Constitutional principles and retaining the balance in federal transfers between the Union and the States and amongst the States. At a time when the growth prospects of the economy are uncertain, innovative use of targeted grants linked to performance-based criteria for specified sectors through the States and local governments address glaring gaps in public services and potentially trigger reform in critical sectors.

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India's federal fiscal framework is characterized by a remarkable stability across time, notwithstanding a fragmented transfer system[1]. A major reason for this has been the broad continuity in the approach of the fifteen Finance Commissions that have been constituted since the adoption of the Constitution. With Finance Commissions being the single largest source of transfers from the Union government to the States, this continuity has resulted in the relatively consistent post-transfer shares of the Union and the States in the combined revenue and expenditure of general government[2]. While the Constitution has defined the basic role and tasks for the Finance Commission in inter-governmental transfers, contemporary challenges as well as macro-fiscal environment have been addressed by each Commission to serve the evolving development objectives of the nation.

Each Finance Commission[3] is expected to ensure a certain amount of continuity in the basic framework, while introducing changes, as necessary, to reflect the evolving circumstances. A recent study on fiscal federalism has identified five consistent strands in the approach and recommendations of the fourteen Finance Commissions.[4] These are: (i) focus on revenue account, with emphasis on assessment and recommendations relating to revenue resources and revenue expenditure; (ii) attempt to reduce inequalities amongst States by balancing the recommendation between provision of uniform standards of public service and ensuring or enabling minimum standards of such service; (iii) giving overwhelming primacy to tax devolution over grants as the preferred mode of transfer; (iv) providing revenue gap-filling grants (revenue deficit grants) with no conditions attached, but prescribing conditions and performance criteria for other type of sector-specific or state-specific grants; and (v) use of exogenously imposed 1971 population from the Sixth Commission onwards with the intent of not penalizing states that had performed well on the demographic front. These broad principles have been found to be consistent with the Constitutional intent and spirit and done justice to both the Union and the States as well as amongst the States. There has been universal acceptability of the recommendations, and barring a few exceptions, the recommendations of each of the Commissions have been accepted by the President.

In this broad paradigm, the two latest Finance Commissions – the Fourteenth Finance Commission (FC-XIV)[5] and the Fifteenth Finance Commission (FC-XV)[6]– mark a

break from the past. The fundamental shift was a consequence of the abolition of the Planning Commission in August 2014, just four months prior to the deadline given to FC-XIV to submit its report. This effectively ended sixty-five years of central planning and created the grounds for a structural change in the mechanism of transfers to the States. Till then, except for FC-IX, each Commission from the FC-III to the FC-XIII had confined its recommendations to the non-plan revenue account of the Union and the States[7].

The focus of the paper is on the question of how the Fourteenth and Fifteenth Commissions tackled the changing contours of fiscal federalism. It explores the structural shift and contemporaneous circumstances that shaped the approach of the FC-XV and examines the intersections and divergence, continuity and change, with FC-XIV in terms of its treatment of and approach to the three core issues of vertical and horizontal devolution, grants-in-aid to the States and transfers to local governments[8]. How did they treat the unoccupied space in India's transfer mechanism that opened up with the end of plan transfers? What was their approach to grants-in-aid to states, an item that constituted the core of Planning Commission transfers? In what manner did they address the issues relating to transfers for local governments?

The paper is divided into seven parts. The second section is a brief overview of the changes in the public finance architecture following the abolition of Planning Commission and up to the setting up of the FC-XV. The third section analyses the economic situation confronting the FC-XV and the issues arising from the terms of reference (ToR). The fourth section deals with the vertical and horizontal devolutions. The fifth evaluates the approach to grants-in-aid. The sixth section deals with grants to local governments. The last section is the conclusion.

II

NITI (National Institution for Transforming India) Aayog was set up on 1 January 2015 to replace the Planning Commission but, unlike its predecessor, with no role in the allocation of resources. The classification of expenditure as plan and non-plan was removed from the Union Budget of 2017-18, on the culmination of the Twelfth Five-Year Plan in March 2017 and replaced by the more universally accepted categories of revenue and capital expenditure[9].

Why did the abolition of Planning Commission mark a structural break in India's inter-government transfers system? The existence of multiple channels of transfers has

been one of the main characteristics of fiscal federalism in India. Apart from the Finance Commission, the Planning Commission assisted the States, through the instrument of grants and loans for implementation of the Five-Year Plans. In addition, there were also transfers from Union ministries under Centrally Sponsored Schemes, determined in consultation with the Planning Commission, and non-plan grants[10]. In the last four decades, the share of statutory transfers through the Finance Commission was in the range of 60.13 per cent during the Eighth Commission award period (1984-89) and approximately 64 per cent in the 2005-14 decade – the period covered by the FC-XII and FC-XIII. Thus, on an average, transfers through the Plan process accounted for 35-40 per cent of total transfers to states.

In the assessment of previous Commissions, Plan expenditure of the Union, including the gross budgetary support (GBS), were treated as a residual and, in the case of the States, it was excluded from the analysis. In the ToR of the FC-XIV there was no direction for it to confine its assessment and recommendations only to the non-plan revenue account. Moreover, reforming the classification of expenditure and reorientation of Planning Commission were being debated within the Union government itself.[11] Predictably, the FC-XIV, in a major departure from the past, took a comprehensive view of the entire revenue account. As a result, following its award, the share of statutory transfers[12] has gone up to about 75 per cent. With the end of Plan grants to States, the ratio of Finance Commission (FC) transfers to non-FC transfer has also improved – from 54:46 of gross revenue receipts of the Centre in the 2005-10 period to 73:27 in 2016-17.

The next big change in the country's fiscal landscape was the implementation of the nation-wide goods and services tax (GST) from 1 July 2017, which structurally altered the indirect taxation landscape in the country. It has amalgamated a large number of Union and State taxes into a single tax with a common base for both the Union and the States. The creation of the GST Council with representation from the Union and States (plus three Union Territories with legislature, Jammu & Kashmir, Delhi and Puducherry), with a constitutional mandate to jointly decide about the structure, design and operation of the tax, carves a new institutional mechanism in inter-governmental finances.

The FC-XV was set up in December 2017 with the Terms of Reference (ToR) reflecting the structural and procedural changes that started with the abolition of the Planning Commission and, in addition, setting out new dimensions in terms of

expectations from the Commission.

III

When the FC-XV was constituted, the economy was also going through a period of sluggish growth and had started to decelerate. The slowdown, combined with the structural changes that had taken place over the previous two years – a new monetary framework, demonetization, introduction of GST in July 2017, bankruptcy code for resolution of stressed assets and a new corporate tax structure – made the assessment of medium-term prospects for the revenues and expenditures of the government extremely uncertain. As a result, the term of the FC-XV was extended for another year. Since its report was to cover the period 2020-25, it submitted an interim report for one year – 2020-21 and made its make its recommendations for the period 2021-26.

The outbreak of the unprecedented Covid-19 pandemic early into the extended term of the FC-XV, impacted the economy in multiple ways. The pandemic struck in the fourth quarter (Q4) of 2019-20 at a time when the Indian economy was already slowing – growth in that quarter had contracted to 3.1 per cent over the corresponding quarter of the previous year. This was further exacerbated by the pandemic. No sector of the economy - financial, monetary, fiscal and real - escaped the adverse fallout. The fiscal management of all levels of government was impacted by the "scissors effect" - the need for higher additional expenditure on treatment, augmenting health-care facilities and for providing relief, on the one hand, and a sharp decline in the revenue collections on the other.

The FC-XIII's recommendations covering the period 2010-15 had also been framed amid the global economic crisis. External uncertainties, high external account imbalances, slowing growth rate, large fiscal deficits of the Union government and high and sustained inflation had reduced the policy space for a counter cyclical fiscal policy. However, there was expectation of an economic recovery, with an annual average nominal growth rate forecast of 13.2 per cent and inflation forecast of 4.5-5 per cent for the Commission's tenure. The FC-XIV, too, had been confronted with a declining GDP growth, tardy growth in revenues at both Union and State level and high fiscal imbalance at the Union level. However, the softening of oil prices, easing of inflation and expectations of domestic policy changes following a change in government at the Union were expected to have a positive impact on both fiscal and current account deficits. The

Twelfth Plan growth target of 9 per cent was reduced downwards to 8 per cent for the entire Plan period, but the optimism was evident in the forecast of 13.5 per cent nominal growth assumed by FC-XIV during the award period.

However, the repercussions of the Covid-19 pandemic on the economy were far graver than anything comparable in independent India's history. The GDP declined steeply in the first quarter of 2020-21, and prospects of recovery in later quarters were uncertain. That 2020-21 would end with a negative growth was certain; the debate was on the magnitude of the fall. The GDP estimates are critical in any assessment of revenue collection and expenditure needs of the Union and State governments. Decline in growth implies less availability of revenues for the government due to the shrinking of tax bases. Besides, in an era of rule-based fiscal control, with a numeric cap on fiscal deficit, it implies a contraction in government expenditure to keep the deficit at a sustainable level, a proposition contrary to the counter cyclical fiscal expansion necessary to bring the derailed growth on track. Unlike the past Commissions, which had the luxury of robust analytical data and assessment to project a uniform nominal rate of growth over the five-year award period, the uncertainties surrounding the spread and abatement of the pandemic made a forecast for growth for the award period by the FC-XV extremely complicated and challenging, with an associated risk of significant forecast errors. The Commission had to calibrate year on year growth estimates based on its own analysis of high-frequency indicators like the index of industrial production, production of key intermediate goods, data on mobility in public spaces and revenue collections of governments.

Given this backdrop, the FC-XV titled its report "Finance Commission in Covid Times". The Commission outlined its vision to "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."[13] The objectives combine the imperatives of alleviating the damage due to the pandemic, fostering higher and efficient growth which would be equitable and inclusive, and encouraging investment to prepare for and adapt to the needs of the future.

Five key principles underline the recommendations : (i) adherence to the Constitutional mandate and addressing the terms of reference within that mandate; (ii) ensure stability and predictability of finances for both the Union and the States through

an optimum mix of devolution, grants and fiscal deficit limits; (iii) design grants to catalyse important public services, with greater flexibility and freedom in the choice of inputs keeping in balance collaborative federalism; (iv) use performance based incentives to reward and motivate innovation and reforms with outcomes linked to desired national objectives; (v) rule-based fiscal consolidation with sufficient flexibility and resilience to advance development and growth objectives.

IV

The ToR on vertical and horizontal devolution were broadly in conformity with the Constitutional provisions under Article 280 (3). But the appointment of the FC-XV was followed by an unprecedented controversy around some unusual terms of reference that precipitated speculation on the approach it would take on the vertical and horizontal devolution. All four previous Commissions appointed after the 80th Constitutional amendment[14] had terms of reference that were almost identical, barring a few issues under “other considerations”.

For FC-XV, the most controversial term of reference was the use of population figures based on the 2011 Census. All Commissions since the Sixth Commission (1974-5 to 1978-9) had used the 1971 census data. While the FC-XIV had been given flexibility to consider demographic changes since 1971, the use of 1971 population data was mandated for devolution and determination of grants. Doubts were also expressed on the clauses in the ToR of the FC-XV relating to the need for revenue deficit grants, imposition of conditions on borrowing, review of the level of devolution recommended by the FC-XIV and the imperative of national development programmes, including New India 2022. Subsequently, another clause was added on exploring the possibility of a separate mechanism for funding defence and internal security and the manner of funding it.

Was a review of the “substantially enhanced” share of 42 per cent recommended by FC-XIV and the requirement for the national development programme imply that the FC-XV reduce the share of States in the divisible pool? What could be a separate mechanism for funding defence and internal security when the original ToR required the Commission to factor in the expenditure on defence, amongst other items, as a demand on the resources of the Union? Would such a mechanism first sequester the requirement

for defence from the divisible pool and then carry out the vertical devolution exercise? These were some of the questions that were raised in the wake of the ToR.

VERTICAL DEVOLUTION: The FC-XIV's approach to vertical devolution had emerged out of twin considerations – stability of transfers, and flexibility to states to meet their expenditure needs as per their own priorities. It found an increase in the capacity of the States to address their development needs in diverse ways. Different development models named after individual states had emerged, each reflecting the capabilities of designing strategies for economic management. Therefore, in line with its trust-based approach towards all layers of government, greater flexibility was required to be given to the States to calibrate their policies. Yet, there was a recognition of the limits to which the Union can transfer to the States from its total revenues. Based on the existing level of aggregate transfers between 2009-10 to 2014-15, this limit was set around 49 per cent of gross revenue receipts, and far higher than the limit of 39 per cent set by the Thirteenth Commission.[15] The FC-XIV also factored in the sharp increase in cesses and surcharge, which are not shareable, and the rise in the share of non-statutory transfers compared to statutory transfers. Thus, in its recommendation, both the reduction in the size of the divisible pool and the constriction of the fiscal space of the States by the pre-emption of funds for CSS, justified an alteration in the transfer scheme. The alternative lay in increasing the unconditional formula-based transfers which gave the States the flexibility to calibrate their policies and expenditure needs. The FC-XIV chose to address this increase through a compositional shift within the available fiscal space of 50 per cent of gross revenue receipts available with the Union for transfers. The abolition of the Planning Commission and the freedom given to the Commission in the ToR to take a comprehensive view of both plan and non-plan revenue expenditures of States facilitated the shift, as several transfers through Planning Commission got subsumed within the vertical devolution. In sum, the vertical share was increased from the level of 32 per cent recommended by the Thirteenth Commission to 42 per cent of the divisible pool.

Predictability in resource flow enables the States to plan ahead and stability ensures that there are no sudden shocks to the flow of funds. For the FC-XV, in view of the pandemic, predictability and stability of resources was a paramount criterion. To allay any misgivings on the sequestration of funds for defence and internal security from the divisible pool, the FC-XV reaffirmed the Constitutional principles that precluded it

from pre-empting any sum from the divisible pool for such expenditure. At the same time, any doubts on the review of quantum of vertical transfers were dispelled. Since several Plan transfers had got subsumed into the vertical share, and the distinction between plan and non-plan had been abolished, any change, it was argued, would destabilise the States.

Three other factors shaped the quantum of vertical devolution. The first is continuity in the flow of funds to impart predictability and stability to long-term budgeting and fiscal marksmanship. The second is the unconditional nature of tax devolution which provides the States the desired flexibility in addressing their needs. The third is the advantage of States getting higher revenues by way of Union's share in a buoyant economy with higher tax collections and, in case of a slowdown, the Union's macro-stabilisation role becoming the anchor to absorb the shocks at the State level. Thus, there was no change in the level of vertical share of the States. In line with the report of the FC-XIV and, taking a holistic view of transfers at 50 per cent of the gross revenue receipts of the Union, the share of States was kept stable at 41 per cent of the divisible pool[16]. The remaining share within the 50 per cent overall transfers would be through various forms of FC and non-FC transfer mechanisms for which adequate fiscal space was available with the Union.

HORIZONTAL DEVOLUTION: Transfers resolving horizontal imbalance are meant to ensure horizontal equity or equal treatment of equals (as against geographical equity) across the federation. In line with the broad approach of recent Commissions, the horizontal devolution formula of FC-XV set out to achieve four specific objectives. These were: "(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 equalize fiscal capacities of States (revenue equalization); (iv) to provide for cost differentials among States for providing basic public service (expenditure equalization)."[17] The formula attempts to balance needs, equity and efficiency with weights that ensure both stability and predictability in transfers with a degree of continuity and few changes in the formula that the FC-XIV had prescribed.

The FC-XIV's approach to the horizontal devolution itself had deviated from the past in three respects.

- The ToR mandated use of 1971 population for determination of devolution and grants but left open the option to take into account the demographic

changes that had taken place subsequent to 1971. Taking a cue from this, the Commission decided on the weight for 1971 population first and then separately introduced a weight for 2011 population to reflect the demographic changes, including migration and age structure.

- It introduced a new criterion of forest cover in the formula. Forests needed to be rewarded because they were a universal public good and a national asset, with an opportunity cost lost in terms of area not available for other economic activities. In forest areas, there was both a loss of revenue and higher than normal expenditure to provide public services.
- It dropped the fiscal efficiency criterion. As fiscal discipline, both in terms of tax effort and expenditure control, came within the purview of obligations cast upon States by the Fiscal Responsibility and Budget Management (FRBM) Act, it was not considered to be an appropriate criterion to benchmark performance.

While the FC-XV continued with population, area, forest cover and income distance criteria from the FC-XIV, with minor adjustments in weights, it re-introduced the efficiency criterion. The approach is to reward States for their past performance and create an incentive structure for better utilization of resources.

The criterion of 'demographic performance' used by the FC-XV is an innovative interpretation of the ToR. Population criteria impacts the horizontal share in two ways. One is the loss due to decline in the percentage share of a state in total population. The other is the use of population as a scaling factor in measuring distance of per capita income and tax effort. Several States which had performed creditably in reducing their Total Fertility Rate (TFR) since 1971 were likely to lose substantially due to the use of the 2011 census data. However, the ToR also suggested that a performance incentive to States for efforts and progress made in moving towards replacement rate of population growth be considered. Demographic performance, accordingly, was designed to measure the inverse of TFR of each State scaled by the population of the State as per 1971 census. Thus, a State with lower TFR will score higher and a State with higher TFR will score lower. This criteria with a weight of 12.5 per cent has been labelled as an 'umbrella performance reward'[18] for efforts made by States in controlling their population and achieving better human capital outcomes in education and health. Importantly, this

minimizes the disruption caused by the change in the use of the population from 1971 census to 2011 census and imparts the much-needed stability in the horizontal shares.

FC-XV also re-introduced the criteria on tax effort, which the FC-XIV had dropped, albeit with a small weight of 2.5 per cent, with the objective to incentivize States with higher efficiency of tax collection. At a time when fiscal consolidation has been a subject of concern for many States as well as the Union, this criterion reinforces the emphasis the FC-XV lays on importance of resource mobilization going forward into the award period[19].

V

The ToR required the FC-XV to lay down the principles that would govern the grants-in-aid to the States and the sums to be paid to them under Article 275 (1) of the Constitution. Though this has been one of the core mandates of all Finance Commissions, the ToR also, in a departure from past practice, required the Commission to examine the necessity of giving revenue deficit grants. Amongst other considerations, FC-XV was required to consider proposing measurable performance-based incentives for States, at the appropriate level of government in 11 policy areas.

The emphasis on performance-based incentives in the ToR was somewhat surprising because the FC-XIV had eschewed recommending both sector-specific and state-specific grants for several reasons. The FC-XIV found discontinuity in the sectors recommended by past Finance Commissions, lack of uniformity in determining the size of the grants and State-wise allocations, and subjectivity in choice of sectors and projects. As the Finance Commissions usually had a limited tenure, many grants suffered from poor design and implementation problems, tardy utilization and overlaps and duplication with existing schemes. The FC-XIV also argued that the size of the grants constituted a very small percentage of the total grants going to States. It nevertheless emphasized the case of transfers from the Union government to the States to augment expenditure in specific sectors with high degree of externalities to ensure desired minimum level of expenditures in every state.

However, in the light of the challenges that emerged as a consequence of the pandemic, the FC-XV found in the ToR an opportunity "to shift to a new paradigm of performance – and innovation – in achieving these prerequisites for advancing India's

development"[20] and resume sector and state specific grants. The pandemic had revealed enormous shortcomings in critical public services. If the ultimate objective of growth is to enable the country to adapt and move towards more sustainable human development, special focus was required to address the gaps. Unlike formula-based devolution, the grants-in-aid can make corrections for cost disabilities and other redistributive requirements through better targeting of deficiencies in public services to promote national development goals. At a time when the growth prospects of the economy are uncertain, targeted grants linked to performance-based criteria incentivize accountability, transparency, and innovation and potentially trigger reform in critical sectors.

In the past all Commissions, including the FC-XIV, had recommended revenue deficit grants for deficit states. A conjoint reading of Article 280 (3) (b) and Article 275 (1) by the Finance Commission mandates a Finance Commission to determine the principles that govern grants-in-aid to the States which are in need of assistance. However, the ToR for the FC-XV had not only omitted the words "which are in need of assistance" but also added a caveat on the necessity of giving revenue deficit grants. Gap grants are given to meet the assessed needs of some states which have a post-devolution revenue deficit. This is because of a vertical imbalance that needs correction. It ensures that at the beginning of each year of the award period, all States start with at least a revenue balance. Affirming the Constitutional principle, FC-XV argued that Article 275 (1) read together with Article 280 (3) (b) made it abundantly clear that "we are obligated to assess the needs of the States on sound principles and determine our recommendations accordingly."[21] Unequivocally it decided to continue with revenue deficit grants. With shortfalls in projected revenues and rising expenditure needs, revenue deficit grants provide much-needed stability in the finances of deficient states, especially at a time when the impact of pandemic is pervasive.

In the chosen sectors, a mix of targeted and performance-based grants have been recommended. Grants for health, higher education, maintenance of Pradhan Mantri Gram Sadak Yojana (PMGSY) roads and judiciary fall in the category of specific-purpose grants, with inputs and outcomes spelt out. Grants for school education, agriculture, statistics, aspirational districts, and aspirational blocks are performance based, with release of grants tied to the achievement of specified outcomes. For the power sector, States have

been given an additional borrowing limit provided they achieve, after meeting a basic entry level condition of updated audited accounts of distribution companies (Discoms), certain pre-defined outcomes that are measurable and can be tracked.

Recognizing the need to scale up the pace of expenditure on health services and the level of health infrastructure, the FC-XV conceived a new approach for sector-specific grants for health services. Giving a wide interpretation to the functions provided in the Eleventh and Twelfth Schedules of the Constitution for panchayats and municipalities, which includes public health, specific grants have been provided to local governments based on a progressive[22] formulation for activities and infrastructure that are required at the local level. For services and infrastructure with wider externalities, specific health grants were provided to the States.

VI

In the FC-XV's approach to grants for local governments, there is some continuity with as well as extensive variation from the past. In contrast to the trust-based approach of the FC-XIV, which kept conditionality and tied grants to the absolute minimum, the recommendations of FC-XV are a mix of incentives and conditionalities to address systemic challenges as well as contemporary needs. They continue with the FC-XIV's formula for distribution amongst different tiers in both rural and urban areas in the ratio of 90:10 for population and area respectively or as per the accepted State Finance Commission (SFC) recommendation. Likewise, in order to ensure greater predictability in the transfers, the quantum of funds to be made available has been determined as fixed amounts for the five years of the award period and not as a proportion of the divisible pool[23]. Hence, the share of grants for local governments as a proportion of the gross revenue receipts was increased by 42 basis points from 2.43 per cent to 2.85 per cent.

For the FC-XIV, "neither the ToR nor the Constitution permitted them to play any role in the devolution of powers to panchayats and municipalities or to promote a particular model of decentralization."[24] For rural areas, 90 per cent of the grants were untied and to be spent by only by village panchayats in rural areas responsible for basic services[25]. In urban areas, 80 per cent of the grants were untied. The performance grants – 10 per cent in rural areas and 20 per cent in urban areas – were tied to two fundamental reforms relating to local bodies making audited accounts available and show improvement in own revenues. In line with the trust-based approach, inter-se

distribution was left to the State governments based on the recommendation of the SFC, wherever available; the default option given by the FC-XIV would only apply till such time as the SFC recommendation got accepted. Even the detailed procedure for disbursal of the performance grant was left to the discretion of the State Governments concerned.

However, in a departure from the past, FC-XV chose to address three systemic deficiencies that have plagued local governments – something which all four previous Commissions had highlighted with numerous suggestions for reform. Firstly, there is no uniformity or consistency amongst States in the constitution of SFCs, submission of their reports, their acceptance and implementation. Secondly, there are no proper accounts; audit of accounts is more perfunctory than a true reflection of the state of finances of local bodies. Thirdly, despite repeated recommendations and suggestions from previous Commissions, the resources of the local government, particularly municipalities, have remained abysmally low. The FC-XIV had also identified each of these and trusted the States and local governments to take corrective steps. The question before FC-XV was whether to continue with the status quo in the expectation of change or to incentivize reforms with simple, yet focused, conditions for fostering self-reliance and long-term sustainability. It was also important to ensure that the recalcitrance of State governments does not become a ground for depriving the local governments from the flow of grants.

The approach combines trust with responsibility by fixing entry-level conditions with practical timelines to access grants, other than health grants[26]. Reforms are directed towards making SFCs more effective, maintenance of accounts with regular audit and making them publicly available for rural and urban local governments. Each of the entry-level conditions has been designed to give sufficient time to the States to take corrective action and, in respect of audited accounts, prepare the local bodies to build capacity. For municipalities, an additional entry-level condition incentivizes reform in property tax laws and collections, an issue on which there has been widespread agreement on the need for correction and improvement.

Based on inputs on the role of local governments in handling the pandemic, the approach also aligns the grants to the provision of certain basic public service with wide externalities and leaves a smaller share of untied grants. For panchayats and municipalities with less than one million population, 60 per cent of grants are tied to interventions that promote better health and nutrition outcomes – drinking water,

rainwater harvesting, water re-cycling, maintenance of ODF status and solid waste management. For urban agglomerations (UAs) with over one million population, contemporary challenges of air pollution, drinking water, sanitation and solid waste management were identified as critical focus areas to raise the quality of life of the citizens. FC-XV recognized the complexities of governance in UAs. Thus, in implementation, the concerned ministries in the Union Government[27] and the State governments are expected to guide institutional and technological innovations to achieve the benchmarks to access the Million-plus Cities Challenge Fund. A challenge fund has also been designed for incubation of new cities to foster innovations in urban governance on a pilot basis.

VII

When the FC-XV was constituted, there was much scepticism on the stand that it would take on the contentious issues in the ToR. Reddy and Reddy hoped that the FC-XV would "have the courage and wisdom to be guided by the letter and spirit of Constitutional provisions in discharging its responsibility and upholding the sanctity of the institution[28]." Institutional credibility and neutrality are essential to facilitate harmonious negotiation and bargaining among different levels of government. The FC-XV's approach and recommendations are designed to maintain the balance between the Union and the States[29]. On each of the issues which were perceived to be tilted in favour of the Union – quantum of vertical devolution, need for revenue deficit grants, possible sequestration of defence and internal security expenditure from the divisible pool – Constitutional propriety and rational analytical judgement ensures that the overall federal fiscal balance remains stable and strong. Misgivings amongst the States on account of the use of 2011 population was addressed innovatively to maintain the stability in the transfer system. Dr. Ambedkar told the Constituent Assembly that the Finance Commission will be acting "as a bumper between the President and the provinces.[30]" The FC-XV justified that faith.

The FC-XIV introduced a compositional shift in transfers and raised the vertical share of taxes in the expectation that the increase in unconditional transfers will provide the States with the flexibility to prioritise and spend on their needs. As the FC-XV has also kept the vertical shares of the States stable and giving the States the desired flexibility, a

question often asked is whether this will deliver the desired outcomes. The shares of expenditure between general, social and economic services during the award period of the FC-XIV show wide variation, particularly the inequality in spending on social services. Expenditure on general services and committed expenditure remains high for most States. The own tax revenues of the States have also declined. Where the FC-XV differs from FC-XIV is in its explicit emphasis on austerity in establishment-related expenses, with the expectation that developmental expenditure for social sector and human development will receive special attention to overcome the shocks caused by the pandemic. Grants have been designed to nudge the States and the Union in that direction.

We have highlighted the approach of FC-XV to address the core mandates of a Finance Commission and flagged the elements of continuity and change from the award of its predecessor. Many non-core recommendations have also been addressed by Finance Commissions, which, when acted upon, led to meaningful reforms. The FC-XV, in keeping with the precedents, has also addressed several fiscal and non-fiscal issues that impact public finances. With the battle with the pandemic continuing, it is expected that the stability in inter-governmental finances will be maintained, and growth prospects strengthened with the reforms that the FC-XV has proposed.

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ENDNOTES

[1] Rao, M. Govinda and Nirvikar Singh, 2005. Political Economy of Federalism in India, New Delhi, Oxford University Press. For a more recent discussion Reddy, Y.V. and G.R. Reddy, 2019. Indian Fiscal Federalism, New Delhi, Oxford University Press.
[2] The term 'general government' is used to denote both the Union government and all state governments taken together.
[3] All Finance Commissions henceforth will be referred to as FC-I, FC-II and so on up to FC-XV.
[4] Reddy and Reddy, *ibid*, p.62.
[5] Period of award is 2015-2020
[6] Period of award 2020-2026 included in two reports. One report is for the year 2020-21 and the main report is for the period 2021-26.
[7] Plan expenditure was excluded not because this was a constraint imposed by the Constitution but because either the Terms of Reference (ToR) limited the mandate to the assessment of non-plan revenue account or, as in the case of the Eleventh Commission, due to the practical difficulties associated with assessing plan revenue expenditure and the recognition of the complementary role of the Planning Commission. The Ninth Commission did consider revenue expenditure on both Plan and non-Plan accounts and recommended separate gap grants to meet the revenue deficits for each.
[8] The Constitution defines the role of the Finance Commission in Article 280. Three core mandates have been laid down to address the vertical and horizontal imbalance by determining the appropriate share of Central taxes to be apportioned to and between the States, formulating the principles to govern the grants-in-aid to the States in need of assistance and, recommend measures to augment the Consolidated Fund of the States to supplement the resources of the panchayats and municipalities. The Constitution also provides for the President to seek the Commission's views on any other matter in the interest of sound finance which are set out in the terms of reference (ToR).
[9] Roll-out of direct benefit transfers (DBT) through the Public Finance Management Systems (PFMS), merger of the railway budget with general budget and advancement of the budget presentation to 1 February beginning with the budget of 2017-18 were other reforms introduced in the Union government.

[10] With the abolition of the Planning Commission and its replacement by the NITI Aayog, the channel of Central funding has got confined to the Finance Commission awards and Central grants through the various Centrally Sponsored Schemes administered by line ministries.
[11] For a background on removal of Plan:Non-plan distinction, please see the *Report of the High Level Expert Committee on Efficient Management of Public Expenditure, July 2011*, Planning Commission, New Delhi, which recommended doing away with the segmented Plan-Non Plan distinction in expenditure and its replacement with a more holistic view of revenue-capital classification. For the necessity of reorienting Planning Commission, please see the farewell speech of Dr. Manmohan Singh, as Prime Minister and Chairman of the Planning Commission, to the Planning Commission on April 30, 2014, reported in Financial Express, May 1, 2014 https://www.financialexpress.com/archive/in-farewell -speech-pm-manmohan-singh-says-india-story-work-in-progress/1245663/ , where he spoke of reorienting the body to remain relevant in the globalized world. For a report on complete restructuring of Planning Commission, please see Reforming the Planning Commission- An assessment by the Independent Evaluation Office, mimeo ??? and Business Standard, June 24, 2014 https://www.business-standard.com/article/economy-policy/plancom-should-be-replaced-by-new-think-tank-evaluation-office-114062300893_1.html. The announcement by the Prime Minister Narendra Modi on August 15, 2014 ended the sixty-five year long era of central planning.

[12] Statutory transfers are transfers that take place from the Union to the States based on the award of the Finance Commission. These are assured transfers and provide predictability to the flow of funds to the States unlike non-statutory or non-FC transfers that have a discretionary characteristic.

[13] Report of the Fifteenth Finance Commission, Vol. I, Ministry of Finance, Government of India, New Delhi, para 1.9, page 3 accessible at https://fincomindia.nic.in/ShowContent.aspx?uid1=3&uid2=0&uid3=0&uid4=0

[14] By the 80th Constitution amendment in 2000, Article 270 was amended to combine several direct and indirect taxes into a common divisible pool and Article 272, which enabled the Union to levy and collect taxes and distribute a share to the States, was omitted.

[15] The share of transfers (including direct transfers to implementing agencies) has remained in the range of 48 per cent to 53 per cent from 2008-09 onwards. Report of the Fourteenth Finance Commission, Ministry of Finance, Government of India, New Delhi, Table 12.1, page 159 accessible at https://fincomindia.nic.in/writereaddata/html_en_files/oldcommission_html/fincom14/others/14thFCReport.pdf and FC-XV Report, *ibid,* Table 3.19, page 91

[16] One per cent was taken out from 42 per cent share fixed by FC-XIV to adjust for Jammu and Kashmir and Laddakh becoming Union Territories.

[17] FC-XV Report, *ibid*, Para 6.33, p 157

[18] FC-XV Report, *ibid*, para 1.48, p 12

[19] A separate chapter on "Resource Mobilization" has been included in the report to emphasize its criticality for the country.

[20] FC-XV Report, *ibid*, para 1.14, p 4

[21] FC-XV Report, *ibid*, Para 10.14, p 293

[22] Inter-se distribution is done on the basis of per capita health expenditure distance method, similar to the income distance method used in the horizontal formula and derived separately for North-East & Himalayan States and the General states.

[23] The FC-XIII had determined the grants for local governments as a percentage of the divisible pool of the previous year as stipulated by the Commission, after converting this share into grants-in-aid under Article 275 of the Constitution. Adhering to the Constitutional principles, the FC-XIV did away with this practice.

[24] Report of the Fourteenth Finance Commission, Ministry of Finance, Government of India, New Delhi, para 9.63, p 111 accessible at https://fincomindia.nic.in/writereaddata/html_en_files/oldcommission_html/fincom14/others/14thFCReport.pdf

[25] Intermediate and districts panchayats were excluded from the grants because they were not directly responsible for providing basic services. FC-XIV Report, *ibid.*

[26] Health grants to local governments are totally unconditional and flow from the first year of the award.

[27] Ministry of Housing and Urban Affairs and Ministry of Environment, Forests and Climate Change.

[28] Reddy and Reddy, 2019, *ibid*, page 256.

[29] Unlike the cover page of previous Commission's report, the cover of FC-XV report has the weighing scale in perfect balance depicting the Union on one side and the States on the other.

[30] Constituent Assembly Debates, August 10, 1949.
https://www.constitutionofindia.net/constitution_assembly_debates/volume/9/1949-08-10