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Will 14th Finance Commission burn out the oil bonanza?

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Bottom line: Reddy for decentralization, growth deepening

Clients are asking whether the Reddy Finance Commission will restrict the Budget's ability to support growth despite the drop in oil prices. Our answer: Yes, it will constrain Finance Minister (FM) Arun Jaitley's capacity to step up infrastructure investment tomorrow (Feb 28). And no, it will not pull down infrastructure spend *per se*, as States will disburse the same money.

Our estimates are that the Center will have to pay States an additional Rs1,346bn in FY16. This will offset the Rs1088bn oil bonanza from lower oil subsidies (Rs309bn) and higher oil taxes (Rs779bn). This, in turn, should limit growth in the Center's expenditure to 4.5% (vs 5.9% in FY15) if FM Jaitley targets the pre-committed 3.6% of GDP. However, once adjusted for the increase in States' share of taxes to 42% as per the Reddy Commission, the growth in gross expenditure comes to 12.6%.

On balance, we believe the seed of decentralization, sown by the Reddy Finance Commission will deepen growth in the coming years. Its impact will likely be as far reaching as the Rangarajan Commission, which transferred funds and generated faster growth in the poorer States. See Appendix for details.

3.6% of GDP fiscal deficit, Rs4,800bn net borrowers

We expect FM Jaitley to target a fiscal deficit of 3.6% of GDP for FY16, in line with the pre-committed fiscal consolidation path. This should lead to net borrowing of Rs4,800bn, lower than the Rs5,000bn in FY15. In response, our South Asia rates strategist, Rohit Garg, sees the 10y softening to 7.25%, especially as we expect the RBI to cut policy rates by 25bp each on April 7 and in June, and a total of 100bp more by April 2016.

Reddy Finance Commission transfers spending to States

We estimate that the Center will have to pay States an additional Rs1,346bn in FY16 as the Reddy Finance Commission has hiked the share of States in Central taxes to 42% from 32%. This will offset the Rs1,088bn oil bonanza from lower oil subsidies (Rs309bn) and higher oil taxes (Rs779bn). We had already highlighted this in our pre-Budget report (link) that the Reddy Finance Commission will transfer funds from the Center to the States (Tables 1-3).

We now estimate Center's net tax revenues at Rs9,275bn which, in turn, will limit growth in the Center's expenditure to 4.5% (vs 5.9% in FY15) if FM Jaitley targets the pre-committed 3.6% of GDP. Alternatively, if he targets a higher fiscal deficit of 4%, Center's expenditure growth could then be higher at 8.1% to allow for higher infrastructure spending. However, once adjusted for the increase in States' share of taxes to 42% as per the Reddy Finance Commission, the growth in gross expenditure (including additional transfer to States) comes to 12.6% in case of the 3.6% of GDP fiscal deficit target (and 16.3% with 4% fiscal deficit target).

We highlight that the States will spend the money transferred to them. The Reddy Finance Commission has recommended that the Center should phase out the 66

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Central Sponsored Schemes (CSS) that it is now funding. FM Jaitley has told the media that the Center will likely continue to fund some of these schemes.

A simplified example

We present a highly simplified numerical example explaining the Reddy Finance Commission's impact on the Budget.

Current position:

1. Let us suppose the Center raises gross taxes of Rs100: Share of cess and surcharges is assumed at Rs13 (as per FY14 actuals), and that cannot be shared with States as per the Constitution. So, Rs87 goes into the divisible pool.
2. Centre transfers Rs28 (32% of Rs87) to States.
3. In addition, it transfers another Rs34 to States to finance Central Sponsored Schemes (CSS), and other Plan and non-Plan grants. There are 66 CSS projects that get about Rs10.
4. In short, Rs62 goes to States. This seems to range at Rs55-65, depending on the version/year one takes.
5. The Center spends Rs38 on its own account.

Reddy Finance Commission's proposal:

1. The Center will now have to transfer 42% of Rs87 to the States.
2. This works out to Rs37, up from Rs28 earlier.
3. This Rs9 should be largely set off by the phase-out of Central Sponsored Schemes (CSS). So, Rs34 should come off by Rs9 as well.
4. This means that the Center's gross expenditure (inclusive of States' transfers) will shrink by Rs9.
5. At the same time, the Center will continue to spend Rs38 on its account.
6. So, there should not be any major impact on State borrowing, as the higher tax transfer will have to fund the erstwhile CSS.

Spending on Infrastructure:

1. The Center will now have Rs9 less to spend.
2. This Rs9, however, will be spent by States.
3. So, infra spend will not change overall, only the decision will be at the State level rather than with the Center. As a result, the quality of fiscal consolidation would now depend at the State level, rather than at the Union level.

Oil bonanza:

1. The oil bonanza of Rs1,088bn will yield 0.8% of GDP at US$55/bbl.
2. We assume that higher oil taxes of Rs779bn will have a road cess component of Rs230bn (@ Rs2/ltr) to fund national highways. Rs549bn of additional oil taxes will therefore go into the divisible pool.
3. 42% of Rs549bn, i.e. Rs231bn (0.16% of GDP) will go to the States in the new sharing arrangement, as opposed to Rs176bn (@32%) as per the earlier arrangement.
4. The rest Rs318bn of higher oil taxes (0.22% of GDP), along with Rs309bn in savings on oil subsidies (0.22% of GDP), will go towards fiscal consolidation if the FM wants to target GDP fiscal deficit of 3.6%.

Table 1: Center to meet 4.1% in FY15; target 3.6% for FY16

Item/Rsbn	FY14 RE	FY 15-BE	FY15E	FY16E	FY16E (Case II)
1.Revenue receipts	**10153**	**11898**	**10829**	**11475**	**11475**
Tax revenue	8160	9773	8704	9275	9275
Non-tax revenue	1992	2125	2125	2200	2200
2. Non-debt capital receipts	**401**	**740**	**480**	**675**	**675**
Recovery of loans	125	105	105	125	125
Other receipts	276	634	375	550	550
3. Total receipts (1+2)	**10553**	**12637**	**11309**	**12150**	**12150**
4. Non-plan expenditure	**11104**	**12199**	**11953**	**12500**	**13000**
4.1 On revenue account	10230	11146	11178	11600	12000
4.1.1 of which: Int. payments	*3775*	4270	4270	4650	4650
4.1.2 of which: Oil Subsidy	*855*	*634*	*634*	*325*	*325*
4.2 On capital account	874	1053	775	900	1000
5. Plan expenditure	**4531**	**5750**	**4600**	**4800**	**4900**
5.1 On revenue account	3525	4535	3500	3600	3700
5.2 On capital account	1005	1215	1100	1200	1200
6. Total expenditure (4+5)	**15635**	**17949**	**16553**	**17300**	**17900**
6.1 Gross Exp (adj for higher States' share in FY16)	15635	17949	16553	18646	19246
7. Gross fiscal deficit (6-3)	**5081**	**5312**	**5244**	**5150**	**5750**
8. Revenue deficit (4.1 + 5.1 - 1)	**3603.1**	**3783.5**	**3849.0**	**3725.0**	**4225.0**
% of GDP					
9. Gross fiscal deficit	**4.5**	**4.2**	**4.1**	**3.6**	**4.0**
10. Revenue deficit	**3.2**	**2.9**	**3.0**	**2.6**	**2.9**

Source: BofA - Merrill Lynch Global Research estimates, CGA

Table 2: Net central tax revenue falls as states' share rises in FY16

% yoy	FY14	FY15 BE	FY15 YTD (up to Dec)	FY15 BofAMLe	FY16 BofAMLe
Corporate	10.76	14.27	6.59	4.50	13.00
Income	18.02	19.55	8.39	11.00	18.00
Customs	4.10	17.25	9.45	11.00	17.00
Excise	-4.00	22.21	0.17	1.00	57.75
Service	16.61	39.67	8.53	13.00	20.00
Gross Tax Revenue	9.90	19.82	6.99	7.64	22.03
States Share	**7.52**	**21.69**	**10.58**	**11.71**	**59.90**
Net Tax Revenue	**10.85**	**19.09**	**5.42**	**6.06**	**6.56**
Rs bn					
Corporate	3947	4510	2776	4124	4661
Income	2378	2843	1666	2639	3115
Customs	1721	2018	1356	1911	2235
Excise	1695	2071	1019	1712	2700
Service	1546	2160	1052	1747	2097
Gross Tax Revenue	11388	13645	7957	12258	14959
States Share	**3182**	**3873**	**2500**	**3555**	**5684**
Net Tax Revenue	**8206**	**9773**	**5457**	**8704**	**9275**

Source: BofA - Merrill Lynch Global Research estimates, CGA

Table 3: Table 4: Subsidies to shrink in FY16

% of GDP	FY13	FY14	FY15-BE	FY15 BofAMLe	FY16 BofAMLe
Food	0.85	0.81	0.89	0.91	0.91
Fertiliser	0.66	0.60	0.57	0.55	0.35
Petroleum	0.97	0.75	0.49	0.50	0.23
Interest	0.07	0.07	0.07	0.07	0.06
Other subsidies	0.02	0.02	0.01	0.02	0.02
Subsidies	**2.58**	**2.25**	**2.02**	**2.05**	**1.56**
Rs bn					
Food	850	920	1150	1150	1300
Fertiliser	660	680	730	700	500
Petroleum	969	855	634	634	325
Interest	74	82	85	85	90
Other subsidies	24	19	8	25	25
Subsidies	**2577**	**2555**	**2607**	**2594**	**2240**

Source: BofA - Merrill Lynch Global Research estimates, CGA

Appendix

14th Finance Commission recommendations: An excerpt

The Appendix is an excerpt from the full commission report which is publicly available at: http://finmin.nic.in/14fincomm/14fcreng.pdf

In this section, we present an excerpt from pages 243 – 261 of the original report.

Sharing of Union Taxes

1. Considering all factors, in our view, increasing the share of tax devolution to 42% of the divisible pool would serve the twin objectives of increasing the flow of unconditional transfers to the States and yet leave appropriate fiscal space for the Union to carry out specific-purpose transfers to the States.

2. We have not consented to the submission of States on minimum guaranteed devolution.

3. Though we are of the view that use of dated population data is unfair, we are bound by our ToR and have assigned a 17.5% weight to the 1971 population. On the basis of the exercises conducted, we concluded that a weight to the 2011 population would capture the demographic changes since 1971, both in terms of migration and age structure. We, therefore, assigned a 10% weight to the 2011 population.

4. For area we have followed the method adopted by the FC-XII and put the floor limit at 2% for smaller States and assigned 15% weight.

5. We believe that large forest cover provides huge ecological benefits, but there is also an opportunity cost in terms of area not available for other economic activities and this also serves as an important indicator of fiscal disability. We have assigned 7.5% weight to the forest cover.

6. We have decided to revert to the method of representing fiscal capacity in terms of income distance and assigned it 50% weight. We have calculated the income distance following the method adopted by FC-XII.

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

8. As service tax is not levied in the State of Jammu & Kashmir, proceeds cannot be assigned to this State. We have worked out the share of each of the remaining

twenty-eight States in the net proceeds of service taxes and presented this in Table 8.3.

Local Governments

9. We recommend that the local bodies should be required to spend the grants only on the basic services within the functions assigned to them under relevant legislations.

10. We recommend that the books of accounts prepared by the local bodies should distinctly capture income on account of own taxes and non-taxes, assigned taxes, devolution and grants from the State, grants from the Finance Commission and grants for any agency functions assigned by the Union and State Governments. In addition to the above, we also recommend that the technical guidance and support arrangements by the C&AG should be continued and the States should take action to facilitate local bodies to compile accounts and have them audited in time.

11. We recommend distribution of grants to the States using 2011 population data with weight of 90% and area with weight of 10%. The grant to each state will be divided into two, a grant to duly constituted gram panchayats and a grant to duly constituted municipalities, on the basis of urban and rural population of that state using the data of census 2011.

12. We have worked out the total size of the grant to be Rs.2,87,436 crore for the period 2015-20, constituting an assistance of Rs. 488 per capita per annum at an aggregate level. Of this, the grant recommended to panchayats is Rs.2,00,292.20 crore and that to municipalities is Rs.87,143.80 crore. The grant assessed by us for each state for each year is fixed.

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

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

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

16. We are providing performance grants to address the following issues: (i) making available reliable data on local bodies' receipt and expenditure through audited accounts; and (ii) improvement in own revenues. In addition, the urban local bodies will have to measure and publish service level benchmarks for basic services. These performance grants will be disbursed from the second year of our award period, that is, 2016-17 onwards so as to enable sufficient time to State Governments and the local bodies to put in place a scheme and mechanism for implementation.

17. To be eligible for performance grants, the gram panchayats will have to submit audited annual accounts that relate to a year not earlier than two years preceding the year in which the gram panchayat seeks to claim the performance grant. It will also have to show an increase in the own revenues of the local body over the preceding year, as reflected in the audited accounts. To illustrate, the audited accounts required for performance grants in 2016-17 will be for the year 2014-15; for performance grants in 2017-18, the audited accounts will be for the year 2015-16; for performance grants in 2018-19, the audited accounts will be for 2016-17; and for performance grants in 2019-20, the audited accounts will be for 2017-18.

18. We are of the opinion that it may be better that the detailed procedure for disbursal of the performance grant to gram panchayats based on revenue improvement be designed by the State Government concerned, keeping in view the two conditions given above. The operational criteria, including the quantum of incentive to be given, are left to the discretion of the State Governments. In case some amount of the performance grant remains after disbursement to the eligible gram panchayats, this undisbursed amount should be distributed on an equitable basis among all the eligible gram panchayats. The scheme for disbursement of the performance grant will be notified by the State Governments latest by March 2016, in order to enable the preparation of the eligibility list of local bodies entitled to them. The concerned Ministries of the Union Government will also be informed in order to facilitate release of the instalment of performance grants.

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

20. These guidelines for the disbursement of the rural and urban performance grants will remain in force for the period of our award. We recommend that the

Union Government accept the detailed procedure prepared by the State which incorporates our broad guidelines without imposing any further conditions.

21. We recommend that no further conditions or directions other than those indicated by us should be imposed either by the Union or the State Government for the release of funds.

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

23. We recommend that stern action should be ensured if irregularities in the application of funds are noticed or pointed out.

24. We recommend that the State Governments should strengthen SFCs. This would involve timely constitution, proper administrative support and adequate resources for smooth functioning and timely placement of the SFC report before State legislature, with action taken notes.

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

26. We suggest that the levy of vacant land tax by peri-urban panchayats be considered. In addition, a part of land conversion charges can be shared by State Governments with municipalities and panchayats.

27. We recommend that the States should review the position and prepare a clear framework of rules for the levy of betterment tax.

28. We suggest that States may like to consider steps to empower local bodies to impose advertisement tax and improve own revenues from this source.

29. We recommend that States review the structure of entertainment tax and take action to increase its scope to cover more and newer forms of entertainment.

30. We recommend raising the ceiling of professions tax from Rs. 2500 per annum to Rs.12,000 per annum. We further recommend that Article 276(2) of the Constitution may be amended to increase the limits on the imposition of professions tax by States. The amendment may also vest the power to impose limits on the Parliament with the caveat that the limits should adhere to the Finance Commission's recommendations and the Union Government should prescribe a uniform limit for all states.

31. We recommend that State Governments take action to assign productive local assets to the panchayats, put in place enabling rules for collection and institute

systems so that they can obtain the best returns while leasing or renting common resources.

32. We recommend that the urban local bodies rationalize their service charges in a way that they are able to at least recover the operation and maintenance costs from the beneficiaries.

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

34. We recommend that the Union and State Governments examine in depth the issue of properly compensating local bodies for the civic services provided by them to government properties and take necessary action, including enacting suitable legislation, in this regard.

35. We recommend that local bodies and States explore the issuance of municipal bonds as a source of finance with suitable support from the Union Government. The States may allow the larger municipal corporations to directly approach the markets while an intermediary could be set up to assist medium and small municipalities who may not have the capacity to access the markets directly.

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

Disaster Management

37. The financing of the NDRF has so far been almost wholly through the levy of cess on selected items, but if the cesses are discontinued or when they are subsumed under the GST in future, we recommend that the Union Government consider ensuring an assured source of funding for the NDRF.

38. While making appropriations into the NDRF, we recommend that past trends of outflows from it should be taken into account by the Union Government to ensure adequacy of the Fund in order to assure timely availability and release of funds to the States.

39. Recognizing that contributions from the public and institutions could be another source of financing the NDRF, we recommend that a decision on granting tax exemption to private contributions to the NDRF be expedited and that the Union Government consider invoking the use of Schedule VII of the Companies (Corporate Social Responsibility Policy) Rules 2014 as an enabling provision for financing the NDRF.

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

41. Considering the usefulness of a scientifically validated risk vulnerability indicator to measure the type, frequency and intensity of disasters, and also in view of the very wide responsibility cast on governments at different levels by the statute, we recommend that the Union Government should expedite the development and scientific validation of the Hazard Vulnerability Risk Profiles of States.

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

43. We recommend that all States contribute 10% to SDRF during our award period, with the remaining 90% coming from the Union Government.

44. We are in agreement with the views of the FC-XIII that the decision of constituting DDRFs is best left to the wisdom of the State Governments, and hence, separate grant for the financing of DDRFs are not recommended.

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

46. Considering the need for flexibility in regard to state-specific disasters, we recommend that up to 10% of the funds available under the SDRF can be used by State Governments for natural disasters that they consider to be 'disasters' within the local context in the State and which are not included in the notified list of disasters of the Ministry of Home Affairs.

47. While calculating the requirement for funds from the NDRF during severe calamities, the existing practice of adjusting the contribution made by the Union Government to the SDRF should continue.

Grants-in-Aid

48. A total revenue deficit grant of Rs. 1, 94,821 crore is recommended during the award period for eleven States (Table 11.3).

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

50. We endorse the proposal made by the Department of Justice to strengthen the judicial systems in the States and urge State Governments to use the additional fiscal space provided by us in the tax devolution to meet such requirements.

51. Our projection of the expenditure needs of the States has taken into account the high base of expenditure for both general administration and police. Therefore, in our view, the States have the appropriate fiscal space to provide for the additional expenditure needs as per their requirements. This should help them address the problems and facilitate them to build capacity and bridge the existing gaps in regard to general administration and police.

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

53. We consider health, education, drinking water and sanitation as public services of national importance, having significant inter-state externalities. However, in our view, the grants to these sectors should be carefully designed and implemented and an effective monitoring mechanism put in place with the involvement of the Union, States and domain expertise. Therefore, we have desisted from recommending specific purpose grants and have suggested that a separate institutional arrangement be introduced for the purpose.

Towards Cooperative Federalism

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

55. We believe the existing arrangements for transfers between the Union and the States need to be reviewed with a view to minimizing discretion, improving the design of transfers, avoiding duplication and promoting cooperative federalism, insofar as such transfers are required to be made outside of the recommendations of the Finance Commission.

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

57. We urge that the suggested new institutional arrangement also consider taking up issues related to identifying and recommending resources for inter-state infrastructure schemes in the North-eastern States.

58. We urge that the new institutional arrangement should also become the forum for integrating economic and environmental concerns in decision making.

59. We suggest that the present role of the Inter-State Council be expanded to include the functions envisaged in paragraphs 12.28, 12.32 and 12.35.

60. We expect that the Union Government will utilize its available fiscal space to continue to address the needs and expectations of the States and ensure the prevailing level of transfers to States of about 49% of the gross revenue receipts during the award period.

Goods and Services Tax

61. There are several challenges and many unresolved issues. In the absence of clarity on the design of GST and the final rate structure, we are unable to estimate revenue implications and quantify the amount of compensation in case of revenue loss to the States due to the introduction of GST.

62. The Union may have to initially bear an additional fiscal burden arising due to the GST compensation. This fiscal burden should be treated as an investment which is certain to yield substantial gains to the nation in the medium and long run. We also believe that GST compensation can be accommodated in the overall fiscal space available with the Union Government.

63. In the case of VAT, compensation was provided to the States for three years, at 100% in the first year, 75% in the second year, and 50% in the third year. In our view, it will be appropriate to keep this precedent as the basis for compensation for GST also. However, given the scale of reform and the apprehensions of revenue uncertainty raised by the States, the revenue compensation, in our view, should be for five years. It is suggested that 100% compensation be paid to the States in the first, second and third years, 75% compensation in the fourth year and 50% compensation in the fifth and final year.

64. We recommend creation of an autonomous and independent GST Compensation Fund through legislative actions in a manner that it gives reasonable comfort to States, while limiting the period of operation appropriately.

65. We recommend that the Constitutional legislative and design aspects of the GST enable transition towards universal application of GST over the medium to long term, while making necessary provisions for smooth transition through temporary arrangements.

Fiscal Environment and Fiscal Consolidation Roadmap

66. Keeping in mind the importance of risks arising from guarantees, off-budget borrowings and accumulated losses of financially weak public sector enterprises when assessing the debt position of States, we recommend that both Union and State Governments adopt a template for collating, analyzing and annually reporting the total extended public debt in their respective budgets as a supplement to the budget document.

67. To curb the scope for perverse allocation of available funds among competing projects and to ensure that the economy benefits from investments in capital works, we recommend that the Union and the State Governments provide a statutory ceiling on the sanction of new capital works to an appropriate multiple of the annual budget provision.

68. In the light of our approach to fiscal consolidation and the fiscal roadmap as developed through our assessment of Union and State finances, we recommend a set of rules for the Union and the States.

69. For the Union Government, the ceiling on fiscal deficit will be 3% of GDP from the year 2016-17 onwards up to the end of our award period. We expect that an improvement in the macroeconomic conditions and revival of growth as well as tax reforms (rationalization of the tax structure on the direct taxes side and implementation of goods and services tax (GST) on the indirect taxes side) should enhance the total tax revenues of the Union Government, enabling it to eliminate the revenue deficit completely much earlier than 2019-20.

70. The fiscal deficit targets and annual borrowing limits for the States during our award period are enunciated as follows: i. Fiscal deficit of all States will be anchored to an annual limit of 3% of GSDP. The States will be eligible for flexibility of 0.25% over and above this for any given year for which the borrowing limits are to be fixed if their debt-GSDP ratio is less than or equal to 25% in the preceding year. ii. States will be further eligible for an additional borrowing limit of 0.25% of GSDP in a given year for which the borrowing limits are to be fixed if the interest payments are less than or equal to 10% of the revenue receipts in the preceding year. iii. The two options under these flexibility provisions can be availed of by a State either separately, if any of the above criteria is fulfilled, or simultaneously if both the above stated criteria are fulfilled. Thus, a State can have a maximum fiscal deficit-GSDP limit of 3.5% in any given year. iv. The flexibility in availing the additional limit under either of the two options or both will be available to a State only if there is no revenue deficit in the year in which borrowing limits are to be fixed and the immediately preceding year. If a State is not able to fully utilize its sanctioned borrowing limit of 3% of GSDP in any particular year during the first four years of our award period (2015-16 to 2018-19), it will have the option of availing this un-utilized borrowing amount (calculated in rupees) only in the following year but within our award period.

71. We recommend that for the purpose of assigning State-specific borrowing limits as a percentage of GSDP for a given fiscal year *(t)*, GSDP should be estimated on the basis of the annual average growth rate of the actual GSDP observed during the previous three years or the average growth rate of GSDP observed during the previous three years for which actual GSDP data are available. This growth should be applied on the GSDP of the year *t-2.* Specifically, GSDP for the year (*t-1*) and the given fiscal year *(t)* should be estimated by applying the annual average growth rate of GSDP in *t-2*, *t-3* and *t-4* years on the base GSDP (at current prices) of *t-2*. We recommend that State estimates of GSDP published by the CSO should be used for this purpose.

72. In the case of the interest payments-revenue receipts ratio required for determining additional borrowing limits, we recommend that figures for both should be based solely on the Finance Accounts data for the year *t-2.* The same procedure should be followed in estimating the debt-GSDP ratio. The Ministry of Finance should adhere to the above rules and methodology while determining the annual borrowing ceiling for individual States.

73. We are of the opinion that it would be appropriate to exclude the States from the operations of the NSSF scheme in future, even as they should honor the obligations already entered into insofar as servicing and repayment of outstanding debt is concerned. We recommend that State Governments be excluded from the operations of the NSSF, with effect from 1 April, 2015.As for the fiscal burden incurred in the course of the operations of the NSSF, prior to 1 April, 2015, since the scheme has been administered almost in its entirety by the Union Government , no part of this fiscal burden, incurred till that date, should be passed on to the States. We recommend that the involvement of the States in the NSSF scheme with effect from 1 April 2015, therefore, may be limited solely to discharging the debt obligations already incurred by them until that date.

74. Keeping in view the experience of the States in this regard, we recommend the Union Government should examine the desirability of setting up of Consolidated Sinking Fund at this stage.

75. Recognizing that the fiscal environment should be conducive to equitable growth, we recommend that the Union and all the States should target improving the quality of fiscal management encompassing receipts and expenditures while adhering to the roadmap we have outlined.

76. We urge that all stakeholders recognize the predominant role of the Union in fiscal management, while considering our roadmap for the Union and the States that treats a conducive fiscal environment as the joint responsibility of both.

77. To enable wider dissemination of the manner in which this shared responsibility for a conducive fiscal environment is being discharged by the Union and State Governments, we recommend that the Union Government and the RBI bring out a bi-annual report on the public debt of the Union and State Governments on a regular and comparable basis and place it in public domain.

78. In the light of the experience gained so far and considering the challenge in designing a basic incentive-compatible framework for achieving fiscal correction and adherence to rule-bound fiscal framework for the Union and State Governments to hold each other accountable over agreed fiscal targets, we stress the need for stronger mechanisms for ensuring compliance with fiscal targets and enhancing the quality of fiscal adjustment, particularly for the Union Government.

79. We recommend that the Union Government should consider making an amendment to the FRBM Act to omit the definition of effective revenue deficit from 1 April 2015. We also recommend that the objective of balancing revenues and expenditure on the revenue account enunciated in the FRBM Acts should be pursued.

80. We recommend an amendment to the FRBM Act inserting a new section mandating the establishment of an independent fiscal council to undertake ex-ante assessment of the fiscal policy implications of budget proposals and their consistency with fiscal policy and Rules. In addition, we urge that the Union Government take expeditious action to bring into effect Section 7A of the FRBM Act for the purposes of ex-post assessment.

81. Our approach outlined and recommendations made warrant amendments to the FRBM Acts. To this end, we recommend that the State Governments may amend their FRBM Acts to provide for the statutory flexible limits on fiscal deficit. The Union Government may amend its FRBM Act to reflect the fiscal roadmap, omit the definition of effective revenue deficit and mandate the establishment of an independent fiscal council. Further, the Union and State Governments may also amend their respective FRBM Acts to provide a statutory ceiling on the sanction of new capital works to an appropriate multiple of the annual budget provision.

82. We urge the Union Government to continue to exercise its powers under Article 293 (3), in an effective but transparent and fair manner, enforcing the fiscal rules consistent with the fiscal consolidation roadmap suggested by us for the award period.

83. In order to accord greater sanctity and legitimacy to fiscal management legislation, we urge the Union Government to replace the existing FRBM Act with a Debt Ceiling and Fiscal Responsibility Legislation, specifically invoking Article 292 in its preamble. This could be an alternative to amending the existing FRBM

Act as proposed by us. We urge the State Governments also to consider similar enactments under Article 293(1).

Pricing of Public Utilities

84. We recommend that 100% metering be achieved in a time-bound manner for all electricity consumers as already prescribed statutorily.

85. The Electricity Act, 2003, currently does not have any provision of penalties for delays in the payment of subsidies by State Governments. We, therefore, recommend that the Act be suitably amended to facilitate levy of such penalties.

86. In order to provide financial autonomy to the SERCs, Section 103 of the Electricity Act, 2003, provides for the establishment of a State Electricity Regulatory Commission Fund by State Governments, to enable the SERCs to perform their responsibilities, as envisaged under the Act. We reiterate the importance of financial independence of the SERCs and urge all States to constitute a SERC Fund, as statutorily provided for.

87. We endorse the initiative to set up a Rail Tariff Authority (RTA) and urge expeditious replacement of the advisory body with a statutory body, through necessary amendments to the Railways Act, 1989.

88. We recommend that accounting systems in the State Road Transport Undertakings make explicit the types of subsidies, the basis for determining the extent of subsidies, and also the extent of reimbursement by State Governments.

89. We recommend the setting up of independent regulators for the passenger road sector, whose key functions should include tariff setting, regulation of service quality, assessment of concessionaire claims, collection and dissemination of sector information, service-level benchmarks and monitoring compliance of concession agreements.

90. We recommend that all States, irrespective of whether Water Regulatory Authorities (WRAs) are in place or not, consider full volumetric measurement of the use of irrigation water. Any investment that may be required to meet this goal should be borne by the States, as the future cumulative benefits, both in environmental and economic terms, will far exceed the initial costs.

91. We reiterate the recommendations of the FC-XIII and urge States which have not set up WRAs to consider setting up a statutory WRA, so that the pricing of water for domestic, irrigation and other uses can be determined independently and in a judicious manner. However, this may not be practical for the North-eastern states, due to the small size of their irrigation sectors, with Assam being the exception. Further, we recommend that WRAs already established be made fully functional at the earliest.

92. We recommend that States (and urban and rural bodies) should progressively move towards 100% metering of individual drinking water connections to households, commercial establishments as well as institutions. All existing individual connections in urban and rural areas should be metered by March 2017 and the cost of this should be borne by the consumers. All new connections should be given only when the functioning meters are installed. While providing protected water supply through community taps is unavoidable for poorer sections of population, metering of water consumed in such cases also would ensure efficient supply.

Public Sector Enterprises

93. We recommend that the new realities outlined in para 16.14 be recognized in order to shape and develop a comprehensive public sector enterprise policy with adequate focus on the fiscal costs and benefits. We further recommend that the new realities be considered in evaluating the future of each public enterprise in the entire portfolio of Central public sector enterprises.

94. The evaluation of the fiscal implications of the current level of investments in, and operations of, the existing public enterprises, in terms of opportunity costs, is an essential ingredient of credible fiscal consolidation. Hence, we recommend that the fiscal implications in terms of opportunity costs be factored in while evaluating the desirable level of government ownership for each public enterprise in the entire portfolio of Central public sector enterprises.

95. We recommend that the basic interests of workers of Central public sector enterprises should be protected at a reasonable fiscal cost, while ensuring a smooth process of disinvestment or relinquishing of individual enterprises. We further recommend that employment objectives should be considered in evaluating the portfolio of public enterprises, not only in the narrow context of the enterprises' employees, but also in terms of creating new employment opportunities.

96. We recommend that the enterprises be categorized into 'high priority', 'priority', 'low priority' and 'non-priority' in order to: (i) facilitate coordinated follow-up action by policy makers and (ii) provide clarity to public enterprises themselves on their future and to the financial markets about the opportunities ahead for them.

97. We recommend that the route of transparent auctions be adopted for the relinquishment of unlisted sick enterprises in the category of non-priority public sector enterprises.

98. We recommend that the level of disinvestment should be derived from the level of investment that the government decides to hold over the medium to long term in each enterprise, based on principles of prioritization advised by us, while the process of disinvestment should take into account the market conditions and budgetary requirements, on a year to year basis.

99. We recommend that the government devise a policy relating to the new areas of public sector investments. We also recommend the purchase of shares where the existing portfolio holding in the 'high priority' and 'priority' public sector enterprises is less than the desired level of government ownership.

100. We reiterate the recommendations made by the FC-XIII to maintain all disinvestment receipts in the Consolidated Fund for utilisation on capital expenditure. The National Investment Fund in the Public Account should, therefore, be wound up in consultation with the Controller General of Accounts (CGA) and Comptroller & Auditor General (C&AG).

101. There is considerable merit in the Union Government dispensing a small share of proceeds of disinvestment to the States. In the case of Central public sector enterprises with multiple units located in different states, the distribution of this share could be uniform across all the States where units are located. In cases where only vertical unit-wise disinvestment is done, the share could go to the State/States where the units being disinvested are located.

102. We recognize the importance of making Central public sector enterprises effective and competitive, but suggest that the monitoring and evaluation of these enterprises take into account the institutional constraints within which their managements operate.

103. If the Central public sector enterprises are burdened with implementing social objectives of the government, it should compensate them in a timely manner and adequately through a transparent budgetary subvention. Similarly, losses on account of administered price mechanisms should also be calculated and fully compensated for.

104. We recommend that governance arrangements be reviewed, especially in regard to separation of regulatory functions from ownership, role of the nominee as well as independent Directors, and, above all, the framework of governance conducive to efficiency.

105. We recommend that as part of the comprehensive review of the public sector enterprises proposed by us, policies and procedures relating to borrowing by the enterprises, payment of dividends and transfer of excess reserves be enunciated and enforced.

106. We recommend that, in view of the significant fiscal implications, a clear-cut and effective policy on investments of Central public sector enterprises in their subsidiaries be adopted.

107. We recommend that a Financial Sector Public Enterprises Committee be appointed to examine and recommend parameters for appropriate future fiscal support to financial sector public enterprises, recognizing the regulatory needs, the multiplicity of units in each activity and the performance and functioning of the DFIs.

108. We recommend that, in addition to acting upon the recommendations of the FC-XIII on state-level enterprises, the logic of our recommendations on public sector enterprises in general be adopted, to the extent appropriate, by State Governments.

Public Expenditure Management

109. We endorse the view that the transition to accrual-based accounting by both the Union and State Governments is desirable. We also recognize that this transition can only be made in stages, as it requires considerable preparatory work and capacity-building of accounting personnel. We reiterate the recommendation of the FC-XII that the building blocks for making a transition to the accrual-based accounting system in terms of various statements, including those listed by the Commission, should be appended in the finance accounts by the Union and State governments. We also reiterate its recommendation that action should be taken to build capacity among accounting professionals in accrual-based accounting systems.

110. We reiterate the importance of prompt and effective follow-up on the observations of the C&AG while preparing accounts, and adherence to the timeline prescribed for the laying of accounts before the Parliament and State Legislatures.

111. We recommend that a view be taken expeditiously on all the recommendations of the LMMHA Committee made in 2012.

112. At the Object Head level, we believe it is sufficient to have a few uniform Object Heads, such as salary, maintenance, subsidies and grants-in aid, across both the Union and States. Regarding the other Object Heads, we recommend that States retain their existing flexibility to open new Object Heads according to their functional requirements.

113. We reiterate the importance of linking outlays with outcomes. However, we emphasize that it is essential to spell out key indicators for outputs and to monitor these within an already defined accountability framework.

114. We recommend the formulation of appropriate indicators for the measurement of outputs, specification of standards and costs and establishing a suitable accountability framework.

115. We suggest serious consideration of the issue of assigning primary responsibility for preparing outcome budgets at the level of actual spending and its consolidation at the relevant level of government.

116. We recommend synergizing the efforts of the Union Government and State Governments towards building a technological platform, in which their systems can interface and information can be shared, leading to end-to-end linkages, particularly in respect of sector-specific grants from the Union Government to the States.

117. We recommend that the Union and State Governments consider the recommendations of the Second Administrative Reforms Commission (submitted in 2009) on internal audit and internal control systems, and take a decision on each recommendation expeditiously.

118. We reiterate the views of the FC-XI for a consultative mechanism between the Union and States, through a forum such as the Inter-State Council, to evolve a national policy for salaries and emoluments.

119. We recommend the linking of pay with productivity, with a simultaneous focus on technology, skill and incentives. We recommend that Pay Commissions be designated as 'Pay and Productivity Commissions', with a clear mandate to recommend measures to improve 'productivity of an employee', in conjunction with pay revisions. We urge that, in future, additional remuneration be linked to increase in productivity.

120. We urge States which have not adopted the New Pension Scheme so far to immediately consider doing so for their new recruits in order to reduce their future burden.

121. We recommend that both the Union and State Governments improve their forecasts, by adopting a more scientific approach for this process. Similarly, the fiscal responsibility legislations and estimates in the MTFPs should be backed by well-calibrated reasoning to justify the forecasts. When forecasts are out of line with past trends, it is important to make a detailed statement on the intended reforms necessary to enhance revenue productivity and rationalize expenditures. We also recommend that the Union and State Governments undertake measures to improve their cash management practices.

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