Syllabus subtopic:

- Functions and Responsibilities of the Union and the States, Issues and Challenges Pertaining to the Federal Structure, Devolution of Powers and Finances up to Local Levels and Challenges Therein
- Statutory, Regulatory and various Quasi-judicial Bodies.

Prelims and Mains focus: about the recommendations by FFC and the action taken by the government; types of deficits; about finance commission

News: The finances of revenue-deficit states may be hit as the Finance Minister in her budget allocated only 40% of the Rs.74,340 crore revenue deficit grants for FY21, which was recommended by the 15th Finance Commission (FFC), despite having accepted its proposal.

Background

- The Commission had recommended post-devolution revenue deficit grants for 14 states in 2020-21.

- Of the Rs.74,340 crore revenue deficit grants, Rs.37,917 crore was meant for Andhra Pradesh, Kerala, Punjab, Tamil Nadu and West Bengal. The remaining Rs.36,423 crore was for Assam, Himachal Pradesh, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura and Uttarakhand.

- The government had accepted the above recommendation of the Commission.

Recommendations made by the FFC

1. Revenue deficit grants

   - As per FFC estimates, 25 of the 28 states face a total pre-tax devolution revenue deficit of Rs.6.43 trillion in 2020-21.
• After accounting for the projected tax devolution to the states of Rs.8.55 trillion, 14 states garner post-tax devolution revenue surplus of Rs.3.08 trillion, while the remaining 14 face a combined post-tax devolution revenue deficit of Rs.74,340 crore. These states have been compensated by the FFC.

• The largest beneficiaries of the recommendation are Kerala (Rs.15,323 crore), Himachal Pradesh (Rs.11,431 crore), Punjab (Rs.7,659 crore), Assam (Rs.7,579 crore), Andhra Pradesh (Rs.5,897 crore), Uttarakhand (Rs.5,076 crore) and West Bengal (Rs.5,013 crore).

2. Weightage of population and demographic performance

• Since the FFC used 2011 Census data, the tax share of most southern states with low population growth rates, such as Andhra Pradesh, Kerala and Karnataka, has come down, while the share of Bihar, Madhya Pradesh, Punjab, Maharashtra and Gujarat has gone up.

• The FFC assigned 15% weight to the population of a state, down from the 17.5% allocated by the 14th Finance Commission, while raising the weight under demographic performance from 10% to 12.5%.

3. Special grants & nutrition grants

• The finance ministry has also asked the FFC to review its recommendations on special grants and nutrition grants to the states.

• The commission had recommended special grants of Rs.6,764 crore for 2020-21 to ensure that no state receives less than what it received in FY20 on account of tax devolution and revenue deficit grants.

• However, the Union finance ministry has requested the FFC to reconsider the recommendation, holding that “it introduces a new principle”. The beneficiaries of the proposal were Karnataka, Mizoram and Telangana.

Types of deficits & how they are calculated
1. Revenue Deficit:

- Revenue Deficit is the excess of government’s total revenue expenditure to its total revenue receipts. Revenue Deficit is only related to revenue expenditure and revenue receipts of the government.

- The difference between total revenue expenditure to the total revenue receipts is Revenue Deficit.

What does it mean?

A revenue deficit indicates that the government doesn’t have sufficient revenue for the normal functioning of the government departments. In other words, when the government starts spending more than it earns, it results in Revenue Deficit. Revenue Deficit forces the government to disinvest or cover the shortage by borrowing.

Remedial measures:

In the case of Revenue Deficit government usually tries to curtail their expenses or increase its tax and non-tax receipts. This can be done by introducing new taxes or increasing the tax on people in higher-earning slabs.

2. Fiscal Deficit:

The excess of total expenditure over total receipts excluding borrowings is called Fiscal Deficit. In other words, the Fiscal Deficit gives the amount needed by the government to meet its expenses. Thus a large Fiscal Deficit means a large amount of borrowings.

What does it mean?

Simply put a Fiscal Deficit is a measure of how much the government needs to borrow from the market to meet its expenditure when its resources are inadequate.

Remedial measures:
Various measures might be taken to reduce Fiscal Deficit, some of them can be **reducing public expenditure in the form of subsidies**, reduction in expenditure on bonus, LTC, Leaves encashment etc. Alternatively, **measures to increase the revenue are also taken** in forms of broadening **tax base restructuring** and **sale of shares in public sector units** etc.

3. **Primary Deficit:**

Primary Deficit is **Fiscal Deficit of the current year minus interest payments on previous borrowings**. While Fiscal Deficit represents the government’s total borrowing including interest payments, Primary Deficit shows the amount of borrowing excluding interest payments.

**What does it mean?**

Primary Deficit shows the amount of government borrowings specifically to meet the expenses by **removing the interest payments**. Therefore, a zero Primary Deficit means the need for borrowing to meet interest payments.

**Remedial measures:**

A higher Primary Deficit reflects the **amount of new borrowings in the current year**. Since this is the amount on top of already existing borrowings (Fiscal Deficit) similar measures can be taken to reduce the amount of borrowings.

**About Finance Commission (FC)**

- It is a **Constitutionally mandated body** that is at the centre of fiscal federalism.

  - Set up **under Article 280 of the Constitution**, its **core responsibility** is to:
    1. **evaluate** the state of finances of the Union and State Governments,
    2. **recommend** the sharing of taxes between them
    3. **lay down** the principles determining the distribution of these taxes among States.
• Its working is characterised by extensive and intensive consultations with all levels of governments, thus strengthening the principle of cooperative federalism.

• Its recommendations are also geared towards improving the quality of public spending and promoting fiscal stability.

• First Finance Commission was set up in 1951 and there have been fifteen so far. Each of them has faced its own unique set of challenges.

• The Fifteenth Finance Commission was constituted on 27 November 2017 against the backdrop of the abolition of Planning Commission (as also of the distinction between Plan and non-Plan expenditure) and the introduction of the goods and services tax (GST), which has fundamentally redefined federal fiscal relations.

• The Terms of Reference of the current Commission have some distinctive features, including recommending monitorable performance criteria for important national flagship programmes and examining the possibility of setting up a permanent non-lapsable funding for India’s defence needs.


• As an important Constitutional entity, the Commission is committed to balancing competing claims and priorities among all three tiers of government in a credible manner.