THE NEW DEBATE ON DEFENCE FUNDING

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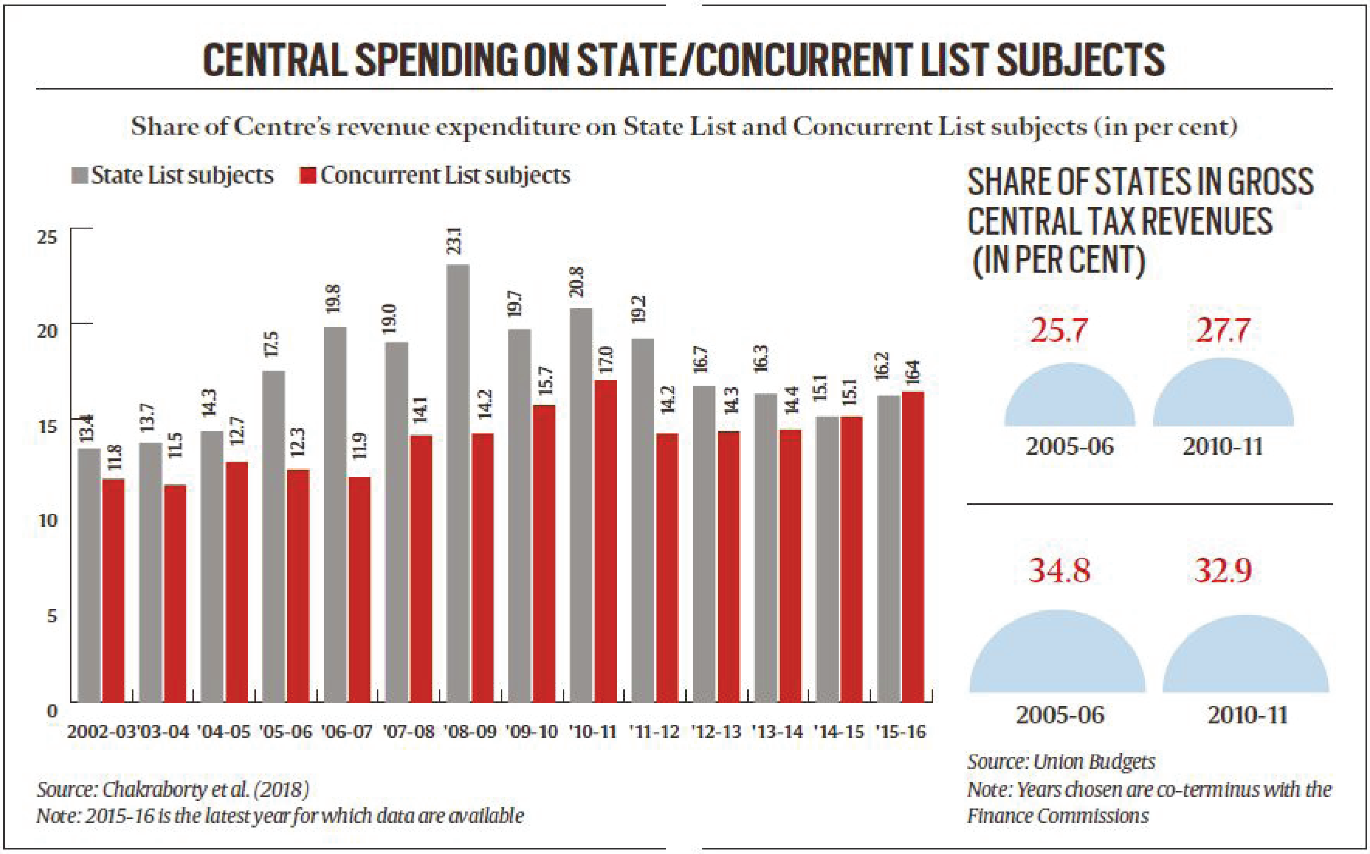
"The Centre has asked the 15th Finance Commission to examine whether a separate mechanism for funding of defence and internal security should be set up. What are the implications for the finances of the states?"

Earlier this month, the Union Cabinet amended the terms of reference (ToR) of the 15th Finance Commission (FC) to widen their scope. Through the change, the government has requested the FC to look into the possibility of a separate mechanism for the funding of defence and internal security. Critics of the decision have questioned the addition to the FC's ToR on the ground that it would undermine the federal structure of Indian polity.

What is the FC and what is its mandate?

The Finance Commission is a constitutional body that owes its existence to Article 280 of the Indian Constitution. Its mandate is to determine the distribution of tax revenues between the Centre and the states, and amongst the states themselves. The FC has a five-year term; the 15th FC was constituted in November 2017 and



its recommendations will apply from 2020 to 2025. In the past, FCs have also dwelt on the distribution of central grants to states, as well as the flow of resources to the third tier of governance — the panchayats and the municipalities.

In a federal structure such as India's, powers and responsibilities are divided between the Centre and the states. While the Union collects a majority of the tax revenue, states have a greater responsibility for the delivery of public goods.

Thus, FCs aim to do two types of adjustments. One, to address the vertical imbalance between the taxation powers of the Centre and the expenditure priorities of the states.

Two, to allay the horizontal imbalances between the states themselves with the objective of ensuring balanced regional development.

What is the role of the ToR, and why is the latest tweak being criticised?

One of the reasons why FCs are reconstituted every five years is to ensure that they can take into account the changing dynamics of the political and fiscal landscape. Even though the ToRs are essentially in the nature of guidelines to the FC, yet a change in ToRs over the years has reflected the changing needs of India's overall development.

Any changes in ToRs can, and often do, have their critics. For instance, several southern states had protested against the 15th FC ToR last year because of apprehensions that it would lead to a reduction in their share of tax revenues.

The latest addition to the 15th FC's ToR calls for the FC to examine the possibility of allocation of adequate, secure and non-lapsable funds for defence and internal security of India. In other words, the Centre has requested the FC to examine whether a separate mechanism for funding of defence and internal security ought to be set up, and how such a mechanism could be operationalised.

With capital spending on defence continuing to fall short of requirements, it is difficult to contest the basic premise that spending on defence needs to be bolstered.

However, sequestering funds for defence from the Centre's gross tax revenues means a reduction in the overall tax pool that is shared with states. This is likely to be protested by the states, several of whom are arguing for an increase in their share in taxes collected to 50 per cent from the current 42 per cent. This request by the Centre also raises questions over the fiscal space at its disposal to finance spending on items in the Union list.

The Seventh Schedule of the Constitution lists the separate (Union List and State List) and joint (Concurrent List) responsibilities of the Centre and the states. Defence is in the Union List. The Centre's request to the FC for greater resources means that it has limited ability to ramp up expenditure on items in the Union list.

This is partly because the Centre's expenditure on items in the State and Concurrent Lists has been increasing over the years. Research has shown that the share of the Centre's revenue expenditure on items in the State List has broadly grown over the years; it went up from 13.4 per cent in 2002-03 to 23.1 per cent in 2008-09, before declining to16.2 per cent in 2015-16.

Similarly, the Centre spent 16.4 per cent of its revenue expenditure on Concurrent List subjects in 2015-16, up from 11.8 per cent in 2002-03 (see chart). This increase in spending by the Centre on items in the State and the Concurrent Lists has led to a reduction in its spending on items in the Union List.

Are states being squeezed out of funding?

The added fiscal pressures of the Centre and the requirement of having to share tax revenues with states has left the Centre in a peculiar position.

To shore up its revenues, the Centre has, over the years, begun to rely more on cesses and surcharges. In the recent Union Budget, too, it increased the special additional excise duty and road and infrastructure cess on petrol and diesel by one rupee each.

But the revenue from cesses and surcharges is not part of the divisible tax pool that is shared with the states. It is kept by the Centre. This implies that states receive a lower share of the Centre's gross tax revenue collections.

For instance, the states' share in central taxes has been pegged at Rs 8.09 lakh crore in 2019-20. This works out to around 33 per cent of the gross tax revenues. In comparison, post the government accepting the recommendations of the 14th FC, states' share in central taxes rose to 42 per cent from the 32 per cent earlier.

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Finance Commission

Why in the news?

- In the chairmanship of Prime Minister Narendra Modi, the Union Cabinet has approved the extension of the 15th Finance Commission till November 30, 2019.
- In view of this, the Finance Commission will be able to consider various comparable estimates for financial estimates.

Formation

- In the chairmanship of Prime Minister Narendra Modi, the Union Cabinet has approved the extension of the 15th Finance Commission till November 30, 2019. In view of this, the Finance Commission will be able to consider various comparable estimates for financial estimates.
- To give recommendations to the President on the sharing of finance between the Center and the States.
- Under Article 280 (1) of the Constitution, it is clearly stated that within two years after the implementation of the Constitution and then at the end of every fifth year or before this time, if the President considers it necessary, will constitute finance commission.

Functions

- To recommend to the President of India how to distribute the net receipts of taxes between the Union and the States and allocation of such proceeds between states.
- Grants / assistance to states from the consolidated fund under Article 275.
- Based on the recommendations made by the State Finance Commission, recommend necessary steps for promotion of the state's consolidated fund for the supply of resources to panchayats and municipalities.
- Any other specific instructions given by the President, which are in the interest of the country's sound finance.

Powers

- The Commission submits its report to the President, which the President presented it before both the Houses of Parliament.
- An explanatory memorandum should be kept along with the recommendations presented so that the information of the proceedings regarding each recommendation is made.
- Recommendations made by the Finance Commission are advisory in nature, its upto the government to accept it or not.

14th Finance Commission

- The 14th Finance Commission was formed on January 2, 2013, under the chairmanship of former Governor of RBI Dr. Y.V. Reddy.
- The recommendations of this commission are applicable for the period of five years from April 1, 2015.
- Recommendations of this commission are valid for the financial year 2019-20.
- The 14th Finance Commission submitted its report on December 15, 2014 to the President.

15th Finance Commission

- The Union Cabinet approved the formation of the 15th Finance Commission on November 22, 2017.
- The 15th Finance Commission will have a tenure of 2020-25.
- Shri N.K. Singh will be the Chairman of 15th Finance Commission.
- Mr. Singh is a former Secretary of the Government of India and former Member of Parliament

Dispute

- The terms of reference for the idea of 15th Finance Commission are being questioned on the cooperative federalism of the Center.
- Allocation of resources based on the census of 2011, replacing the 1971 census.
- With this, southern states are more likely to suffer, which have been performing better to control their population for decades.
- This situation is creating interstate tension, which is fatal to the integrity of the country.

Challenges

- Increasing inequality among states due to unbalanced distribution of private investment
- The burden on the financial condition of states for the economic revival of the power distribution companies.
- Providing disaster management and proper funds to deal with various natural calamities like drought, flood, landslide, cyclone.
- Making a consistent financial strategy for governmental commitments to meet the goals of inclusive growth and tackling climate change.

Expected Questions (Prelims Exams)

1. In reference to Finance Commission,Consider the following statements-

1. Finance Commission is a constitutional body.
2. The recommendations of 15th Finance Commission will be implemented from 2020 to 2025.
3. After accepting the recommendation of 15th Finance Commission state's share in central taxes will increase from 32% to 42%.

Which of the above statements is/are incorrect?

(a) Only 2 (b) Only 3

(c) 2 and 3 (d) All of the above

Expected Questions (Mains Exams)

Q. Critically evaluate the works of Finance Commission and new changes in the terms of reference of the Finance Commission recently. **(250 Words)**

Note: Answer of Prelims Expected Question given on 31 July. is 1(c).