Challenges Before the Sixteenth Finance Commission*

By Dr M Govinda Rao, Chief Economic Adviser, Brickwork Ratings

The Sixteenth Finance Commission will have to be appointed soon and it will have challenging tasks in the prevailing difficult fiscal environment of Indian federalism. The Fifteenth Finance Commission's recommendations will be up to 2025-26 and the new Commission's recommendations should be available for consideration by the Finance Ministry before presenting the Union budget for 2026-27. It takes at least two years for the new Commission to finalise the report and, therefore, the Commission will have to be appointed by the President of India within the next few months.

Article 280 (3) of the Constitution lists the basic tasks of the Commission. These include (a) the distribution of taxes from the divisible pool between the Union and the States and allocation of the States' share to individual States; (b) the principles governing the grants to be given to the States from the consolidated fund of India; (c) recommend measures to augment the consolidated funds of the States to supplement the resources of Panchayats and Urban Local Bodies (ULBs) based on the recommendations of the State Finance Commissions and (d) any other matter in the interests of a sound finance. Under (d), a number of matters are referred to the Commission in the Presidential Order appointing the Commission; notable among them are making recommendations on disaster relief and reviewing deficit and debt levels of the Union and States recommending fiscal consolidation roadmap for the ensuing five years. The Presidential Order also includes a number of matters to be taken into account while making recommendations which often serve as the 'guidelines.

The Sixteenth Finance Commission will have formidable challenges to face in the prevailing precarious fiscal environment. The relationships between the Union and some States have become more and more acrimonious and the competition for fiscal resources is acute. Besides the general election to the Parliament, elections are slated in a number of States including Madhya Pradesh, Chhattisgarh, and Rajasthan in 2023-24, and with a promise of various freebies, subsidies, transfers, and guarantees, the fiscal situation is likely to deteriorate further. The Coronavirus pandemic has severely strained the finances of the Union and the States and competition for resources is much more acute than that was seen before. The Union government's strategy of mobilising additional resources through special excises on diesel and motor spirit and increasing cesses and surcharges in the aftermath of the 14th Finance Commission's recommendations have continued to be contentious.

The finances of both the Union and the State governments have deteriorated sharply in recent years. The pandemic pushed the aggregate fiscal deficit and public debt to 13.3% and 89.6% of GDP, respectively in 2020-21. As the economy recovered post-pandemic, the deficit and debt ratios have receded to 8.9% and 85.1%, respectively but the targets of limiting the aggregate debt to GDP ratio at 60% which was predicated before the pandemic no longer looks feasible, at least in the short and medium. In fact, even before the pandemic, in 2019-20, there were considerable slippages in limiting

the debt-to-GDP ratio as compared to the FRBM targets set by the 14th Finance Commission at less than 60%.

At the Union level, the ratio of fiscal deficit to GDP rose to 9.2% in 2020-21 before receding to 6.9% the next year. The debt-to-GDP ratio rose to 61.5% in the pandemic year before falling to 57,1% in 2022-23. Almost three-fourths of the fiscal deficit was used for meeting revenue expenditures in 2020-21. The fiscal consolidation plan had to be abandoned by the Union government, and the States were given relaxation in their borrowing limit from 3 % of GSDP to 4% without conditions and 5% with some reform conditions. The relaxation of the target resulted in the slippage in the gross fiscal deficit at the State level to 4.1% of GDP but returned strongly to reduce the deficit to 2.8% the next year largely by compressing capital expenditures. However, both deficit and debt levels in some of the States have risen sharply to unsustainable levels.

Macroeconomic stabilization is predominantly a Central function, and the States have no incentive to contain their deficits and debt except that the accumulation of debt increases their interest burden and crowds out much-needed expenditures on social and physical infrastructure. Since the States are required to seek the Centre's permission to borrow as long as they are indebted to the former, some of the States cut down the capital expenditures and resorted to off-budget borrowings through their enterprises. Also, the Fifteenth Finance Commission could not factor in the impact of the pandemic on the finances of the States in its entirety in its projections. One of the guidelines issued in the Presidential Order appointing the Commission was to "…examine whether revenue deficit grants be provided at all" and the Commission worked out its projections to phase out the post-devolution deficits in the terminal year by adjusting the States' own revenues and revenue expenditures so that no major State is eligible to get the grants in the terminal year of its recommendation. Most of the fiscally stressed States were recipients of revenue deficit grants and as they failed to undertake reforms to align their growth of revenues and expenditures to contain the deficit, their debt situation was driven to unsustainable levels. Furthermore, the Commission assumed that the GST compensation will continue for the period of its award and as this was discontinued in July 2022 the situation in these States became precarious.

The Sixteenth Finance Commission will have the challenging task of dealing with the problem of fiscal imbalances. Making recommendations for tax sharing and grants in a fiscally stressed situation and in a politically surcharged environment will require the Commission to tread the path with utmost care. In addition, incentivising the States, particularly the fiscally stressed ones, for prudent fiscal behaviour would be a major challenge. The related issue is of framing the next-generation fiscal rules. The Fifteenth Finance Commission had recommended the setting up of an inter-governmental group to define and achieve fiscal sustainability and design a new framework and implementation schedule which has not been done. The Commission will do well to take stock of the impact of various reform incentives, including those on local governments, to strategize further reforms.

**** Views are personal.***

Contacts:

Investors & Media Contact
+91 95133 99706
1-860-425-2742
investordesk@brickworkratings.com
media@brickworkratings.com

ABOUT BRICKWORK RATINGS

Brickwork Ratings (BWR) is India's home-grown credit rating agency built with the superior analytical prowess of the industry's most experienced credit analysts, bankers and regulators. Established in 2007, BWR aims to provide reliable credit ratings by creating new standards for assessing risk and by offering accurate and transparent ratings. BWR provides investors and lenders timely and in-depth research across the structured finance, public finance, financial institutions, project finance and corporate sectors. BWR has employed over 280 working professionals including credit analysts and credit market professionals across 8 offices in India. Our experienced analysts have published over 13,370 ratings across asset classes. BWR is committed to providing the investment community with products and services needed to make informed investment decisions. BWR is a registered credit rating agency by Securities and Exchange Board of India (SEBI) and a recognised External Credit Assessment Agency (ECAI) by the Reserve Bank of India (RBI) to carry out credit ratings in India. BWR is promoted by Canara Bank, India's leading public sector bank.

More information on Canara Bank is available for reference at www.canarabank.com

BWR Rating Criteria are available at https://www.brickworkratings.com/ratingscriteria.aspx Brickwork Ratings, a SEBI-registered credit rating agency, has also been accredited by the RBI, and it offers rating services for bank loan, NCD, commercial paper, bonds, securitised paper etc. BWR has Canara Bank, a nationalised bank, as its promoter and strategic partner. BWR has its corporate office in Bengaluru and a country-wide presence, with offices in Ahmedabad, Chandigarh, Chennai, Hyderabad, Kolkata, Mumbai and New Delhi, along with representatives in 150+ locations. BWR has rated debt instruments/bonds/bank loans, securitised paper of over ₹ 19,09,101 Cr. Additionally, fixed deposits and commercial papers, among others, worth over ₹ 84,580 Cr have been rated.

DISCLAIMER

Copyright © 2023 by Brickwork Ratings India Pvt Ltd., 3rd Floor, Raj Alkaa Park, 29/3 & 32/2, Bannerghatta Main Rd, Kalena Agrahara, Bengaluru, Karnataka 560076.Telephone: +91 80 4040 9940. Fax: +91 80 4040 9941. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings, Brickwork Ratings relies on factual information it receives from issuers and underwriters and from other sources Brickwork Ratings believes to be credible. Brickwork Ratings conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Brickwork Ratings' factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Brickwork Ratings' ratings should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Brickwork Ratings relies on in connection with a rating will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Brickwork Ratings and to the market in offering documents and other reports. In issuing its ratings Brickwork Ratings must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

THE INFORMATION IN THIS REPORT IS PROVIDED "AS IS" WITHOUT ANY REPRESENTATION OR WARRANTY OF ANY KIND. A Brickwork Ratings rating is an opinion as to the creditworthiness of a security. This opinion is based on established criteria and methodologies that Brickwork Ratings is continuously evaluating and updating. Therefore, ratings are the collective work product of Brickwork Ratings and no individual, or group of individuals, is solely responsible for a rating. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Brickwork Ratings is not engaged in the offer or sale of any security. All Brickwork Ratings reports have shared authorship. Individuals identified in a Brickwork Ratings report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Brickwork Ratings rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time, for any reason in the sole discretion of Brickwork Ratings. Brickwork Ratings does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Neither Brickwork Ratings nor its affiliates, third party providers, as well as their directors, officers, shareholders, employees or agents (collectively, "BWR Reps") guarantee the accuracy, completeness or adequacy of the Report, and no BWR Reps shall have any liability for any errors, omissions, or interruptions therein, regardless of the cause, or for the results obtained from the use of any part of this publication. In no event shall any BWR Reps be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of any part of the Report even if advised of the possibility of such damages. Brickwork Ratings receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities.