Fourteenth Finance Commission: An Analysis of the Key Recommendations

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Abstract. The Fourteenth Finance Commission (FFC) has submitted its recommendations for the period 2015-16 to 2020-21. They are likely to have major implications for center-state relations, for union and state budgeting and for the fiscal situation of the center and the states. The spirit behind the FFC recommendations is to increase the automatic transfers to the states to give them more fiscal autonomy and this is ensured by increasing the share of states from 32 to 42 per cent of divisible pool. The FFC has made far-reaching changes in tax devolution that will move the country toward greater fiscal federalism, conferring more fiscal autonomy on the states. It is hoped that the far-reaching recommendations of the FFC will further the Government's vision of cooperative and competitive federalism.

Keywords: Fourteenth Finance Commission, Central assistance, Fiscal autonomy, cooperative federalism, competitive federalism

"We want to promote co-operative federalism in the country. At the same time, we want a competitive element among the states. I call this new form of federalism Co-operative and Competitive Federalism"

Prime Minister Narendra Modi

1 Introduction

The Finance Commission is a Constitutional body formulated under Article 280 of the Indian Constitution. It is constituted every five years by the President of India to review the state of finances of the Union and the States and to suggest measures for maintaining a stable and sustainable fiscal environment. It also makes recommendations regarding the devolution of taxes between the Center and the States from the divisible pool which includes all central taxes excluding surcharges and cess which the Centre is constitutionally mandated to share with the States. The Fourteenth Finance Commission (FFC) was appointed on 2nd January, 2013 under the chairmanship of Dr. Y. V. Reddy. In addition to the primary objectives mentioned above, the terms of reference for the commission sought suggestions regarding the principles which would govern the quantum and distribution of grants-in-aid (non-plan grants to states), the measures, if needed, to augment State government finances to supplement the resources of local government

and to review the state of the finances, deficit and debt conditions at different levels of government. In making these recommendations, the commission is required to consider aspects like:

a. The resources of the central government and the demands on the resources of the central government
b. The resources of the state governments and the demands on the resources of the state governments under various heads, including the impact of debt levels on resource availability in debt-stressed states.
c. The objective of not only balancing the receipts and expenditure on revenue accounts, of the states and the union, but also generating surpluses for capital investments.
d. The taxation efforts of the central government and each state government and the potential for additional revenue mobilization
e. The level of subsidies required for sustainable and inclusive growth and equitable sharing of subsidies between the central and state governments.
f. The need for insulating the pricing of public utility services like drinking water, irrigation, power, public transport etc from policy fluctuations through statutory provisions

2. Key Recommendations and Analysis

The FFC has submitted its recommendations for the period 2015-16 to 2020-21. They are likely to have major implications for center-state relations, for union and state budgeting and for the fiscal situation of the center and the states. Some of the major recommendations are as follows

Vertical Distribution: The FFC has radically enhanced the share of the states in the central divisible pool from the current 32 percent to 42 per cent which is the biggest ever increase in vertical tax devolution. The last two Finance Commissions viz. Twelfth (period 2005- 10) and Thirteenth (period 2010-15) had recommended a state share of 30.5 per cent (increase of 1 percent) and 32 per cent (increase of 1.5 percent), respectively in the central divisible pool.

The consequence of this recommendation is that the fiscal space for the centre will reduce in the same proportion. However, such a greater devolution in the share of revenues as well as reduced role of the centrally sponsored schemes (CSS) has been amongst the main demands of the states. Under the new arrangement outlined by the FFC shall result in an increase in the flow of untied resources to the states. It allows the states to have their own tailor-made and need-driven developmental schemes in view of the local needs and aspirations. Thus, this recommendation signals the end of one size fits all kind of an approach that had been a major limitation of centrally sponsored schemes. This makes considerable sense in the backdrop of the observation by the FFC in its report that over the years the share of untied tax devolution recommended by the Finance commission had been declining with a corresponding increase in the share of conditional grants. Therefore, the commission had rightly noted in its report that there is an urgent need to restructure the mechanism of transfer of resources from centre to states in order to meet the following objectives:

I. Providing higher state level fiscal autonomy by reducing the conditional transfers
II. Aligning priorities according to the constitutional assignment of functions for union and the state governments
III. Moving towards a system of 'centre-state fiscal relations' of greater fiscal cooperation through the institutional mechanism of "cooperative federalism".

FFC has taken the view that tax devolution should be the primary route of transfer of resources to the states. It needs to be noted that in reckoning the requirements of the states, the FFC has ignored the plan and non-plan distinction. It sees the enhanced devolution of the divisible pool of taxes as a "compositional shift in transfers - from grants to tax devolution". Thus FFC expects the role of CSS in particular and the central assistance to state plans (CAS) in general to reduce and be replaced by greater devolution of taxes.

However, the FFC recommendations cannot be perceived as revenue-neutral to the union government because fiscal arithmetic is not that simple. It is neither feasible nor desirable to reduce central grants to the state plans by a percentage or amount equivalent to the increase in the tax devolution. Notwithstanding the challenges in this area of future fiscal arithmetic, the policy shift in favour of greater fiscal autonomy to the states by ensuring that a lion's share of

their resources shall flow via the untied route of Finance Commission devolutions is a step in the right direction.

Horizontal Distribution: The FFC has also proposed a new horizontal formula for the distribution of the states' share in divisible pool among the states. There are changes both in the variables included/excluded as well as the weights assigned to them. Relative to the Thirteenth Finance Commission, the FFC has incorporated two new variables: 2011 population and forest cover; and excluded the fiscal discipline variable

Table-1: Horizontal Devolution Formula in the 13th and 14th Finance Commissions:

Variable	Weight (13th FC)	(Weight 14thFC)
Population (1971)	25	17.5
Population (2011)	0	10
Fiscal capacity/Income distance	47.5	50
Area	10	15
Forest Cover	0	7.5
Fiscal discipline	17.5	0
Total	**100**	**100**

Source: Reports of 13th and 14th Finance Commission

An interesting finding relates to the decomposition of the resource transfers through tax devolution due to the increase in the divisible pool per se and due to the change in the horizontal devolution formula itself. The significant impact due to increase in the divisible pool is on states like Uttar Pradesh, Bihar, Madhya Pradesh, West Bengal and Andhra Pradesh (United) while states like Arunachal Pradesh, Chhattisgarh, Madhya Pradesh, Karnataka and Jharkhand are the major gainers due to a change in the horizontal devolution formula which now gives greater weight to a state's forest cover.

- Several other types of transfers have been proposed including grants to rural and urban local bodies, a performance grant along with grants for disaster relief and revenue deficit. These transfers total to approximately 5.37 lakh crore for the period 2015-20, and cover subjects like local government, disaster management and post devolution revenue deficit.
- The FFC has not made any recommendation concerning sector specific-grants unlike the Thirteenth Finance Commission.

3. Conclusions

Based on its recommendations and projections, the FFC has assessed and quantified the implications for the revenues of states. The total increase in FFC transfers in FY 2015-16 from FY 2014-15 is estimated to be about 2 lakh crores (both from tax devolution and FFC grants). All states stand to gain from FFC transfers in absolute terms. The FFC recommendations are expected to add substantial spending capacity to states' budgets.

The spirit behind the FFC recommendations is to increase the automatic transfers to the states to give them more fiscal autonomy and this is ensured by increasing share of states from 32 to 42 per cent of divisible pool. Assuming the recommendations of FFC were to be implemented as it is, there is concern that fiscal space or fiscal consolidation path of the Centre would be adversely affected. However, to ensure that the Centre's fiscal space is secured, the suggestion is that there will be commensurate reductions in the Central Assistance to States (CAS) known as "plan transfers".

The FFC had identified 30 centrally sponsored schemes which ought to have been transferred to the state governments because expenditure on them has already been taken into account as state expenditure, in arriving at the greater devolution of 42%. The government has already decided that 8 of these centrally sponsored schemes be delinked from support from centre. However, certain CSS will have to continue unaltered as they are either legal/constitutional obligations or are privileges available to peoples' representatives for welfare of their constituents. Even more vital is the fact that the union government may have to continue to support certain programmes which are for the benefit of the socially disadvantaged sections in an unaltered manner, from its own resources. However, henceforth the union government will have to be extra cautious in announcing big CSS with huge fiscal implications, especially in functions which are either the primary domain of the states or are best delivered by the states.

The main conclusions are that the FFC has made far-reaching changes in tax devolution that will move the country toward greater fiscal federalism, conferring more fiscal autonomy on the states. It is hoped that the far-reaching recommendations of the FFC will further the Government's vision of cooperative and competitive federalism.

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