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14th Finance Commission and Fiscal Transfer

"I feel more and more that we must function more from below than from the top… too much of centralization means decay at the roots and ultimately a withering of branches, leaves and flowers."

Pandit Jawaharlal Nehru

"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

Fundamentals Of Finance Commission

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 suggest measures for maintaining a stable and sustainable fiscal environment.

Functions

1. Distribution of *net proceeds of taxes* between Centre and the States, to be divided as per their respective contributions to the taxes.
2. Determine factors governing *Grants-in Aid to the states* and the magnitude of the same.
3. To make recommendations to president as to the measures needed *to augment the Consolidated Fund of a State* to supplement the resources of the panchayats and municipalities in the state on the basis of the recommendations made by the Finance Commission of the state.

Composition

The Chairman of the Finance Commission is selected among people who have had the *experience of public affairs*. The other four other members are selected from people who:

1. Are, or have been, or are qualified, *as judges of High Court*, or
2. Have knowledge of *Government finances or accounts*, or
3. Have had *experience in administration and financial expertise*, or
4. Have *special knowledge of economics*

Procedure and Powers of the Commission

The Commission has the power to determine their own procedure and has all ***powers of the civil court*** as per the Court of Civil Procedure, 1908. Hence, it can

1. *summon and enforce the attendance* of any witness or ask any person to deliver information or produce a document, which it deems relevant.
2. Ask for the *production of any public record or document* from any court or office.

Terms Of Office Of Members

Every member will be in office for the time period as specified in the order of the president, but is eligible for reappointment provided he has, by means of a letter addressed to the president, resigned his office.

Salaries and Allowances of the members

The members shall be paid Salaries and Allowances *as per the provisions made by the Central Government*.

14th Finance Commission Recommendations

The Fourteenth Finance Commission (FFC) was appointed on 2nd January, 2013under the chairmanship of ***Dr. Y. V. Reddy***. The major recommendations given by FFC are shown in the image below:

NEW CENTRE-STATE FISCAL PACT

PAVING THE WAY for a complete overhaul in Centre-state fiscal relations, the Fourteenth Finance Commission has suggested a 10% jump in the tax devolution to states to 42% for the five-year period starting April 1, 2015. But the panel has also recommended a number of measures to spruce up government functioning and improve the fisc.

RECOMMENDATIONS ACCEPTED

- Devolution of tax to states increased to 42% from 32%. Total devolution at 45%.
- Performance-based grant of Rs 2.87 lakh crore to local bodies for the five year period — Rs 2 lakh crore to panchayats and Rs 87,143 crore to municipalities.
- Eleven states given a post-devolution revenue deficit grants of Rs 1.94 lakh crore to wipe out revenue deficit.
- Of the 20 suggested, Centre to de-link 8 Centrally-sponsored schemes from Central support.
- Upto 10% of grants in state disaster relief fund can be used for occurrences considered as disasters.

OTHER RECOMMENDATIONS

FISCAL CONSOLIDATION:

- Union and states to cap sanction of new capital works at an appropriate multiple of the annual budget provision.
- Reduce fiscal deficit to 3% by 2016-17, eliminate revenue deficit, do away with concept of effective revenue deficit.
- States will be further eligible for an additional borrowing limit of 0.25% of GSDP.
- Replace the existing FRBM Act with a Debt Ceiling and Fiscal Responsibility Legislation

PUBLIC UTILITIES:

- Amend the Electricity Act, 2003, to levy penalties for delays in the payment of subsidies by states.

PSUs:

- Enterprises be categorised into 'high priority', 'priority', 'low priority' and 'non-priority' to decide current policy and future course of actions.
- The National Investment Fund to be wound up, proceeds from stake sales to go in Consolidated Fund, part of it shared with state where PSU is located.

STATE FINANCES:

- States to review tax on entertainment and profession, local bodies to impose advertisement tax.
- Royalties from mining to be shared with local body where the mine is located.
- Local bodies, states explore issuing municipal bonds.
- Strengthen the judicial system by using fiscal space provided by the tax devolution.

COOPERATIVE FEDERALISM:

- Inter-state Council to be expanded for cooperative federalism to identify sector specific grants to states.

GST:

- Autonomous GST Compensation Fund through legislative actions to give assurance to states.

Changes From The 13th Finance Commission

1. **Increase In Share Of Divisible Pool**
   - The FFC has radically enhanced the share of the states in the central divisible pool ***from the current 32 % to 42 %*** which is the biggest ever increase in vertical tax devolution.
   - The last two Finance Commissions viz. 12th and 13th had recommended a state share of 30.5 % (increase of 1 %) and 32 % (increase of 1.5 %), respectively in the central divisible pool.

2. **New Horizontal Formula**
   - The FFC has also proposed a new horizontal formula (Shown in Table below)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 13th FC, the FFC has incorporated two new variables: ***2011 population and forest cover***; and excluded the ***fiscal discipline variable***.

Table 10.1 : Horizontal Devolution Formula in the 13th and 14th Finance Commissions

Variable	Weights accorded	
	13th	14th
Population (1971)	25	17.5
Population (2011)	0	10
Fiscal capacity/Income distance (See box-1)	47.5	50
Area	10	15
Forest Cover	0	7.5
Fiscal discipline (See box-1)	17.5	0
Total	100	100

Source: Reports of 13th and 14th Finance Commission

Box 10.2 : Special Category States (SCS) and General Category States (GCS)

The concept of a special category state was first introduced in 1969 when the Fifth Finance Commission sought to provide certain disadvantaged states with preferential treatment in the form of central assistance and tax breaks. Initially three states **Assam, Nagaland** and **Jammu & Kashmir** were granted special status but since then eight more have been included (**Arunachal Pradesh, Himachal Pradesh, Manipur, Meghalaya, Mizoram, Sikkim, Tripura** and **Uttarakhand**). All other states barring these are treated as General Category States. The rationale for special status is that these states, because of inherent features, have a low resource base and cannot mobilize resources for development. Some of the features required for special status are: (i) **hilly and difficult terrain**; (ii) **low population density or sizeable share of tribal population**; (iii) **strategic location along borders with neighbouring countries**; (iv) **economic and infrastructural backwardness**; and (v) **non-viable nature of state finances**.

Fiscal Capacity/Income Distance	Fiscal Discipline
The income distance criterion was first used by 12th FC, and it implicitly applies *a single average* ***tax-to-GSDP ratio*** to determine fiscal capacity distance between states. The 13th FC changed the formula slightly and recommended the use of *separate averages* for measuring tax capacity, one for *general category states (GCS) and another for special category states (SCS).*	Fiscal discipline as a criterion for tax devolution was used since 11th FC to provide an incentive to states managing their finances prudently. The index of fiscal discipline is arrived at by comparing improvements in the ***ratio of own revenue receipts of a state to its total revenue expenditure*** relative to the corresponding average across all states.

Implications Of FFC Recommendations For Fiscal Federalism

1. **Increase In Total Transfer**

   The total increase in FFC transfers in FY2015-16 from FY2014-15 is estimated to be about ***2 lakh crores*** (both from tax devolution and FFC grants).

2. **Distributional Effects On States**

   - ***All states stand to gain*** from FFC transfers in absolute terms. However, to assess the distributional effects, the increases should be scaled by population, Net State Domestic Product (NSDP) at current market price, or by states' own tax revenue receipts.
   - The ***biggest gainers in absolute terms*** under GCS are *UP, West Bengal and MP* while for SCS it is *J&K, HP, and Assam*. A better measure of impact is benefit per capita.
   - The ***major gainers in per capita terms*** turn out to be *Kerala, Chhattisgarh and MP* for GCS and *Arunachal Pradesh, Mizoram and Sikkim* for SCS.
   - The FFC transfers have more favorable impact on the states (only among the GCS) which are relatively less developed which is an indication that the FFC transfers are ***progressive*** i.e. states with lower per capita NSDP receive on average much larger transfers per capita.
   - The significant impact due to increase in the ***divisible pool*** is on states like *UP, Bihar, MP, West Bengal and Andhra Pradesh (United)* while states like *Arunachal Pradesh, Chhattisgarh, MP, 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.

3. **Fiscal Autonomy Of State Increased**

   - 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 % of divisible pool which will increase the *flow of untied resources* (or resources transferred without condition) to States.
   - Estimates show that post the 14th commission award, the untied statutory transfers would be *more than 70 % of the aggregate resource transfers* from the Union to the States.

4. **Fiscal Space Of Centre - Not Much Affected**

   - There is concern that fiscal space or fiscal consolidation path of the Centre would be adversely affected as Centre has to shed 42% of the share. However, it must be realized that there is *no significant rise in the devolution* as there will be commensurate reductions in the Central Assistance to States (CAS) known as "plan transfers.
   - The Centre should not have much difficulty in meeting its fiscal consolidation plan as the actual increase in tax devolution to states is only 3 to 4 %.
   - Thus, there is more like a *qualitative shift to the States, rather the quantitative shift*.

5. **Impact On Centrally Supported Schemes**

   - A major issue, post Budget 2015-16, is the sharp decline in allocations to the social sector in the form of various conditional grants to the States. This decline has happened to accommodate a large increase in tax devolution. As per the Budget estimates, enhanced tax devolution should result in an increase in the flow of untied funds to the tune of Rs.1,86,150 crore and a reduced flow of grants to the tune of Rs.87,730 crore.

- This decline in grants has happened in ***two categories***: in a specified list of schemes where the *Centre's contribution has been reduced*, implying a corresponding increase in contribution by the States and for a set of schemes where *Central support has been withdrawn*. Important schemes in the first category are the RKVY, the ICDS, Swachh Bharat Abhiyaan and allocation for elementary education under the MDM and the SSA. Major schemes delinked from Central support are the JNNURM, the BGRF and Normal Central Assistance.
- This change in the structure of grants has also to be viewed in the context of a restructuring of Centrally Sponsored Schemes (CSS), which is a right step.

Conclusion

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*. This will be enhanced by the FFC-induced imperative of having to reduce the scale of other central transfers to the states. In other words, states will now have greater autonomy on the revenue and expenditure fronts. The numbers also suggest that this renewed impulse toward fiscal federalism need not be to the detriment of the center's fiscal capacity. A collateral benefit of moving from Central Assistance To States(CAS) to FFC transfers is that overall progressivity will improve.