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The Fourteenth Finance Commission (FFC) – Major Recommendations & Implications for Fiscal Federalism in India

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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. 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 FFC has submitted its recommendations for the period **2015-16 to 2020-21.**Some of the major recommendations are as follows:

- 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 FFC has also proposed a **new horizontal formula** for the distribution of the states' share in divisible pool among the states. Relative to the Thirteenth Finance Commission, the FFC has incorporated two new variables: 2011 population and forest cover; and excluded the fiscal discipline variable.
- The FFC has not made any recommendation concerning sector specific-grants unlike the Thirteenth Finance Commission.
- **Grants**: Should be distributed to states for local bodies on the basis of the 2011 population data; the grants be divided into two broad categories on the basis of rural and urban population — constituting gram panchayats, and constituting municipal bodies respectively.
- **Types of grants**: A basic grant and a performance grant — the ratio of basic to performance grant be 90:10, with respect to panchayats; and 80:20 in the case of municipalities.
- **Rail Tariff Authority**: Replacement of the advisory body with the statutory through required amendments to the Railways Act 1989
- **Delinking of schemes**: Eight centrally sponsored schemes (CSS) will be delinked from support from the Centre; various CSS will now see a change in sharing pattern, with states sharing a higher fiscal responsibility.

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	47.5	50
Area	10	15
Forest Cover	0	7.5
Fiscal discipline	17.5	0
Total	100	100

1 The nature of shift

The shift, however, as the distinguished chairman of the commission Y. V. Reddy has himself admitted, is qualitative and not quantitative. In the aggregate, states have not gained and overall resources transferred to them by the Centre have not increased. The seminal shift is in terms of composition of transfer.

This means that states will have more "untied" funds at their disposal and will be free to deploy them in the manner they deem appropriate to their needs and concerns. Planning within states now assumes even greater importance even if the Planning Commission has been abolished.

2 Which states will gain?

States normally compare their shares with previous Finance Commissions to judge whether they have gained or lost. Strictly speaking, this is not right because different Finance Commissions have used different formulae to allocate the share of states to each individual state. The formula used in the Fourteenth Finance Commission is not the same as that used by its predecessor and so the share of individual states cannot really be compared.

Reddy's Commission, for instance, has given 7.5% weightage to forest cover, which had not been done by the Thirteenth Finance Commission. As a result, some large states with low forest cover like Uttar Pradesh and Bihar are complaining that their share in tax devolution has decreased. It has, but the basis for calculations has itself undergone a change. Nevertheless, all the states stand to gain from FFC transfers in absolute terms.

3 Changed Equations

- The FFC seeks to fundamentally alter the Centre-State funding patterns to give boost to the idea of "**cooperative federalism**". For instance Central assistance for critical developmental programmes being implemented by states relating to health, child development, education, rural drinking water, housing etc has been reduced drastically by about Rs 75,000 crore in the budget for 2015-16..
- However, the union government has argued that the reduction of Rs 75,000 crore in the central funding of development programmes is more than compensated with the States receiving an additional Rs1,85,000 crore from the total taxes and duties collected by the Centre. The States will get an additional Rs1,00,000 crore on a net basis every year.
- The States will have to show results on the ground while implementing their own exclusively designed development programmes in health, education, agriculture, sanitation, housing and drinking water. In future they **cannot really complain** that the Centre is not giving enough funds for these programmes.
- One apprehension is what if regional leaders resort to wasteful expenditures like laptops distributed by the UP government some years ago. Another argument is crony capitalism and corruption is far more rampant in State politics which does not even get captured by the CAG which is mostly focused on big cases of Central corruption.

4 Case of Bihar in the post FFC scenario

Bihar's inter se share in the FFC award, compared to the Thirteenth Finance commission, has declined, the flow of resources to that extent would be lower for Bihar during the FFC award period. However, there has been an absolute increase in tax devolution to Bihar to the tune of more than Rs 12,600 crore in the fiscal year 2015–16 due to the increase in vertical devolution to 42%.

5 Restructuring of Centrally sponsored schemes(CSS)

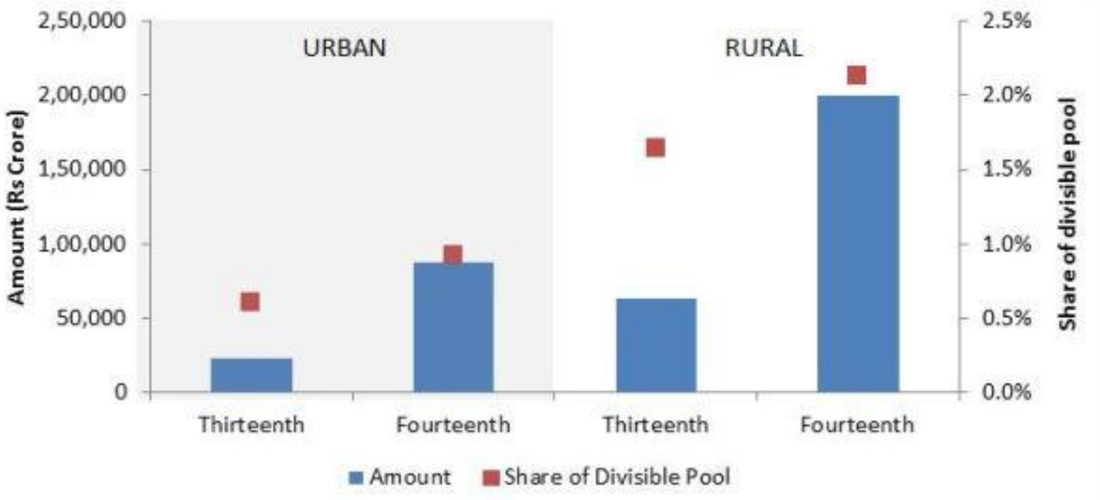
- In the last decade, the proliferation of big-ticket CSS has emerged as the key fiscal strategy to transfer grants to States. The States having to fund these schemes with a higher matching contribution. And, they may have to bear the same burden of CSS conditionalities, reducing fiscal autonomy and the available untied fiscal space.
- Restructuring is not only important from the perspective of State finances. It is also about getting the expenditure priorities right for both the Union and the State governments. Therefore FFC recommend Eight centrally sponsored schemes (CSS) to be delinked from support from the Centre and various CSS will now see a change in sharing pattern, with states sharing a higher fiscal responsibility.
- As articulated in the 14th commission's report, "between 2002-05 and 2005-11, revenue expenditure by the Union Government on State List subjects increased from an average of 14 per cent to 20 per cent, and on

Concurrent List subjects from an average of 13 per cent to 17 per cent. This implies a reduction in expenditure, in percentage terms, on Union List subjects.

- The Union government should move its focus from spending on overlapping functional domain to subjects that squarely fall in the functional domain of the Union, as in the Union List, and limit its intervention on the 'State List' and 'Concurrent List' on subjects of national priority having a consideration of externality.

6 FFC and Local Government

- The FFC has given the refreshing title "local governments" as against local bodies used by the previous commissions to the chapter dealing with grants to the third tier of government.
- The 14th FC has given due consideration to the fiscal federalism framework in India by devolving a larger amount to local governments. The 14th FC has recommended a grant-in aid for local governments that is equal to an estimated 3% of the divisible pool. This is higher than the recommended allocation of 2.5% by the 13th FC.



- Equity is and should be the overarching concern of any federal polity worth the name. It is the underlying rationale for federalism. For inter se distribution of local government grants to the states, the FFC uses the **2011 population** with weight of 90% and area 10%. The choice of 2011 population has adversely affected states like Kerala, Tamil Nadu etc. who have undertaken family planning to contain population.
- The effort of the Thirteenth Finance Commission to divide local government grants into basic **unconditional grants and conditional performance grants** was meant to incentivise the "laggards". To avail of performance grants, the PRIs had to fulfill six conditionalities and urban local bodies nine. The FFC has not only **reduced** the share of performance grants to 10% from 34%, the conditionalities are also made less demanding.

7 Amending FRBM (Fiscal Responsibility and Budget Management) Act

- FFC recommended that the Union Government should consider making an amendment to the FRBM Act to omit the definition of effective revenue deficit from 1 April 2015.
- It recommended an amendment to the FRBM Act inserting a new section mandating the establishment of an **independent fiscal council** to undertake ex-ante assessment of the fiscal policy implications of budget proposals and their consistency with fiscal policy and Rules. In addition, the Union Government take expeditious action to bring into effect Section 7A of the FRBM Act for the purposes of ex-post assessment.
- FFC recommended that the State Governments may amend their FRBM Acts to provide for the statutory flexible limits on fiscal deficit.

8 Pricing of Public Utilities

- FFC recommended that **100 per cent metering** be achieved in a time-bound manner for all electricity consumers as already prescribed statutorily. The Electricity Act, 2003, currently does not have any provision of penalties for delays in the payment of subsidies by State Governments. Therefore, the Act be suitably amended to facilitate levy of such penalties.
- In order to provide financial autonomy to the SERCs, the Electricity Act, 2003, provides for the establishment of a State Electricity Regulatory Commission Fund by State Governments.The FFC reiterated the importance of financial independence of the SERCs and suggested all States to constitute a **SERC Fund**, as statutorily provided for.
- It endorse the initiative to set up a **Rail Tariff Authority (RTA**) .The RTA is expected to lead an era of rationalisation of fares and freight structures for improving the fare-freight ratio and gradually brining down cross subsidisation between different segments.
- It recommend the setting up of **independent regulators** for the **passenger road sector** whose key functions should include tariff setting, regulation of service quality, assessment of concessionaire claims, collection and dissemination of sector information, service-level benchmarks and monitoring compliance of concession agreements.
- It endorsed that all States, irrespective of whether Water Regulatory Authorities (WRAs) are in place or not, consider **full volumetric measurement** of the use of irrigation water. FFC reiterated the recommendations of the FC-XIII and urge States which have not set up WRAs to consider setting up a statutory WRA, so that the pricing of water for domestic, irrigation and other uses can be determined independently and in a judicious manner.

9 Balancing Fiscal Autonomy and Fiscal Space

The spirit behind the FFC recommendations is to increase the automatic transfers to the states to give them more fiscal autonomy .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 **Economic Survey 2014-15** notes that CAS transfers per capita are only mildly progressive. This is a consequence of plan transfers moving away from being Gadgil formula-based to being more discretionary in the last few years. Greater central discretion evidently reduced progressivity. A corollary is that implementing the FFC recommendations would **increase progressivity** because progressive tax transfers would increase and discretionary and less progressive plan transfers would decline.

10 Conclusion

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. 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.