

The Fourteenth Finance Commission

Key Recommendations and Analysis

Introduction

The Finance Commission primarily concerns itself with formulating recommendations for Centre-State financial relations. These include guidelines for sharing of tax proceeds among the two tiers (**vertical devolution**) as well as suggestions for disbursing the funds of State for local governance institutions such as the Panchayati Raj (**horizontal devolution**). It is a constitutional body under the Exchequer, the Chairman of which is appointed by the President of India. Each Financial Commission is formed two years prior to the expiry of the planning cycle, and their recommendations are to be implemented for a period of five years. The Fourteenth Finance Commission (FFC) was constituted under the chairmanship of ex- RBI Governor Dr. Y.V. Reddy in December 2013 for 2015-2020.

The first Finance Commission was constituted in 1951 under the leadership of KC Neogy, a politician. Since then, much has changed with regards to the structure, composition and nature of recommendations of the Finance Commissions, the foremost one being the nature of distribution of tax proceeds between the Centre and the State. In lieu of Centre disbursing “grants” to States, the language has been altered to reflect the equal relationship with respect to tax- sharing for the expenses of Government. Yet another change was initiated by the Twelfth Finance Commission which rearticulated lending by the Centre; States could now borrow directly instead of the Centre borrowing and then lending to States. This has led to a decrease in the debt obligation of States to the Centre, thus prompting broader questions on the credit autonomy of States. Also, if the states were to be given debt relief over and above the distribution of tax proceeds, certain conditions of fiscal discipline had to be enforced, in order to promote good governance. The Thirteenth Finance Commission lay the groundwork for implementing the GST in 2010. This was taken forward by the Fourteenth Finance Commission, who also mandated the creation of a Fiscal Council. However, the most radical of the changes introduced in the FFC Recommendations is outlined in the summary given below.

Summary of FFC Report

Recommendations relating to vertical devolution

1) The FFC report created waves with its recommendation for hiking vertical devolution from 32 per cent to 42 per cent. This unprecedented move drew immediate bouquets and brickbats but the Centre accepted it wholeheartedly, in pursuance of greater **cooperative federalism**. However, the increase was a practical

reprieve to the states from the impending implementation of Goods and Services Tax (GST), apart from providing an interim relief of revenue compensation for the first 5 years.

2) Additionally, the number of Centrally- Sponsored Schemes (CSSs) were scaled down to 27 from 66, as the greater devolution of tax pool was justified on the basis that states can put those extra funds to judicious use, with greater efficiency. The Centre pointed out that CSS exist to ensure minimum standards across the country, and that the implementation of an entire national-level scheme could not be achieved by the Centre alone. Certain Constitutional commitments prevented its departure from *all* schemes, such as MNREGA or PMGSY, and for the other schemes, the financing was decided at a Centre-to-State ratio of 60:40. Therefore, the FFC recommendation to shift from grant disbursement to greater devolution of taxes shrinks the fiscal space that the Centre has, while placing expanded fiscal responsibility squarely on the States.

The Committee report referred to the fact that states themselves had demanded this composite shift during the discussions leading up to the preparation of the report. It also pointed out that the Divisible Pool of Central Taxes does not include cesses and surcharges, and hence more devolution to the states ought to be acceptable.

3) Another significant change that the Committee has adopted is in doing away with distinctions between Plan and Non- Plan Expenditures and to simply account for the states' revenue expenditure. To make up for any shortfalls in 11 revenue deficit states, the FFC has also called for a "Post- Devolution Revenue Deficit Grants" for five years as part of **Grants-in-Aid**, accounting for the states' revenue requirements and their mobilization capacities. The Grants-in-Aid are available to all states, in varying magnitudes, but the Post- Devolution Revenue Deficit Grants is available only to the 11 revenue deficit states.

Recommendations relating to horizontal devolution

1) As regards its proposals for horizontal devolution, the Committee has adopted the criteria of classifying states according to the population of the 1971 Census, demographic shift, forest cover, areas and income distance with exceptions in unique cases. The State grants are channelled two-ways to Gram Panchayats and Municipalities, based on the urban-rural divide and divided into a basic and a performance grant. For Gram Panchayats, the ratio of basic to performance grant is 90:10 while for Municipalities, it is 80:10. This move is to simultaneously keep track of the state's receipts while boosting state revenues. The Committee has additionally made a number of suggestions for improving States' deficits.

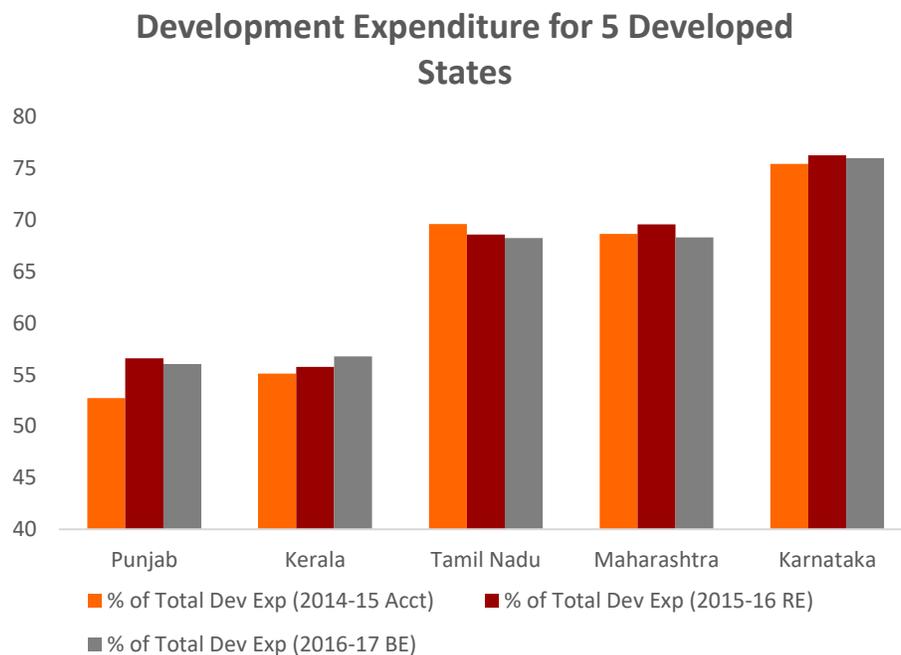
2) The FFC recommendations have far- reaching impacts such as the National Disaster Relief Fund, hitherto endowed through Central cesses, will have to be allotted an assured income source from elsewhere, as cesses would be subsumed under GST (which will also be a part of the pool of divisible funds). According to the report, the NDRF could be deployed for needs identified by districts as well. This opens up the possibility that individual districts would be mandated to form disaster response funds from their own coffers.

3) Apart from this, legislative attempts need to be made in order to amend the Fiscal Responsibility and Budget Management Act of 2003 or to bring about new laws. The FRBM Act, promulgated to hold the Centre responsible for the spending the Consolidated Fund, will require major rewrites given the higher devolution of the funds. Therefore, similar laws enacted at the state-level will ensure that greater accountability will also be transferred to the states.

States' performance under the FFC

The Economic Survey Report 2014-'15 discusses the impact of the FFC recommendations on the States' revenue emoluments and objectively assesses the Central Assistance to State (CAS) transfers as progressive, promoting fiscal federalism. Though there might be transitional costs due to the reduction in the CAS, the FFC transfers will make up for it by reassigning larger amounts to states with larger CAS, thus yielding it a more efficient exercise, as the report shows quantitatively.

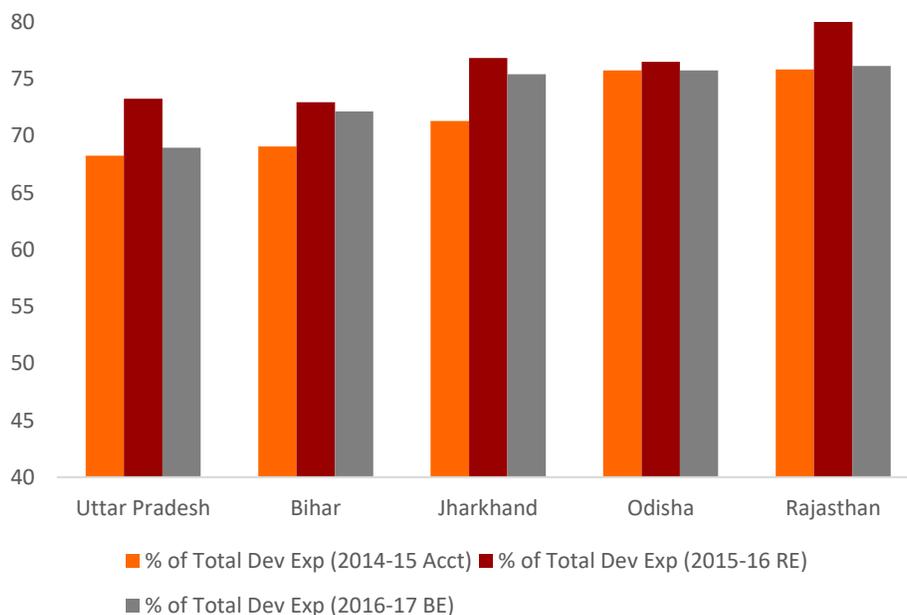
The RBI Statement of States' Expenditures illustrates data for each State's expenses under various fiscal heads, most importantly health and education, which fall under development expenditures of a state. An analysis of this expenditure as a proportion of combined development and non-development related expenditures undertaken by a State provides a clear picture of how the State utilises its funds given the new tax sharing structure, in the context of increased burden on the States to fund previously CSS welfare programmes.



Source: RBI Data for State Expenditures

The above is an illustration of five developed and five developing States in the country, elucidating both pre and post- FFC funding design; the bar for 2014- '15 indicates the percentage of development expenditure prior to the FFC recommendations and the bars for 2015- '16 and 2016- '17 alludes to after-FFC allocations in Rs. Crores. The graph shows that **Kerala** is the only state which has **increased** the Development Expenditure (in BE) for the present year, owing to the fact that it receives **additional Post- Devolution Revenue Deficit Grants** owing to its status as one of the 11 revenue deficit states.

Development Expenditure for 5 Developing States



Source: RBI Data for State Expenditures

The states have been contrasted against those that are faring at a similar level. This depiction brings out how the FFC recommendations have advanced a shift in Central allocations to states which has directly translated to the spike in development expenditure. **Additionally, the scale of the graphs indicates that the developing states have budgeted higher amounts in development activities such as education, health and rural development, which is a welcome phenomenon.** However, no conclusion can be drawn from comparing the plots between developed and developing states, as development expenditure pre and post-FFC has varied due to size, population and policies of the States.

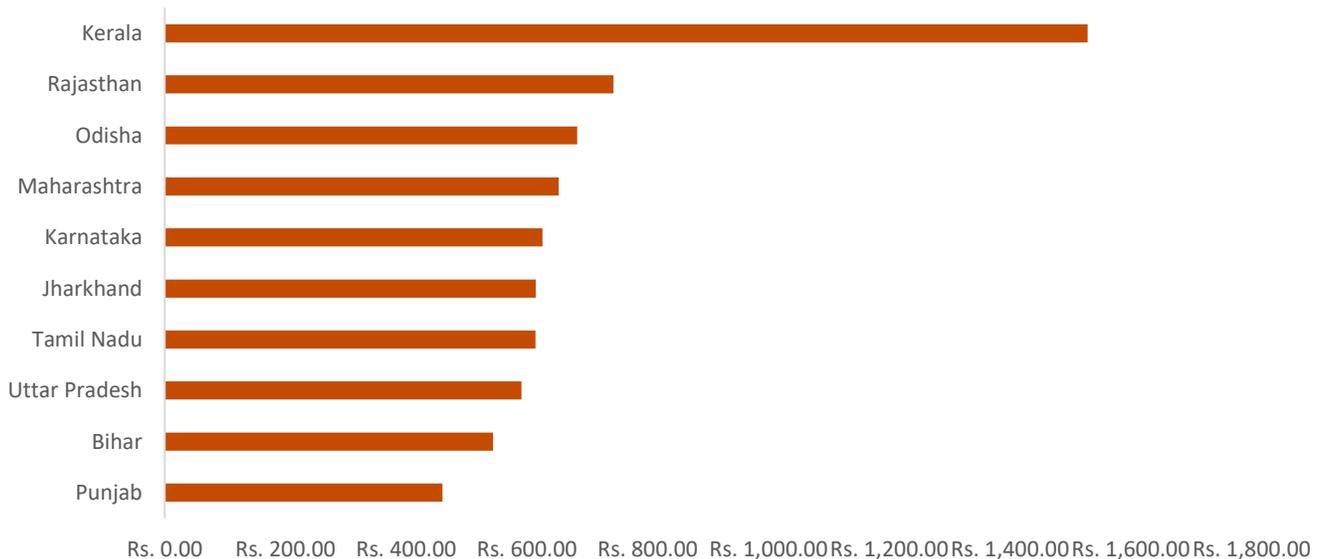
Gram Panchayats under the FFC

The recommendations of the Fourteenth Finance Commission fundamentally altered the perception of the political economy of revenue- sharing between the two tiers of governance. What is often viewed as a competitive relationship between two levels of power that are possibly governed by different political views

and localised concerns was reorganised as a mutually respectful relationship. However, as the Commission report notes, the transition period will witness some loss of revenue for States, while the Centre attempts to stay afloat with the increased expenditures.

By conferring increased autonomy on local governance, the FFC recommendations contribute to the strengthening of the Panchayati Raj institutions. The data for FFC allocations to Gram Panchayats per state for the period of 2015-'16 and 2016-'17 can be leveraged to understand per capita availability of FFC funds for development activities of the GP. This has been plotted here for the same set of 10 states.

FFC Availability Per Capita Panchayat Population



Source: RBI Data for State Expenditures

The graph illustrates how increased per-capita availability of funding correlates with better indicators for standard of living of the rural population. The plot between FFC allocations to Gram Panchayats (in rupees) and the State's rural population (in numbers) give the amount of funding allocated per capita for the rural population. This is a relatively simplistic depiction, as the figures can be distorted by population and size of states, and the definition of what constitutes the "rural". For instance, Rajasthan and Kerala have a similar rural population, but the difference in the grants made available to them puts Kerala at a much higher per-capita availability of funds for developmental activities. Rajasthan, is at rank 4 among these 10 states and receives a higher quantum of grants, which also leads to its unique position. However, it is still a useful visualisation that contributes to the understanding of the impact of FFC recommendations.

Further, it is noteworthy that there is a comprehensive shift in economic policies which describes a state of the nation, which will be a marker of our times- the FFC Recommendations along with the constitution of the NITI Aayog, the introduction of GST, the 7th Central Pay Commission, altogether signal a departure from a Planning-era approach with a 60-year old history of arguably monotonous approaches to the development of the economy. Looking forward, we ought to contemplate altering legal frameworks to accommodate GST, institutionalising its compliance, as well as removing now obsolete legislation such as Fiscal Responsibility and Budget Management Act of 2003. Additionally, new tax devolution regimes and such redefining of CSS pose relevant questions regarding minimum standards of development and the efficacy of the Central government in delivering them. While the government has to be held accountable as to how it spends public money, increased civilian consciousness in this regard also needs to be developed in tandem with introducing such sweeping changes. Greater transparency in government flows needs to be prioritised in light of the single-channel transfer of resources from the Centre to States. This was addressed by the Thirteenth Finance Commission Report, but overlooked in this one. Hopefully, the new devolution regime will lead to higher efficiency in the use of Central resources, and more local- specific initiatives may be adopted in order to maximise the benefits of increased State incomes.