The Fourteenth Finance Commission (FFC) – Implications for Fiscal Federalism in India?[1]

10

CHAPTER

"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

10.1 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 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, 2013under 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.

10.2 Major Recommendations of FFC

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 budgeting by, and the fiscal situation of, the center and the states. Some of the major recommendationsare 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 (Table 10.1)*** 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

[1] A more detailed version of this piece will be available online at finmin.nic.in after the Budget is presented.

Box 10.1 : Finance Commission - Concepts and definitions

Tax Devolution

One of the core tasks of a Finance Commission as stipulated in Article 280 (3) (a) of the Constitution is to make recommendations regarding the distribution between the Union and the states of the net proceeds of taxes. This is the most important task of any Finance Commission, as the share of states in the net proceeds of Union taxes is the predominant channel of resource transfer from the Centre to states.

Divisible Pool

The divisible pool is that portion of gross tax revenue which is distributed between the Centre and the States. The divisible pool consists of all taxes, except surcharges and cess levied for specific purpose, net of collection charges.

Prior to the enactment of the Constitution (Eightieth Amendment) Act, 2000, the sharing of the Union tax revenues with the states was in accordance with the provisions of articles 270 and 272, as they stood then. The eightieth amendment of the Constitution altered the pattern of sharing of Union taxes in a fundamental way. Under this amendment, article 272 was dropped and article 270 was substantially changed. The new article 270 provides for sharing of all the taxes and duties referred to in the Union list, except the taxes and duties referred to in articles 268 and 269, respectively, and surcharges on taxes and duties referred to in article 271 and any cess levied for specific purposes.

Grants-in-aid

Horizontal imbalances are addressed by the Finance Commission through the system of tax devolution and grants-in-aid, the former instrument used more predominantly. Under Article 275 of the Constitution, Finance Commissions are mandated to recommend the principles as well as the quantum of grants to those States which are in need of assistance and that different sums may be fixed for different States. Thus one of the pre-requisites for grants is the assessment of the needs of the States.

The First Commission had laid down five broad principles for determining the eligibility of a State for grants. The first was that the Budget of a State was the starting point for examination of a need. The second was the efforts made by States to realize the potential and the third was that the grants should help in equalizing the standards of basic services across States. Fourthly, any special burden or obligations of national concern, though within the State's sphere, should also be taken into account. Fifthly, grants might be given to further any beneficent service of national interest to less advanced States.

Grants recommended by the Finance Commissions are predominantly in the nature of general purpose grants meeting the difference between the assessed expenditure on the non-plan revenue account of each State and the projected revenue including the share of a State in Central taxes. These are often referred to as 'gap filling grants'. Over the years, the scope of grants to States was extended further to cover special problems. Following the seventy-third and seventy-fourth amendments to the Constitution, Finance Commissions were charged with the additional responsibility of recommending measures to augment the Consolidated Fund of a State to supplement the resources of local bodies. This has resulted in further expansion in the scope of Finance Commission grants. The Tenth Commission was the first Commission to have recommended grants for rural and urban local bodies. Thus, over the years, there has been considerable extension in the scope of grants-in-aid.

Fiscal capacity/Income distance

The income distance criterion was first used by Twelfth FC, measured by per capita GSDP as a proxy for the distance between states in tax capacity. When so proxied, the procedure implicitly applies a single average tax-to-GSDP ratio to determine fiscal capacity distance between states. The Thirteenth 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

Fiscal discipline as a criterion for tax devolution was used by Eleventh and Twelfth FC to provide an incentive to states managing their finances prudently. The criterion was continued in the Thirteenth FC as well without any change. 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.

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**

forest cover; and excluded the fiscal discipline variable (Box-1).

- 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 5.3 lakh crore for the period 2015-20.[2]

- The FFC has not made any recommendation concerning sector specific-grants unlike the Thirteenth Finance Commission.

10.3 Implications of FFC Recommendations for Fiscal Federalism: A way Ahead

Based on its recommendations and projections, the FFC has assessed and quantified the implications for the revenues of states. In this analysis the revenue implications are reassessed based on more recent data (for 2014/15) and slightly differing assumptions about GDP growth, tax buoyancy[3] and other fiscal parameters.The estimated benefits (both from tax devolution and FFC grants together), based on certain assumptions related to both FY2014-15and FY2015-16,are shown in Table 10.2. 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). Several points are worth noting.

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[4], or by states' own tax revenue receipts[5]. These are shown in columns 4-6 of Table 10.2.The biggest gainers in absolute terms under GCS (Box-2) are Uttar

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**.

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[2] Other than tax devolution (vertical and horizontal) which are specified in percentages, other transfers are specified as absolute numbers. Since we use different revenue numbers, we have assumed that these transfers will broadly grow in line with nominal GDP growth.

[3] Tax buoyancy is an indicator to measure efficiency and responsiveness of revenue mobilization in response to growth in the Gross domestic product or National income. It is measured as a ratio of growth in Tax Revenue to the growth in GDP. If the buoyancy value is greater than one then the growth in tax collection would be higher than the growth in GDP growth.

[4] NSDP at current market prices is for the year 2012-13.

[5] Own Tax Revenue is for the year 2011-12.

Table 10.2 : Additional FFC Transfers (in 2015-16 over 2014-15)

State	Category	Benefits from FFC (in ₹ crore)	Benefits Per capita (₹)	Benefits as % of OTR	Benefits as % of NSDP
1	2	3	4	5	6
Andhra Pradesh (united)	GCS	14620	1728	27.4	2.2
Arunachal Pradesh	SCS	5585	40359	1758.1	51.0
Assam	SCS	7295	2338	95.5	5.8
Bihar	GCS	13279	1276	105.3	4.9
Chhattisgarh	GCS	7227	2829	67.5	5.2
Goa	GCS	1107	7591	44.1	3.0
Gujarat	GCS	4551	753	10.3	0.8
Haryana	GCS	1592	628	7.8	0.5
Himachal Pradesh	SCS	8533	12430	207.7	14.6
Jammu & Kashmir	SCS	13970	11140	294.4	22.4
Jharkhand	GCS	6196	1878	89.1	4.8
Karnataka	GCS	8401	1375	18.1	1.8
Kerala	GCS	9508	2846	37.0	3.1
Madhya Pradesh	GCS	15072	2075	55.9	4.5
Maharashtra	GCS	10682	951	12.2	0.9
Manipur	SCS	2130	8286	578.7	19.5
Meghalaya	SCS	1381	4655	198.0	8.6
Mizoram	SCS	2519	22962	1410.1	33.3
Nagaland	SCS	2694	13616	886.5	18.7
Odisha	GCS	6752	1609	50.2	3.2
Punjab	GCS	3457	1246	18.3	1.4
Rajasthan	GCS	6479	945	25.5	1.6
Sikkim	SCS	1010	16543	343.7	10.7
Tamil Nadu	GCS	5973	828	10.0	0.9
Tripura	SCS	1560	4247	181.8	6.9
Uttar Pradesh	GCS	24608	1232	46.8	3.5
Uttarakhand	SCS	1303	1292	23.2	1.4
West Bengal	GCS	16714	1831	67.0	3.0
Total		204198	1715		

Source **: Ministry of Finance.**

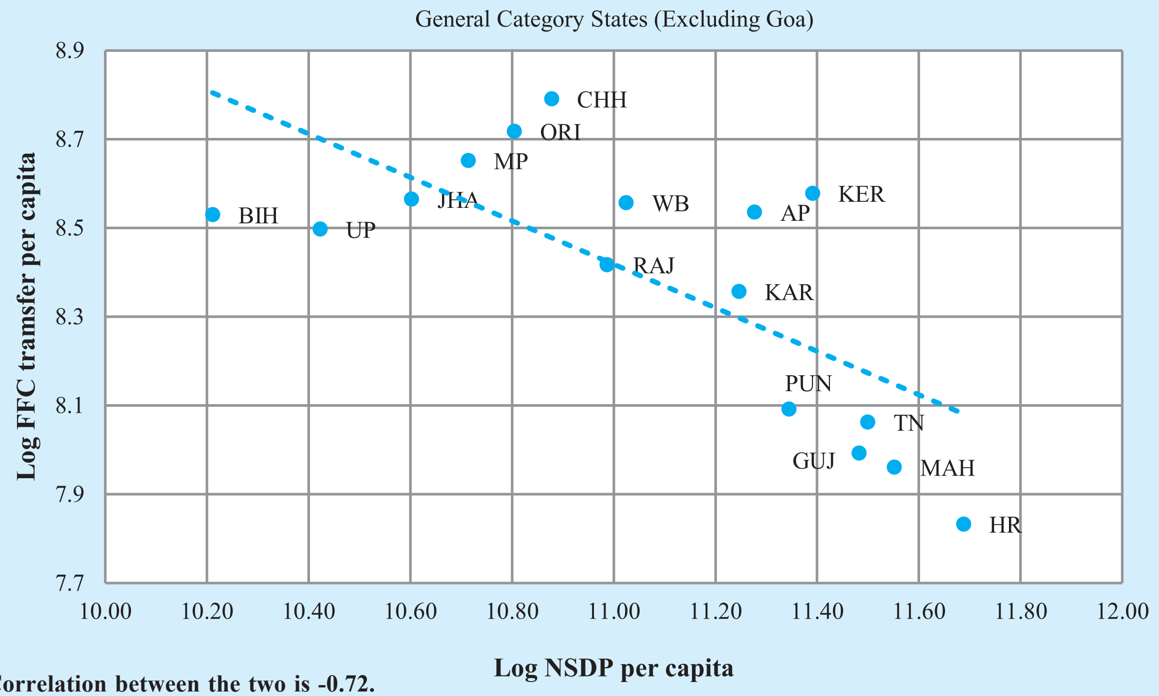
GCS- General Category States; SCS-Special Category States

Pradesh, West Bengal and Madhya Pradesh while for SCS it is Jammu & Kashmir, Himachal Pradesh 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 Madhya Pradesh for GCS and Arunachal Pradesh, Mizoram and Sikkim for SCS.

The FFC recommendations are expected ***to add substantial spending capacity*** to states' budgets. The additional spending capacity can better be measure by scaling the benefits either by NSDP at current market price or by states' own tax revenue. In terms of the impact based on NSDP, the benefits of FFC transfers are highest for Chhattisgarh, Bihar and Jharkhand among the GCS and for states like Arunachal Pradesh, Mizoram and Jammu & Kashmir among the SCS. While in terms of states' own tax revenues, the largest gains accrue to GCS of Bihar, Jharkhand and Chhattisgarh and SCS of Arunachal Pradesh, Mizoram and Nagaland.

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

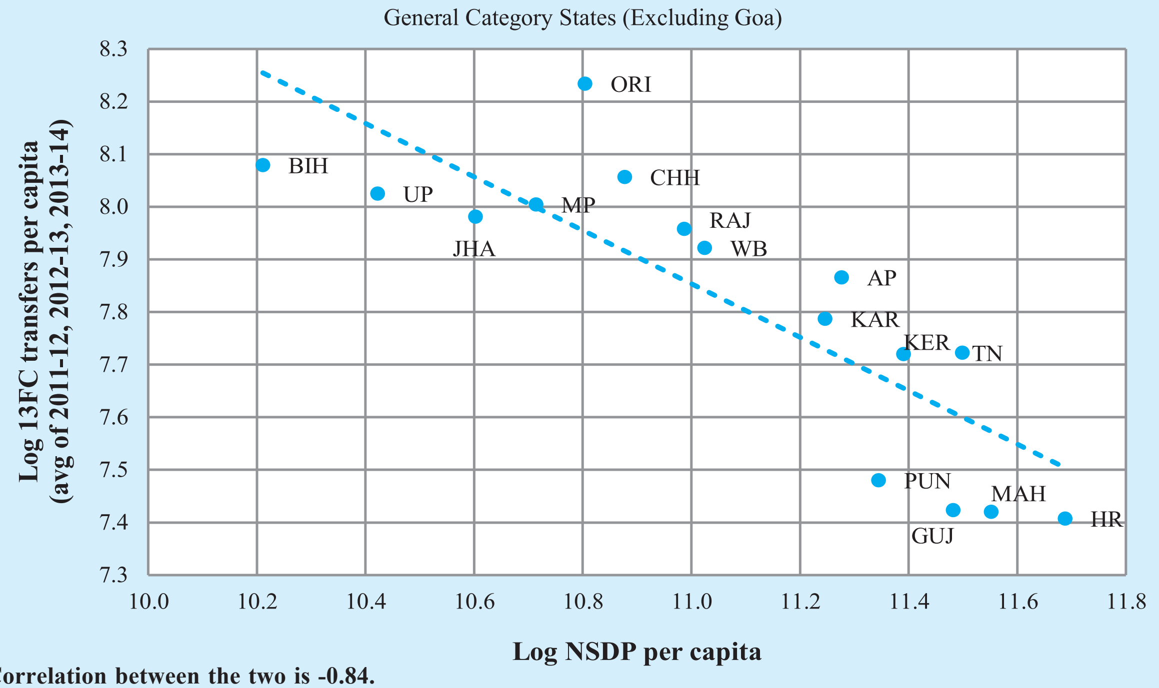
Figure 10.1: FFC transfers per capita and NSDP per capita



Correlation between the two is -0.72.

lower per capita NSDP receive on average much larger transfers per capita (Figure 10.1). The correlation between per capita NSDP and FFC is transfer per capita is -0.72. This indicates that the FFC recommendations do go in the direction of equalizing the income and fiscal disparities between the major states. However, FFC transfers are less progressive compared to the transfers of Thirteenth Finance Commission (TFC). The correlation coefficient between the NSDP per capita and TFC transfers per capita (average of 2011-12, 2012-13 and 2013-14) per capita is-0.84 (Figure 10.2).

Figure 10.2: TFC transfers per capita and NSDP per capita



Correlation between the two is -0.84.

A final 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 (Table 10.3).

10.4 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 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

Table 10.3 : Decomposition of FFC Transfers to States

State	State share in 14th FC	State share in 13th FC	Decomposition of FFC Transfers: Due to change in Divisible pool	Decomposition of FFC Transfers: Due to change in Share
Andhra Pradesh (United)	0.06742	0.06937	107.5	-7.5
Arunachal Pradesh	0.0137	0.00328	24.9	75.1
Assam	0.03311	0.03628	129.0	-29.0
Bihar	0.09665	0.10917	142.8	-42.8
Chhattisgarh	0.0308	0.0247	64.9	35.1
Goa	0.00378	0.00266	53.9	46.1
Gujarat	0.03084	0.03041	96.7	3.3
Haryana	0.01084	0.01048	92.3	7.7
Himachal Pradesh	0.00713	0.00781	128.9	-28.9
Jammu & Kashmir	0.01854	0.01551	69.5	30.5
Jharkhand	0.03139	0.02802	78.2	21.8
Karnataka	0.04713	0.04328	82.7	17.3
Kerala	0.025	0.02341	86.1	13.9
Madhya Pradesh	0.07548	0.0712	87.4	12.6
Maharashtra	0.05521	0.05199	87.1	12.9
Manipur	0.00617	0.00451	56.6	43.4
Meghalaya	0.00642	0.00408	47.7	52.3
Mizoram	0.0046	0.00269	43.7	56.3
Nagaland	0.00498	0.00314	47.3	52.7
Odisha	0.04642	0.04779	107.7	-7.7
Punjab	0.01577	0.01389	76.2	23.8
Rajasthan	0.05495	0.05853	118.4	-18.4
Sikkim	0.00367	0.00239	49.0	51.0
Tamil Nadu	0.04023	0.04969	207.5	-107.5
Tripura	0.00642	0.00511	64.1	35.9
Uttar Pradesh	0.17959	0.19677	129.0	-29.0
Uttarakhand	0.01052	0.0112	118.2	-18.2
West Bengal	0.07324	0.07264	98.0	2.0

Source **: Ministry of Finance and Reports of Finance Commissions.**

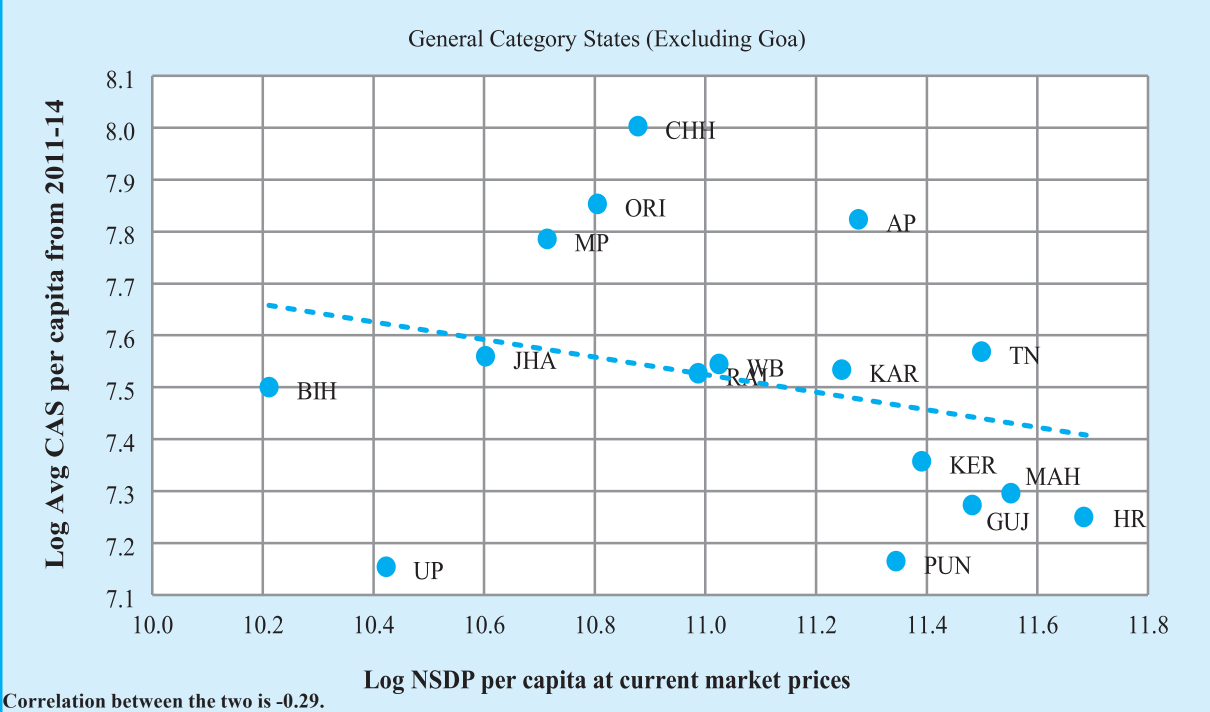
that there will be commensurate reductions in the Central Assistance to States (CAS) known as "plan transfers."

One immediately noteworthy fact is that CAS transfers per capita are only mildly progressive (Figure 10.3): the correlation coefficient with state per capita NSDP is -0.29. 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.

Balancing the enhanced fiscal autonomy of the states with preserving fiscal space of the Centre entails reduction in CAS transfers. But there are many ways of doing the latter from the totally discretionary to formula-based. Within the latter too there are many options: (i) proportionate cuts across the states in CAS transfers; (ii) ensuring the implementation of legally-backed/mandated schemes[6] and then proportionately cutting the residual; (iii) equal per capita distribution of CAS transfers; (iv) implementing the legally-backed schemes and then distributing the remaining amount in line with the FFC formula for tax devolution; and many more. For simplicity, here we discuss options (i) only. We calculate the net surplus to the states, i.e. the difference between increase in FFC transfers less the reduction in CAS transfers and display the results in Table 10.4.

Table-10.4 is constructed to compare state-wise the increased benefits from FFC and the CAS transfers in 2015-16. The surplus/shortfall[7] shown in column 3 has been obtained by taking the difference between total benefit from FFC and reduction in CAS in 2015-16 over 2014-15. This difference is also shown in columns 4, 5 and 6 in terms of population, NSDP and own tax revenues respectively. Essentially, the

Figure 10.3: Average CAS transfers per capita in 2011-14 & NSDP per capita



Correlation between the two is -0.29.

[6] Legally backed schemes are SSA, MGNREGA, MPLAD, SPA to EAP, PMGSY and others.

[7] The surplus and shortfall are based on certain assumptions regarding the estimation/projection of CAS allocations to states in 2014-15 and 2015-16. The calculation of surplus/shortfall may vary once the actual numbers of CAS allocation for 2014-15 and estimated CAS allocations to states are out.

Table 10.4 : Total Surplus/shortfall after transfer under CAS but preserving the fiscal space for Center

State	CAS over and above legally backed schemes (in ₹ crore)	surplus/short fall after transfer under CAS but preserving the fiscal space for centre			
		Absolute (₹ crore)	Per capita (in ₹)	% of NSDP	% of OTR
Andhra Pradesh(united)	5062	10134	1198	1.5	19.0
Arunachal Pradesh	2555	4572	33038	41.8	1439.2
Assam	5860	4378	1403	3.5	57.3
Bihar	6998	8783	844	3.2	69.6
Chhattisgarh	2673	5258	2058	3.8	49.1
Goa	180	995	6820	2.7	39.6
Gujarat	4179	2454	406	0.4	5.5
Haryana	1509	714	282	0.2	3.5
Himachal Pradesh	3593	6826	9944	11.7	166.2
Jammu & Kashmir	8185	10679	8515	17.1	225.0
Jharkhand	2870	4650	1410	3.6	66.9
Karnataka	4873	5300	867	1.1	11.4
Kerala	2778	7834	2345	2.5	30.5
Madhya Pradesh	7959	10389	1431	3.1	38.5
Maharashtra	5365	7496	667	0.6	8.6
Manipur	2029	1250	4861	11.4	339.5
Meghalaya	1536	661	2229	4.1	94.8
Mizoram	1157	1967	17925	26.0	1100.7
Nagaland	2019	1839	9293	12.7	605.0
Odisha	6826	3497	833	1.7	26.0
Punjab	1820	2478	893	1.0	13.2
Rajasthan	6618	2423	353	0.6	9.5
Sikkim	1415	489	8006	5.2	166.3
Tamil Nadu	2376	2644	366	0.4	4.4
Tripura	2139	458	1246	2.0	53.3
Uttar Pradesh	9110	18716	937	2.7	35.6
Uttarakhand	3014	-48	-48	-0.1	-0.9
West Bengal	8386	11365	1245	2.0	45.6
TOTAL	113081	138198			

Source : **Ministry of Finance.**

numbers in these columns also answer the question of whether the states, if they wanted to, can maintain the same level of spending on the programs financed by the CAS especially the legally-backed schemes, and still have additional resources to finance their own new programs. If they do not want to accept Centrally Sponsored Schemes, all the increase in FFC transfers is new, unencumbered money. All the GCS gain from FFC transfers net of CAS reduction. The top three gainers in absolute terms under GCSare Uttar Pradesh, West Bengal and Madhya Pradesh while for SCS it is Jammu & Kashmir, Himachal Pradesh and Arunachal Pradesh. The better way of measuring the surplus/shortfall would be in per capita terms. The major gainers are Goa, Kerala and Chhattisgarh for GCS and Arunachal Pradesh, Mizoram and Himachal Pradesh for SCS.

The surplus/shortfall as per cent of NSDP at current market price are shown in column 5 of table 10.4, the states which add up maximum fiscal resources are Chhattisgarh, Jharkhand and Bihar among the GCS while among the SCS it is Arunachal Pradesh, Mizoram and Jammu & Kashmir. The surplus is going to add significant amount to the states revenue. There are nine states among the GCS which are expected to get more than 25 per cent of their own tax revenue (column 6 of table 10.4)

10.5 Caveats and Conclusion

Some caveats or complications to this exercise must be noted. First, they are sensitive to the assumptions underlying GDP growth, revenue and expenditure estimations/projections for 2014-15 and 2015-16. Secondly, assumptions are also made about CAS amounts in 2014-15 and about reductions in CAS amounts in 2015-16. So, these must be treated as illustrative calculations. For example, another option would simply be to transfer those schemes that are on State list back to the states. Also, estimates have only been presented for the year 2015-16. Thereafter, additional factors such as GST implementation and the next Pay Commission awards will affect projections beyond the coming year.

With these caveats, 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. 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 CAS to FFC transfers is that overall progressivity will improve.

To be sure, there will be transitional costs entailed by the reduction in CAS transfers. But the scope for dislocation has been minimized because the extra FFC resources will flow precisely to the states that have the largest CAS-financed schemes.

In sum, the far-reaching recommendations of the FFC, along with the creation of the NITI Aayog, will further the Government's vision of cooperative and competitive federalism. The necessary, indeed vital, encompassing of cities and other local bodies within the embrace of cooperative and competitive federalism is the next policy challenge.