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# POLICY BRIEF

June 2015 | Issue I

## Fourteenth Finance Commission

## Background

The Indian Constitution provides an institutional framework to facilitate Union-State Transfers. This body is the Finance Commission, which came into existence in 1951, under Article 280 of the Indian Constitution. The Finance Commission is required to recommend the distribution of the net proceeds of taxes of the Union between the Union and the States (referred to as vertical devolution); and the allocation between the States of the respective shares of such proceeds (referred to as horizontal devolution).

Functions of the Finance Commission can be explicitly stated as:

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.

The 14th Finance Commission (FFC) was constituted by the orders of President on 2nd January, 2013 and submitted its report on 15thDecember, 2014. The Commission's recommendations cover the period April 1, 2015 to March 31, 2020. The commission was headed by former RBI governor, Y.V Reddy and the report had a dissent note by Abhijit Sen. The major highlights of the report are analyzed in the following sections.

## Increased Vertical Devolution-The Facts & Myths

From the standpoint of federalism, the most significant aspect of the commission's report is the hike in devolution of tax proceeds to the states from 32% to 42%. As compared to the total devolutions in 2014-15, the total devolutions of the states in 2015-16 will increase by over 45 per cent. As the Chairman and Members of the FFC have emphasised subsequent to the release of the report, the change in the quantum of vertical devolution is more transformational than incremental.[1]

States have been complaining about the growing asymmetry in the federal fiscal relationship arising from a number of factors. These have included the inability of state governments to pursue their own development models due to the one size fits all approach and the rising dominance of rights based central sector schemes with matching state commitments. The quantum jump in the states' share in the divisible pool squarely addresses all these concerns and brings states to the forefront of the development agenda.[2]

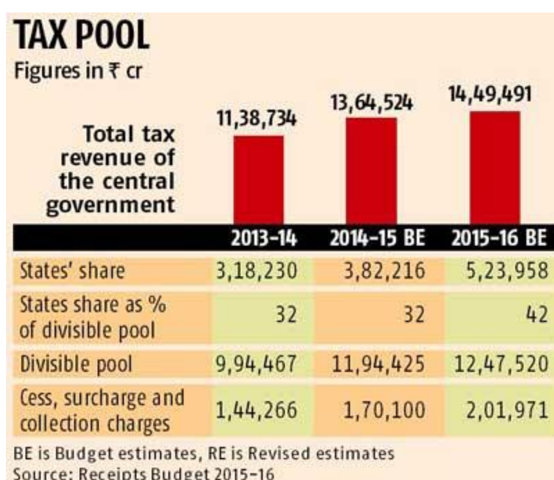
Politically, the increase could also serve as a confidence-building measure, given that the centre and states are negotiating the introduction of a goods and services tax (GST) under which the latter will forego most of their taxation powers.

Further the commission also recommended that tax devolution shall be the primary route of transfer of resources to the states. The consequence of this much greater devolution to the States is that the fiscal space for the Centre will reduce in the same proportion. ***Indeed the increase of devolution by 45% should be read along with a sharp reduction of about 66% in central budgetary outlays in social sector CSS in the last union budget.***

1. KK George: "Overview of Fourteenth Finance Commission", seminar on Fourteenth Finance Commission organized by ISDG (May, 2015)
2. The Fourteenth Finance Commission report (2015)

It is also important to understand here that the central divisible pool is not equivalent to the gross central tax revenue (Table 1). Taxes like cess and surcharge is not part of the central divisible pool and interestingly their contribution to the central exchequer has been on the rise over the years. The total cess, surcharges and collection charges for 2013-14 and 2014-15 work out to Rs 1.44 lakh-crore and Rs 1.7 lakh-crore while for 2015-16 is approximately Rs 2 lakh-crore. So, with the share of the cess and surcharge going up over the years, the total divisible tax pool for states as a percentage of total tax revenues has actually gone down. According to the 14th Finance Commission as well, the share of cess and surcharges in gross tax revenue of the Central government has increased from 7.53 per cent in 2000-01 to 13.14 per cent in 2013-14. This means essentially only 87 per cent of the total tax revenue forms the basis of the devolution to the states.[3]

**Table 1: Tax Pool Overview**



TAX POOL

Figures in ₹ cr

| | 2013-14 | 2014-15 BE | 2015-16 BE |
|---|---|---|---|
| Total tax revenue of the central government | 11,38,734 | 13,64,524 | 14,49,491 |
| States' share | 3,18,230 | 3,82,216 | 5,23,958 |
| States share as % of divisible pool | 32 | 32 | 42 |
| Divisible pool | 9,94,467 | 11,94,425 | 12,47,520 |
| Cess, surcharge and collection charges | 1,44,266 | 1,70,100 | 2,01,971 |

BE is Budget estimates, RE is Revised estimates

Source: Receipts Budget 2015-16

Courtesy: Business Standard

## Whose Interest is National Interest?

The absence of a clear transitional mechanism from planning commission to NITI Ayog further complicates the implementation of key social sector schemes. Many of the critiques point out that in the absence of a mediation space like the planning commission of India, the union finance ministry itself seems to be 'recentralising' powers with less negotiating space for the states. The recommendation of FFC also need to be seen from the point of view of the larger political economy of the union and states on the one hand and that of the public finance on the other hand.

Despite the tendency to project the 'shining India', our country has the largest number of poor people in the world with a high incidence of hunger, malnutrition, infant mortality and maternal mortality. . It was the flagship social protection programmes such as MGNREGA and right to food that provides the much needed social protection programmes to ensure a relatively more inclusive growth and at least an incremental economic distribution model.

While it looks good to have a relatively better share of the tax and tax devolution, there is a concern that to what extent the state policy makers will ensure implementation of social protection programmes. Centrally sponsored schemes are ear- marked funds and can't be diverted. However, an analysis of the state budgets in many of the states in India clearly shows a tendency to divert funds for social protection to others and desperate need for more resources to meet the increasing non-plan expenditure, often undermining the social sector programme through deliberate effort to spend less or to divert.

Planning commission and planning boards have a role in this regards by adopting effective measures to effectively design and use social sector funding and also ensure monitoring and evaluation. As of now NITI Ayog's mandate is still not clear and it appears more like a government funded policy think tank to provide policy analysis and recommendations rather than a body to provide appropriate guidelines on social sector and to provide effective framework for resources monitoring and evaluation. In the absence of the planning commission, the states no longer have a space for effective negotiation with the union nor is there an effective monitoring mechanism for implementation of social sector programmes.

3."Cess surcharge helps centre fill its coffers", Business Standard (Mar 5, 2015)

## Horizontal Devolution- A New Formula

The recommendations of the FFC compared to those of the six earlier finance commissions are summarised in Table 2. We review the major parameters adopted by the FFC.

**Table 3: Horizontal Devolution Parameters Adopted by Previous Finance Commissions**

| | XII | XIII | XIV |
|---|---|---|---|
| Population 1971 | 25 | 25 | 17.5 |
| Adjusted area | 10 | 10 | 15 |
| Income distance/fiscal cap distance | 50 | 47.5 | 50 |
| Fiscal discipline | 7.5 | 17.5 | - |
| Tax effort | 7.5 | - | - |
| Demographic change 2011 population | - | - | 10 |
| Forest area | - | - | 7.5 |
| TOTAL | 100 | 100 | 100 |

Courtesy: Economic and Political Weekly (EPW)

**Demographic Change & Forest Area- The new parameters**

The FFC adopted the 2011 population as a proxy indicator for demographic changes and gave it a weight of 10%. 2011population as a proxy for demographic change is inappropriate for the following reasons[4]:

(1) Demographic change reflects variations in population structure over a period, capturing changes in birth and death rates as well as migration trends. Population is a static figure representing headcount at a particular moment in time. Thus demographic change reflects flow and the population reflects stock. How far the latter can be a proxy for the former is debatable.

(2) Of the four remaining criteria adopted by the FFC, only one—income distance—is affected by changing demography as per capita incomes change with population size. The FFC has taken into account the projected state-wise population figures for 2010–11, 2011–12 and 2012–13 while determining average per capita Gross State Domestic Product (GSDP). As these demographic changes have been incorporated into the determination of state shares, there appears to be little case for including an additional criterion for this purpose.

(3) Effectively, the FFC has increased the weightage given to population from 25% to 27.5% (17.5% for 1971 population and 10% for 2011 population). Per se, population is a neutral parameter in the devolution process. It does not contribute to either equity or efficiency. An increase in the weightage to the population parameter helps both rich and poor states. It does not increase the progressivity of the award.

FFC notes that "large forest cover provides huge ecological benefits, but there is also an opportunity cost in terms of area not available for other economic activities and this also serves as an important indicator of fiscal disability" and has given a weightage of 7.5% to this criterion. It is only fair that the states are compensated adequately for revenue loss, funds spent for maintenance of forests, and compensation for acting as a net 'carbon sink' incurring opportunity cost of economic growth and food security.

## Whither Equity?

Equity is and should be the overarching concern of any federal polity worth its name. The FFC is to be commended for increasing the weightage for this factor from 47.5% to 50%, which demonstrates the importance it places on equity. Despite its conscious efforts to provide additional weightage to the equity criterion, when compared to the award of the Thirteenth Finance Commission, the share of high income states has increased and the share of low income states has declined.

The Economic Survey 2014-15 notes, "FFC transfers are less progressive when compared to the 13th FC transfers". While increasing the devolution share, the FFC has simultaneously restricted grants-in-aid to only three categories—revenue deficit, disaster relief, and local bodies. The FFC has consciously withdrawn from providing specific purpose

4. V Bhaskar: "Stance on Devolution and Grants", Economic &Political Weekly (May 23, 2015)

grants, which were provided by previous commissions towards equalisation. Perhaps, the FFC could have considered at least some basic equalisation grants as part of its award. Further, providing a significant volume of grants protects the states if the revenue projections made by the commission are perchance over-optimistic.

On an absolute scale all states stand to gain but on a relative scale, with the addition of the new criterion Uttar Pradesh is the biggest loser followed by Bihar. Uttar Pradesh's per-se share has reduced from 19.677 per cent in 13th Finance Commission to 17.959 per cent now, while Bihar's has come down from 10.917 per cent to 9.665 per cent. Meanwhile, 19 states stand to gain from the new arrangement. Arunachal Pradesh is the biggest gainer, followed by Chhattisgarh. Among the other major gainers are Maharashtra, Madhya Pradesh, Karnataka, Jharkhand and Jammu and Kashmir.

**Table 3: Inter se share of states 13th vs 14th Finance Commissions**

| State | XIII | XIV |
|---|---|---|
| Andhra Pradesh | 6.937 | 4.305 |
| Arunachal Pradesh | 0.328 | 1.370 |
| Assam | 3.628 | 3.311 |
| Bihar | 10.917 | 9.665 |
| Chhattisgarh | 2.470 | 3.080 |
| Goa | 0.266 | 0.378 |
| Gujarat | 3.041 | 3.084 |
| Haryana | 1.048 | 1.084 |
| Himachal Pradesh | 0.781 | 0.713 |
| Jammu & Kashmir | 1.551 | 1.854 |
| Jharkhand | 2.802 | 3.139 |
| Karnataka | 4.328 | 4.713 |
| **Kerala** | **2.341** | **2.500** |
| Madhya Pradesh | 7.120 | 7.548 |
| Maharashtra | 5.199 | 5.521 |
| Manipur | 0.451 | 0.617 |
| Meghalaya | 0.408 | 0.642 |
| Mizoram | 0.269 | 0.460 |
| Nagaland | 0.314 | 0.498 |
| Orissa | 4.779 | 4.642 |
| Punjab | 1.389 | 1.577 |
| Rajasthan | 5.853 | 5.495 |
| Sikkim | 0.239 | 0.367 |
| Tamil Nadu | 4.969 | 4.023 |
| Telangana | - | 2.437 |
| Tripura | 0.511 | 0.642 |
| Uttar Pradesh | 19.677 | 17.959 |
| Uttarakhand | 1.120 | 1.052 |
| West Bengal | 7.264 | 7.324 |
| All States | 100.000 | 100.000 |

Courtesy:CNN-IBN

## Impact on Kerala

As observed earlier all states including Kerala stands to gain on an absolute scale due to the increased vertical devolutions. Kerala along with other 18 states also stand to gain relatively since the formula for horizontal devolution is favourable to Kerala. Thus Kerala’s share in the total divisible pool increased from 2.341% in the thirteenth finance commission to 2.5% in the fourteenth finance commission.

The forest area covers 29% of the geographical area of the state as against 23.4% for the country as a whole. In respect of geographical area covered by forest, Kerala’s position is fourth among the states and union territories and with 7.5% weightage given to forest area Kerala stands to gain significantly. The decision to do away with fiscal discipline is also advantageous to Kerala. However the weightage of 10% given to demographic change based only on 2011 population impacts Kerala negatively since it has been at the forefront of family planning.

## Rewarding Fiscal Indiscipline

The Finance Commission is also required to make recommendation regarding the principles governing grants-in-aid of the States’ revenues, by the Centre. As noted by the FFC , while calculating grants to the States they “have departed significantly from previous Finance Commissions, by taking into consideration a States’ entire revenue expenditure needs without making a distinction between Plan and Non-Plan”

5. MA Oommen: “Implications for Local Governments”, Economic &Political Weekly, May 23 and seminar on Fourteenth Finance Commission organized by ISDG (May, 2015)

The FFC has provided for revenue deficit grants when compared to non-plan revenue deficit (NPRD) grants provided by previous finance commissions. With the FFC discarding the parameters of tax effort and fiscal efficiency from the criterion for horizontal devolution, a scenario where more states seeking to join this "exclusive" club of revenue deficit states could arise.

The Government of Kerala has candidly accepted in its budget MTFP (medium-term fiscal plan projection) document for 2015–16 "The ….elimination of fiscal discipline criteria is advantageous to Kerala". With the lack of any incentive for prudent fiscal performance and energetic tax effort, we need to guard against building up of perverse incentives for other states to seek to join the list of revenue deficit states in the future.[4]

## Fiscal Federalism and Local Self Governments

The Finance Commission is also required to recommend on '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'.

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 undue weightage given to population is iniquitous especially because of the use of 2011 Census figures. The 90% weightage to population is unprecedented and certainly a quantum jump compared to the 50% followed by the Thirteenth Finance Commission and 40% by the Twelfth and Eleventh Finance Commissions. The fallouts of using 2011 population have already been explained earlier. The deliberate omission of other relevant criteria can only help to put democratic de-centralisation on the back burner.

The decision to use 1971 population followed from the days of the Seventh Finance Commission was taken to avoid possible bias or disadvantage to any state that might choose to pursue family planning to contain population, a policy initiated and vigorously incentivised by the central government. The choice of 2011 population has thus adversely affected states like Kerala, Tamil Nadu, West Bengal and Andhra Pradesh which adopted successful family planning programmes.

FFC has also recommended grants to be in two parts; a basic grant, and a performance grant, for duly constituted Gram panchayats and municipalities. The ratio of basic to performance grant is 90:10 with respect to Panchayats and 80:20 with respect to Municipalities. The FFC when compared to thirteenth Finance commission has not only reduced the share of performance grants to 10% from 34%, the conditionality's have also been made less demanding.[5]

## Conclusion-Continuity and Change

The FFC needs to be commended for bringing the states back to the forefront of the growth framework and providing them with substantial freedom to pursue their development agenda. The report is transformational, but the fall in progressivity in its award is of some concern. The use of 2011 population and revenue deficit grants raise queries on the fiscal prudence of the state. The weightage for forest area is a progressive step consistent with sustainable development. Overall FFC represents continuity to a considerable extent while also rebalancing in certain areas to take stock of the changing realities in the fiscal architecture.

In the context of the larger political economy the decrease in social sector spending and the absence of a transitional mechanism from planning commission to NITI Ayog raises concerns on the inclusiveness of the Indian growth model.

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