Fourteenth Finance Commission, Continuity, Change and Way Forward

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Part-B: Unit – 4 Fiscal Federalism in India

Readings 1: - Fourteenth Finance Commission, Continuity, Change and Way Forward

The Ex-RBI Governor and fourteenth finance commission (FFC) chairman Dr. Y. V. Reddy here has recommended a transformational reform process in fiscal federalism guided by the Terms of References and relegating a greater devolution of power to the states. FFC reviewed the deliberation in detail the views of National Development Council, Administrative Reform Commission (1966), National Commission on Review of the Working of the Constitution (Venkatchallaih Commission 2002), Commission on Centre-State Relation (Sarkaria Commisssion 1998), Commission on Centre-State Relation (Punchhi Commission 2010) etc, to analyse union state fiscal relations in a fundamental manner. The FFC followed the work processes and procedures consistent with previous practices that includes internal procedures, consultations with states, ministries in union government, experts, political parties, local bodies, educational institutions, in order to obtain an overview of state finances.

Mandate:

The core mandate of the FFC, as laid down in Article 280 of the Constitution and incorporated in the ToR relates to:

(a) proceeds of taxes to be divided between union and the states, usually referred to as the "vertical balance;"

(b) the allocation of distribution of taxes among the states, usually referred to as the horizontal balance;

(c) the principles which should govern the grants-in-aid to states by the finance commission, which are over and above the devolution of taxes as per a formula; and

(d) measures to augment the consolidated fund of a state to supplement the transfer of resources to panchayats and municipalities, based on the recommendations of the respective state finance commissions, usually referred to as finance commission grants to local bodies. In addition, the ToR also incorporated what are generally referred to as other TOR by virtue of the powers of the President to refer "any other matter in the interest of sound finance."

The plan gave the opportunity to explore and examine the various fundamental of states as well centre. Population, fiscal and financial condition, vertical and horizontal balance, devolution of taxes all are studied as per the ToR.

The Commission recommended to dispense with the plan and non-plan expenditure distinction as was recommended by C Rangarajan keeping in view of the autonomy of the state to continue with the distinction as per their choice. As a follow-up, it is essential to delink the plan from the classification in budget documents and accounts so that the intended benefits accrue. Such a delinking will facilitate assessment, scrutiny and approval of all expenditures in a sector or activity, or department in a comprehensive manner, and not only incrementally

Secondly in addition to the population base figures of 1971, the demographic changes since 1971 also suggested to taken into account. Both 1971 and 2011 population has been taken but higher weight was ascribed to 1971.

The Context:

The prevailing macroeconomic and fiscal position was not encouraging during FFC times. Assessment of past finances of the union and states, as well as the projections, took in to account of the prevailing environment for FFC's work. Over the years the balances between the public and private sectors, the government and the public enterprises, the domestic and global economy, and the fiscal and non-fiscal elements of the government have changed dramatically. This was considered in depth by the FFC, since this cannot but have a significant impact on the union–state fiscal relations during the award period (2015–16 to 2019–20). The FFC, thus, took into account the changing

balances and new realities of the macroeconomic management and made an effort to place the prevailing fiscal situation and the evolving relationship between the union and the states in the broader context as well. This This approach resulted in a special emphasis by the FFC on some of the issues that are relevant to the work of all finance commissions.

First, a demonstrably symmetric view of the union finances, state finances and their fiscal relations was attempted. Second, an integrated view of revenue expenditure with no distinction between plan and non-plan, and a comprehensive view of revenue and capital expenditures, including public debt were attempted. Third, the special responsibilities of the union in macroeconomic management and its relationship with the global economy had to be explicitly recognised. Fourth, a comprehensive view of the transfer from the union to the states, both within and outside the recommendations of the finance commission, was necessary to address the fundamental issues relating to the constitutional assignment, plans and centrally sponsored schemes (CSS). Implicitly, the issue of conditionalities in the transfers and the role of tied and untied grants had to be reckoned. Fifth, the predominant role of the states, in particular, the state finance commissions, in empowering local bodies had to be re cognised. Finally, the FFC examined the issue of separate treatment of the special category states.

It was concluded that a combination of a well-designed formula to restore horizontal balance by taking into account revenue and cost disabilities of the states in the projection of revenues and expenditures, as necessary, will address problems of all states in a fair manner.

A planned approach in the current context involves actions in multiple areas, as well as by several institutions and layers of government. The union government may have to consult the Comptroller and Auditor General on this matter, though the proposed change will not be inconsistent with globally accepted budgeting and accounting practices. In brief, the plan mindset should be replaced with a development mindset, of which government budgets are one element.

Review of Fiscal Positions:

To achieve the warranted fiscal indicators both quantitatively and qualitatively, prudent review, realistic projection has to be done. The judgement has to be based on what is desirable outcome & its implications and for that the union government's projection in regards to both macro and fiscal position should be the anchor along the FFC proceedings. At the same time, the FFC articulated that there is significant scope for improving the fiscal position of the union through increased disinvestment of shares in public enterprises, a rational dividend policy, sale proceeds from spectrum, a discriminatory capital infusion into the financial enterprises and the introduction of a Goods and Services Tax (GST). Keeping this cushion in view, the possible initial fiscal burden due to GST has not been reckoned.

The fiscal position of all states taken together has shown significant improvement during the review period, both in terms of quantity and quality. In fact, many states had not fully utilised the fiscal space available to them to incur capital expenditure within the fiscal targets prescribed by the Thirteenth Finance Commission. The FFC recognised that the process of fiscal consolidation in the union should ideally be accompanied by prudent fiscal expansion at the level of states. The intergovernmental fiscal relations in future will also, hopefully, reflect the principles underlying the recommendations of the FFC.

Intergovernmental Transfers:

The review has shown that, within the overall fiscal trend in the country, there has been a greater expansion in the fiscal activity of the union than of the states. In particular, the transfers from the union to the states have increased substantially. Moreover, overall transfers, namely, Finance Commission transfers and other transfers put together, far exceeded the indicative ceiling prescribed by the previous commissions. Within the transfers, discretionary components had increased in the review period, undermining the role of the finance commissions.

In the Indian context, in taking a comprehensive but symmetric view of union and state finances, the criticality of the fiscal management of the union relative to the states had to be recognised in terms of (a) creating space to undertake countercyclical policies; (b) managing the impact of shocks, such as global

uncertainties and uncertain monsoon conditions; and (c) the sensitivity of financial markets to the fiscal policies of the union government. In brief, it was concluded that the burden of fiscal consolidation rests heavily on the union government, in view of the initial conditions and its importance. In such a situation, the FFC concluded that it was not possible to increase the level of aggregate transfers from the union to the states. The focus, therefore, was to concentrate on the composition and the quality of the aggregate transfers from the union to the states.

Union Finances:

As the FFC dispensed the distinction between plan and non-plan, and since the Government of India had dispensed with its role of borrowing from the markets in order to lend to the states, the FFC had to take responsibility of balancing union and states' revenue powers with expenditure responsibilities listed in the Seventh schedule of the constitution of India. Hence, in its assessment, the priority was to provide appropriate fiscal space to the union government for expenditures, as defi ned in the Union List.

In the treatment of committed expenditure, the FFC took into account the resources required for the union to meet its commitment for providing the public services detailed in the Union List. In addition, it has taken into account the expenditure commitment of the union government listed in the Concurrent or State Lists, to the extent that it was warranted. In brief, the FFC followed the practice of assessment of union finances that was done by earlier finance commissions, but, in addition, the FFC considered the magnitudes, legitimacy and appropriateness of union transfers to states outside the mechanism of the finance commissions, keeping in view the Constitutional provisions.

A major challenge in this regard was the enacted legal commitment and expenditures on ongoing schemes that fell under the Concurrent List and were being funded by both the union and the states. Internal exercises were undertaken to obtain insights relevant to the assessment of respective needs of the union and states. Other untied transfers from the union to states are not relatable to individual sectors or activities in the Seventh Schedule, and hence did not pose a problem.

State Finances:

Though the basic approach remained same however the FFC differed from the earlier commissions in taking account of both plan and nonplan expenditures in the revenue account.

In regard to assessment of the own tax revenues of states, the FFC considered aggregate own tax revenue as a single category, following the methodology adopted by the preceding three finance commissions.

In making the projections, a two-step methodology was followed. The first step involved reassessment of the base year 2014–15. The second step involved application of normative growth rates for the projections. For states with an above average tax–GSDP ratio, the assumed own tax buoyancy was 1.05 implying a moderate increase, and for others, a higher buoyancy of 1.5 till it reaches the target tax–GSDP ratio. This resulted in an improvement in the assumed aggregate tax–GSDP ratio from 8.26% of GSDP to 9.0% in the terminal year. The assessment of own non-tax revenues was made in terms of major items of non-tax revenue separately for each state, consistent with past practice.

In the assessment of revenue expenditures of states, it included revenue expenditure under plan also in the assessment. Liabilities were treated as committed expenditure. Fiscal deficit target was 3%. No debt restructuring request was entertained on the ground that it would be a good practice for governments to honour their debt obligations. It was noted that open market borrowings by states through banks cannot be restructured at the instance of FFC. Hence, the relief may not be substantial in view of significantly reduced share of the states' debts to the Government of India in the total debt outstanding.

The FFC also attempted to address the goal of equalisation of expenditures across the states in terms of per capita expenditures. It made an additional expenditure provision in assessment of needs of states which required such a provision to ensure that in the final year of the FFC projections every state reached at least 80% of all state average per capita revenue expenditure (excluding interest payment and pension and CSS transfers). It is interesting to note that the own revenue receipt–GDP ratio will be 8.58% during the award period, as against 7.36% projected by the states. The assessment of expenditure needs would be 11.12% of GDP against 13.57% projected by the states. The pre-devolution deficit as estimated by FFC is 2.70%, which has been fully covered by tax devolution and revenue deficit grants. It needs to be highlighted here that for many states, post devolution surplus is huge and the actual equalisation would be more than what has been estimated in the FFC report.

Vertical Balance:

The approach to vertical devolution was governed by three factors; namely (a) the spirit of constitutional provisions; (b) the concerns about the fiscal space expressed by the states and the union; and (c) the need for clarity on the respective functional and expenditure responsibilities of the union and states. As already mentioned, the

FFC took the view that there was no scope to reduce the fiscal space available for discharging its responsibilities in the Union List of the Constitution. Against this background, the FFC took a consolidated view of the aggregate transfers from the union and the states while recognising that the tax devolution should be the primary route of transfer of resources to states since it is formula-based and, thus, conducive to sound fiscal federalism. It was also recognised that to the extent the formula-based transfers do not meet the needs of the specific states, they need to be supplemented by grants-in-aid on an assured basis and in a fair manner.

FFC recommended to increase the share of tax devolution to 42% that would serve twin objectives of increasing the flow of unconditional transfers to the states and yet leave appropriate fiscal space for the union to carry out its own functioning and make specific purpose transfers to the states.

Horizontal Balance:

In regard to horizontal balance, the FFC was guided by the broad criteria of the earlier finance commissions, namely, (a) population and income to reflect needs; (b) area and infrastructure distance to indicate cost disabilities; and (c) fiscal indicators relating to tax and fiscal discipline to assess resources. In recent years the ToR of finance commission used population of 1971 as a factor for determination of devolution of taxes and grants-in-aid. However, FFC added the demographic changes that have taken place post 1971. Bounded by the ToR higher weightage of 17.5% to the 1971 population was given but demographic changes were incorporated by giving 10% weightage to 2011 population. No doubt, the age structure of the population and net immigration are more direct indicators, but analysis showed that the population of 2011 best reflected the changes, while being transparent and simple.

Local Governments:

The local bodies are the primary responsibility of states concerned, both in the spirit of the Constitution and the wording of the ToR. Similarly, state finance commissions (SFC) are required to play a key role in allocation of resources within a state. FFC should not undermine or enhance the statutorily determined role and functions of local bodies. It was essential to avoid advocacy of centralised mechanisms to facilitate democratic decentralisation through conditionality by the FFC. Against this background, the FFC concluded that it was necessary to significantly enhance the resources to be transferred to local bodies on an assured basis and mainly without imposition of conditions by the union or states.

As per the final recommendations, the local bodies are required to spend almost all the grants only on the services within the functions assigned to them under the

relevant legislations. Their performance grant has been restricted to compilation of accounts and their audit, and generation of own resources. The distribution of grants between the panchayats and between the municipalities has been left to the state governments provided it is based on the recommendations of the SFCs. In case the SFC formula was not available, a default option was provided whereby the distribution was on the basis of the 2011 population with a weight of 90% for population and 10% for area.

Among the measures to augment revenues suggested is mobilisation of funds for the local bodies through municipal bonds, either directly or through an intermediary institution to be set up by the state governments. There are certain "scheduled" areas which are covered under the proviso to Article 275(1) and excluded from the consideration of the finance commission in the ToR. However, the FFC urged the union government to consider a large, sustained and more efficient intervention for the upgradation of administration as well as development of these areas.

Grants-in-Aid:

The FFC departed, to some extent, from previous practice, and adopted four principles: First, the devolution of taxes from the divisible pool should, as in the past, be based upon an appropriate formula which should, to a large extent, offset revenue and cost disabilities. Second, the assessment of expenditures should build in additional expenditures in the case of those states with a per capita expenditure significantly below the all-state average. The assessment of revenues should build in the scope for additional revenue mobilisation based on the current tax–GSDP ratio relative to the all-state average. This will enable fiscally-disadvantaged states to upgrade their services without earmarking or specifying sectors. Third, if the assessed expenditure needs of a state, after taking into account the enabling resources for augmentation, exceeds the sum of revenue capacity and devolved taxes, then the state concerned will be eligible to receive a general-purpose grant-in-aid to fill the gap. Fourth, grants-in-aid for state specific projects or schemes will not be considered, as these are best identified, prioritised and financed by the respective states. Fifth, promotion of sustainable development is mainstreamed by taking the area under forest cover as a factor in tax devolution itself.

The FFC conceded that there is a case for transfers from the union government to the states to augment expenditure in specific sectors with a high degree of externalities in order to ensure desired minimum level of expenditures in every state. However, past experience shows that achieving this through the mechanism of finance commission grants may not be appropriate. The FFC concluded that all such transfers, in whichever sectors are considered necessary, should be addressed through a different institutional arrangement proposed by the FFC.

Other Transfers:

In recent years, the aggregate transfers from the union to the states, including "direct transfers" to implementing agencies in the states as a percentage of the gross revenue receipts of the union, have ranged between 45% and 54%. The finance commission transfers comprised only 59% of the aggregate transfers of the union to the states, with the other transfers accounting for 41%.

The other transfers flow mainly as plan grants, and marginally as non-plan grants. Plan grants can be divided into two broad categories, namely, (a) central assistance (normal, additional, special and special plan); and (b) central schemes and CSSS which are conditional upon the implementation of specified schemes and programmes.

Discussion with the National Development Councils and the observations of previous finance commission led the FFC to the following conclusions in regards to the other transfers:

There is some need for transfer of funds from the union to the states which go beyond tax devolution and grants from the finance commission. Such transfers should be for supplementing the transfers recommended by the finance commission, and not supplanting or undermining them. At the same time, duplication should be avoided. There are differences in views about the scope or purpose of other transfers, and the conditionalities associated with such transfers. There is agreement, however, about the need for flexibility for the states in regard to design and mechanism for implementation of such schemes. Significant discomfort has been expressed about the union government unilaterally deciding the scope, the nature and design of the CSSS. The union government was keen to accord flexibility to states. Finally, the previous finance commissions had also expressed their discomfort in regard to the significant quantum of central transfers being made, particularly through CSSS. Their suggestions included transferring of all these schemes to the states along with funds and restoring the predominance of formula-based plan transfers.

The approach of the FFC can be summarised as follows: First, the option of entrusting the finance commission with responsibilities relating to all transfers from the union to the states is not advisable when the finance commission is a temporary body. At the same time, the Finance Commission should take a comprehensive view of all fiscal transfers from the union to the states. However, it should limit its own recommendations only to tax devolution, grants-in-aid as per the principles indicated earlier and any other matter referred to it in the interest of sound finance. Second, the union government should continue to have fiscal space to provide grants

to states for functions that are broadly in the nature of “overlapping functions” and for area specific interventions, especially of inter-state significance. Third, the existing arrangements for transfers between the union and the states need to be reviewed with a view to minimising discretion, improving the design of transfers, avoiding duplication and promoting cooperative federalism, insofar as such transfers are required to be made outside the recommendations of the finance commission. Fourth, in the light of this, the finance commission recommended for consideration the evolution of a new institutional arrangement for: (i) identifying the sectors in the states that should be eligible for grants from the union, (ii) indicating criteria for interstate distribution, (iii) helping design schemes with appropriate flexibility being given to the states regarding implementation, and (iv) identifying and providing area-specific grants. In this light, the FFC suggested that present role of the Inter-State Council be expanded to operationalise the institutional arrangements for rationalising other transfers in the interest of sound and healthy union fiscal relations.

Goods and Services Tax:

The FFC did not indicate any fiscal incentives to the states to adopt such a tax nor did it indicate an appropriate design. However, to facilitate speedy resolution of the outstanding issues, suggestions were made for consideration of the union and states on (a) period of GST compensation; (b) legal status of the compensation fund; and (c) universal application of the GST regime.

Fiscal Environment:

The Fiscal environment and fiscal consolidation of FFC in relation to ToR is more comprehensive than of previous commissions. It was tasked to evolve an approach that creates a sustainable, more equitable growth. The pioneering work of Twelfth and Thirteenth Finance Commission in this regard benefitted FFC. The debt position of the union and states puts FFC in problem assessing the fiscal environment. The FFC has recommended computing of extended public debt of both the union and states and presenting it as a supplement to the budget documents.

A statutory ceiling on the sanction of new capital works to an appropriate multiple of the annual budget provision has been proposed as the FFC noted that both the union and state governments often take up capital projects far in excess of capacity to implement them.

Fiscal deficit ceiling at 3% of GDP as per fiscal rules consistent with past approaches considered appropriate. some flexibility has been suggested in regard to fiscal targets and annual borrowing limits linked to: (a) a shortfall in utilisation of borrowing limits in the preceding year; (b) the interest payments being less than or

equal to 10% of the revenue receipts in the preceding year, provided there were no revenue deficits in the year in which borrowing limits are to be fixed, and (c) the debt–GSDP ratio being less than or equal to 25% of the preceding year.

In view of the uncertainties in regards to the future of National Small Savings Fund (NSSF) and friction in the union-states relations in this regard, it got discontinued. As per the recommendation the FFC suggested to dispense with the concept of "Effective Revenue Deficit"[1].

The FFC suggested replacing the existing FRBM Act with a debt ceiling and fi scal responsibility legislation, specifically invoking Article 292 in its preamble. This recommendation for formally invoking the Constitution is to accord greater sanctity and legitimacy to fiscal management legislation.

Way Forward:

The FFC benefited immensely from the work done by the previous commissions. It benefited from the way the ToR was constructed. The listing of considerations in assessment of resources and needs was thoughtful, though superfluous matters persist. Regarding the way forward, it is hoped that the ToRs of future finance commissions will continue to facilitate, but will be confined to consideration of fundamental and contextual issues directly relevant to sound finance and will also accommodate some of the suggestions made in the report of the FFC. On the way forward, it may be appropriate to consider significant inter-state exchange of information and even expertise in regard to public fiscal management and public expenditures, in particular. In regard to local bodies, it is hoped that the state governments will, depending on the local circumstances, strengthen the local bodies, in particular, those in urban areas. The quality and credibility of fiscal management in both union and states requires to be critically examined. In this regard, the relationships between government, public enterprises, and regulators are still treated in a "joint family approach," where contributions, burdens and financial linkages are seldom clearly accounted for. Hence, the fiscal accounts conceal more than what they reveal, both at union and state levels. Improvements in this regard will facilitate the work of future finance commissions.

In brief, the inherent complexities in rebalancing the resources and needs of union and several states are so complex in India that the task of the finance commissions warrants humility to learn and listen.

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[1] Effective Revenue Deficit is the difference between revenue deficit and grants for creation of capital assets. This is suggested by the Rangarajan Committee on Public Expenditure.