**14th Finance Commission – YV Reddy**

**Guiding Factors and Work Processes**

The Fourteenth Finance Commission (FFC), like its predecessors, was guided by the terms of reference (ToR); the approach of previous finance commissions; the experience gained in this regard; the prevailing macroeconomic situation, in particular, the fiscal environment of the country; and the evolving circumstances relevant to the ToR. In addition, the FFC reviewed in detail the relevant deliberations in the meetings of the National Development Council, the views of the Administrative Reforms Commission (1966), National Commission on Review of the Working of the Constitution (Venkatachalaiah Commission 2002), Commission on Centre–State Relations (Sarkaria Commission 1988), Commission on Centre–State Relations (Punchhi Commission 2010), etc, to analyse union– state fiscal relations in a fundamental manner. In the process, reference to debates in the Constituent Assembly also became necessary and useful.

In addition, in order to obtain an overview of state finances from local experts, the FFC commissioned studies for every state generally through universities and institutions located in those states. This was in addition to the previous practice of engaging the National Institute of Public Finance and Policy (NIPFP), as well as other institutions, to study select subjects.

**Mandate**

The core mandate of the FFC included:

(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

 (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 Context**

The FFC recognised that the then prevailing macroeconomic and fiscal position was not encouraging while the global uncertainties were striking. However, during the work of the FFC, especially towards the later part of its work, the sentiments improved for the Indian economy. Following past practice, the assessment of finances of the union and states, as well as the projections, took account of the prevailing environment relevant to the FFC’s work. The fact that 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 dramatically changed over the years, 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 cognizance of the changing balances and the new realities of the macroeconomic management and tried to place the prevailing fiscal situation and the evolving relationship between the union and the states in the broader context as well.

It was concluded that a combination of a well-designed formula to restore horizontal balance by considering 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. Given that forest cover is an important factor in revenue and cost disabilities, this approach provided an opportunity for the commission to mainstreaming sustainability in ecology and environment in the devolution formula itself.

**Review of Fiscal Positions**

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.

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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).

**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. 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 and State Finances**

Since the FFC decided to dispense with the distinction between plan and nonplan, 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. Hence, in its assessment, the priority was to provide appropriate fiscal space to the union government for expenditures, as defined in the Union List. 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.

The FFC differed from the earlier commissions in taking account of both plan and nonplan expenditures in the revenue account. 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 FFC also did not consider any proposal for debt-restructuring 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.

**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 recognized 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.

The FFC recommended that increasing the share of tax devolution to 42% of the divisible pool would serve the 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 functions 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. There are three notable features of the criteria used by the FFC. In recent years, the ToR of the finance commission required use of the population in 1971, whenever population was utilised as a factor for determination of devolution of taxes and grants-in-aid. The ToR of the FFC, however, added that demographic changes that have taken place after 1971 could also be considered. The FFC was of the view that use of dated population data was unfair, but having been bound by the ToR, a weight of 17.5% has been given.

**Local Governments**

The amounts that each state sets apart for transfer to local governments from the consolidated funds themselves are unclear. There are certain areas which are explicitly excluded from the jurisdiction of the finance commission. The FFC had to address these issues with basically similar limitations as those of the previous commissions. In addressing these issues, the FFC recognised that 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.

**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. Third, if the assessed expenditure need 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, prioritized 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. 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 FFC decided to consider other transfers in detail. The ***other transfers*** flow mainly as plan grants, and marginally as non-plan grants.

The FFC has been tasked with evolving an approach based on its review of union and state finances to create a fiscal environment that is sustainable and promotes equitable growth. The FFC had the benefit of pioneering work in this regard done by the Twelfth and Thirteenth Finance Commissions. It also had the benefit of experience in implementing these fundamental changes. Inevitably, the review by the FFC encompassed legal and institutional aspects. A major problem faced by the FFC in assessing the fiscal environment in a comprehensive manner was the debt position of states, and to some extent, the union government as well.

The FFC has formulated its recommendations without reference to the distinction between plan and non-plan. 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. The intergovernmental fiscal relations in future will also, hopefully, reflect the principles underlying the recommendations of the FFC.

First, our Constitution, and for that matter, the available literature on the subject, does not confer overriding responsibilities to national governments on the economic and fiscal management of state governments. Every tier of government should be regarded as equally accountable and responsible for functions assigned to it. At the same time, the existence of overlapping responsibilities should be recognised and mechanisms put in place for their discharge. Clarity regarding respective jurisdictions including overlapping responsibilities will add to healthy union– state relations. No doubt, the residuary powers will remain with the union, but residuary powers do not imply overriding powers.

Second, the global trend is towards greater centralization of taxes and decentralization of government expenditures, and such trends should be analyzed in their relevance to our systems.

Third, it should be recognized that the Directive Principles of State Policy of the Constitution or national priorities are of equal concern to union and state governments. Similarly, a subject of national importance does not automatically confer total expenditure responsibility on the union government without reference to the Constitution.

Regarding local bodies, it is hoped that the state governments will, depending on the local circumstances, strengthen the local bodies those in urban areas. The state governments could consider three important initiatives, namely, to remove the bottlenecks and hurdles in the exercise of the powers of local bodies within the existing legislation; empower the SFCs; assist capacity building at local levels for implementing works and maintaining accounts; and review the existing legislations to empower the local governments in terms of resources and functions.