

# A watershed 14th Finance Commission

It is clear that the far-reaching recommendations of the 14th Finance Commission, along with the creation of NITI Aayog, will radically alter Centre-state fiscal relations, write Syed Zubair Naqvi, Kapil Patidar and Arvind Subramanian

The report of the Fourteenth Finance Commission (FFC) was tabled in Parliament yesterday. The government has accepted its far-reaching, indeed radical, recommendations that have the potential to redefine Indian federalism in a long overdue and desirable manner. This piece describes the key recommendations and highlights some of their major implications. It is based on updating assumptions in the FFC report, which is the only source of data used in the numbers presented below. The discussion below, especially the estimates, should be seen as illustrative at best.

## Vertical and horizontal devolution

The FFC has increased the amount that the Centre has to transfer to the states from the divisible pool of taxes by 10 percentage points, from 32 per cent to 42 per cent. Its radical nature is indicated by the comparison with the previous two Finance Commissions (FCs) that increased the share going to the states by 1 and 1.5 percentage points, respectively. So, the FFC recommendations represent a ten and six-and-a-half fold increase, respectively relative to the previous two FCs. Had the new share been implemented in 2014-15 (Budget estimates), the Centre's fiscal resources would have shrunk by about 1.20 lakh crore (0.9 per cent of gross domestic product or GDP). If the comparison were to be in terms of overall (tax plus non-plan grants) devolution, the increase would be roughly comparable to that in tax devolution.

In addition, the FFC has significantly changed the sharing of resources between the states — what is called horizontal devolution. The FFC has proposed a new formula (see table: *Horizontal Devolution...*) for the distribution of the divisible tax 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 forest cover; and excluded the fiscal discipline variable.

Several other types of transfers have been proposed, including grants to rural and urban local bodies, a performance grant, and grants for disaster relief and reducing the revenue deficit of eleven states. These transfers total approximately 5.3 lakh crore for the period 2015-20.

## Uniformly large addition to states' resources

The impact of FFC transfers to the states needs to be assessed in two ways: gross and "net" FFC transfers will clearly add



## HORIZONTAL DEVOLUTION FORMULA IN THE 13TH AND 14TH FINANCE COMMISSIONS

Variable	Weights accorded	
	13th	14th
Population (1971)	25.0	17.5
Population (2011)	0.0	10.0
Fiscal capacity/Income distance	47.5	50.0
Area	10.0	15.0
Forest cover	0.0	7.5
Fiscal discipline	17.5	0.0
Total	100	100

Source: Reports of 13th and 14th Finance Commission

to the resources of all the states in absolute terms and substantially. They will also increase resources when scaled by states' population, net state domestic product, or own tax revenues, with the latter connoting the addition to fiscal spending power.

Implementing the FFC recommendations alone would undermine the centre's fiscal position substantially. The philosophy of the FFC report is that there should be some corresponding reduction in the central assistance to states (CAS, the so-called plan transfers). Thus, greater fiscal autonomy to the states would be achieved both on the revenue side (on account of states now having more resources and more untied resources) and on the expenditure side because of reduced CAS transfers. The exact mechanism for implementation will be discussed in the months ahead but the legally backed schemes as well as flagship schemes that meet core objectives, such as rural livelihoods and poverty alleviation, will be, and need to be, preserved.

The net impact on the states will depend not just on the transfers effected via the FFC, but also the consequen-

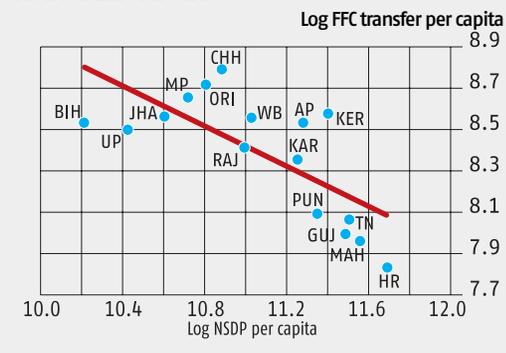
tial alteration of CAS. Under some simple assumptions about how the latter will be distributed, we find that all states will end up better off than before, although there will be some variation amongst the states.

## Increase in progressivity of overall transfers

The FFC transfers have a more favourable impact on the states that are relatively less developed, which is an indication that they are progressive, that is, states with lower per capita net state domestic product (NSDP) are likely to receive on average much larger transfers per capita. The correlation between per capita NSDP and FFC transfers per capita is -0.72 based on some broad assumptions about FFC transfers. (see chart: *FFC transfer...*) This indicates that the FFC recommendations do go in the direction of equalising the income and fiscal disparities between the major states.

In contrast, CAS transfers are only mildly progressive: the correlation coefficient with state per capita GDP (over the last three years) is -0.29. This is a consequence of plan transfers moving

## FFC TRANSFER PER CAPITA AND NSDP PER CAPITA



away from being formula-based (Gadgil-Mukherjee formula) to being more discretionary in the last few years. Greater central discretion evidently reduced progressivity.

A corollary is that implementing the FFC recommendations would help address inter-state resource inequality: progressive tax transfers would increase, while discretionary and less progressive plan transfers would decline.

## Weakening fiscal discipline?

Will FFC transfers lead to less fiscal discipline? There are two reasons to be optimistic. First, in the last few years the overall deficit of the states has been about half of that of the Centre: in 2014-15 (Budget estimates) for example, the combined fiscal deficit of the states was estimated at 2.4 per cent of GDP compared to 4.1 per cent for the Centre. So, on average, states, if anything, are more disciplined than the Centre.

Based on analysing recent state finances, we find that additional transfers toward the states as a result of the FFC will improve the overall fiscal deficit of the combined central and state governments by about 0.3-0.4 per cent

of GDP. Moreover, nearly all the state governments have enacted fiscal responsibility legislations (FRLs), which requires them to observe high standards of fiscal discipline such as keeping the deficit low.

Further, as part of the new Centre-state fiscal relations, for example, under the NITI Aayog, mechanisms for peer assessments and mutual accountability could be created, and incentives could be provided for maintaining fiscal discipline. This is becoming routine practice in many federal structures where sovereignty is shared between the members. The FFC recommendations and the consequences they entail offer an opportune time for instituting such mechanisms.

## Conclusions

With the caveats noted earlier, 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 both on the revenue and expenditure fronts.

This, of course, is in addition to the benefits that will accrue from addressing all the governance and incentive problems that have arisen from programmes being dictated and managed by the distant central government rather than by the proximate state governments.

To be sure, there will be transitional challenges, notably how the Centre will meet its multiple objectives given the shrunken fiscal envelope. But there will be offsetting benefits: moving from CAS to FFC transfers will increase the overall progressivity of resource transfers to the states. Another is that overall public finances might actually improve by more than suggested by looking at the central government finances alone.

In sum, it is clear that the far-reaching recommendations of the FFC, along with the creation of the NITI Aayog, will radically alter Centre-state fiscal relations, and 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 this new federalism is the next policy challenge, a change that we would like to see.

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