14th Finance Commission report

Balancing fiscal space

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> **An important change introduced is a shift from tied grants to untied tax devolution plus a general purpose revenue deficit grant. This enables greater autonomy for the states in the allocation and management of their finances without eroding the fiscal space of the Union**

It is very gratifying for the chairman, members and the excellent staff of the 14th Finance Commission that its report has been so well-received by all: the Union government, the state governments, and commentators. The report has been variously described as pathbreaking, radical, seminal, and as being set to fundamentally reform the architecture of inter-governmental fiscal relations. If the implementation of the report achieves that goal, our efforts will have been amply rewarded. Meanwhile, it is necessary to correct some impressions about what the report actually recommends on some key issues, and draw attention to other important issues that have not been much noticed so far. That is the purpose of this piece.

From the outset, the Commission was committed to adhering to the letter and spirit of our very wide terms of reference (TOR). We were also committed to maintaining continuity with the recommendations of earlier commissions, where feasible, to provide an element of stability in inter-governmental transfers. However, we were also committed to rebalancing these transfers in line with the constitutional responsibilities of the three tiers of government—the Union, states and local—where expectations and changing circumstances warranted this. We also felt that inter-governmental fiscal relations should be primarily based on trust and cooperation rather than conditions and control. These were the guiding principles underlying the recommendations of the report, some of which are discussed below.

The recommendation that has received maximum attention is the increase in the share of devolution to states from around 32% earlier to 42% of the shareable pool of tax revenues. It has been interpreted as a massive shift of the vertical fiscal balance in favour of the states at the cost of the Union government's fiscal space. However, the two percentages are not comparable. While the TORs of earlier Finance Commissions restricted their transfer proposals to financing only non-Plan revenue expenditure, our TOR made no such distinction between Plan and Non-Plan expenditure, enabling a comprehensive approach to financing total revenue expenditure. Moreover, tax devolution is only one of several channels of resource transfer from the Union to the states. There are, in addition, transfers through statutory and non-statutory grants, which have been minimised by this Commission. Taking these into account, total transfers amounted to as much as 63.9 % in FY13, and has on average amounted to about 60% of the divisible pool in recent years.

Our assessment was that there was no room to further raise this share without compromising the fiscal space required by the Union government to fulfil its responsibilities. Accordingly, the share of total transfers in the shareable pool has not been significantly raised by our Commission. The important change we have introduced is a shift from tied, often conditional, specific purpose grants to untied tax devolution plus a general purpose revenue deficit grant. This change has enabled us to meet the states' demand for greater flexibility and autonomy in the the allocation and management of their own finances without eroding the fiscal space of the Union.

In the horizontal allocation, apart from needs, represented by population (1971 supplemented by 2011in line with TOR) and area, and fiscal capacity, represented by income distance from richest major state, we have introduced a new element of forest cover. This will benefit the states with large forest cover that bear the substantial financial and opportunity cost of maintaining a critical global public good for sustainable development. Though fiscal performance has not been retained in the horizontal devolution formula, strong fiscal performance has been incentivised in the normative projections underlying the assessment of required post-devolution revenue deficit grant discussed below.

The Commission has provided a post devolution revenue deficit grant to states that fall short of a minimum level of spending on public services because of their fiscal disability. One important feature of the normative projections of states' own revenue and expenditure underlying this grant is the higher buoyancy assumed for states with lower-than-average own tax ratios, requiring an improved tax effort on their part. On the expenditure side, projections were made to ensure that states with below average per capita revenue expenditure could achieve at least 80% of the all states average by FY20, the terminal year of the award. This will enable some equalisation across states in their spending on public services for citizens who pay the same national rates of taxes.

While enabling some equalisation across states in the delivery of public services, the Commission also recognised that for some nationally important public goods, often with spillover effects beyond individual states, such as basic health care, basic education, drinking water and sanitation it may be necessary to ensure a minimum level of services to all. However, past grants for such services have been very small compared to total states' spending on these services and there have been multiple overlapping Union grants for some of these services. A grant for a limited period by a Finance Commission may not be the best way of ensuring sustained delivery of these services. Instead, the Commission has proposed a new institutional arrangement of cooperative federalism for this purpose, possibly under a strengthened Inter-States Council, consisting of representatives of the Union and state governments, along with domain experts. Such a body can carefully identify and design these services, allowing enough flexibility to meet diverse conditions across states, monitor their delivery, and determine criteria for inter-state distribution. Adequate fiscal space has been provided for the Union government to finance such services of national importance.

Apart from a grant for disaster relief, the only other specific purpose the Commission has recommended is a grant for strengthening decentralisation and local governments. A part of this is a basic grant to augment gram panchayat and municipal resources for delivery of key local services. Another component is an incentive grant linked to their timely preparation of proper audited accounts and enhancing their own resource mobilisation.

At the macro level, the Commission has essentially maintained the FRBM approach of the 13th Finance Commission, with a fiscal roadmap as revised in the last budget in response to changing conditions. The Union government is required to reduce the fiscal deficit to 3% of GDP by FY17 and maintain that till FY20. The fiscal deficit of states is anchored to 3% of the state GDP, but with some upward flexibility for states with prudent debt profiles. The key proposal here relates to fiscal councils. The states' compliance with fiscal rules can be enforced by the Union government. But there is no existing arrangement to ensure compliance with fiscal rules by the Union government. The Commission has recommended establishment of an independent fiscal council for ex ante assessment of the fiscal rule consistency of budget proposals in addition to expeditious implementation of ex post assessment by the CAG as already provided for in the act.

Apart from those, highlighted here are a host of other recommendations ranging from a legislated GST compensation fund, to pricing of public utilities, prioritisation of public enterprises for both divestment and new investment, etc. The interested may like to review the Commission's report on these subjects.

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