Changes in Federal Fiscal Architecture[1]

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On 5th December 2014, the 14th Finance Commission presented its report to the Union Government. This note presents an overview of the changes to the fiscal architecture in India over the past year, as well as those anticipated in the near future.

Key Recommendations of the 14th Finance Commission

I. Tax Devolution

The most widely reported recommendation of the 14th FC is to increase vertical devolution. The share of States in the divisible pool of taxes collected by the Union has been enhanced to 42% from 32%. This has meant that States receive Rs. 5.24 lakh crore in FY 2015-16, as opposed to Rs. 3.82 lakh crore in FY 2014-15.

Further, the 14th FC changed the criteria for horizontal sharing, i.e. the distribution of the taxes between States. The most significant changes are the 10% weight assigned to the 2011 population, and the 7.5% weight assigned to forest cover. (See Table 1 below)

While the weightage of some States such as Uttar Pradesh, Bihar and Tamil Nadu have reduced by nearly 1 percentage point, other such as Chhattisgarh and Madhya Pradesh have seen increases. However, every state gets a greater absolute tax devolution as compared to the 13th FC.

Table 1a: 14th FC horizontal sharing criteria

CRITERIA	WEIGHTAGE
1971 population	17.5%
2011 population	10%
Income distance	50%
Area	15%
Forest cover	7.5%

Table 1b: 13th FC horizontal sharing criteria

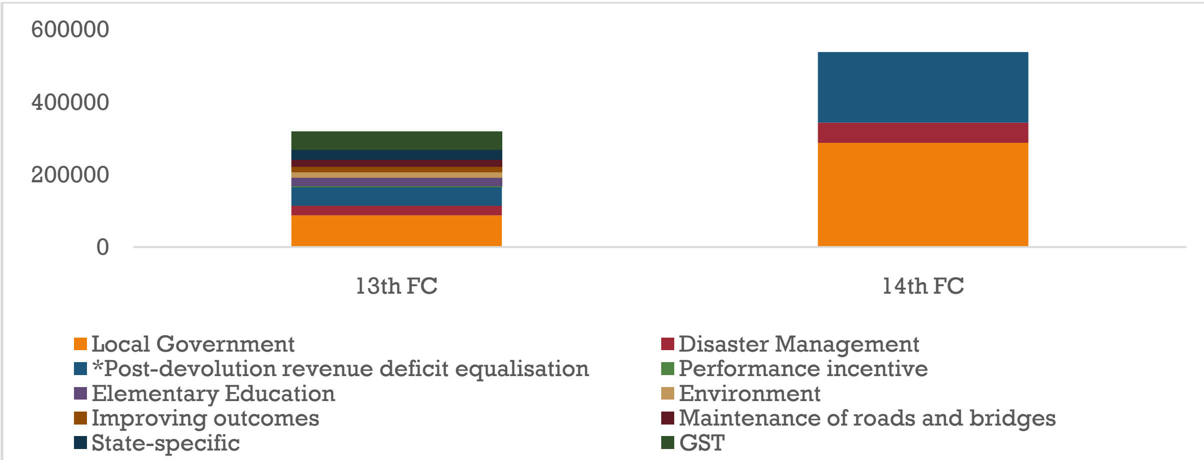
CRITERIA	WEIGHTAGE
1971 population	25%
Fiscal discipline	17.5%
Fiscal distance	47.5%
Area	10%

II. Grants-in-aid

Sector-specific and State-specific grants-in-aid have been discontinued. Grants-in-aid are only awarded for removing revenue deficits, for local governments and disaster management. The total sum has been increased from Rs. 3.19 lakh crore to Rs. 5.37 lakh crore over the five-year period. (See Table 2 below)

[1] Information collated from the Finance Commission Reports and Union Budget 2015-16

Table 2: Comparison of Grants-in-aid under the 13th and 14th Finance Commissions (Rs. Crore)[2]



Consequently, Table 3 below summarizes the per-capita increase as a proportion of GSDP on grants in aid and taxes devolved to states as per the 14th FC's recommendations

Table 3: Per-capita transfers as per the 14th FC's recommendations[3]

	Share in Total Devolution (taxes & grants in aid)	Increase as % of projected GSDP	Per Capita Transfer (Rs)
Chhattisgarh	2.8%	2.9%	2703
Kerala	3.1%	1.8%	2644
WB	8.1%	2.5%	2282
MP	6.9%	2.6%	1934
Jharkhand	2.9%	2.8%	1828
Odisha	4.3%	1.9%	1674
Karnataka	4.3%	1.1%	1358
UP	16.3%	2.2%	1195
Rajasthan	5.2%	1.1%	1164
Bihar	8.8%	2.6%	1130
Punjab	1.5%	0.7%	1085
Maharashtra	5.4%	0.6%	947
Gujarat	3.0%	0.6%	871
Haryana	1.1%	0.4%	713
TN	3.8%	0.3%	427

[2] 14th and 13th Finance Commission
[3] Calculated from 14th FC and Population Data from Census 2011

III. Deficits and the FRBM

The 14th FC recommends that States adhere to a limit of 0 revenue deficit, and 3% of GSDP for fiscal deficits. This limit can be raised by 0.25% of GSDP if the total debt of the State was less than 25% of GSDP in the previous year, and a further 0.25% of GSDP if interest payments did not exceed 10% of the State's revenue receipts in the previous year.

IV. "New Institutional Mechanism"

The 14th FC believes that transfers between the Union and the States which are made outside its recommendations (such as Centrally Sponsored Schemes (CSS)) need to be reviewed with a view to minimizing discretion, improving the design of transfers, avoiding duplication and promoting cooperative federalism

It recommends 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 inter-state distribution
iii. Helping design schemes with appropriate flexibility being given to the States, and
iv. Identifying and providing area-specific grants

Union Budget 2015-16

I. Overall transfers

The Union Budget implemented the recommendations of the 14th FC and devolved substantial additional funds to States through taxes and grants-in-aid, amounting to an increase of Rs. 1.8 lakh crore over the previous year. However, these were also met by a reduction of Union spending on key schemes in States: CSS and Central Assistance to State Plans, taken together, decreased by Rs. 1.16 lakh crore.

Thus, the net impact of the budget is an increase in overall transfers to States by only Rs. 64,000 crore (amounting to nearly 5% of States' estimated own revenues). However, State autonomy over funds increased since taxes and grants-in-aid are largely untied, while Union schemes come with many conditionalities attached. The increase in additional untied funding amounts to nearly 15% of States' estimated own revenues.

II. The social sector

While nearly Rs. 51,000 crore was provided by the Union Government by discontinuing various forms of assistance to States (previously mediated by the Planning Commission) including Normal, Additional, and Special Central Assistance, the bulk of the money came from cuts in spending on various schemes, including many in the social sector.
The Union Government classified schemes into three categories:

i. 31 schemes where the Union will continue to bear its full share: *MGNREGS,MPLADS etc*

ii. 24 schemes where States will be asked to bear an increased share: *ICDS, NHM, SSA, RKVY*
iii. 24 schemes which the Union will no longer fund: *BRGF, JNNURM, RGPSA*

Table 4: Budget cuts in various Ministries and Schemes[4]

Ministry	2014-15 BE	2015-16 BE	% change BE
MHRD	82,771	69,075	-17%
MoWCD	21,194	10,382	-51%
MoRD	83,852	73,333	-13%
MoHFW	38,238	33,282	-13%
MoDWS	15,267	6,244	-59%
MoUD	20,009	19,217	-4%

Scheme	2014-15 BE	2015-16 BE	% change BE
SSA	28,258	22,000	-22%
SBM	4,260	3,625	-15%
NHM	22,971	18,875	-18%
RMSA	5,000	3,565	-29%
MGNREGS	34,000	34,686	2%
ICDS	18,391	8,754	-52%

Future developments

Restructuring Centrally Sponsored Schemes

As previously mentioned, States will bear a higher share of funding in CSS. In addition, a sub-committee of Chief Ministers has been formed in the Niti Ayog, to recommend restructuring of CSS. Press reports suggest that draft recommendations are on the following lines:

i. Reduce the number of CSS to approximately 30
ii. Divide CSS into two groups: one group to form the National Development Agenda, and the other to be constituted of various optional social sector schemes
iii. Union will bear at least 50% of every CSS, and flexi-funds under each CSS will increase to 25% from the current 10%

A final report of the sub-committee is expected to be presented to the Government by July 2015.

Role of the NITI Ayog

The Planning Commission has been replaced by a Niti Ayog to foster a spirit of co-operative federalism between the Union and the States.

3 Sub-Committees of Chief Ministers have been constituted: a) To restructure CSSs, b) To study skill development, and c) To study the Swachh Bharat Abhiyan.

The Union Budget also allocated Rs. 20,000 crores to the Niti Ayog, raising the possibility of transfers to States on the lines of the erstwhile Planning Commission.

[4] Union Budget