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14th Finance Commission: Review and Outcomes

The 14th Finance Commission (FFC) was constituted on 2nd January, 2013 and submitted its report on 15th December, 2014. The recommendations for the period from 1st April, 2015 to 31st March, 2020 were presented for discussion on February 24th 2015.

Purpose of FC

- The Finance Commission is required to recommend the distribution of the net proceeds of taxes of the Union between the Union and the States (vertical devolution); and
- At the next level, the allocation between the States of the respective shares of such proceeds is decided (horizontal devolution).

Criteria used for devolution

The following are the weights attached to different parameters that are used for deciding on the allocation to various states.

Table 1: Weights of different parameters

	Share (%)
Population	17.5
Demographic change	10.0
Income distance	50.0
Area	15.0
Forest cover	7.5

How is the devolution this time?

The FC is of the view that 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. However, to the extent that formula-based transfers do not meet the needs of specific States, they need to be supplemented by grants-in-aid on an assured basis and in a fair manner.

With regard to vertical distribution, FFC has recommended that the States' share in the net proceeds of the Union tax revenues be 42%. This is a big jump from 32% recommended by the 13th Finance Commission and is the largest ever change in the percentage of devolution; as in the past Finance Commissions have recommended an increase in the range of 1-2%. Compared with the devolutions in 2014-15 the devolution of the States in 2015-16 will increase by over 45%.

In reckoning the requirements of the States, the FFC has ignored the Plan and Non-Plan distinction and views the enhanced devolution of the divisible pool of taxes as a "compositional shift in transfers from grants to tax devolution"

Keeping in mind the spirit of cooperative federalism that has underpinned the creation of National Institution for Transforming India (NITI), the Government has accepted the recommendation of the FFC to keep the States' share of Union Tax proceeds (net) at 42%. The total amount of funds to be transferred would be:

Table 2: Amount of funds to be transferred

Rs lkh cr	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Tax devolution	5.79	6.68	7.72	8.93	10.35	39.48
Grants from FC	0.88	1.00	1.03	1.11	1.33	5.37
Aggregate	6.68	7.69	8.75	10.04	11.68	44.85

Outcome

The consequence of this much greater devolution to the States is that the fiscal space for the Centre will reduce in the same proportion. The centrally sponsored schemes will have to diminish in value unless the revenues grow at a very fast rate. Based on the higher devolution, over 30 Centrally Sponsored Schemes have been identified which ought to have been transferred to the States because expenditure on them has already been taken into account as State expenditure, in arriving at the greater devolution of 42% to the States. However, keeping in mind that many of these schemes are national priorities, and some are legal obligations (such as MGNREGA) most of these are proposed to be continued. The Government has decided that only 8 Centrally Sponsored Schemes be delinked from support from the Centre.

A consequence would be that the Union Budget will have to rework the numbers for the schemes that are retained in its purview as the funds available through taxation will be lower than that earlier. To this extent there has to be some fiscal re-engineering at the centre.

From the point of view of states, they will have greater flexibility in the use of funds. It has been a demand from several states that these funds should be allocated directly to them so that they can use them for the various social and economic schemes. This is a more efficient way of passing on funds from the top. It has been enabled now that the Planning Commission has been done away with, which was earlier involved in such pass-through processes. *However, the higher flexibility accorded to states could also mean that the Schemes per se to pursue would be discretionary and the funds could be diverted for other purposes within the contours of these allocations.*

Another consideration would be that with larger stream of funds coming from the top, a shortfall in tax revenue at the centre would automatically get reflected in lower allocations to the states which in turn will affect their ability to carry out certain schemes. In the earlier format, where the centrally sponsored schemes were concerned, unless the central government cut down on the programme, the allocations were assured. This could be another trade-off in the new system of devolution of funds from above.

Horizontal distribution

In recommending horizontal distribution, the FFC has used broad parameters of population (1971) and changes of population since, income distance, forest cover and area. The shares of various states under the 14th FC have been given below along with those under the 13th FC.

What are the shares of various states now?

Table 3: % Share of various states

%	14th FC	13th FC
Andhra Pradesh	4.31	6.94
Arunachal Pradesh	1.37	0.33
Assam	3.31	3.63
Bihar	9.67	10.92
Chhattisgarh	3.08	2.47
Goa	0.38	0.27
Gujarat	3.08	-3.04
Haryana	1.08	1.05
Himachal Pradesh	0.71	0.78
Jammu & Kashmir	1.85	1.55
Jharkhand	3.14	2.80
Karnataka	4.71	4.33
Kerala	2.50	2.34
Madhya Pradesh	7.55	7.12
Maharashtra	5.52	5.20
Manipur	0.62	0.45
Meghalaya	0.64	0.41
Mizoram	0.46	0.27
Nagaland	0.50	0.31
Odisha	4.64	4.78
Punjab	1.58	1.39
Rajasthan	5.50	5.85
Sikkim	0.37	0.24
Tamil Nadu	4.02	4.97
Telangana	2.44	
Tripura	0.64	0.51
Uttar Pradesh	17.96	19.68
Uttarakhand	1.05	1.12
West Bengal	7.32	7.26
All States	**100.00**	**100.00**

There have been changes based on the formula now being pursued.

- The bifurcation of AP into AP and Telangana has resulted in slightly lower allocation for the combination.
- States with lower share in total allocations are: UP, Uttarkhand, Tamil Nadu, Odisha, Rajasthan, Bihar, Assam and Himachal.
- All the north eastern states barring Assam would be getting a relatively higher share under the new formula for the next five years.
- UP, Bihar, MP, West Bengal, Maharashtra and Rajasthan have higher shares and account for ~53% of total.

Devolutions further down the line

The Finance Commission also makes recommendations on 'the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State'.

The FFC has recommended distribution of grants to States for local bodies using 2011 population data with weight of 90% and area with weight of 10%. The grants to States will be divided into two, a grant to duly constituted Gram Panchayats and a grant to duly constituted Municipal bodies, on the basis of rural and urban population. Further, the FFC has recommended grants in two parts; a basic grant, and a performance grant, for duly constituted Gram Panchayats and municipalities. The ratio of basic to performance grant is 90:10 with respect to Panchayats and 80:20 with respect to Municipalities. FFC has recommended, out of a total grant of Rs 2.87 lkh crore for five year period from 1.4.2015 to 31.3.2020, Panchayats would be allocated Rs 2.00 lakh crore and municipalities would receive Rs 0.87 lakh crore.

The Finance Commission is also required to make recommendation regarding the principles governing grants-in-aid of the States' revenues, by the Centre. Taking this into account the expenditure requirements of the States, the tax devolution to them, and the revenue mobilization capacity of the States, the FFC have recommended "Post-Devolution Revenue Deficit Grants" of a total of Rs. 1.94 lakh crores, for the five year period. A total of 11 states - Andhra Pradesh, Assam, J&K, Himachal Pradesh, Kerala, Manipur, Meghalaya, Mizoram, Nagaland, Tripura and West Bengal have been identified for receiving these revenue deficit grants.

There is another grant on account of disaster management which has been put at Rs 0.55 lakh crore.

Table 4: Grants-in-Aid to the States

	Rs lakh crore
Local Government (all States)	2.87
Disaster Management (all States)	0.55
Post-devolution Revenue Deficit (11 States)	1.94
Total	5.37

The ULB devolution

A detailed procedure for the disbursal of the performance grant to urban local bodies would have to be designed by the State Government concerned, subject to certain eligibility criteria. To be eligible, the urban local body will

- Have to submit audited annual accounts that relate to a year not earlier than two years preceeding the year in which it seeks to claim the performance grant.
- It will also have to show an increase in the own revenues over the preceding year, as reflected in these audited accounts. The improvement in revenues will be determined on the basis of these audited accounts and on no other basis. For computing the increase in own revenues in a particular year, the proceeds from octroi and entry tax must be excluded.
- In addition, it must publish the service level benchmarks relating to basic urban services each year for the period of the award and make it publically available. The service level benchmarks of the Ministry of Urban Development may be used for this purpose.

This is a progressive step and will help to usher in financial discipline for the ULBs which can then think of raising money in the capital market through bonds of institutional finance. The demand for funds for creating urban infrastructure is high but on account of the present comfort of devolutions as well as existing revenue sources, ULBs have not been aggressive in creating these structures. A limitation for the smaller ones has been the non-publication of accounts in the desired format which can be audited. By putting these preconditions the ULBs will tend towards this goal which will better position them for bringing about development in their regions.

On Municipal bonds market

The resource requirements of local bodies for the delivery of basic services and creation of infrastructure are too large and no single source may be able to provide all the funds needed for this. The FC sees its role as one to only supplement the resources of the panchayats and municipalities, not substitute them. It is for the local bodies, particularly the urban local bodies, to take appropriate action, with the support of the State Governments, to augment their own revenue sources and also explore sources of borrowings, including issuance of bonds for meeting huge requirements for provision of basic civic services and creation of urban infrastructure.

The FC points out that the study on municipal finances shows that only ten States reported borrowings by urban local bodies. Of the Rs. 920 crore borrowed by them in 2012-13, Rs. 854 crore was borrowed by municipal corporations. Of these, municipal corporations in Madhya Pradesh and Maharashtra accounted for Rs. 548 crore. The study observes that market or institutional borrowings are less popular among urban local bodies. The study recommends that State Governments should remove restrictions on the borrowing powers of urban local bodies and give them freedom to mobilize resources, *based on their credit ratings*.

The FC observes that the market for municipal securities has grown slowly but noticeably after the Corporation of Ahmedabad issued bonds. Since 1998, local bodies in other cities like Nashik, Nagpur, Ludhiana, and Madurai have

accessed the capital markets through municipal bonds. In most cases, bond proceeds have been used to fund water and sewerage schemes or road projects. Tamil Nadu and Karnataka have experimented with pooled financing with an intermediary, set up by the State, borrowing for the purpose of lending to small municipalities which may not be able to access the capital market on their own.

The FC recommends that local bodies and States explore the issuance of municipal bonds as a source of finance with suitable support from the Union Government. *The States may allow the larger municipal corporations to directly approach the markets while an intermediary could be set up to assist medium and small municipalities who may not have the capacity to access the markets directly.*

Given that SEBI too has been pressing for furthering the municipal bond market, it may be expected that this segment would become more active in the coming years under the pressure of demand for creating urban infrastructure as well as the conditions recommended by the FC.

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