CHAPTER-VII

RECOMMENDATIONS OF FOURTEENTH FINANCE COMMISSION

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7.1 Introduction

The Fourteenth Finance Commission (FC-XIV) was constituted by the President under Article 280 of the Constitution on January 2, 2013 to make recommendations for the period 2015-20 under the Chairmanship of Dr. Y.V. Reddy with three full time Members i.e. Ms. Sushama Nath, Dr. M. Govinda Rao and Dr. Sudipto Mundle. Prof. Abhijit Sen was appointed as a part-time Member. Shri. Ajay Narayan Jha was appointed as Secretary to the Commission. The FC-XIV submitted its Report to the President on December 15, 2014, which was placed before the Parliament on February 24, 2015. This chapter is devoted to the recommendations of the Fourteenth Finance Commission pertaining to devolution of Central taxes and duties, grants-in-aid, Criteria used for horizontal sharing of tax share and grants-in-aid and other important recommendations have been examined.

7.2 Terms of Reference

The Terms of Reference (ToR) of the Commission mandated the following:

1. The Commission shall make recommendations as to the following matters:
   (i) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under Chapter I, Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds;
   (ii) the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States which are in need of assistance by way of grants-in-aid of their revenues under article 275 of the Constitution for purposes other than those specified in the provisos to clause (1) of that article; and
   (iii) the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayat and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.

2. The Commission shall review the state of the finances, deficit and debt levels of the Union and the States, keeping in view, in particular, the fiscal consolidation roadmap recommended by the Thirteenth Finance Commission, and suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth including suggestions to amend the Fiscal Responsibility and Budget Management Acts currently in force and while doing so, the Commission may consider the effect of the receipts and expenditure in the form of grants for creation of capital assets on the deficits; and the Commission shall also consider and recommend incentives and disincentives for States for observing the obligations laid down in the Fiscal Responsibility and Budget Management Acts.
3. In making its recommendations, the Commission shall have regard, among other considerations, to:

    (i) the resources of the Central Government, for five years commencing on 1 April 2015, on the basis of levels of taxation and non-tax revenues likely to be reached during 2014-15;

    (ii) the demands on the resources of the Central Government, in particular, on account of the expenditure on civil administration, defence, internal and border security, debt-servicing and other committed expenditure and liabilities;

    (iii) the resources of the State Governments and the demands on such resources under different heads, including the impact of debt levels on resource availability in debt stressed states, for the five years commencing on 1 April 2015, on the basis of levels of taxation and non-tax revenues likely to be reached during 2014-15;

    (iv) the objective of not only balancing the receipts and expenditure on revenue account of all the States and the Union, but also generating surpluses for capital investment;

    (v) the taxation efforts of the Central Government and each State Government and the potential for additional resource mobilisation to improve the tax-Gross Domestic Product ratio in the case of the Union and tax-Gross State Domestic Product ratio in the case of the States;

(vi) the level of subsidies that are required, having regard to the need for sustainable and inclusive growth, and equitable sharing of subsidies between the Central Government and State Governments;

(vii) the expenditure on the non-salary component of maintenance and upkeep of capital assets and the non-wage related maintenance expenditure on plan schemes to be completed by 31 March, 2015 and the norms on the basis of which specific amounts are recommended for the maintenance of the capital assets and the manner of monitoring such expenditure;

(viii) the need for insulating the pricing of public utility services like drinking water, irrigation, power and public transport from policy fluctuations through statutory provisions;

(ix) the need for making the public sector enterprises competitive and market oriented; listing and disinvestment; and the relinquishing of non-priority enterprises;

(x) the need to balance management of ecology, environment and climate change consistent with sustainable economic development; and

(xi) the impact of the proposed Goods and Services Tax on the finances of Centre and States and the mechanism for compensation in case of any revenue loss.

4. In making its recommendations on various matters, the Commission shall generally take the base of population figures as of 1971 in all cases where population is a factor for determination of devolution of taxes and duties and grants-in-aid; however, the Commission may also take into account the demographic changes that have taken place subsequent to 1971.

5. The Commission may review the present Public Expenditure Management systems in place including the budgeting and accounting standards and practices; the existing system of classification of receipts and expenditure; linking outlays to outputs and outcomes; best practices within the country and internationally, and make appropriate recommendations thereon.

6. The Commission may review the present arrangements as regards financing of Disaster Management with reference to the funds constituted under the Disaster Management Act, 2005 (53 of 2005), and make appropriate recommendations

thereon.

7. The Commission shall indicate the basis on which it has arrived at its findings and make available the State-wise estimates of receipts and expenditure.

7.3 Devolution of Central Taxes and Duties

One of the core tasks of a Finance Commission as stipulated in Article 280 (3) (a) of the Constitution is to make recommendations regarding the distribution between the Union and the states of the net proceeds of taxes. This is the most important task of any Finance Commission, as the share of states in the net proceeds of Union taxes is the predominant channel of resource transfer from the Centre to states. The 14th Finance Commission is of the view that tax devolution should be the primary route for transfer of resources to the States. According to the Commission, the increased devolution of the divisible pool of taxes is a ``compositional shift in transfers'' – from grants to tax devolution.

7.3.1 Vertical Distribution

With a view to minimising discretion, improving the design of transfers, avoiding duplication and promoting co-operative federalism, the FC-XIV suggested a review of existing arrangements for transfers outside the recommendations of the FC. Accordingly, it suggested that a new institutional arrangement may be evolved which can, inter alia, make recommendations regarding sector-specific and area-specific grants. The FC-XIV has radically enhanced the share of the states in the central divisible pool from the current 32 percent (as recommended by FC-XIII) to 42 per cent which is the biggest ever increase in vertical tax devolution. The last two Finance Commissions viz. Twelfth (period 2005-10) and Thirteenth (period 2010-15) had recommended a state share of 30.5 per cent (increase of 1 per cent point basis) and 32 per cent (increase of 1.5 per cent point basis), respectively in the central divisible pool. The sector-specific FC grants to be dispensed with - reflecting compositional shift in transfers from grants to tax devolution with a view to meet 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 specific purpose transfers to the States (RBI, 29 Jan 2016). The balance in fiscal space thus remains broadly the same in quantitative terms, but tilts in favour of states in qualitative terms through a compositional shift in favour of devolution and hence fiscal autonomy (Reddy, 2015).

7.3.2 Horizontal Distribution

Inter-state devolution attempts to mitigate the impact of the differences in fiscal capacity and cost disability among States. The 14th FC has not used the distinction between non-special and special category states. The FC-XIV proposed a new horizontal formula for the distribution of the states' share in divisible 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 FC-XIV incorporated two new variables i.e. 2011 population and forest cover; and excluded the fiscal discipline variable. Fiscal discipline as a criterion for tax devolution was used by FC-XI and FC-XII to provide an incentive to states managing their finances prudently. The criterion was continued by the FC-XIII as well by giving more weightage of 17.5 per cent. The index of fiscal discipline is arrived at by comparing improvements in the ratio of own revenue receipts of a state to its total revenue expenditure relative to the corresponding average across all states. The Commission had a view that the devolution formula should continue to be defined in such a way that it attempts to mitigate the impact of the differences in fiscal capacity and cost disability among States. Therefore they have used the following criteria with specified weightage.

Population and Demographic Change: The FC-XIV assigned a 17.5 per cent weight to the 1971 population. On the basis of the exercises conducted, the commission concluded that a weight to the 2011 population would capture the demographic changes since 1971, both in terms of migration and age structure. The FC-XIV assigned a 10 per cent weight to the 2011 population.

Area: The FC-XIV agreed with the views of the some of the previous Finance Commissions that a State with larger area will have to incur additional administrative and other costs in order to deliver comparable services to its citizens. The Commission followed the method adopted by the FC-XII and put the floor limit at 2 per cent for smaller States and assigned 15 per cent weight.

Forest Cover: The FC-XIV believed that a large forest cover provides huge ecological benefits, but there is also an opportunity cost in terms of area not available for other economic activities and this also serves as an important indicator of fiscal disability. The commission assigned 7.5 per cent weight to the forest cover.

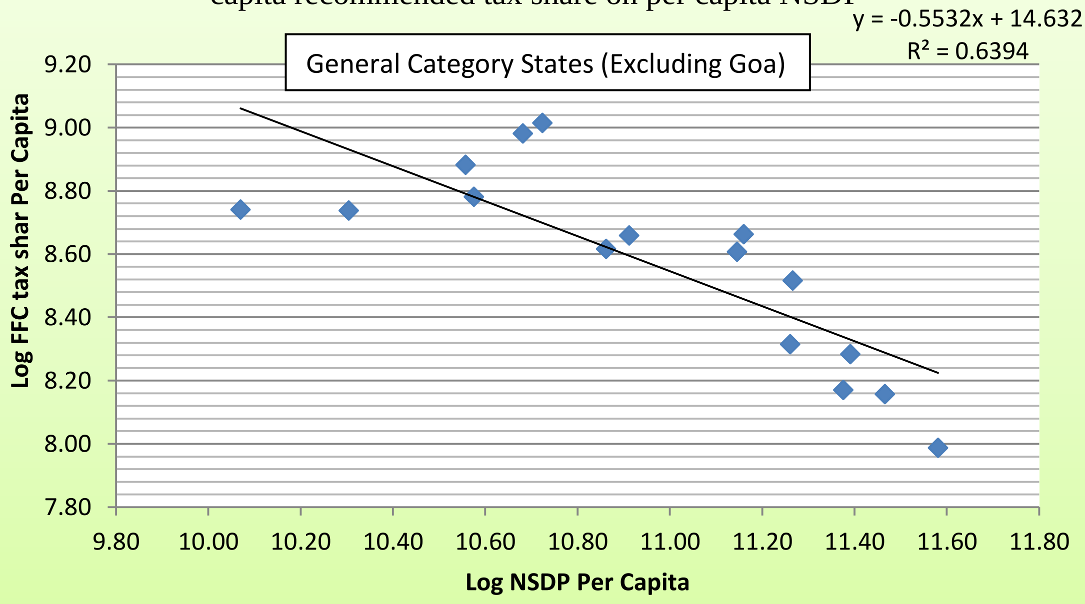
Income Distance: Successive Finance Commissions have used the distance of actual per capita income of a State from the State with the highest per capita income as a measure of fiscal capacity. The FCXIII, however, introduced a new criterion based on distance between estimated per capita taxable capacity for each State and the highest per capita taxable capacity and used this for inter-se devolution. However, The FC-XIV observed that the relationship between income and tax is non-linear, as the consumption basket differs between high, middle and low income States. Therefore they decided to revert to the method of representing fiscal capacity in terms of income distance and assigned it 50 per cent weight. The commission calculated the income distance following the method adopted by the FC-XII. A three-year average (2010-11 to 2012-13) per capita comparable GSDP was taken for all the twenty-nine States. Income distance was computed by taking the distance from the State having highest per capita GSDP. Though, Goa has the highest per capita GSDP, followed by Sikkim. Since these two are very small States, adjustments were needed to avoid distortions and hence income distance was computed from the State with the third highest per capita GSDP- Haryana. The commission provided Goa, Sikkim and Haryana the same distance as obtained for the State with the smallest distance of income with Haryana.

It can be observed that the distribution of taxes may seem unfair because there is no provision to reward states for fiscal discipline, or sound revenue management, or even progress on human indicators. The existing criteria actually reward poorly performing states: the lower they are on the per capita income scale; the more they get from the union tax pool. Many states had suggested that the length of time for which they maintain fiscal discipline should also be given a significant weight to encourage consistent fiscal prudence; but FC-XIV has dropped fiscal performance altogether as a criterion for horizontal devolution. At the same time it must be noted that the finance commission is not a body that rewards economic performance; its aim is to ensure that distribution among states creates more equitable resources. Poorer states or states with larger populations and large areas need more funds to compete with those that have advantages in these areas.

7.3.3 Progressivity of Tax Devolution

The regression of Fourteenth Finance Commission's recommended per capita tax share on per capita NSDP is presented in figure 7.1. It seems that XIV Finance Commission's tax devolutions are progressive i.e. states with lower per capita NSDP are likely to be received on average much larger per capita tax share compared to States with high per capita NSDP. The average response of per capita tax devolutions in rupees as per capita NSDP increases by one rupee was -0.5532 for Fourteenth Finance Commission's tax devolutions. It implies that, when per capita NSDP increases by one rupee, average per capita tax devolutions would fall by 0.5532 rupees. This indicates that the XIV FC's recommended tax devolutions would be in the direction of equalizing the income and fiscal disparities between the general category states (Except Goa). However, XIV FC's tax devolutions would be less progressive compared to the tax devolutions of previous three Finance Commissions. The value of Coefficient of Determination (R^2) for the regression of recommended XIV Finance Commission's per capita tax devolution on per capita NSDP is 0.6394, which indicates that tax devolutions would be less associated with the per capita NSDP compared to recommendations of previous XI and XIII Finance Commissions and would be same as XII FC.

Figure 7.1: Regression of Fourteenth Finance Commission's per capita recommended tax share on per capita NSDP



Source: Fourteenth Finance Commission Report, CSO and Population Census Reports 2001 and 2011.

7.4 Grants-in-aid

The terms of reference for the commission sought suggestions regarding the principles which would govern the quantum and distribution of grants-in-aid (non-plan grants to states), the measures, if needed, to augment State government finances to supplement the resources of local government and to review the state of the finances, deficit and debt conditions at different levels of government.

The previous Finance Commissions recommended grants-in-aid for five purposes – revenue deficit, disaster relief, local bodies, sector-specific schemes and state-specific schemes. In terms of sector-specific grants the FC-XII observed that grants-in-aid can be used to look at certain common, as well as specific, needs of the States. The FC-XIII listed three objectives in recommending grants. The first is to reduce disparities in the standards of various administrative and social services across states. The second is to enable particular States to meet special financial burdens emerging from their peculiar circumstances. The third is to provide resources for specific activities considered to be national priorities.

Apart from the sector-specific grants, Finance Commissions from the FC-VI onwards have recommended grants-in-aid for specified needs of the States. The grants-in-aid recommended for state-specific schemes and projects have steadily increased from Rs. 1,246 crore (FC-X) to Rs. 27,945 crore (FC-XIII). While recommending state-specific grants, the FC-XIII noted that such grants are relevant where they address deprivation, generate significant externalities (especially environmental externalities), meet the needs of the marginal groups or areas and encourage policy innovations.

The five key considerations were influenced the approach of FC-XIV towards state-specific grants. First, the state-specific grants recommended by previous Finance Commissions constitute a small fraction of the proposals submitted by the States. Second, the state-specific grants were not allocated on the basis of any formula or any uniform principle. Third, state-specific schemes are best identified, prioritised and financed at the level of the State Government. Fourth, State Governments repeatedly raised the issue of the need for flexibility in the use of state-specific grants during their discussions. This need for flexibility arises as there is a minimum time lag of two years between the times state-specific schemes are originally proposed to the Finance Commission and when the implementation process actually begins. Due to changed circumstances, there is often a need to revisit the originally recommended schemes. This flexibility is not possible in grants recommended by Finance Commissions. After considerable deliberations, the FC-XIV came to the conclusion that grants for both sector-specific and state-specific schemes by the Finance Commission are not necessary.

Keeping in view the principles adopted by previous Finance Commissions, the views expressed by Union and States, the review of past experience and in the context of our overall approach to fiscal relations between Union and States, the FC-XIV adopted the following four principles in their approach to grants-in-aid:

i) The devolution of taxes from the divisible pool should be based on a formula which should, to a large extent, offset revenue and cost disabilities.
ii) The assessment of expenditures should build in additional expenditures in the case of those States with per capita expenditure significantly below the all-State average. The assessment of revenues should build in the scope for additional revenue mobilisation based on current tax-GSDP ratio relative to the all-State average. This will enable fiscally-disadvantaged States to upgrade their services without earmarking or specifying sectors.
iii) 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 general purpose grants-in-aid to fill the gap.
iv) Grants-in-aid for state-specific projects or schemes will not be considered, as these are best identified, prioritised and financed by the respective States.

To strengthen the judicial systems, expenditure for both general administration and police, maintenance expenditures, enhance expenditure on maintenance of capital assets to the appropriate levels in the States the FC-XIV urged the State Governments to use the additional fiscal space provided by them in the tax devolution to meet such requirements.

The FC-XIV considered health, education, drinking water and sanitation as public services of national importance, having significant inter-state externalities. However, in their view, the grants to these sectors should be carefully designed and implemented and an effective monitoring mechanism put in place with the involvement of the Union, States and domain expertise. Therefore, they desisted from recommending specific purpose grants and suggested that a separate institutional arrangement be introduced for this purpose.

The FC-XIV recommended total amount of grants of Rs. 537354 crores to states, which comes to around 5.72 per cent of divisible pool. The commission recommended grants for three purposes i.e. post-devolution revenue deficit, local bodies and disaster relief respectively of Rs. 194821, 287436 and 55097 crore.

Figure 7.2: Objective wise per cent allocation of Grants-in-Aid to States by Fourteenth Finance Commission

Source (Basic Data): Fourteenth Finance Commission Report

Figure 7.2 exhibits the recommended objective wise per cent allocation of grants-in-aid to States by Fourteenth Finance Commission. Sector-specific FC grants to be dispensed with include grants-in-aid to be given for local bodies (53.49 per cent share in total grants); disaster management (10.25 per cent share) and post devolution revenue deficit grant where devolution alone could not cover the assessed gap (36.26 per cent share). Accordingly, 11 States qualified to receive such grants. States such as Andhra Pradesh, Himachal Pradesh, Jammu and Kashmir, Manipur, Mizoram, Nagaland and Tripura will need a revenue deficit grant for each of the years of the award period. In addition, four States, viz., Assam, Kerala, Meghalaya, and West Bengal will need a revenue deficit grant for at least one of the years of the award period. The post devolution revenue deficit as calculated by the 14th FC has been fully covered by the recommended revenue deficit grant.

7.4.1 Local Governments

Horizontal Distribution

The commission recommend distribution of local body grants to the States on the basis of 2011 population data with weight of 90 per cent and area with weight of 10 per cent. The grant to each state supposed to be divided into two, a grant to duly constituted gram panchayats and a grant to duly constituted municipalities, on the basis of urban and rural population of that state using the data of census 2011.

The share of Gram Panchayats is to be 69.68 per cent of the total grants during the award period 2015-2020; further, The FC-XIV continued with the 13th FC recommendation of making these grants available to local bodies in two parts – a basic grant and a performance grant, in a ratio of 90:10 for PRIs and 80:20 for ULGs. The basic grant is an unconditional grant, intended to be used by local bodies to deliver basic services. In the words of FC-XIV, "the purpose of basic grants is to provide a measure of unconditional support to the gram panchayats and municipalities for delivering the basic functions assigned to them".

The FC-XIV kept aside a small portion (10% for PRI and 20% for ULGs) as performance grant. To be eligible for performance grants, the gram panchayats will have to submit audited annual accounts that relate to a year not earlier than two years preceding the year in which the gram panchayat seeks to claim the performance grant. It will also have to show an increase in the own revenues of the local body over the preceding year, as reflected in the audited accounts.

To be eligible, the urban local body will have to submit audited annual accounts that relate to a year not earlier than two years preceding 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. 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.

Strengthening Role of SFCs:

The Commission recommended that the State Governments should strengthen SFCs. This would involve timely constitution, proper administrative support and adequate resources for smooth functioning and timely placement of the SFC report before State legislatures, with action taken notes.

Measures to Augment the Consolidated Fund of States:

The commission noticed that there is considerable scope for the local bodies to improve revenues from own sources by taking steps as recommended by the SFCs and the Finance Commissions.

The commission feels that States need to ensure property tax reforms including objective determination of the base and its regular revision to adjust for inflation, strengthening of mechanisms for assessment, levy and collection and improving billing and collection efficiency. Therefore, the commission suggested that the existing rules be reviewed and amplified to facilitate the levy of property tax and the granting of exemptions be minimised. The assessment of properties may be done every four or five years and the urban local bodies should introduce the system of self-assessment. Further, commission recommend that action be taken by the States to share information regarding property tax among the municipalities, State and Union Governments.

The levy of vacant land tax by peri-urban panchayats be considered. In addition, a part of land conversion charges can be shared by State Governments with municipalities and panchayats.

The States may like to consider steps to empower local bodies to impose advertisement tax and improve own revenues from this source. Further, the States should also review the structure of entertainment tax and take action to increase its scope to cover more and newer forms of entertainment.

The commission recommended raising the ceiling of professions tax from Rs. 2,500 to Rs. 12,000 per annum. They further recommend that Article 276(2) of the Constitution may be amended to increase the limits on the imposition of professions tax by States.

It can be concluded that by recommending more funds local bodies in the total grants and allocating all PRIs funds to gram panchayats, which are directly responsible for the delivery of basic services instead of recommending funds to panchayat samities (intermediate or block panchayats) and zilla parishads which previous Finance Commissions did, it seems a strong and courageous step forward by the FC-XIV towards strengthening the decentralisation process in India.

7.4.2 Disaster Management

The FC-XIV pointed out that based on the recommendations of the FC-XIII, the available balances in the CRF on 1 April 2010 were merged with the SDRF. The NCCF's balance was similarly merged with the NDRF. Since financial year 2010-11, the Union Government has been financing the NDRF through the levy of a cess and the SDRF as grants-in-aid, based on the recommendations of the FC-XIII. The Disaster Management Act has not framed specific rules for the merger of funds or for the financing of the NDRF and SDRF. To increase the contributions from the public and institutions in the NDRF, the FC-XIV recommend that a decision on granting tax exemption to private contributions to the NDRF be expedited and that the Union Government consider invoking the use of Schedule VII of the Companies (Corporate Social Responsibility Policy) Rules 2014 as an enabling provision for financing the NDRF.

The FC-XIV adopted the practice of the previous Commissions and used past expenditure on disaster relief for the period 2006-07 to 2012-13 to determine the SDRF corpus for each State. Further, The FC-XIV followed the methodology (expenditure-based approach) of the FC-XIII to arrive at an aggregate corpus for all States of Rs. 61,219 crore for the award period. The commission recommended that all States should contribute 10 per cent to SDRF during their award period, with the remaining 90 per cent coming from the Union Government.

The FC-XIV agreed with the views of the FC-XIII that the decision of constituting DDRFs is best left to the wisdom of the State Governments, and hence, separate grant for the financing of DDRFs were not recommended.

Considering the need for flexibility in regard to state-specific disasters, the FC-XIV recommend that up to 10 per cent of the funds available under the SDRF can be used by State Governments for natural disasters that they consider to be 'disasters' within the local context in the State and which are not included in the notified list of disasters of the Ministry of Home Affairs.

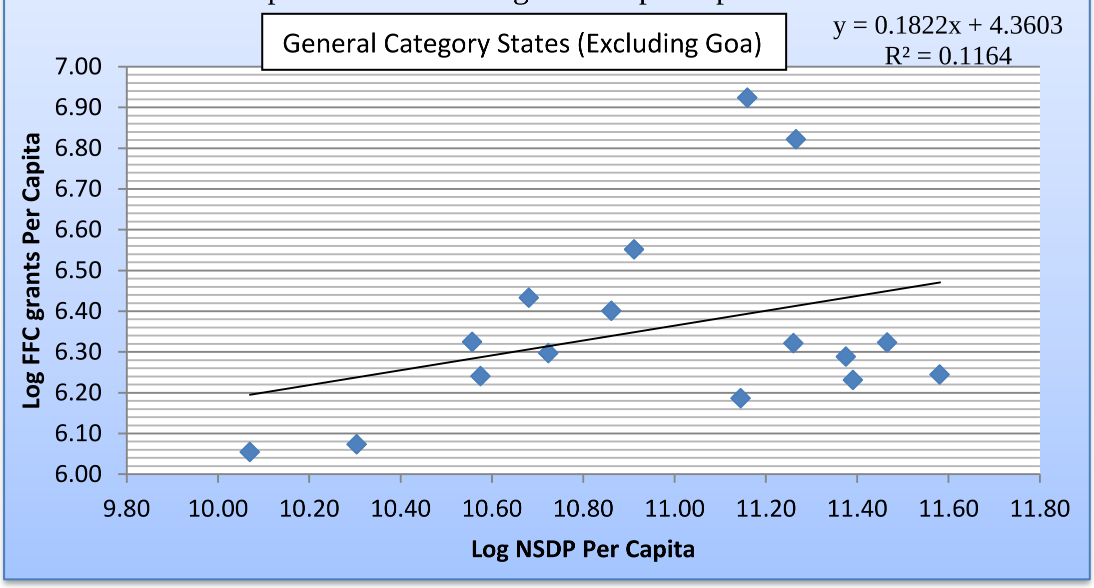
The FC-XIV further recommended that while calculating the requirement for funds from the NDRF during severe calamities, the existing practice of adjusting the contribution made by the Union Government to the SDRF should continue.

7.4.3 Post-Devolution Revenue Deficit Grant

The objective of this grants-in-aid was to give grants to those States which are projected, after due assessment of resources and needs by the Finance Commission, to have a post-devolution non-Plan revenue deficit in any year. These grants-in-aid, to cover the non-Plan revenue deficit, have generally been the largest component of Finance Commission grants. It was only in the FC-XIII that the grants to local bodies formed the largest component of grants-in-aid. On the basis of the assessment, FC-XIV worked out the pre-devolution revenue deficit for each State. In this regard, they departed significantly from previous Finance Commissions, by taking into consideration a State's entire revenue expenditure needs without making a distinction between Plan and non-Plan. The FC-XIV recommended a total revenue deficit grant of Rs. 1, 94,821 crore during their award period for eleven States.

7.4.4 Progressivity of FC-XIV's Grants

Figure 7.3: Regression of Fourteenth Finance Commission's per capita recommended grants on per capita NSDP



Source (Basic Data): Fourteenth Finance Commission Report, CSO and Population Census Reports 2001 and 2011.

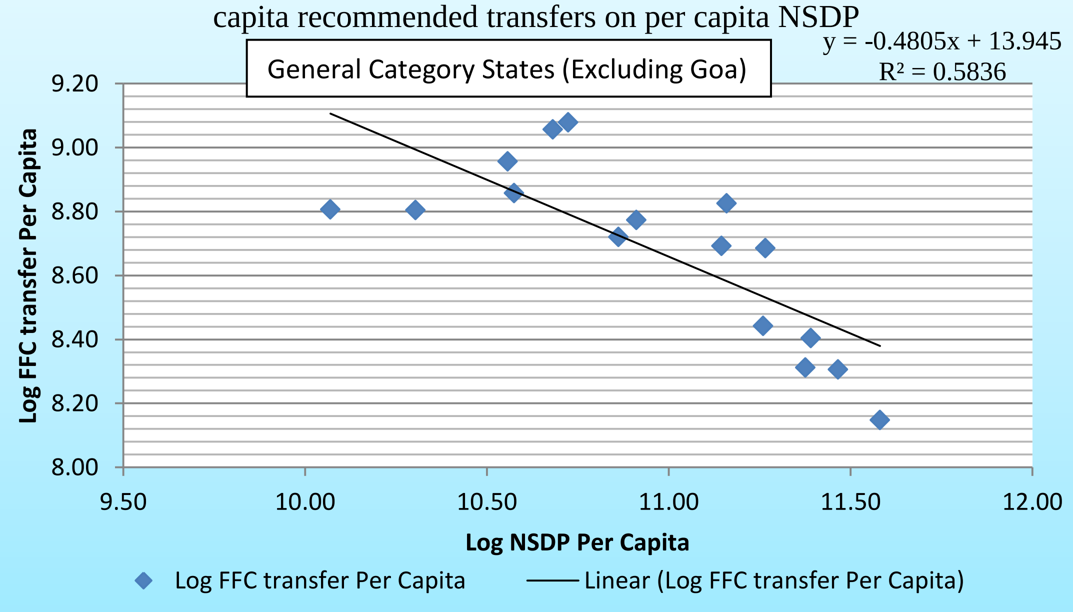
Figure 7.3 shows the regression of Fourteenth Finance Commission's per capita recommended grants on per capita NSDP. It can be observed that like previous Eleventh, Twelfth and Thirteenth Finance Commission's, Fourteenth Finance Commission's per capita grants also had no favourable impact on the states (only among the GCS) which are relatively less developed which is an indication that the

XIV Finance Commission's grants were not progressive i.e. states with lower per capita NSDP not received on average much larger per capita grants, but compared to FC-XI, FC-XII and FC-XIII grants, FC-XIV grants would be regressive in some extent. The value of average response of per capita grants in rupees as per capita NSDP increases by one rupee was 0.1822 for the Fourteenth Finance Commission's recommended grants. It implies that, when per capita NSDP increases by one rupee, average per capita grants would increase by 0.1822 rupees. This indicates that the XIV FC's grants would not in the direction of equalizing the income and fiscal disparities between the general category states (Except Goa). The value of Coefficient of Determination (R^2) for the regression of recommended Fourteenth Finance Commission's per capita grants on per capita NSDP is 0.1164. It implies that model explains only 11.64 per cent variations of total variation of per capita grants.

7.5 Progressivity of 14th FC's Total Transfers

In this section attempt has been made to measure the progressivity of total Fourteenth Finance Commission transfer for sixteen general category states excluding Goa using regression analysis.

Figure 7.4: Regression of Fourteenth Finance Commission's per capita recommended transfers on per capita NSDP



Source (Basic Data): Fourteenth Finance Commission Report, CSO and Population Census Reports 2001 and 2011.

The regression of Fourteenth Finance Commission's recommended per capita total transfers on per capita NSDP is shown in figure 7.4. It seems that XIV Finance Commission's transfers are progressive i.e. states with lower per capita NSDP are likely to be received on average much larger per capita transfers compared to States with high per capita NSDP. The average response of per capita transfers in rupees as per capita NSDP increases by one rupee was -0.4805 for Fourteenth Finance Commission's transfers. It implies that, when per capita NSDP increases by one rupee, average per capita transfers would fall by 0.4805 rupees. This implies that the XIV FC's recommended transfers would be in the direction of equalizing the income and fiscal disparities between the general category states (Except Goa). However, XIV FC's transfers would be less progressive compared to the transfers of previous three Finance Commissions. The value of Coefficient of Determination (R^2) for the regression of recommended XIV Finance Commission's per capita total transfers on per capita NSDP is 0.5836, which indicates that transfers would be less associated with the per capita NSDP compared to recommendations of previous three Finance Commissions.

7.6 Towards Cooperative Federalism

The commission believed that the existing arrangements for transfers between the Union and the States need to be reviewed with a view to minimizing discretion, improving the design of transfers, avoiding duplication and promoting cooperative federalism, insofar as such transfers are required to be made outside of the recommendations of the Finance Commission. The commission recommended that a new institutional arrangement consistent with the overarching objective of strengthening cooperative federalism be evolved 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 regarding implementation and (iv) identifying and providing area-specific grants. The commission suggested that the present role of the Inter-State Council be expanded to include these functions.

7.7 Goods and Services Tax

In the absence of clarity on the design of GST and the final rate structure, the commission was unable to estimate revenue implications and quantify the amount of compensation in case of revenue loss to the States due to the introduction of GST. The FC-XIV recommended that the compensation for revenue loss to the States due to implementation of GST is to be 100 per cent for first 3 years, 75 per cent in the fourth year and 50 per cent in the fifth year and an autonomous and independent GST Compensation Fund is to be created.

7.8 Fiscal Discipline and FRBM

The FC-XIV recommended that the States' annual GFD-GSDP ratio is to be anchored at 3 per cent of GSDP and will have the flexibility of upto 0.5 per cent provided the following conditions are met. Making a marked departure, the FC-XIV has linked fiscal discipline to borrowing criteria rather than devolution criteria and the States are eligible for additional borrowings if: (i) the debt-GSDP ratio is less than or equal to 25 per cent; and/ or (ii) the interest payments are less than or equal to 10 per cent of the revenue receipts in the preceding year. Availing additional borrowing is conditional on the State having no revenue deficit in the year in which borrowing limit is to be fixed as also in the preceding year. Further, States to be given the option to carry forward unutilised borrowing limit in the following year during the award period. Thus, a State can have a maximum GFD-GSDP limit of 3.5 per cent in any given year during the award period. This may enable fiscally well managed States to borrow more for undertaking developmental capital expenditure.

The FC-XIV has recommended that the Union Government should consider making an amendment to the FRBM Act to omit the definition of effective revenue deficit from April 1, 2015. Moreover, it recommended an amendment to the FRBM Act mandating the establishment of an independent fiscal council to undertake ex-ante assessment of the fiscal policy implications of budget proposals and their consistency with fiscal policy and rules.

In continuation with the disintermediation principle advocated by the 13th FC, the FC-XIV has recommended that States may be excluded from the operations of the

NSSF with effect from April 1, 2015, and their involvement be limited to discharging the liabilities already incurred. However, Union Budget 2015-16 has made a provision of ₹103.4 billion for NSSF's investment in State Government securities, indicating that NSSF would continue to finance State Governments' fiscal deficit. The FC-XIV recommended that all the States should target improving the quality of fiscal management encompassing receipts and expenditures. Further, State Governments are to provide statutory ceiling on the sanction of new capital works to an appropriate multiple of the annual budget provision. However, some of the above recommendations are yet to be considered by the Union Government.

7.9 Implications for State Government Finances

The FC-XIV's recommendation of 42 per cent tax devolution may not significantly alter the aggregate resource transfers from the Centre, although it may give more untied transfers to the States, thus providing greater fiscal autonomy. To address horizontal imbalance, FC-XIV has accorded greater importance to fiscal capacity, with the indicators of cost and revenue disabilities being assigned a combined weight of 72.5 per cent as against 57.5 per cent assigned by the 13th FC.

As per the recommendations of the FC-XIV, the Centre-State funding pattern of some of the Centrally Sponsored Schemes (CSS)/ Programmes is being modified in view of the larger devolution of tax resources to States. Such grants require states to make matching contributions and do not give them the autonomy to design or implement the schemes. They are also "one-size-fits-all" schemes; as they are not tailored to the specific ground level requirements of each state.

FC-14 strongly recommends that the Centre reduce the number of Centrally Sponsored Schemes, and instead move the resources directly to the states so that they can design, implement and monitor the end use of funds at the state and local level. The Union Budget 2015-16 proposed that eight CSS be delinked from support from the Centre. In respect of various other CSS, the sharing pattern will undergo a change with States sharing a higher fiscal responsibility in terms of scheme implementation (RBI, 29 Jan 2016).

Chakraborty (2015) pointed out that shift in policy towards greater fiscal autonomy to the states by ensuring more than 70% of the fund flow through the Finance Commission route and also preserving the fiscal space for the union for its own functions. It is thus about getting expenditure priorities right for each level of government. The delinking of normal central assistance and specific plan schemes from the plan grants implies that states would be the sole authority in determining their priorities, which they can with the enhanced fiscal space due to higher tax devolution. At the same time, given the overall resource envelope and larger untied and statutory transfers, the union government will have to be extra cautious in announcing big CSS with huge fiscal implications for both the union and states, especially in functions which are either primarily the domain of the states or are best delivered by the states.

Reddy (2015) while examining the Union transfers to State brought to notice that the restructuring of central assistance for state plans proposed in the union budget will result in depriving the states of the benefit of an increase in untied transfers following the increase in tax devolution recommended by the FC-XIV. What is required is not so much an increase in plan transfers to states, but a significant reduction in the number of CSSs by grouping them into core and non-core schemes and giving the states an option to choose from a shelf of schemes in the non-core category within their allocation as per their priorities.

To Sum up:

The FC-XIV 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 FC-XIV induced imperative of having to reduce the scale of other central transfers to the states. The increase in tax devolution rate, therefore, may be an important step towards shifting the institutional mechanism towards transfers that promote states' fiscal autonomy. In other words, states will now have greater autonomy on the revenue and expenditure fronts. The Commission is of the view that sharing pattern in respect to various Centrally-sponsored schemes need to change. It wants the States to share a greater fiscal responsibility for the implementation of such schemes. In short we can say that the FC-XIV brought five important changes from the past. First, radically enhanced the share of the states in the central divisible pool from the current 32 percent (as recommended by FC-XIII) to 42 per cent which is the biggest ever increase in vertical tax devolution. Second, to take into account plan revenue expenditures while assessing revenue deficit grants. Third, to discontinue the distinction between special category and general category States. Fourth, to desist from awarding sector or state specific grants or to subject grants to conditionality and, fifth, to suggest institutional mechanisms for better monitoring of fiscal rules and to achieve "co-operative federalism". In short it can be argued that there is now renewed impetus on the states to have larger control over their desired fiscal direction, priorities and areas of improvement.

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