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Fiscal Federalism in India

14th Finance Commission Award: 2015-16 to 2019-20

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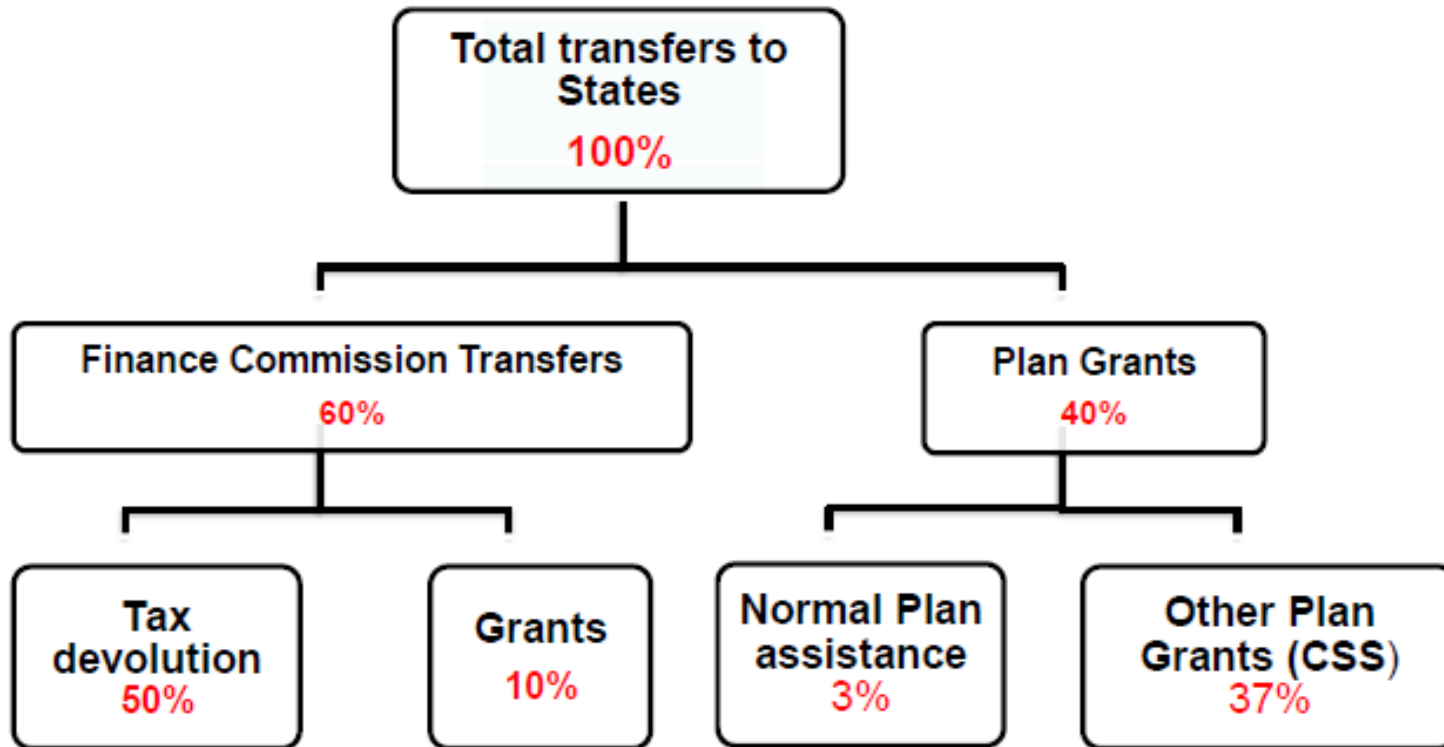
Why Finance Commissions?

- Constitution assigns distinct revenue and spending responsibilities to different levels of government
- Union Government raises on average about 60 % of revenue, but accounts for about 45 % of spending
- States raise roughly 40 % of revenue, but account for 55% of spending (own + Union agency)
- Vertical imbalance needs resolution through transfers
- The horizontal allocation of these transfers across States also has to be determined
- Finance Commissions assigned this dual task as their core function by the Constitution

Role Of Finance Commissions

- Recommend States' share of Union tax revenue: vertical devolution [Article 280(3)] + recommend the distribution of States' share among States: horizontal devolution
- Recommend additional Union grants-in-aid for States if required [Article 275]
- Additional Terms of Reference could be added if the President so desires
- 14th Finance Commission given many additional terms of reference.

Vertical Transfer Channels



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Tax Devolution Under Article 380

- Around 62% of shareable pool (Union taxes) already being transferred to States
- No room to raise this much. Union needs balance 38% to accomplish it's responsibilities
- Compositional shift possible to meet States complaints about tied & conditional grants(CSS)
- 14th FC could take comprehensive view since TOR not limited to only Non-Plan grants
- Raised untied tax devolution to 42%, still leaving 20% of shareable pool for FC+ other grants

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Horizontal Devolution Formula

- Devolved taxes need to be allocated among States based on fair principles
- Allocation formula based on needs, capacity to raise own revenue, cost disability and other challenges

Item	Weight(%)
Population(1971)	17.5
Demographic Change	10
Area	15
Income Distance	50
Forest Cover	7.5

14th Finance Commission Awards Grants

- Avoided any sector or State specific grants
- Only three grants: disaster relief, local government, and a revenue deficit grant
- Revenue deficit an important equalizing grant
- Expenditure need projected so no State left behind below 80% of all States per capita spending in 2019 -20
- Deficit = Expenditure need – own revenue (normative projection) - tax devolution
- Revenue deficit grant of Rs1,94,821 crore to benefit 11 states with projected deficits

Comparative Picture of Fiscal Transfers in 2014-15 & 2015-16 Budgets

Total transfers as % of sharable pool

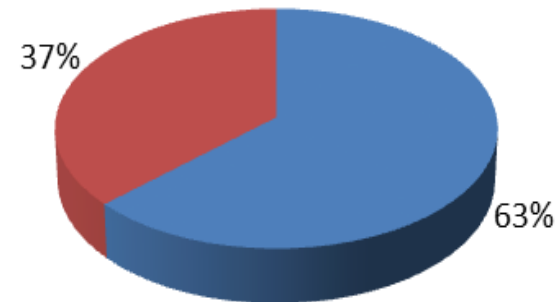
2014-15	62%
2015-16	63%
14 th FC Total	63%

2014-15



■ Devolution of Taxes ■ Other Grants

2015-16



■ Devolution of Taxes ■ Other Grants

Main Take aways

- Preserved fiscal space for Union : 38% of shareable pool + cesses & surcharges + non-tax revenues
- Raised fiscal space for spending on Union List items
- Met States complaints about tied, conditional, discretionary grant through compositional shift
- Attempted enabling equal level of public services for equal tax price across country
- Rationalized overlapping grants from multiple channels
- Left fiscal space (15% of divisible pool) for CSS type grants for national priorities, externalities across States
- New federal institution proposed to oversee such flows

Main Take aways

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- Pushed environment protection (forest cover), disaster relief, local government empowerment as per TOR
- New institutional mechanism of Fiscal Councils proposed to monitor fiscal prudence, FRBM compliance of Union as it monitors States
- Addressed wide range of other issues ranging from legally mandated GST compensation mechanism to systems for public utility pricing, expenditure management, divestment of non-priority public undertakings, etc

Thank You