Are states really at the Centre?

It is not the Finance Commission, but the Union government that determines the transfers to the states

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Ever since the Fourteenth Finance Commission (FFC) recommended the tax devolution of 42% of the divisible pool to the states, many have held it responsible to the fiscal woes of the Union government. It is understandable when the Union finance minister complains about it, for he has to find a culprit to blame for his fiscal woes. However, when a respectable senior editor like TN Ninan in his widely read editorial ruminates about "…the overly generous recommendations of the Finance Commission" resulting in the, "…Central transfers to State governments ballooning by an astonishing 60 per cent in 2014-15", resulting in the total revenues in that year growing by 32%, we need to look at the matter more seriously. In fact, he is not alone, many scholars and policy makers have an impression that the Commission has made a hash and some even go to the extent of stating that the government should appoint a new Commission to undo the "damage". It is therefore necessary to ask whether the FFC is really the demon responsible for the Centre's fiscal woes or is it the fall guy.

Ninan states that the central transfers to the states "ballooned" by 60% in 2014-15, consequent to the Fourteenth Finance Commissions' recommendations. The fact is, the FFC's recommendations came into effect in 2015-16 and not in 2014-15 and therefore, the story of transfers ballooning by 60% in 2014-15 is actually a mere accounting change! It may be recalled that until 2013-14, a significant portion of central assistance to state plans was given directly to implementing agencies, bypassing the states, and this practice was reversed in 2014-15 based on the recommendations on the Expert Committee on Efficient Management of Government Expenditures, chaired by C Rangarajan. Thus, ballooning is merely an accounting change and in any case, Finance Commission recommendation was implemented only in 2015-16.

How generous was the FFC's "bonanza"? Indeed, 42% tax devolution, as compared with the 32% recommended by the previous Commission, looks like a quantum jump. But, as the Terms of Reference of the Fourteenth Finance Commission required it to consider total revenue expenditure requirements of the states without making a distinction between plan and non-plan, the Commission had to subsume the grants for state plan schemes (Gadgil formula grants) in its recommendations and that was equivalent to 5.5% of the divisible pool. In addition, as the Commission included area under forest cover as one of the factors to determine the share of individual states in tax devolution and decided that it will not give any grants other than those to achieve the states' budgetary balance, local governments and disaster relief, the amount saved on those discretionary grants was equivalent to 1.5% of the divisible pool. The Commission desisted from giving specific purpose grants and discretionary grants and left them to the Union government. It may be recalled that some of the previous Commissions had given grants to activities such as construction of medical college, Governor's house, lake and temple rejuvenation and airports. In the event, the increase actually is from 39% to 42%?

How did it translate in terms of actual numbers? The accompanying table and the graph give the real picture of the volume of Union transfers to states. In terms of percentage of GDP, tax devolution increased by one point in 2015-16 over the previous year due to Finance Commission's recommendation, but grants declined by 0.4 percentage point. Similarly, the share of tax devolution in Union taxes increased by 7.5 percentage points in 2015-16 over the previous year, but the increase in total transfers was just 2 percentage points! In fact, if one looks at a slightly longer time series, despite the Finance Commission's "bonanza", the total transfers relative to GDP actually declined from 6.3% in 2011-12 to 6% in 2015-16. The decline in the grants was due to the inclusion of plan grants in Finance Commission's recommendations and partly due to the restructuring of the centrally sponsored schemes.

Why did the Commission decide to give higher tax devolution, albeit marginal of about 3% of divisible pool? The Commission's analysis showed that between 2002-05 and 2005-11, Union government's revenue expenditures on state subjects increased from 14% to 20% and on Concurrent subjects, the increase was from 13% to 17% (Para 6.17). The Union government never found the lack of fiscal space a constraint in foraying into spending on various activities in the state list, quite a few of them in the nature of transfer payments. The arguments by the states was that why should the Finance Commission leave so much fiscal space for the Union government to intrude into their area though various centrally sponsored schemes? While some of the central schemes are meritorious and it is important to ensure minimum standards of services in respect of them across the country. Therefore, the Commission left adequate fiscal space to the Union government to carry them out and recommended that these schemes should be decided by a committee comprising of representatives from the Union and states along with domain experts. At the same time, the Commission decided to provide greater flexibility to the states to spend on the subjects under their jurisdiction by increasing the untied transfers marginally through tax devolution.

As a matter of fact, in the prevailing situation, it is not the Finance Commission, but the Union government that determines the total volume of transfers to the states. The Finance Commission can only determine the volume of untied transfers and that is what the FFC did. The Finance Commission cannot be held responsible if the Union government did not pass on the benefits of lower oil prices but decided to levy cesses and surcharges on petroleum products to use the funds to initiate more schemes and expand on the existing ones.

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CENTRAL TRANSFERS TO STATES

	Per cent of GDP			Per cent of Central Tax revenues (Gross)		
	Tax dev	Grants	Total	Tax devolution	Grants	Total transfers
2011-12	2.89	3.43	6.32	28.7	34.09	62.8
2012-13	2.91	2.99	5.90	28.1	28.90	57.0
2013-14	2.78	2.46	5.24	27.95	24.67	52.62
2014-15	2.71	2.74	5.45	27.13	27.4	54.53
2015-16 RE	3.73	2.31	6.04	34.68	21.51	56.19
2016-17 BE	3.79	2.32	6.11	35.0	21.46	56.46

Central Transfers to States (% of GDP)