Fourteenth Finance Commission
Impact of Its Recommendations

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Preliminary evidence on the impact of the recommendations of the Fourteenth Finance Commission suggests that there has been an increase in central transfers and social sector expenditures in a number of states in 2015–16. This evidence is biased upwards due to two factors. First, much of the gains have been measured with respect to a low base year. Second, the inferences are affected by systematic differences between actuals, revised estimates, and budget estimates. Using a modified base and comparable estimates for 15 major states, it is seen that these are much smaller. Besides, in most states, social services have received a lower priority over economic services in 2015–16.

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The recommendations of the Fourteenth Finance Commission (FFC) have important implications for revenues and expenditures of state governments. The share of states in divisible pool of taxes has increased from 32% to 42% following the FFC recommendations: an increase much higher than the levels recommended by the previous finance commissions.[1] To accommodate this increase, the union government was expected to reduce conditional transfers to states in the form of grants, as the available fiscal space was inadequate to absorb the increase in tax devolution.[2] The reduction in grants, however, has been an issue of concern as much of the grants relate to centrally sponsored schemes (CSS), initiated to support expenditures in the social sector and the development of infrastructure. Although increased tax devolution has provided the states with untied resources to compensate the loss in grants, questions on what has been the net gain in resources at the state-level, and how have individual states used the increased untied resources to meet their fiscal priorities have remained matters of empirical investigation.

The FFC recommendation for increasing tax devolution to states was primarily intended to bring about a shift in the composition of central transfers to states. With increased tax devolution, it was expected that the states would receive a larger volume of untied funds relative to tied funds. This will enhance the states' autonomy in deciding their expenditure priorities. Much of the tied transfers to states were towards CSS, which were initiated by the central government, but required a "matching contribution" of funds from the states. It has been pointed out by various state governments that the requirement of matching contribution in most CSS schemes had squeezed the fiscal space of states (Finance Commission 2015). Many of the CSS schemes were also on subjects in the state and concurrent lists of the Indian Constitution, and an expansion of these schemes have led to an increase in the union government's expenditure on subjects other than those on the union list (Chakraborty 2015). The increased tax devolution, therefore, was not only expected to provide states with a greater degree of expenditure autonomy, but also allow the union government to focus more on areas that are constitutionally enlisted in the union list.

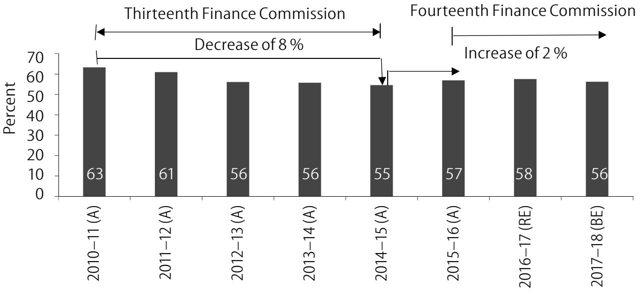
The net gain or loss of resources in states will be determined by the relative increase or decrease of untied and tied funds in the states. Transfers are also affected by changes introduced by FFC with respect to the criteria for horizontal distribution of resources across states. The net gain or loss of transfers in states depends on the combined effect of changes in tax devolution, grants and the criteria for horizontal distribution of resources among states.[3]

Net Gain in Resources?

Preliminary evidence on receipts of central transfers in states almost unanimously suggested a net gain in resources following the FFC recommendations. Studies on Bihar and Odisha have shown that the estimated gain from increased tax devolution is likely to be more than adequate to compensate for the loss of grants (Chakraborty 2016; OBAC 2015). In Maharashtra too, the increased tax devolution is likely to have expanded the fiscal space (Shetty 2016). A broader study of 19 states for the first year of the award period of FFC had also shown that there had been a substantial increase in resources in almost every state in the first year of the FFC award period (Accountability Initiative 2016).

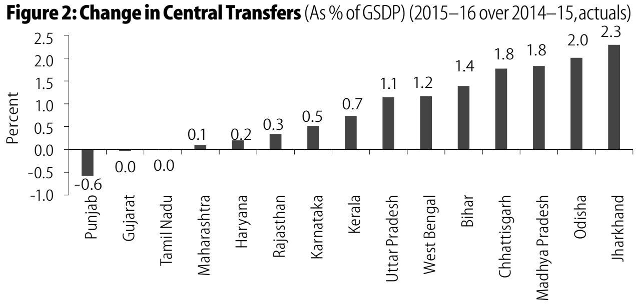
Similarly, a World Bank study for 20 states showed that in almost all the states, there was a net gain in resources following the FFC recommendations (World Bank 2016). The only contrasting evidence was provided by an early study in Karnataka, which showed that the gain in share of taxes in the state was unlikely to compensate for the loss in grants in the first year of the FFC award period

Figure 1: Aggregate Transfers to States (As % of GTR of the union government)



Source: Budget document of the union government, various years.

Figure 2: Change in Central Transfers (As % of GSDP) (2015–16 over 2014–15, actuals)



Source: *Finance Accounts* of respective states, various years. For West Bengal, data have been sourced from the state budget document.

(Kotasthane and Ramachandra 2015). However, a later study by the same authors using updated information also suggested that even in Karnataka, there was likely to be a net gain in resources (Kotasthane and Ramachandra 2016). Additionally, it has been pointed out that social sector expenditures were likely to increase in almost every state allaying concerns of any adverse impact on the social sector at the state-level following the FFC recommendations (Accountability Initiative 2016). Specifically, expenditures on health and education were likely to increase in various states (World Bank 2016).

The existing studies on the issue are associated with two important problems. First, much of the evidence is based on a year-to-year comparison between 2014 and 2015 (the last year of the Thirteenth Finance Commission or TFC award period) and 2015–16 (the first year of the FFC award period). In all the existing studies, the base year for measuring changes in the first year of FFC has, therefore, been with reference to the single year 2014–15 of the TFC period. This is because comparable state-level figures of transfers and expenditures prior to 2014–15 are not available from budgets. Till 2013–14, much of the grants under CSS were not routed through the state treasuries and were not captured in budgetary figures of the state governments.[4] Since the last year of TFC (2014–15), these grants are being routed through state treasuries and are captured in budgetary figures. Thus, 2014–15 is the only year in the TFC period in which budgetary data on transfers and expenditures are comparable with the FFC years, and studies have used 2014–15 as the base for measuring changes in the FFC period. This may be problematic if the values for 2014–15 are unusually high or low with respect to the average of the TFC period.

Second, the existing evidence on the increase in central transfers and social sector expenditures is likely to be biased upwards due to systematic differences in the nature of estimates used for the analyses. Much of the evidence is based on a comparison of actuals to revised estimates or revised estimates to budget estimates of transfers and expenditures between 2014–15 and 2015–16.[5] As actual estimates for both these years were not available till then, early studies have compared revised estimates for 2014–15 with budget estimates for 2015–16. More recent studies have compared actuals for 2014–15 with revised estimates for 2015–16.

Notably, in the past, in any year, almost invariably, actuals were lower than revised estimates, and revised estimates were lower than budget estimates. A comparison of revised estimates of any year with budget estimates of the next year, therefore, induces an upward bias in the measurement of gains. Similarly, a comparison of actuals of any year with revised estimates of the next year inflates the gains.

In this paper, we add to the existing analysis in two ways. First, using union and state budgets, we highlight the upward bias that occurs in measurement of gains following FFC recommendations if one uses 2014–15 as the base for comparison, vis-à-vis the other years of the TFC period. Second, to reduce bias, we provide a comparison of the first year of the FFC period (2015–16) with the average value over the TFC period, instead of a single year 2014–15 as in existing studies. Using this approach, we revisit two questions: (i) what has been the net gain in central transfers to states following the FFC recommendations; and (ii) how has social sector expenditures fared in states following the FFC recommendations? Further, we compare the changes in expenditure on "social services" vis-à-vis "economic services" in states to examine the relative priorities of states in the two services in the first year of the FFC award period.

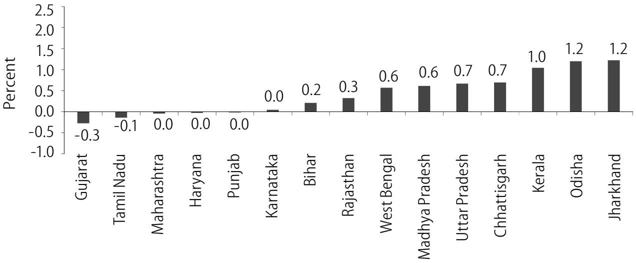
A Note on the Data Used

Information on central transfers and expenditures pertaining to 15 major states for the years 2011–12 to 2015–16 has been drawn from *Finance Accounts* compiled by the Comptroller and Auditor General of India for each state.[6] For some states, central transfers for the social sector were not easily identifiable from *Finance Accounts* as several items were clubbed together. We, therefore, use budget documents for information on central transfers for the social sector. Notably, data on central transfers and expenditures since 2014–15 are not comparable to earlier years as a significant portion of central transfers prior to 2014–15 were off budget in nature. To ensure comparability over the years, off-budget transfers in each year have been included for each state. For central transfers to states, gross tax revenues (GTR) and cost of tax collection of the union government have been compiled from union budget documents for various years.

Quantum of Transfers

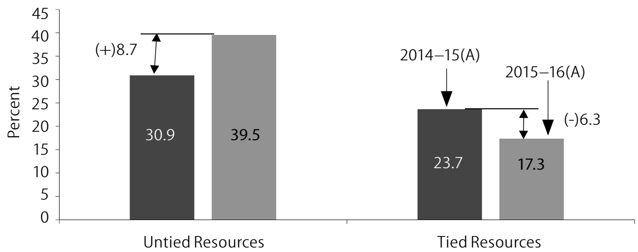
Analysis suggests that increase in aggregate transfers to states from the union government in the first two years of the FFC award period has been relatively small (Figure 1). The share of states in GTR of the union government has increased by two percentage points in

Figure 3: Change in Central Transfers (As % of GSDP) (2015–16 over 2011–15, actuals)



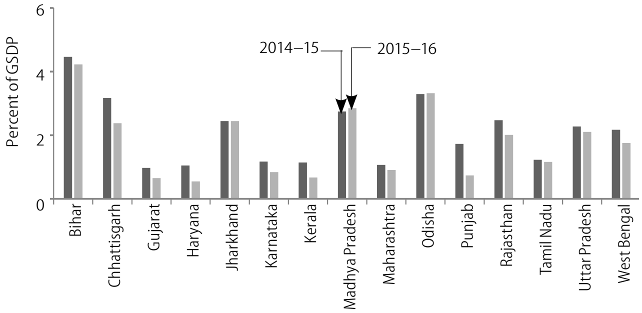
Source: *Finance Accounts* of respective states for various years. For West Bengal, data have been sourced from the state budget document.

Figure 4: Untied and Tied Transfers to States (As % of GTR of the union government)



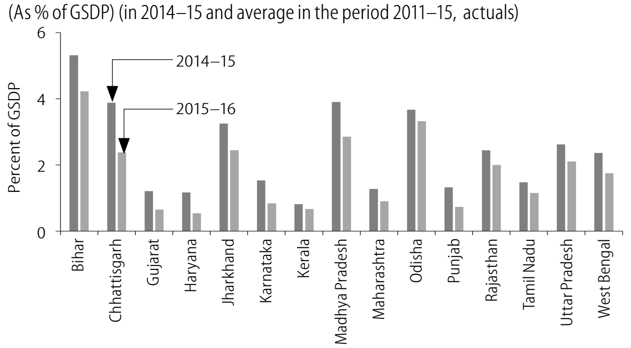
See endnote 9.
Source: Budget document of the union government, various years.

Figure 5: Receipts of 'Tied Plan Grants' in States
(As % of GSDP) (in 2014–15 and 2015–16, actuals)



Tied plan transfers at the state-level refer to all receipts under plan grants other than normal central assistance.
Source: *Finance Accounts* of respective states, various years. For West Bengal 2015–16, data have been sourced from the state budget document.

Figure 6: Receipts of 'Tied Plan Grants' in States
(As % of GSDP) (in 2014–15 and average in the period 2011–15, actuals)



Source: Same as Figure 5.

2015–16 (the first year of the FFC award period) over the previous year 2014–15 (Figure 1).[7] Notably, transfers in 2014–15 (the base year from which increase has been measured) were particularly low (Figure 1). In 2014–15, transfers as a proportion of GTR of the union government was the lowest among all the years in the TFC period. The 2% increase in transfers to states since 2014–15 is a marginal recovery from a fall of around 8% since the beginning of the TFC period. In fact, figures for earlier years provided in the FFC report suggest that the level of transfers to states in 2014–15 was the lowest since 2008–09 (Finance Commission 2015: 52). Part of the increase in 2015–16 over 2014–15 is therefore, due to measurement from a low base. In the second year of the FFC award period (2016–17), aggregate transfers show a marginal increase of one percentage point over 2015–16 (Figure 1). Thus, increase in aggregate transfers in the first two years of FFC period has not been particularly higher than the average of the TFC period.

The upward bias in measurement of gains in central transfers in the first year of FFC period (2015–16) with respect to 2014–15 is reflected in transfers reported in state budgets too. A comparison of changes in the volume of central transfers suggests that the gains in aggregate central transfers vary between 0.1% and 2.3% of gross state domestic product (GSDP) in states (Figure 2, p 75). If one uses the average between 2011–12 and 2014–15 (referred to as 2011–15 hereafter) as the base for comparison, the gains are much lower: the maximum being 1.2% of GSDP (Figure 3).[8]

Composition of Transfers

With little fiscal space available with the union government to increase aggregate transfers, the increased tax devolution was primarily intended to change the composition of central transfers to states. It was expected that the union government would withdraw some of the transfers on CSS schemes and reduce tied transfers to states. Untied transfers were expected to rise due to increase in the share of tax devolution. Thus, the composition of transfers to states was expected to change in favour of more untied resources.

As expected, there has been a reduction in conditional (tied) transfers and an increase in unconditional (untied) transfers to states between 2014–15 and 2015–16.[9] As percent of GTR of the union government, tied transfers reduced by 6.3% while untied transfers increased by 8.7% between the two years (Figure 4). The net increase of around two percentage points reflects the additional transfers to states in 2015–16. The decline in tied transfers has been largely brought about through a reduction of resources for CSS schemes as was recommended by FFC. The reduced volume of resources for CSS schemes is also mirrored in a decline in tied plan transfers at the state-level in almost all states (Figure 5).[10] Notably again, the decline in tied plan grants at the state-level is higher when one compares it with the average for the period 2011–15 than when compared to 2014–15 alone (Figure 6).

Social Sector Expenditures

The decline in tied plan grants from the union government has resulted in a contraction in the volume of transfers for the social sector.[11] A comparison of the grants for social sector between 2014–15 and 2015–16 suggests that central transfers in social sectors as a percentage of GSDP fell in almost all major states (Figure 7, p 77). It may be noted that a part of the grants under schemes like Tribal Sub-plan, Border Areas Development Programme, Special Component Plan for Scheduled Castes, etc, are also used for social sector expenditures. However, differences in the level of disaggregation at which these grants

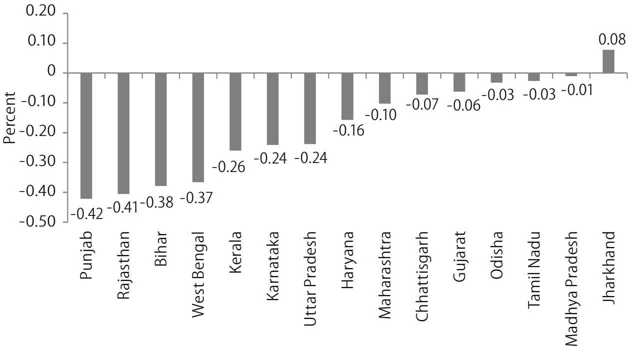


Figure 7: Change in Central Transfers for Social Sector
(As % of GSDP) (in 2015–16 over 2014–15)

Source: State budget documents, 2016–17 and 2017–18.

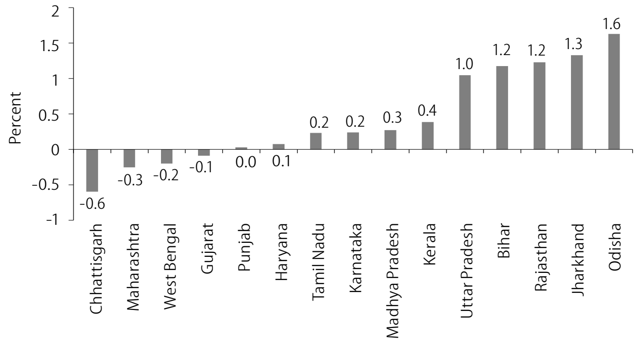


Figure 8: Change in Social Sector Expenditures
(As % of GSDP) (in 2015–16 over 2014–15, actuals)

Source: *Finance Accounts* of respective states, various years. For West Bengal 2015–16, data have been sourced from the state budget document.

are reported in state budgets make it difficult to identify and compare the portion of these grants that are earmarked for social sector expenditures. In most states, the amount of such grants that cannot be identified with any sector, account for less than 10% of total central grants. Even if we consider and add all such grants to transfers for the social sector, the fall is evident in majority of states.

A number of low-income states have compensated for the decline in central grants for the social sector. This is reflected in the fact that despite a fall in central transfers, social sector expenditures have increased in a number of these states (Figure 8 and Figure 9, p 78).[12] The magnitude of increase, however, has been less than 1% of GSDP in most states except Jharkhand and Odisha (Figure 9). Irrespective of the base used for comparison, social sector expenditures have declined in Chhattisgarh, Maharashtra, Punjab, and Haryana. It is important to note that central grants for the social sector account for a relatively small portion of social sector expenditures in states. Central grants for the social sector accounted for around a third of the total social sector expenditures in the eight relatively more centrally dependent states.[13] For other states, the contribution was even smaller. The changes in social sector expenditures are, therefore, determined to a large extent by states' own revenue and fiscal priorities.

Importantly, expenditures on social services have received a lower priority than economic services in the first year of the FFC period in a number of states. States where both expenditures on social services and economic services increased (as percentage of GSDP), the increase has been higher in the latter than in the former. These include Uttar Pradesh, Rajasthan, Odisha, Madhya Pradesh, and Bihar. In others where expenditure declined in both economic and social services (as percentage of GSDP), the decline has been more in the latter than the former (Table 1). These include Punjab and Maharashtra. In other states like Chhattisgarh, Haryana, and West Bengal, while expenditure on social services has fallen, expenditure in economic services has risen. On the whole, in 10 out of the 15 states under analysis here, expenditure in economic services has been relatively higher than social

Table 1: Changes in Selected Indicators of Revenue Receipts and Expenditures in Major States (% of GSDP)

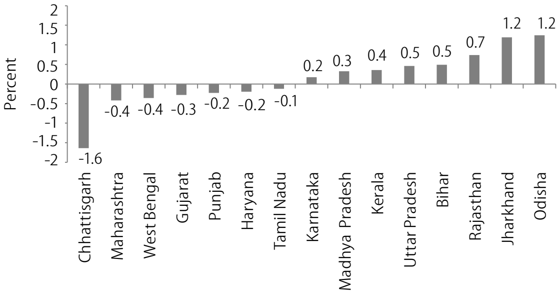
Selected Indicators	Bihar			Chhattisgarh			Gujarat			Haryana			Jharkhand		
	2011–15 (Average)	2015–16	Increase/ Decrease	2011–15 (Average)	2015–16	Increase/ Decrease	2011–15 (Average)	2015–16	Increase/ Decrease	2011–15 (Average)	2015–16	Increase/ Decrease	2011–15 (Average)	2015–16	Increase/ Decrease
Total revenue receipts	24.0	25.2	1.2	17.9	17.8	-0.1	10.6	9.4	-1.2	10.3	9.8	-0.5	15.6	17.6	2.0
Total central transfers	17.7	17.9	0.2	8.6	9.3	0.7	2.7	2.4	-0.3	2.5	2.4	0.0	8.9	10.1	1.2
Total expenditure	26.4	28.2	1.8	20.1	20.0	-0.1	12.7	11.6	-1.1	12.8	13.6	0.8	17.3	19.3	2.0
Expenditure on social services (including rural development)	13.0	13.5	0.5	10.0	8.4	-1.6	5.4	5.1	-0.3	5.3	5.1	-0.2	8.2	9.4	1.2
Expenditure on economic services	5.7	6.4	0.7	5.6	7.0	1.4	3.6	3.2	-0.5	3.5	4.5	1.0	3.8	4.5	0.7

Selected Indicators	Karnataka			Kerala			Madhya Pradesh			Maharashtra			Odisha		
	2011–15 (Average)	2015–16	Increase/ Decrease	2011–15 (Average)	2015–16	Increase/ Decrease	2011–15 (Average)	2015–16	Increase/ Decrease	2011–15 (Average)	2015–16	Increase/ Decrease	2011–15 (Average)	2015–16	Increase/ Decrease
Total revenue receipts	11.9	11.7	-0.2	11.0	12.4	1.4	20.0	19.6	-0.3	10.1	9.6	-0.5	18.7	20.2	1.6
Total central transfers	3.7	3.7	0.0	2.8	3.9	1.0	10.0	10.7	0.6	2.7	2.6	0.0	9.9	11.1	1.2
Total expenditure	13.9	13.6	-0.4	14.4	15.5	1.1	20.8	21.7	0.9	11.5	11.0	-0.5	19.4	22.3	2.9
Expenditure on social services (including rural development)	5.4	5.6	0.2	5.3	5.7	0.4	9.2	9.5	0.3	5.0	4.6	-0.4	9.0	10.2	1.2
Expenditure on economic services	4.6	4.2	-0.4	2.4	2.6	0.2	5.6	6.0	0.4	2.7	2.5	-0.2	5.2	7.2	2.0

Selected Indicators	Punjab			Rajasthan			Tamil Nadu			Uttar Pradesh			West Bengal		
	2011–15 (Average)	2015–16	Increase/ Decrease	2011–15 (Average)	2015–16	Increase/ Decrease	2011–15 (Average)	2015–16	Increase/ Decrease	2011–15 (Average)	2015–16	Increase/ Decrease	2011–15 (Average)	2015–16	Increase/ Decrease
Total revenue receipts	11.2	10.6	-0.6	15.1	14.9	-0.2	12.1	11.1	-1.0	19.2	20.3	1.1	11.7	11.7	0.0
Total central transfers	3.1	3.1	0.0	6.6	6.9	0.3	3.6	3.4	-0.1	10.3	11.0	0.7	6.4	7.0	0.6
Total expenditure	14.2	13.6	-0.6	17.2	19.1	1.8	14.1	13.8	-0.3	21.7	24.7	3.1	15.0	14.0	-1.1
Expenditure on social services (including rural development)	4.4	4.2	-0.2	8.5	9.2	0.7	6.1	6.0	-0.1	9.1	9.5	0.5	7.5	7.2	-0.4
Expenditure on economic services	2.9	2.9	-0.1	4.2	5.2	1.0	3.0	2.9	-0.1	4.5	7.4	2.9	1.7	1.8	0.1

Source: *Finance Accounts* of respective states, various years. For West Bengal, 2015–16, data have been sourced from the state budget document.

Figure 9: Change in Social Sector Expenditures
(As % of GSDP) (in 2015–16 over 2011–15, actuals)



Source: *Finance Accounts* of respective states, various years. For West Bengal, 2015–16, data have been sourced from the state budget document.

services. Even among the eight relatively more centrally dependent states,[14] in seven states (excluding Jharkhand) expenditure towards social services has been lower than economic services.

Summing Up

Preliminary evidence on the impact of the recommendations of the FFC suggests that there has been an increase in central transfers and social sector expenditures in a number of states in 2015–16, the first year of the FFC award period. Most commentaries on the issue are based on a year-to-year comparison between 2014–15—the last year of the TFC award period—and 2015–16—the first year of the FFC award period. Additionally, these comparisons are between actuals and revised estimates or revised estimates and budget estimates between 2014–15 and 2015–16.

This paper makes two contributions. First, using union and state budgets, we show that the increase in central transfers seems higher if one uses 2014–15 as the base year for comparison rather than other years of the TFC. Second, we revisit questions on the net gain in central transfers in states and how social sector expenditures have fared in states in the first year (2015–16) following the FFC recommendations. In doing so, we use the average of the period 2011–15 as the base for comparison with 2015–16, the first year after the implementation of FFC recommendations. We also examine the relative priority that the states have given to the social services and the economic services in the first year of the FFC award period.

Our analysis suggests that the magnitude of gains from central transfers at the state-level is much lower than what is reported in earlier studies. Despite a significant increase in tax devolution, the share of states in the GTR of the union government was lower in the first year of the FFC period than the average of the TFC period due to a contraction in grants. Although grants from the union government for social sectors have fallen in most states, a number of states have compensated for this fall and increased social sector expenditures. However, expenditures on social services have received a lower priority over expenditures on economic services in the first year of the FFC award period.

The observations made in this paper are a preliminary exploration of the changes in central transfers and social sector expenditures following the recommendations of the FFC. It is likely that 2015–16, the first year of the FFC period, was a year of transition to a new regime of centre–state fiscal relations after the recommendations of the FFC. Over the medium term, the direction of change following the FFC recommendations may play out differently, and from that perspective, trends in the first year only provide an early glimpse of the emerging scenario.

NOTES

1 The shares of 32% to 42% are not strictly comparable. The 32% recommended by the Thirteenth Finance Commission (TFC) was for meeting states' non-plan revenue expenditure alone. The 42% recommended by the FFC was meant for meeting expenditure needs of the revenue account of states (which includes both plan and non-plan). Even if one uses comparable figures, the increase in aggregate transfers to states is likely to be of the order of 3%–4%.

2 The limited fiscal space with the union government for increasing the share of aggregate transfers to states has been pointed out in Finance Commission (2015, Vol 1, p 90).

3 The term "horizontal distribution" refers to the inter se distribution of funds among states. This distribution is done based on a formulae recommended by the Finance Commission. The formulae determines the share of each state in the total pie of resources for states out of the divisible pool.

4 These grants were being released directly to implementing agencies.

5 It may be noted that revised estimates are based on actual figures for at least three quarters of the financial year, and estimates for the fourth quarter.

6 The 2015–16 figures for West Bengal are an exception. As *Finance Accounts 2015–16* for West Bengal is not yet released, actual figures used for that year for West Bengal are as reported in the state budget. Telangana was carved out of Andhra Pradesh in June 2014. The accounts of these states are therefore, not comparable prior and after 2014–15. The two states have, therefore, been excluded from this analysis.

7 Gross tax revenue (GTR) of the union government in this analysis is net of cost of tax collection.

8 GSDP figures for all states are based on 2011–12 series (except West Bengal). For West Bengal, GSDP figures corresponding to 2011–12 series are not available. For West Bengal, therefore, GSDP figures are based on 2004–05 series.
Notably, we use the average for 2011–15 and exclude 2010–11 from the analysis. This is because comparable GSDP data for 2010–11 are not available.

9 Here, untied transfers include states' share in taxes, normal central assistance, revenue deficit grants, and grants for compensation to states for value added tax/central sales tax. Tied transfers include all transfers excluding those included in untied transfers.

10 Tied plan transfers at the state level refer to all plan grants other than normal central assistance.

11 Social sector in this analysis includes expenditure under the budgetary heads of "social services" and "rural development." Correspondingly, "economic services" here excludes "rural development." We include "rural development" in social sector as much of the employment generation and poverty alleviation schemes are included under this head.
Grants provided to states out of the Backward Regions Grant Fund (BRGF) are included in social sector grants as these are predominantly used for social services and rural development.

12 The magnitude of increase in social sector expenditure is lower, if one uses the average of 2011–15 as the base for comparison rather than 2014–15 alone.

13 The eight relatively more centrally dependent states include Bihar, Uttar Pradesh, Jharkhand, Chhattisgarh, Madhya Pradesh, Rajasthan, Odisha, and West Bengal. In these states, central transfers constitute a relatively high proportion of total revenue receipts of states.

14 These include Bihar, Uttar Pradesh, Jharkhand, Chhattisgarh, Madhya Pradesh, Rajasthan, Odisha, and West Bengal.

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