Issues and Challenges for the 14^{th} Finance Commission

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The Indian Constitution provides a federal structure to the nation which is often noted as a federalism with strong 'unitary features'. Part XI of the Constitution provides the framework for the power distribution between the federal government (the Centre) and the States. However, similar to many federal Constitutions, the Indian Constitution is also characterised by an imbalance between the functional responsibilities and the financial powers at different levels of government. In terms of the nature and quantum of intergovernmental transfer of resources between the national and sub-national governments, there have been a number of contentions in India's fiscal architecture. The Indian Constitution vests the Centre with greater powers of taxation and also provides for an institutional mechanism to determine the share of the States in the Central tax revenues. The Constitution provides for the Finance Commission (FC) in Article 280 in order to facilitate the mechanism of these transfers and therefore correct this imbalance. This constitutes one of the most important functions of the FC. In deciding on the devolution of taxes and the provision of grants, the FC is required to address the vertical imbalance (between the Centre and the States) and also the horizontal imbalance, i.e. the one between the States with varying fiscal capacities but similar responsibilities in the provision of public services. The FC is formed once every five years, and currently the centre-state sharing of resources are being guided by the recommendations of the 13^{th} FC (2010-2015). The 14^{th} FC, announced in 2013, with Shri Y. V. Reddy as its Chairman, has already embarked upon its task for formulating recommendations for the period 2015-16 to 2019-20.

In the last two decades a major issue that has evolved in the existing debates and discussions regarding the transfer of resources to the states has been that of a reversed tendency of accentuated powers with the Centre and reduced fiscal autonomy along with a policy roadmap of stringent fiscal consolidation at the sub-national level being pursued by the Union Government. The growing role of the Planning Commission, rise in the number of Centrally Sponsored Schemes and transfer of resources to States tied to the broad / specific objectives of the Central Ministries have been the basis for regular criticism of the Central Government. One of the main reasons for the States to perceive the transfers recommended by the Planning Commission as tied funds is that the proportion of Normal Central Assistance (the formula-based component of the *Central Assistance for State & UT Plans*) in the Gross Budgetary Support of the Centre for the national Five Year Plan has been only around 10 percent in the 11^{th} Plan as well as in the 12^{th} Plan.

In such a backdrop, the FC has been looked upon by the States as the main source of untied transfers comprising the States' share in central taxes and statutory Grants-in-aid. However, it has been noted in several commentaries by the policy experts that rising tendencies of centralization has not been restricted only to transfers made by the Planning Commission. In the last decade, FC transfers have also been showing similar tendencies. The broader trends in devolutions from Centre to States show that the

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ratio between Non-plan grants and Plan grants has declined substantially, indicating the increase in the tied nature of fund transfers to States.

The trends of central transfers to States show that while grants as a proportion of Gross Devolution and Transfers (GDT) have increased slightly over the last two decades, Non-plan grants as a proportion of both total grants as well as GDT have displayed stagnation. While Plan grants have been increasing during this period, the Non-plan grants, which form bulk of the untied transfers to States, have declined thus imposing restrictions on States in their expenditure decisions. Therefore, the contention of vertical resource sharing by the Centre and States in a manner to uphold the federal nature is one of the major challenges being faced by the 14th FC.

The other important factor affecting the governance and quality of services offered by States is directly linked to the above contention and is supposedly another important matter which needs the intervention of the 14th FC. The roadmap of fiscal consolidation and increased transfers with conditionalities has created several restrictions on the States in terms of recruitment of regular cadre staff in the State Government departments in sectors like, education, health, water and sanitation, rural development and agriculture, among others. This is one of the main factors affecting the coverage as well as quality of government interventions in these crucial sectors across many States. It is important to note here that the problem of staff shortage is likely to be more acute in skilled / technical staff positions (including all three kinds of such staff, viz. programme managerial staff, finance and accounts staff, and skilled service providers) than the unskilled / support staff positions. Moreover, the extent of shortages, as depicted by several government data sources, are with reference to the number of posts sanctioned in different States, which is likely to be dated in many cases.

A probable reason for this problem of shortage of staff has been the attempt to eliminate the Revenue Deficit (and even show a Revenue Surplus, in some cases) by the States in order to perform better in the count of fiscal capacity. Such measures seem to have checked the levels of long-term expenditure commitments of the State governments by freezing the recruitments in regular cadres of their departments for more than a decade now. In the prevailing fiscal architecture in the country, the Finance Commission is the only institution, which can address this concern of the State Governments to make long-term expenditure commitments on staff / human resources. Hence, the Fourteenth Finance Commission needs to pay attention to this problem and explore the possible remedies in the domain of sharing of untied resources with State Governments as well as the kind of 'fiscal consolidation' strategies that State Governments should follow during 2015-16 to 2019-20.

The final challenge faced by the 14th FC relates to elementary yet the most contentious issue of equalisation among States apart from the fundamental principles governing the financial relations between the Centre and the States. As mentioned, while it is important to address the existing vertical imbalance, it is equally vital to reduce the horizontal imbalance as both complement each other. The inter-State inequality on account of differences in fiscal capacity is compounded by two major factors. The States with low income levels are also the ones with large population. It implies greater transfers of additional resources if there has to be an impact on equalisation. Further, some States have certain geographical and climatic factors that have extra cost implications for the Centre. Therefore, an explicit equalisation methodology needs to be developed to tackle this systemic problem, which then forms the third major challenge for the 14th FC. In order to achieve this, the current FC needs to first take a call on whether to accept the States' preference of increased revenue-sharing, rather than provide for more Grants-in-aid in the scheme of transfer of funds. Although this point has been a major contention for almost all the FCs constituted so far, it has also remained the most ticklish problem for all of them. Finding a suitable solution therefore constitutes a herculean task for the Commission.