GOVERNMENT OF INDIA
MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS

EXPLANATORY MEMORANDUM AS TO THE ACTION TAKEN ON THE RECOMMENDATIONS MADE BY THE FOURTEENTH FINANCE COMMISSION IN ITS REPORT SUBMITTED TO THE PRESIDENT ON DECEMBER 15, 2014

1. The Fourteenth Finance Commission (hereafter referred to as the Commission) was constituted by the President on January 2, 2013 to give recommendations on specified aspects of Centre State fiscal relations during 2015-20. The Commission submitted its report to the President on December 15, 2014 covering all aspects of its mandate.

2. The report of the Commission (hereafter referred to as the Report) covering the five year period commencing from April 1, 2015, together with this Explanatory Memorandum on the action taken on the recommendations of the Commission is being laid on the Table of the House, in pursuance of Article 281 of the Constitution. Summary of the main recommendations of the Commission relating to the sharing of net proceeds of Union taxes between Centre and States, grants-in-aid of revenue of States under Article 275, Goods and Services Tax (GST), financing of relief expenditure and other recommendations are contained in Chapter 18 of the Report of the Commission.

3. As per the Constitution, "Cooperative Federalism" is the bedrock of financial governance in the Country. Union and the States pool their resources for achieving common National goals.

4. To achieve these National goals, Centrally sponsored schemes were envisaged in the areas of Health, Education, Agriculture and Rural development etc. However, over a period, rigidity involved in these schemes did not allow them to meet the local requirements of the States. Various State Governments have expressed the sentiments that greater flexibility and autonomy is required in the design, implementation and financing of schemes. States further indicated that this is necessary to address region specific requirements. These concerns have been noted by the Finance Commission in paras 8.6 and 8.7 of its report as follows:

> "8.6: *Another dominant view has been that a majority of the resources should flow in the form of tax devolution---* "
>
> "8.7: *An overwhelming majority of States have suggested reducing the number of CSS as well as outlays on them---.* "

5. Idea of "Team India", to achieve National goals is to allow States greater freedom in tailoring the schemes as per their requirements and financing.

6. In this context, as per the recommendations of XIV Finance Commission, Union Government has decided to devolve a much higher share of 42% of Union's net tax receipts, to the States. In comparison to 2014-15, this will be a significant enhancement of 10%, over the 32% during the award period of the XIIIth Finance Commission. As against a total devolution of Rs.3.48 lakh crores approximately in 2014-15, the total devolution to the States in 2015-16 will be Rs.5.26 lakh crores approximately, a year-on-year increase of Rs.1.78 lakh crores approximately. The higher tax devolution will allow States greater autonomy in financing and designing of schemes as per their needs and requirements.

7. It is expected that with this change in the sharing pattern, concerns of the States of asymmetry in fiscal federal relations will be addressed. It is hoped that the States will use the extra fiscal space available to them to create productive capital assets, and that "Team India" in NITI will provide the required guidance and monitoring in this regard.

8. The Government has carefully examined the main recommendations of the Commission. The action to be taken on these recommendations is detailed below.

Sharing of Union Taxes

9. The Commission has recommended that for its award period, the share of States in the net proceeds of Union taxes may be fixed at 42%. The Commission has also recommended on the inter-se distribution of the States' share amongst the States. The details of the formula for inter-se distribution and the corresponding share of each State recommended by the Commission are indicated in Chapter 8 of the Report.

Dissent Note

10. There is a dissent note by Prof Abhijit Sen (Part time member) suggesting tax devolution of 38 per cent of the divisible pool in the first year of the award period and maintained at that level unless there is agreement in the new institutional mechanism to revert to 42 per cent share. Consequently, Prof Sen recommended change in Post devolution Revenue deficit grants.

The Government has accepted the majority decision regarding Tax devolution to States

Grants -in-Aid of Revenues of States under Article 275 of the Constitution

11. The Commission has recommended Grants-in-aid of revenues of States for revenue deficit, local bodies and disaster management under Article 275 of the Constitution.

Revenue Deficit Grant

12. The Commission has assessed the revenues and expenditure of the States for the period 2015-20 and has projected the deficit for each State after taking into account the amount of share in Central taxes for that State. The Commission has recommended a grant of Rs.1,94,821crore to meet this deficit of eleven States. The amount of grant recommended for each state year-wise is indicated in Chapter 11 of the Report.

The Government has accepted the above recommendations "in principle". The Grants-in-aid to be subject to the Revenue raising and fiscal consolidation measures undertaken by the States. Appropriate institutional arrangements shall be put in place to assess and advice Government for making Post devolution Revenue deficit Grants-in-aid.

Local Bodies

13. The Commission has recommended that local bodies should be required to spend the grants only on the basic services within the functions assigned to them under relevant legislations. It has been recommended that distribution of grants to States for local bodies using 2011 population data with weight of 90% and area with weight of 10%. The grants to States will be divided into two parts, a grant to duly constituted Gram Panchayats and a grant to duly constituted municipalities on the basis of urban and rural population. The Commission has worked out a total grant of Rs.2,87,436 crore for the period 2015-2020. Inter-se share of each state including weights assigned for each state in respect of local bodies grant is indicated in Chapter 9 of the Report. The Commission has recommended grants in two parts – a basic grant and a performance grant for duly constituted Gram Panchayats (Rural Local Bodies) and Municipalities (Urban Local Bodies). The ratio of basic to performance grant is 90:10 with respect to Gram Panchayats and 80:20 with respect to Municipalities.

13.1 For Gram Panchayats, the Commission has recommended a basic grant of Rs.1,80,262.96 crore and performance grant of Rs.20,029.22 crore for all the states.

13.2 For Municipalities, the Commission has recommended a basic grant of Rs.69,715.03 crore and performance grant of Rs.17,428.76 crore for all the states.

The Government has accepted the above recommendations.

Disaster Relief

14. The Commission has reviewed the existing arrangement of financing relief expenditure in light of the Disaster Management Act, 2005 and likely implementation of Goods and Services Tax (GST) and has recommended an amount of Rs.61,219 crore as aggregate corpus of State Disaster Relief Fund (SDRF) for all States for the award period and that States contribute 10% (Rs.6,122 crore) to SDRF during the award period with the remaining 90% (Rs.55,097 crore) coming from the Union Government. The Commission has recommended that up to 10 percent of the funds available under the SDRF can be used by a State for occurrences which State considers to be 'disasters' within its local context and which are not in the notified list of disasters of the Ministry of Home Affairs. The amount of grant recommended for each state year-wise is indicated in Chapter 10 of the Report.

The Government has accepted the above recommendations with the modification that the percentage share of the States will continue to be as before, and that the flows will also be of the same order (linked to the extent of cess), as in the existing system; and that, once GST is in place, the recommendation of FFC on disaster relief would be fully implemented.

Other Recommendations

15. In addition to the above, the Commission has made recommendations that deal with issues including Goods and Services Tax, Fiscal Environment and Fiscal Consolidation Roadmap, Pricing of Public Utilities, Public Sector enterprises and Public Expenditure management.

These recommendations will be examined in due course in consultation with various stakeholders.

Implementation

16. Orders on the recommendations under Articles 270 and 275(1) of the Constitution relating to share in Union Taxes and duties and Grants-in-aid, respectively, will be issued after obtaining the approval of the President. Other recommendations of the Commission will be acted upon in due course.

New Delhi
February 24, 2015

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Minister of Finance