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*TOPIC*

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***FINANCE COMMISSION TRANSFERS  
& EQUITY ISSUE***

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## FINANCE COMMISSION TRANSFERS & EQUITY ISSUE

### Context

- The recommendations of **16th Finance Commission (FC)** triggered debate over fiscal autonomy of states, equity and efficiency in resource distribution and growing concerns over political and demographic implications after delimitation.

### About Finance Commission and Fiscal Federalism in India

- The **Finance Commission** is a **constitutional body** established under **Article 280** of the Indian Constitution.
  - It recommends distribution of net tax proceeds between Centre and States (**vertical devolution**), allocation among States (**horizontal devolution**), grants-in-aid under Article 275, and measures to augment State finances.
- Fiscal Federalism in India:** Fiscal federalism refers to the financial relations between different levels of government. It ensures cooperative federalism, promotes balanced regional development, strengthens decentralised governance, and supports social sector expenditure.
  - Correct Vertical Imbalance:** Centre has greater taxation powers, and states have greater expenditure responsibilities.
  - Correct Horizontal Imbalance:** Differences in fiscal capacity among States.

### Key Recommendations of the 16th Finance Commission

- Retention of 41% Vertical Devolution:** The 16th FC retained the States' share at **41%** of the divisible tax pool, continuing the arrangement of the 15th FC.
  - The **reduction from 42% (14th FC)** was due to creation of the Union Territory of Jammu & Kashmir.
- Continued Emphasis on Equity:** The FC retained the philosophy of redistribution toward fiscally weaker States.
  - Major Criteria and Weights:** Income Distance (42.5%); Population (17.5%); and 10% each to Area, Forest & Ecology, Demographic Performance, and Contribution to GDP.
- Introduction of GDP Contribution Criterion:** Replaced the earlier **tax effort criterion**.
  - However, actual GSDP shares were modified using a **square-root transformation**, reducing the advantage of richer States.
- Removal of Certain Grants:** The FC abolished revenue deficit grants, sector-specific grants, and state-specific grants.
  - States were advised to end off-budget borrowings, bring liabilities onto budget books, and maintain fiscal deficit below 3% of GSDP.

Key Changes in the 16th FC Compared to the 15th FC		
Aspect	15th FC	16th FC
Vertical Share	41%	41% retained
Tax Effort Criterion	Included	Replaced by GDP contribution
Demographic Criterion	Inverse fertility rate	Population growth
Equity vs Efficiency	75:25	70:30
Grants	Revenue deficit & sectoral grants	Mostly abolished
GDP Weight	Limited	Introduced but diluted via square-root formula

### Major Concerns Facing the Finance Commission

- **Rising Use of Cesses and Surcharges:** Cesses and surcharges are **not shareable** with States under Article 270.
  - ♦ Their share exceeded 15% of gross tax revenues.
  - ♦ States demanded inclusion in the divisible pool, or capping at 8–10%.
  - ♦ It reduces actual transfers despite nominal devolution.
- **Shrinking Fiscal Space of States:** States face multiple pressures:
  - ♦ **GST-related Constraints:** Loss of taxation autonomy, and rate rationalisation reduced revenue flexibility.
  - ♦ **COVID-19 Impact:** Increased welfare expenditure, lower revenues, and rising debt burden.
  - ♦ **Centrally Sponsored Schemes (CSS):** Increasing tied expenditure, and reduced flexibility.
- **Equity vs Efficiency:** Heavily weighted toward redistribution and income equalisation.
  - ♦ Southern and industrial States argue efficient governance is penalised, population control efforts are ignored, and high tax contributions not adequately rewarded.
  - ♦ **Share of southern States declined:** From 24.8% (6th FC period) to 15.8% (15th FC period).
  - ♦ Meanwhile, beneficiary States' share rose significantly.
- **Persistent Regional Disparities:** Despite higher transfers, poorer States still lag in public services.
  - ♦ **Health Expenditure (2022-23):** Bihar (937 per capita), and Arunachal Pradesh (10,148).
  - ♦ **Education Expenditure:** Bihar (20,282 per student); and Sikkim (1.3 lakh per student).
- **Political Economy and Delimitation Concerns:** India's economically stronger States are not always politically dominant in Parliament.
  - ♦ Post-delimitation, states with larger populations may gain greater representation, and could influence future fiscal transfers.
  - ♦ It raises concerns regarding fiscal fairness, cooperative federalism, and political neutrality of redistribution.

### Way Forward

- **Alternative Devolution Models:** Greater weight should be assigned to fiscal contribution and economic efficiency.
  - ♦ If GDP contribution had been received, Maharashtra, Karnataka and Tamil Nadu would have received substantially higher shares.
- **Rationalise Cesses and Surcharges:** Cap cesses and surcharges at a reasonable limit (8–10% of gross tax revenue), include part of these collections in the divisible pool, and increase transparency and parliamentary oversight over cess utilisation.
- **Increase Fiscal Autonomy of States:** Reduce tied grants and increase untied transfers, allow greater flexibility in scheme design, and strengthen State taxation powers under GST framework.
- **Balance Equity with Efficiency:** Future Finance Commissions should give higher weight to tax effort, fiscal discipline, human development outcomes, capital expenditure efficiency, and ease of doing business indicators.
- **Adopt Data-Driven and Scientific Formulae:** Use objective statistical methods such as Principal Component Analysis (PCA), composite fiscal performance indices, and outcome-based evaluation metrics.
- **Strengthen GST Compensation and Revenue Stability:** Ensure timely GST compensation, broaden GST base, improve compliance through digital systems, and create a permanent GST stabilisation mechanism.
- **Encourage Fiscal Responsibility Without Excessive Austerity:** Continue fiscal responsibility targets, but allow calibrated flexibility for capital expenditure, climate resilience, health and education investments.
  - ♦ Fiscal consolidation should not compromise developmental expenditure.
- **Reform Centrally Sponsored Schemes (CSS):** Rationalise the number of schemes, increase flexibility in implementation, and differentiate contribution ratios based on States' fiscal capacity.

- **Incentivise Outcomes Rather than Population Size Alone:** Reward States for population stabilisation, better learning outcomes, health indicators, environmental conservation, and revenue mobilisation.
- **Strengthen Local Governments:** Increase predictable grants to Panchayats and Urban Local Bodies, improve local revenue mobilisation, and build accounting and auditing capacity.
- **Safeguard Fiscal Federalism After Delimitation:** Ensure FC recommendations remain insulated from political pressures, use objective fiscal indicators rather than purely demographic factors, and maintain constitutional neutrality in resource allocation.

#### Daily Mains Practice Question

[Q] 'The recommendations of successive Finance Commissions of India have intensified the debate between equity and efficiency in India's fiscal federalism'. Examine in the context of the 16th Finance Commission's transfer formula and concerns raised by fiscally stronger States.

Source: TH

