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DAILY EDITORIAL ANALYSIS

TOPIC

FISCAL FEDERALISM: EFFICIENCY VERSUS EQUITY CONCERNS

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Context

- The **16th Finance Commission** under the chairmanship of **Dr Arvind Panagariya** published its report for **2026–31.** It recommended radical reforms in tax devolution and grants, sparking disputes on **fiscal federalism, equity and Centre–State relations.**

About the Finance Commission in India

- The **Finance Commission (FC)** is a **constitutional body** formed under **Article 280** to recommend the devolution of financial resources between the Union and the States.

How States' Shares Are Decided

Population	Per capita distribution of tax revenues should be as uniform as possible
Area Adjusted	States with large inaccessible tracts need additional money
Forest Cover	Forest as % of total area
Infrastructure Index	States with less developed social and physical infra get more funds
Income Distance	Distance of a state's income from the income of the richest three states, adjusted for the state's population
Fiscal Capacity Distance	Distance between a state's per capita tax capacity and that of the highest-performing state
Tax Effort	Measures taken by states to increase tax collections
Fiscal Discipline	Efforts by states to control spending or raise revenues
Demographic Performance	Reward for state with lower fertility, counter balances population criterion
Contribution to GDP	Share of a state's GDP in all states' combined GDP, a new criterion

- It aims to promote **cooperative fiscal federalism**, eliminate vertical and horizontal fiscal imbalances and ensure that States are endowed with appropriate resources to perform their constitutional obligations.

Constitutional Basis

- **Article 280:** It provides for the constitution of the Finance Commission every five years by the President.
- **Article 270:** It governs the distribution of taxes between the Centre and States.
- **Article 275:** It empowers the Union to provide **grants-in-aid** to States requiring financial assistance.
- **Article 281:** It requires the President to place the Commission's recommendations before Parliament with an explanatory memorandum.

16th Finance Commission (FC-16)

- **Objective:** Recommend tax devolution, grants-in-aid and initiatives to enhance budgetary sustainability and **local governance.**
- It maintains the States' share in the **divisible pool at 41%**, as recommended by the 15th Finance Commission.

Formula for horizontal devolution (16th Finance commission)

Criteria	Weight (%)
Population (2011)	17.5
Demographic Performance	10.0
Area	10.0
Forest	10.0
Per Capita GSDP Distance	42.5
Contribution to GDP	10.0
Total	100.0

Major Recommendations of FC-16

- **41% Vertical Tax Devolution Retained:** States' share has been retained at 41% when several States had demanded it to be raised to 50%.
- **Major Restructuring of Grants-in-Aid:** Total grants reduced to **₹9.47 lakh crore** (from **₹10.1 lakh crore** under FC-15).
    - Share of grants in total Finance Commission transfers declines from **19.4% to 8.3%**.
    - Revenue Deficit Grants (RDGs), sector-specific grants, and State-specific grants have been discontinued.
    - Grants are largely confined to local bodies, and disaster management.
- **Greater Focus on Performance-Based Transfers:** Local bodies have been allocated around **Rs 7.2 lakh crore.**
    - Funds will be disbursed against conditions such as water and sanitation outcomes, revenue mobilisation and properly audited accounts.
- **Devolution Formula Changes:** Income Distance weighting reduced from **45% to 42.5%.**
    - **10% weight given for contribution to GDP,** rewarding the economically stronger States.
- **Cesses and Surcharges:** Recommends a **'grand bargain'** to absorb cesses into the divisible pool gradually, without suggesting any binding rollback.

Key Concerns

- **Weakening the Equalisation Role:** The discontinuation of **Revenue Deficit Grants (RDGs)** is a big shift.
    - Grants under **Article 275** were meant to take care of State-specific fiscal impediments which cannot be taken care of by way of devolution of taxes on a formula basis.
- **Efficiency Above Equity:** The Commission considers that equalisation can be replaced with improved fiscal discipline. Nevertheless, States vary considerably in fiscal capability, geography, degrees of development and demographic and social sector duties.
    - It can deepen regional inequality.
- **Disadvantaged States to Suffer Double Whammy:** Some of the States, notably in the **North-East** and those under budgetary difficulties like **West Bengal,** may suffer from reduced tax devolution and loss of compensatory subsidies.
    - This, along with a lower weight on income distance, could worsen existing fiscal hardship.
- **Asymmetry in Fiscal Discipline:** The Commission has been lenient to **cesses and surcharges** that are outside the divisible pool and lower the States' share of central income, whereas RDGs have been abolished on the grounds of **avoiding moral hazard.**
- **Fiscal Autonomy Reduced:** performance-linked payments boost accountability but also conditionality, restricting states autonomy in setting expenditure priorities.

Way Forward: Strengthening India's Fiscal Federalism

- Targeted funds to States with structural disadvantages should be retained **to restore the principle of equalisation.**
- **Balance efficiency and equity,** such that incentives do not offend constitutional obligations to cooperative federalism.
- **Rationalise cesses and surcharges** by gradually including them in the divisible pool to improve transparency and fairness.
- **Improve horizontal fairness** by using devolution criteria that adequately reflect fiscal capacity, geography and development gaps.
- **Enhance the budgetary autonomy of States**, but provide accountability through outcome-based monitoring and not through excessive conditionalities.
- **Adopt a differentiated strategy** that rewards good performance by States, without penalising those who are bound by historical or structural constraints.

Daily Mains Practice Question

[Q] Critically examine the emerging tension between performance-based fiscal transfers and the equalisation principle in Indian fiscal federalism.

Source: TH

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