

## **A case for enhancing the fiscal space of states by increasing the base and size of finance commission grants**

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### **Abstract**

*There exist vertical imbalances in resource sharing between the Union government and the states governments in India. This has serious implications for state finances and leads to fiscal crisis particularly in developed states. The share of FC grants in total grants in aid to the states has been declining while there is an increase in the conditional grants. States are different in terms of their development and other structural patterns, the uniform conditional grants in the form of Centrally Sponsored Schemes (CSS) provided by the Union government are not useful for already developed states. There is a strong need for increasing the share of FC grants that can substitute the loss in the tax share to the states from the devolution. Mere increase in the share of FC grants will not resolve the current fiscal problems of the states. This could be addressed by increasing the base and size of the FC grants.*

### **Introduction**

A pressing issue in India's fiscal federal landscape that demands due attention is the declining share of Finance Commission (FC) grants to states. Its share in total central transfers to the states plummeted from 6% to a mere 3.6% over a decade as per the revenue receipts data 2023-24. Total central transfers of the fiscal resources include tax devolution, FC and non-FC grants. They are considered the Indian states' lifeline owing to their unconditional nature,

meaning FC grants provide states with the autonomy to allocate funds according to their specific requirements. The major fall in FC grant's share and its small size in overall transfers have far-reaching implications for the state finances. It also distorts the transfer dynamics, leading to fiscal contention between the Union and the state governments. Besides, the fiscal imbalance may escalate under the existing transfer mechanism as there is a stark mismatch between the expenditure responsibilities and resource generation capacity between the union and state governments. Therefore, in the wake of the 16th Finance Commission finalizing its report, the critical matter of the dwindling share of FC grants must be addressed to enhance states' autonomy.

### **Changing patterns of fiscal federal resource allocation**

Recent years have witnessed significant shifts in the pattern in which the union government disburses federal resources to the states. The central share of taxes, through tax devolution, commands the largest share in total transfers, followed by non-FC and FC grants. Tax devolution to the states hovered around 21% to 28% of the total resource transfers while FC grants have considerably decreased from 6% to 3.6% during 2009-10 to 2022-23. On the other hand, non-FC grants, particularly grants for Centrally Sponsored Schemes (CSS) have risen from 13.4% to 17.2% during the same period. Notably, the non-FC grants are conditional, discretionary, or tied in nature, giving nil autonomy to the states. The increasing share of conditional grants is clear evidence of an increasing tendency toward centralization rather than decentralization. It poses a significant threat to the fiscal federal landscapes of the country.

### **Dwindling share of FC grants**

FC grants are crucial because they are largely unconditional, allowing states flexibility in their use. However, their continuously declining share portrays a disturbing picture of India's fiscal federal framework. Out of the total grants in aid, FC grants now account for only 17.4% of total central grants to states while the non-FC grants which are often conditional, make up 82.6% (Table 1). Despite constitutional provisions stipulating that grants-in-aid should come from the Consolidated Fund of India (CFI), the Finance Commissions have been allocating these grants from the divisible pool. The divisible pool is the source from which the states receive their share of fiscal resources from the Union government. The 14th FC set aside only 5.72% of this pool for grants in aid to the states, while the 15th FC increased this allocation to 10.03%. Under this allocation, the share of non-FC grants which are conditional

has been rising. During the 14th FC tenure, conditional grants comprised 16% of the divisible pool, increasing to 19% under the 15th FC. These conditional grants pose a challenge for states, as they are earmarked for specific purposes, limiting states' ability to allocate funds according to their unique development needs and priorities. This lack of flexibility can hinder states' capacity to address their most pressing issues effectively.

**Table 1:** Share of FC and non FC Grants from the Union to the States (Percentage)

Year	FC grants/Total grants	Non-FC grants to total
2009-10	470 87 (31.2)	103886 (68.8)
2010-11	48909 (29.9)	114588 (70.1)
2011-12	52199 (28.0)	134217 (72.0)
2012-13	48395 (25.6)	140286 (74.4)
2013-14	67133 (32.6)	138819 (67.4)
2014-15	71447 (21.6)	259358 (78.4)
2015-16	84579 (26.0)	241317 (74.0)
2016-17	95550 (26.8)	260541 (73.2)
2017-18	92244 (22.7)	313713 (77.3)
2018-19	93704 (21.3)	346165 (78.7)
2019-20	123710 (23.1)	410858(76.9)
2020-21	184063 (28.6)	459778 (71.4)
2021-22	207435 (33.3)	415193 (66.7)
2022-23 (A)	172760 (19.7)	705011 (80.3)
2023-24(RE)	140429 (17.4)	665546 (82.6)

*Source: Calculation from RBI's e-STATE database*

### **A case for increasing the base of FC grants**

The constitution of the 16th Finance Commission is in a period where the states grapple with mounting fiscal pressures, hence the call for enhanced FC grants grows louder. With the growing Vertical Fiscal Imbalance (VFI), shrinking divisible pool, contracting volume of Finance Commission grants, and increasing share of discretionary transfers, the woes of state finances have worsened in recent times. The loss of fiscal autonomy due to paradigm shifts in tax regimes like the Goods and Services Tax (GST) exacerbated the concerns. Intriguingly, the post transfers through devolution and grants in aid, the revenue retained by the union government comes to around 50% while the state governments have disproportionately higher expenditure responsibilities than the union government. While states shoulder a whopping 62.4% of expenditure responsibilities, their revenue-generating capacity stands at a mere 37.3%. In stark contrast, the Union government, with only 37.6% of expenditure duties,

commands a formidable 62.7% of revenue capacity. This disparity has set the stage for a fiscal tug-of-war, with states increasingly finding themselves on the losing end. With the declining share of unconditional FC grants, these imbalances further exacerbate.

Though there is an increase in the FC grants as a share of divisible pool from 14th to 15th FC, its share in total grants from the Union declines (Table 2). Since the FC grants have to be distributed from the Consolidated Fund of India, there is much scope for increasing its share. Due to the prominence of conditional non-FC grants, there is a considerable wedge between the states' requirements and transfers. For instance, the state of Kerala submitted in its memorandum, a grant request across 38 categories to the 14th FC, however it received only grants for a mere four items. This disconnects between state needs and central allocations underscore the urgency for a more responsive grants system.

**Table 2:** Transfers recommended by the 14th and 15th FCs

Categories	14 <sup>th</sup> FC		15 <sup>th</sup> FC	
	Amount (crore)	As a % of divisible pool	Amount (crore)	As a % of divisible pool
Divisible pool	9400444		10304292	
Total transfers to states	4485541	47.72	5257822	51.03
Tax share	3948187	42	4224760	41.00
Grants from FC	537354	5.72	1033062	10.03
Fiscal Space for Union Govt	4914903	52.28	5046470	48.97
Provision of other transfers to states	1477943	15.72	1966199	19.08
Total grants from the Centre	2015297	21.44	2999261	29.11

Source: Union Finance Commission Reports (14 & 15)

### Way forward

As India looks to the 16th Finance Commission, the opportunity for meaningful reform presents itself. There is an urgent need to argue for a recalibration of the FC grants system advocating for the increasing share of FC grants relative to conditional allocations. This will enhance the states' autonomy and cater to the specific development needs of the state. Expanding the base for FC grants to include gross revenue or the Consolidated Fund of India is another recommendation that requires immediate attention. It is also justified by the growing revenue kitty of the union government. By increasing the share of FC grants, there will be greater alignment between state-specific needs and grant allocations. Addressing these concerns, the 16th FC could play a pivotal role in bridging the widening resource gap

between the Union and state governments, nurturing a more equitable and efficient federal financial structure. As the debate unfolds, one thing remains clear that the future of India's fiscal federalism hangs in the balance, with the potential to reshape the nation's economic landscape for years to come.

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