

Toward equity in fiscal transfers: Rethinking the criteria for horizontal devolution

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Abstract

The 16th Finance Commission faces the critical task of addressing the persistent issue of horizontal imbalances in the distribution of resources among Indian states. These imbalances, embedded in the design of the devolution formula, have had significant implications for the share each state receives from the central tax pool. This article critically examines the key criteria employed by the 15th Finance Commission, highlighting the structural inequities and unintended consequences, pointing out the unfairness these criteria have caused.

1. Introduction

The 16th Finance Commission (FC) is tasked with addressing the enduring challenge of horizontal imbalances in the distribution of central resources among Indian states. These imbalances, rooted in the formula used for tax devolution, have significant implications for the fiscal autonomy and developmental prospects of states. The Fifteenth Finance Commission adjusted the methodology for determining states' shares by incorporating broader considerations of fiscal needs, equity, efficiency, and performance. It assigned weightages as follows: 45% to income distance, 15% each to population and area, 10% to forest and ecology, 12.5% to demographic performance, and 2.5% to tax and fiscal efforts. Notably, the Commission shifted the population base from the 1971 census to the 2011

census, aiming to reflect contemporary demographic realities. A critical evaluation of the criteria adopted by the 15th Finance Commission reveals how the current devolution mechanism affects state shares, often to the disadvantage of certain states due to inherent structural biases. This article examines the key criteria employed by the 15th FC and explores how these factors have influenced the inter-state allocation of resources by highlighting the inequities these criteria have generated.

The population criterion: Double-edged impact

Population is a foundational factor in the Finance Commission's resource allocation framework. It ensures that states receive resources proportional to their population size and needs, but it also serves as a major determinant of each state's share of the divisible pool of central taxes. Six Hindi-belt states, with 42.85% of India's population, receive 48.57% of the tax pool for 2021-26. In contrast, five southern states, with 21.32% of the population, get only 15.8%, while western, eastern, and northern states, with 30.61%, receive 25.31%. Northeastern and Himalayan states, with 5.32%, get 10.48%. These allocations reveal the disparities in tax distribution, emphasizing for a more equitable framework that adequately addresses the varying needs of all states (Govind Bhattacharjee ;2021)

The effect of population on resource distribution is twofold. On one hand, states with slower-growing populations see a reduction in their percentage share. As India's population has shifted over the decades, particularly in southern states, those with better-controlled population growth are now receiving a smaller share relative to others. On the other hand, population acts as a scaling factor for most other criteria used by the Finance Commission. In fact, about 75% of the transfers either directly or indirectly are influenced by population size. This makes the criterion a key player in shaping resource distribution.

From the 1971 census to the 2011 census: A shift in methodology

The 15th Finance Commission introduced a notable shift by transitioning from the 1971 census to the 2011 census for determining states' fiscal allocations. This was aimed at better reflecting current demographic realities. However, this change has been met with criticism, particularly from states that have successfully managed population growth

To mitigate the backlash, the Finance Commission introduced a new criterion called "demographic performance," with a weight of 12.5%. This criterion seeks to reward states for their efforts in controlling population growth by measuring their Total Fertility Rate (TFR).

States with lower TFRs, indicating better population control, receive a higher score. However, the formula, paradoxically, continues to favour more populous states, raising questions about its effectiveness in truly reflecting states' long-term demographic achievements.

A major concern is that states that controlled their population earlier some as far back as the 1970s might not receive the same level of recognition under this criterion, as the formula relies heavily on contemporary metrics. This raises the question of whether the demographic performance criterion adequately rewards states for their sustained efforts or overlooks their long-term success in controlling population growth. States which have successfully controlled population growth through significant investments in human development, may feel disadvantaged despite their early achievements.

The case for performance-based incentives

While the introduction of the demographic performance criterion is a step in the right direction, its weightage is insufficient to offset the overwhelming influence of population in determining states' shares. Given that 75% of transfers are determined by population, performance-based incentives must be expanded to ensure that states with slower population growth and better human capital development are not unfairly disadvantaged.

One potential improvement could involve incorporating other criteria that reflect states' fiscal needs beyond population size. For instance, factoring in the share of elderly populations could better capture the reduction in fertility and higher life expectancy. Or using the Human Development Index could reflect the unique challenges faced by states with aging populations and higher demands for education or healthcare. These measures would address second-generation problems emerging from demographic shifts, such as the need for increased social spending in states with older populations.

If the Finance Commission's formula is to continue rewarding population control, it must evolve to encompass broader human capital outcomes. By balancing historical achievements in population control with contemporary needs, the formula would align more closely with the principles of fiscal federalism, ensuring a fairer distribution of resources that supports long-term development goals.

Then, regarding tax performance under this criterion of tax effort, States with a higher ratio of Tax/GSDP benefit more based on their tax performance. However, multiplying this ratio

by the 2011 population skews the results in favour of states with larger populations. This results in states like Bihar and Uttar Pradesh appearing to have disproportionately high tax efforts, even if their actual performance might not be as robust as smaller states with better tax collection efficiency. When tax effort is evaluated based on performance criteria alone, states with efficient tax collection like Kerala see significant benefits. However, multiplying by population once again shifts the advantage to states with larger populations. To ensure fair resource allocation, the tax effort calculation should focus solely on performance criteria without multiplying by population. This would more accurately reward states for their tax collection efforts.

Table.1 - Difference in share based on tax effort

As per 15 th FC (%)		Calculation based on Tax effort	
State	Share	State	Share
Uttar Pradesh	18.825	Goa	8.08
Maharashtra	10.546	Telangana	7.55
Bihar	7.651	Chhattisgarh	7
West Bengal	6.682	Uttar Pradesh	7
Madhya Pradesh	6.572	Maharashtra	6.97
Tamil Nadu	6.284	Madhya Pradesh	6.72
Rajasthan	5.645	Karnataka	6.63
Karnataka	5.454	Kerala	6.56
Gujarat	4.83	Andhra Pradesh	6.5
Andhra Pradesh	4.336	Tamil Nadu	6.47
Telangana	3.558	Punjab	6.3
Odisha	3.468	Haryana	6.25
Kerala	2.95	Odisha	6.14
Chhattisgarh	2.406	Rajasthan	6.12
Punjab	2.354	Gujarat	5.94
Jharkhand	2.235	Bihar	5.46
Haryana	2.133	West Bengal	5.44
Assam	2.042	Uttarakhand	5.11
Uttarakhand	0.694	Meghalaya	5.09
Himachal Pradesh	0.467	Himachal Pradesh	5.05
Meghalaya	0.203	Jharkhand	5.03
Tripura	0.176	Assam	4.86
Goa	0.159	Arunachal Pradesh	3.89
Manipur	0.121	Tripura	3.55
Arunachal Pradesh	0.073	Manipur	3.16
Nagaland	0.071	Sikkim	2.93
Mizoram	0.043	Mizoram	2.91

Source: Author's computation based on 15th FC data.

Note: Tax Effort (15th FC): Calculated using the ratio of a state's own per capita tax revenue to its per capita Gross State Domestic Product (GSDP), multiplied by the 2011 census data. Tax Effort (Without Population Multiplication): Calculated without multiplying by the population, providing a clearer assessment of tax effort without population distortion.

Area, Forest, and Ecology

Both the *area* (15%) and *forest and ecology* (10%) criteria in the 15th Finance Commission's devolution formula are not influenced by population size. The area criterion compensates states with larger geographical spread, recognizing the higher costs of governance and service delivery across vast terrains. The forest and ecology criterion rewards states for maintaining dense forest cover especially very dense and moderately dense forests acknowledging the ecological services they provide and the developmental constraints they face. Although population size does not factor into these criteria, population density is an important consideration. States with high population density face greater ecological stress and have limited space for afforestation and conservation, making the task of balancing development and environmental protection more challenging. Recognizing these pressures can enhance the equity and effectiveness of these criteria in future devolution formulas.

Income distance: A contested criterion

The second major factor influencing states' shares in central tax revenues is income distance, which currently holds a 45% weight in the horizontal devolution formula. This criterion measures the gap between a state's per capita income and the state with the highest per capita income. While it is intended to promote equity by allocating more resources to lower-income states, its reliance on per capita measures often fails to capture the diverse fiscal realities across Indian states.

Figure.1 presents the classification of states based on per capita income, categorizing them into three groups, low-income, middle-income, and high-income using the same data employed by the Finance Commission. The classification of states into each category may vary depending on their respective per capita GSDP levels during each Finance Commission's term. Notably, the share of low-income states has increased from the Thirteenth Finance Commission (TFC) to the Fifteenth Finance Commission (FFC). Conversely, the share of high-income states has declined from 23.36% to 15.57%. In contrast, middle-income states have shown an increase in their share, except during the Thirteenth Finance Commission. The Fifteenth Finance Commission recorded a higher proportion of low-income states, indicating a progressive distribution trend. In contrast, figure.2 shows that some high-income states, including Kerala, Goa, Punjab, and Tamil Nadu, experience fiscal

deficit higher than the all-state average (ASA). This challenges the view that high-income states have more fiscal capacity when it looks solely on percapita income.

Figure 1: Tax share among different Income Groups in each Finance Commission

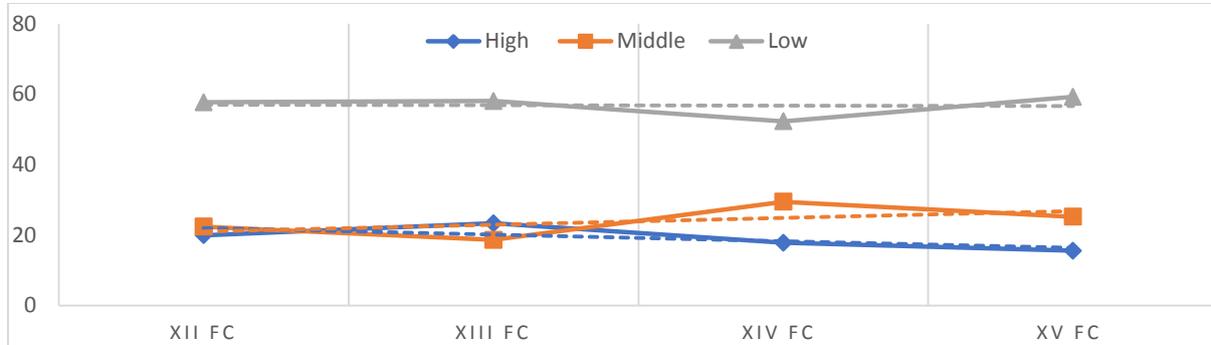
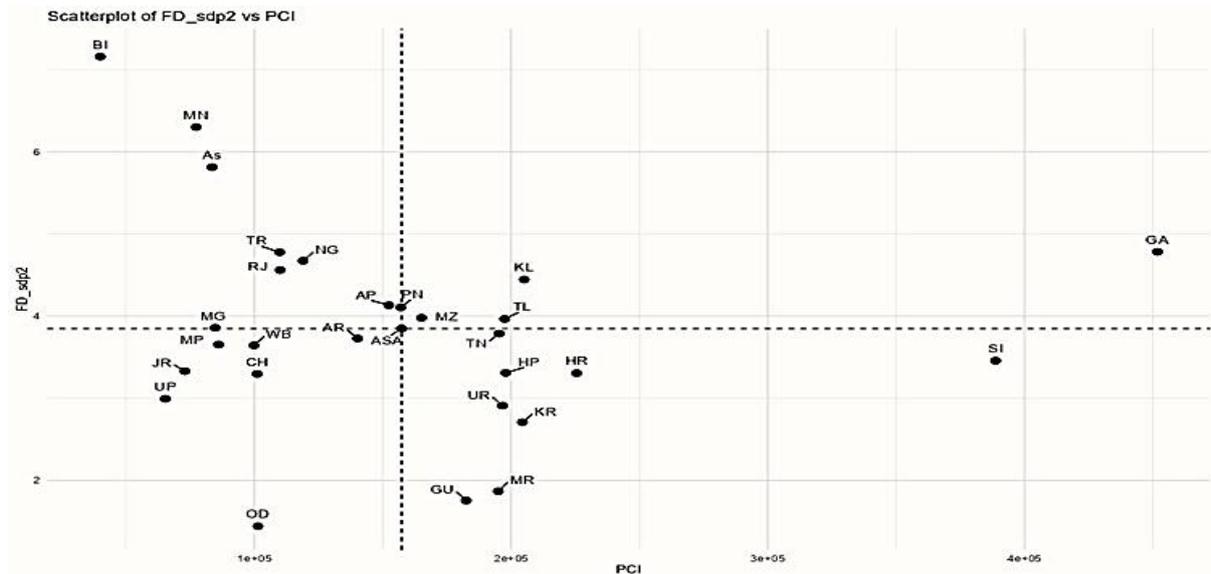


Figure.2: Per capita income and FD-A state-wise Comparison



Source: Author’s computation based on RBI data on state Finances,

Note: ASA = All State Averages. The right side of the figure represents high-income states, while the left side represents low-income states. Each variable is calculated as a three-year average based on Finance Commission calculations.

Higher-income states have consistently advocated for reducing the weight of the income distance criterion, while lower-income states argue for its increase. The issue lies in the formula's narrow focus on per capita income, which does not account for income inequality within states. For instance, a state with significant income inequality may have a large portion of its population earning low incomes, which limits its tax base even though its overall per

capita income appears high. Consequently, this state's ability to generate revenue is overstated, leading to an inadequate share of tax transfers.

Furthermore, structural factors such as urbanization and industrialization heavily influence a state's tax capacity. More industrialized and urbanized states typically have higher taxable economic activities, while states with larger informal sectors may struggle to generate tax revenue despite similar per capita income levels. This discrepancy underscores the limitations of the income distance criterion in achieving equitable resource distribution.

A call for refinement

To address these shortcomings, a more refined approach to income distance is required. Incorporating additional factors such as cost-of-living adjustments and structural economic conditions could lead to a more accurate assessment of states' fiscal capacities. By acknowledging the varied challenges faced by states in generating revenue, the Finance Commission can foster a more balanced and equitable distribution of resources.

Moreover, adjustments should be made to prevent states with slower population growth or higher human capital investments from experiencing share shocks. This could include smoothing mechanisms that minimize the volatility in states' shares over time, ensuring that those facing distinct fiscal challenges are not disproportionately affected.

Way forward for the 16th Finance Commission – A general perspective

- **Revisit Resource Allocation Criteria:** It's decisive to reassess the criteria for resource allocation to ensure fairness. This reevaluation should take into account the principles of fiscal federalism and the unique needs of each state within the GST framework.
- **Include Cess and Surcharges:** Enhance revenue sharing among states by including a portion of cess and surcharges in the divisible pool.
- **Re-evaluate Borrowing Restrictions:** Reassess the imposition of borrowing restrictions to prevent undue hindrance to states' ability to meet their financial obligations.
- **Balance Fiscal Discipline and State Needs:** Strike a balance between fiscal discipline and the necessity for states to finance development projects and welfare schemes.
- **Evaluate Resource Allocation Criteria:** Evaluate the criteria for resource allocation, considering fiscal federalism principles and state-specific needs. Alternatively,

consider compensating with grants to address interstate disparities or support highly meritorious projects.

- If the criterion for performance, states should be rewarded. Avoiding the multiplicative effect of population, and focusing solely on performance-based criteria, Or compensating by other measures
- Capital Investment grants: Capital expenditure is critical for long-term economic sustainability, but it often faces severe constraints in states where revenue expenditure consumes the lion's share of the budget. A shift towards special grants for capital investment could help alleviate this problem by providing states with the necessary fiscal space to undertake crucial development projects without having to sacrifice essential welfare programs While Revenue Deficit Grants have played an important role in addressing immediate fiscal imbalances, they are not a sustainable solution to the deeper structural issues affecting state finances.

Conclusion

As the 16th Finance Commission embarks on its mandate, it has the opportunity to address the complex interplay of demographic changes and fiscal capacity in determining states' shares. By revisiting the population and income distance criteria, and incorporating performance-based incentives alongside structural adjustments, the Commission can pave the way for a more equitable and sustainable model of fiscal federalism.

This evolution in the devolution formula would ensure that states are not unfairly affected for their demographic success while fostering a more accurate reflection of fiscal realities. Aligning the formula with the diverse needs of Indian states will promote balanced development, allowing for a fairer allocation of resources that serves both historical and contemporary demands. Addressing these disparities is vital for fostering inclusive growth and upholding the principles of cooperative federalism in India. While the Finance Commission's criteria aim to ensure equitable distribution, they must evolve to reflect the changing dynamics of state economies and their developmental priorities. It is imperative to re-evaluate the criteria for resource allocation in light of the principles of fiscal federalism and the specific needs of each state, or alternatively, to compensate through grants that address inter-state disparities. There is a pressing need to develop a more balanced and equitable framework that takes into account fiscal capacity, expenditure needs, and cost

differentials across states, while also adhering to the fundamental principle of ensuring the provision of basic needs to every individual.

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