



EDITORIAL

Financial Devolution Among States

Key Points of the Article/Editorial

Background

- Recently various Opposition-ruled States especially from south India have claimed that they have not been receiving their fair share as per the present scheme of financial devolution. They have raised issues about their less than proportionate share of receipt in tax revenue when compared to their contribution towards tax collection.

Divisible Pool of Taxes

- Article 270 of the Constitution provides for the scheme of distribution of net tax proceeds collected by the Union government between the Centre and the States. The taxes that are shared between the Centre and the States include corporation tax, personal income tax, Central GST, the Centre's share of the Integrated Goods and Services Tax (IGST) etc.
- This division is based on the recommendation of the Finance Commission (FC) that is constituted every five years as per the terms of Article 280. Apart from the share of taxes, States are also provided grants-in-aid as per the recommendation of the FC. The divisible pool, however, does not include cess and surcharge that are levied by the Centre.

Role of Finance Commission (FC)

- The FC is constituted every five years and is a body that is exclusively constituted by the Union Government. It consists of a chairman and four other members who are appointed by the President. The Finance Commission (Miscellaneous Provisions) Act, 1951, has specified the qualifications for chairman and other members of the commission. The Union government has notified the constitution of the 16th Finance Commission under the chairmanship of Dr. Arvind Panagariya for making its recommendations for the period of 2026-31.
- Basis for Allocation to States**
- The share of States from the divisible pool (vertical devolution) stands at 41% as per the recommendation of the 15th FC. The distribution among the States (horizontal devolution) is based on various criteria.
- The 15th Finance Commission used the following criteria while determining the share of states: (i) 45% for the income distance, (ii) 15% for the population in 2011, (iii) 15% for the area, (iv) 10% for forest and ecology, (v) 12.5% for demographic performance, and (vi) 2.5% for tax effort. The criteria as per the 15th FC can be briefly explained as follows. 'Income distance' is the distance of a State's income from the State with highest per capita income which is Haryana. States with lower per capita income would be given a higher share to maintain equity among States. Till the 14th FC, weightage was given for the population as per the 1971 Census but that has been discontinued in the 15th FC. 'Forest and ecology' consider the share of dense forest of each State in the aggregate dense forest of all the States.
- 'The demographic performance' criterion has been introduced to reward efforts made by States in controlling their population. States with a lower fertility ratio will be scored higher on this criterion. 'Tax effort' as a criterion has been used to reward States with higher tax collection efficiency.



प्रयास
IAS ACADEMY

An Institute For UPSC & BPSK

8818810183 | 8818810184

www.prayasiasacademy.com

prayasiasacademy101@gmail.com

prayasiasacademy

Majors Issues and Challenges

- The cess and surcharge collected by the Union government is estimated at around 23% of its gross tax receipts for 2024-25, which does not form part of the divisible pool and hence not shared with the States.
- The amount each State gets back for every rupee they contribute to Central taxes shows steep variation. It can be seen that industrially developed States received much less than a rupee for every rupee they contributed as against States like Uttar Pradesh and Bihar.
- The percentage share in the divisible pool of taxes has been reducing for southern States over the last six FCs. This is attributable to the higher weightage being given for equity (income gap) and needs (population, area and forest) than efficiency (demographic performance and tax effort).
- The grants-in-aid as per the recommendation of the FC varies among various States. As per the 15th FC, there are revenue deficit, sector-specific and State-specific grants given to various States as well as grants to local bodies that are given based on population and area of States.

Way Forward

- The divisible pool can be enlarged by including some portion of cess and surcharge in it. The Centre should also gradually discontinue various cesses and surcharges it imposes by suitably rationalizing the tax slabs.
- The weightage for efficiency criteria in horizontal devolution should be increased. GST being a consumption-based destination tax that is equally divided between the Union and the State means that State GST accrual (inclusive of Integrated GST settlement on inter-state sales) should be the same as the Central GST accrual from a State.
- Similar to the GST council, a more formal arrangement for the participation of States in the constitution and the working of the FC should be considered.
- Therefore, these measures are needed to be implemented by the Centre after discussion with all the States. It is also imperative that the States uphold principles of fiscal federalism by devolving adequate resources to local bodies for vibrant and accountable development.



प्रयास
IAS ACADEMY

An Institute for UPSC & BPSK

COMMENCING FROM

23 FEBRUARY
2024

English Medium | Hindi Medium

GS
FOUNDATION
COURSE
for
UPSC



INAUGURAL
OFFER

50%
OFF

Offline and Online

Only for First 200 Students