DAILY EDITORIAL ANALYSIS

TOPIC

Debate over Revenue Sharing Formula

DEBATE OVER REVENUE SHARING FORMULA

In Context

- Recommendations of the Finance Commissions have created friction between States and the Centre.

About Finance Commission

- It is a constitutional body formed by the **President of India** to give suggestions on centre-state financial relations.
- **Article 280(1) of the Constitutions** lays down that the modalities for setting up of a Finance Commission
  - Currently, 41 percent of taxes collected by the Centre is devolved in 14 instalments among states during a fiscal year.
- The **Fifteenth Finance Commission** was constituted in **2017**.
  - The recommendations of the Fifteenth Finance Commission are valid upto the financial year 2025-26.

Roles and responsibilities

- The important tasks of the Finance Commissions are (i)
  - To **recommend the proportion of the Union tax revenues** to be assigned to States and
  - To recommend the share of each State in the assigned tax revenue.

Distribution formula

- It devises a distribution formula to arrive at a share for each State, and it is based on the principles of **equity and efficiency.**
  - Equity stipulates that the revenue-scarce States and States with higher expenditures get larger shares of Union tax revenue than others.
  - Efficiency is to reward the States that are efficient in collecting revenue and rationalising spending.
  - The trade-off between equity and efficiency is normative and remains dynamic in successive Finance Commission recommendations.

Methodology of 15th finance Commission

- Successive Finance Commissions have assigned **10% to 20% weight t**o income tax revenue collection/ assessment in the distribution formula for income tax revenue because collection is not a good indicator of contribution.
- In the 15th Finance Commission, the distribution formula had a tax effort with a weight of **2.5%,** and demographic performance, an indicator of efficiency in population control, was given a weight of **12.5%.**
  - The remaining **85% weight** was distributed among equity indicators of per capita income, population as per the 2011 Census instead of the conventional 1971 Census, area, forest cover, etc.
- It introduced the fertility rate in the formula to reward States which had reduced the fertility levels.

Concerns of various states

- Revenue sharing among states is a controversial subject given that there is always a fund crunch and the welfare needs vary.
- This leads to complaints from some states, especially those in southern India, that they get a smaller share, especially considering their contribution to taxes.
  - Some States have been arguing that their contributions to the Union tax revenue have been higher than others and, therefore, they **rightfully have higher shares i**n the Union tax revenue.
- **Tax contribution is an efficiency indicator** because a State's level of development and economic structure decides its tax contribution.
  - However, Finance Commissions had assigned o**nly 10% to 20%** weight to this efficiency indicator.

- The Finance Commissions have always favoured assigning more than **75% weight to equity indicators.**

Suggestions

- Some states feel 'cheated' because of the overuse of the **equity criterion.**
- Therefore an appropriate balancing of criteria is needed **particularly in the context of the rise in unconditional transfers.**
- **Tax contribution** by each State is a **good measure of efficiency**, and the **Goods and Services Tax (GST) regime creates** an opportunity for its inclusion in the distribution formula.
  - In addition to GST, **petroleum** consumption is also an indicator of tax contribution to the national exchequer.
- But Due attention needs to be paid to the needs of the lower income States**.**
  - These States are expected to provide a relatively larger share of 'demographic dividend' to India in future provided attention is paid to the educational and health needs of their populations
- Instead of using a large number of tax devolution criteria, the transfer of resources to individual States may be guided by the **equalisation principle** using a limited number of criteria such as population, area and distance, supplemented by a suitable scheme of grants.
  - The equalisation principle is **consistent with both equity and efficiency.**
- The dynamics of the emerging fiscal federalism of India entails significant rethinking especially in the context of the 16th Finance Commission.

DAILY MAINS QUESTION

Examine the tax-sharing principles in light of the altered landscape of fiscal federalism in India.