

Central transfers and the issue of shares of some States

There are many issues that the Sixteenth Finance Commission will have to deal with. In this article, we focus on one issue which has been raised by many States, particularly those in the south of India. The issue (or the complaint) is that these States have been facing a decline in their share out of the resources transferred from the Centre to the States, from Finance Commission to Finance Commission.

In finding a solution to this issue, we need to look at: which States have been gaining and which are losing their share over time; the criteria of horizontal distribution which has led to some States steadily losing their share; and what can be done to reverse this trend.

In *Table 1*, the shares of groups of States and those for selected States are shown, for the Twelfth Finance Commission to the Fifteenth Finance Commission (final report). In the case of the southern States, there has been a steady fall in their share, from 19.785% to 15.800%. In a comparison of these two Commissions, the northern and eastern States have also lost. The 'gainer States' were the hilly, central, and western States including Maharashtra.

The distance criterion

The shares of individual States in tax devolution depend on the criteria and the weights used by different Commissions. *Table 2* provides a list of the different criteria used by Finance Commissions, from the Twelfth to the Fifteenth.



C. Rangarajan

is former Chairman, Prime Minister's Economic Advisory Council and former Governor, Reserve Bank of India



D.K. Srivastava

is former Director, Madras School of Economics

The income distance criterion and cesses and surcharges are areas that need review

Share of States/groups of States in tax devolution

Table 1: Share of States (%) in Commission-wise tax devolution for groups and selected States

Region	Overall				Overall	Distance criterion
	FC12	FC13	FC14	FC15 (final)	FC15 (final) minus FC12	
Northern of which:	32.666	33.031	30.285	30.897	-1.769	4.907
Bihar	11.028	10.917	9.665	10.058	-0.970	0.862
Uttar Pradesh	19.264	19.677	17.959	17.939	-1.325	2.509
Central	12.726	12.392	13.767	14.564	1.838	1.298
West of which:	14.434	14.359	14.478	16.207	1.773	2.822
Maharashtra	5.082	5.284	5.649	6.317	1.235	1.758
Gujarat	3.625	3.101	3.156	3.478	-0.147	-0.089
Southern of which:	19.785	18.575	17.978	15.800	-3.985	-8.055
Tamil Nadu	5.305	4.969	4.023	4.079	-1.226	-1.736
Eastern	15.453	15.671	15.277	15.179	-0.274	-0.192
Hilly	3.639	4.421	6.361	7.353	3.714	-0.020

Source (basic data): Reports of Finance Commissions (Twelfth to Fifteenth) and writers' estimates
Notes: (1) The Fifteenth Finance Commission had submitted two reports. Here, the reference is to the final report. | (2) Shares are not strictly comparable across Commissions because of change in the status of Jammu and Kashmir for FC15.

Table 2: Relative weights for different tax devolution criteria: FC12 to FC15 (2)

#	Criteria	FC12	FC13	FC14	FC15 (final)
1	Population	25	25	17.5	15.0
2	Demographic change	-	-	10	12.5
3	Income/ fiscal capacity distance	50	47.5	50	45.0
4	Area	10	10	15	15.0
5	Forest cover	-	-	7.5	10.0
6	Tax effort	7.5	-	-	2.5
7	Fiscal discipline	7.5	17.5	-	-

Source (basic data): Reports of Finance Commissions (Twelfth to Fifteenth)

Table 3: Share of Centre and States in combined revenue (%)

FC period	Pre-transfer		Post-transfer	
	Centre	States	Centre	States
12th FC	64.3	35.7	38.7	61.3
13th FC	61.8	38.2	36.1	63.9
14th FC	62.3	37.7	31.9	68.1
15th FC (first 3 years)	62.6	37.4	31.3	68.7
2020-21	62.3	37.7	29.3	70.7
2021-22	64.1	35.9	32.3	67.7
2022-23	61.5	38.5	32.5	67.5

Source (basic data): IPFS, Union Budget documents, RBI
Notes: (1) Transfers include tax devolution and Finance Commission as well as other grants. | (2) Grants from the Centre to States after 2015-16 are taken from the Union Budget. It includes grants-in-aid to the Union Territories.

The distance criterion has been accorded the highest weight amongst these criteria. Its weight was reduced from 50% to 47.5% by the Thirteenth Finance Commission and further reduced to 45% by the Fifteenth Finance Commission. Earlier, the Eleventh Finance Commission had given this criterion a weight of 62.5%. The equalisation principle has always been regarded in India and elsewhere as a key principle governing distribution. Economic and social justice demand this.

The main reason for the loss of the southern States is the income distance criterion (*Table 1*). Distance criterion means that the farther a State is from the highest income State, the higher its share. The main reason for the gain of the hilly States is area/forest criterion, although its impact is not separately shown. Between these two Finance Commissions, the loss to the southern States due to the distance criterion amounted to 8.055% points, although the overall loss was much less at 3.985% points, implying that there was a gain under other criteria.

Although on account of the distance criterion,

low-income States such as Bihar and Uttar Pradesh have gained over time, they have lost on account of other criteria. Bihar and Uttar Pradesh show, in terms of their overall share, a loss of 0.970% points and 1.325% points.

On population

One other criterion that has caused some controversy is population. Until the Fourteenth Finance Commission, the data for the population in 1971 was used. For the Fifteenth Finance Commission, data for the population in 2011 was used. However, in order not to penalise States that showed better performance in reducing fertility rates, the demographic change criterion was introduced. The joint impact of these two changes has been marginal for all groups of States. For Tamil Nadu, the joint impact was marginally positive.

Steps to take

As mentioned, we cannot give up the income distance criterion. Some raise the question whether such a criterion can continue indefinitely. This is a legitimate question. But this question can be raised in relation to many other issues. Perhaps one step that the Sixteenth Finance Commission can consider is to reduce its weight while correspondingly raising the weights attached to other criteria.

Related to the question of share is also the quantum of the divisible pool. While accepting the recommendation of the Fourteenth Finance Commission to raise the share of all States to 42% from 32%, the Centre increased the cesses and surcharges, thereby reducing the size of the divisible pool. This is not desirable. One option is to limit the share of cesses and surcharges to 10% of the Centre's gross tax revenues. After the recommendation of the Fourteenth Finance Commission, the share of the States in the combined revenue receipts increased from 63.9% to 68.1% (*Table 3*). It increased further to 70.7% in 2020-21. Since then, it has fallen to 67.5% in 2022-23, although this level is still higher than 61.3% in the Twelfth Finance Commission period.

To sum up, there is a case to address the issue raised by some of the States regarding their declining shares. The major factor contributing to this situation is the adoption of income distance criterion and giving it a weight as high as 45%. But in any scheme of fair distribution, this criterion cannot be given up.

The Finance Commission can reduce the weight of this criterion by 5% to 10% points. Also, cesses and surcharges may be subjected to some upper limit by the Sixteenth Finance Commission.