



## Financial Devolution in India

**For Prelims:** [Tax Devolution](#), [Grants-in-aid](#), [GST implementation](#), [Comptroller and Auditor General of India](#), [16th Finance Commission](#).

**For Mains:** Current Status of Fiscal Federalism in India

[Source: TH](#)

### Why in News?

Several Indian states have claimed that they have not been receiving their fair share as per the present scheme of [tax devolution](#). They argue that their states contribute more to the **national tax pool** than they receive in return.

### What is the Current Status of Tax Devolution in India?

- **About: Financial devolution** refers to the transfer of financial resources and decision-making powers from the central government to the states.
- **Constitutional Framework: Article 270** of the Constitution outlines the distribution of net tax proceeds between the Union government and the States.
  - The [Finance Commission \(FC\)](#), constituted every five years, provides recommendations for the vertical distribution of funds from the central government's divisible **pool of taxes** (excluding cess and surcharge).
  - Additionally, it offers a formula for the horizontal allocation of these funds among individual states.
  - Apart from the share of taxes, States are also provided [grants-in-aid](#) as per the recommendation of the FC.
    - The **16<sup>th</sup> Finance Commission**, chaired by **Dr Arvind Panagariya**, has been tasked with making recommendations for the **period 2026-31**.
- **Criteria for Devolution Among States:** Currently, the share of States from the divisible pool (vertical devolution) stands at **41%** as per the recommendation of the 15th FC.

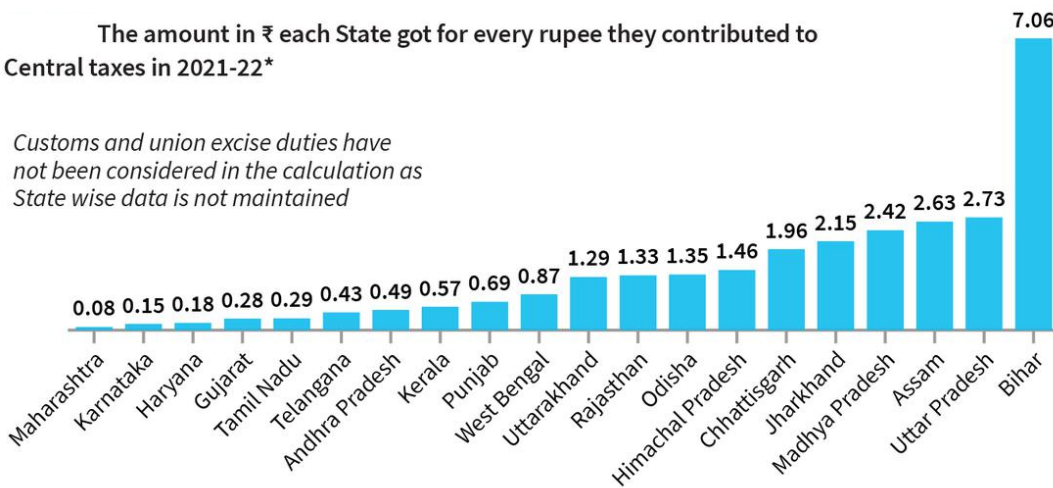
The criteria for horizontal devolution among States over the last five FCs

| Criteria                 | 11th FC<br>2000-05 | 12th FC<br>2005-10 | 13th FC<br>2010-15 | 14th FC<br>2015-20 | 15th FC<br>2021-26 |
|--------------------------|--------------------|--------------------|--------------------|--------------------|--------------------|
| Income Distance          | 62.5               | 50                 | 47.5               | 50                 | 45                 |
| Population (1971 Census) | 10                 | 25                 | 25                 | 17.5               | -                  |
| Population (2011 Census) | -                  | -                  | -                  | 10                 | 15                 |
| Area                     | 7.5                | 10                 | 10                 | 15                 | 15                 |
| Forest cover             | -                  | -                  | -                  | 7.5                | -                  |
| Forest and ecology       | -                  | -                  | -                  | -                  | 10                 |
| Infrastructure index     | 7.5                | -                  | -                  | -                  | -                  |
| Fiscal discipline        | 7.5                | 7.5                | 17.5               | -                  | -                  |
| Demographic performance  | -                  | -                  | -                  | -                  | 12.5               |
| Tax effort               | 5                  | 7.5                | -                  | -                  | 2.5                |
| <b>Total</b>             | <b>100</b>         | <b>100</b>         | <b>100</b>         | <b>100</b>         | <b>100</b>         |

▪ **States Contribution Versus Devolution:**

The amount in ₹ each State got for every rupee they contributed to Central taxes in 2021-22\*

*Customs and union excise duties have not been considered in the calculation as State wise data is not maintained*



▪ **Concerns Regarding Tax Devolution:**

- **Exclusion of Cess and Surcharge:** Concerns are raised regarding the exclusion of [cess and surcharge](#) from the divisible pool of tax revenue, leading to a reduction in states' share of tax revenue.
  - 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.
- **Inadequate Compensation for GST Implementation:** Some states feel that compensation for revenue losses during [GST implementation](#) is insufficient, urging for a fairer mechanism to address revenue shortfalls.
- **Lack of Flexibility in Fund Utilization:** Some States advocate for greater flexibility in utilizing devolved funds to address local priorities.

**Note:**

- **Income Distance:** Refers to the disparity between a state's income and the state with the highest per capita income.
  - States with lower per capita income receive a higher share to ensure equity among states.
- **Population:** Represents the population count based on the [2011 Census](#). Previously, until the 14<sup>th</sup> Finance Commission, population from the **1971 Census** was considered, but this practice was

discontinued in the 15<sup>th</sup> Finance Commission.

- **Forest and Ecology:** Considers the **proportion of dense forest area** in each state compared to the total dense forest area across all states.
- **Demographic Performance:** Introduced to **recognize states' efforts in population control**, with states exhibiting lower fertility ratios receiving higher scores.
- **Tax Effort:** Used to reward states demonstrating **higher efficiency in tax collection**.

## Way Forward

- **Review of Fiscal Federalism Framework:** There is a need to conduct a comprehensive review of the fiscal federalism framework to identify gaps and inefficiencies in the devolution process.
  - This may involve establishing a committee or commission to assess the effectiveness of existing mechanisms and propose reforms.
- **Performance-Based Incentives:** Linking additional devolution to performance indicators in areas like [good governance](#), **transparency, and development outcomes** could incentivize responsible resource management.
- **Strengthening Institutions:** Empowering institutions like the [Comptroller and Auditor General of India \(CAG\)](#) can ensure effective oversight and accountability in managing devolved funds.

## UPSC Civil Services Examination, Previous Year Question (PYQ)

### Prelims

**Q. Consider the following: (2023)**

1. Demographic performance
2. Forest and ecology
3. Governance reforms
4. Stable government
5. Tax and fiscal efforts

**For the horizontal tax devolution, the Fifteenth Finance Commission used how many of the above as criteria other than population area and income distance?**

- (a) Only two
- (b) Only three
- (c) Only four
- (d) All five

**Ans: (b)**

### Mains

**Q. Discuss the recommendations of the 13<sup>th</sup> Finance Commission which have been a departure from the previous commissions for strengthening the local government finances. (2013)**

