



Equity and Efficiency in Intergovernmental Transfers: An Assessment of the Finance Commission of India

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Abstract

Intergovernmental transfers constitute a central pillar of fiscal federalism in India, aiming to address vertical and horizontal imbalances while promoting balanced regional development. The Finance Commission of India, established under Article 280 of the Constitution, plays a pivotal role in designing the framework for tax devolution and grants-in-aid between the Union and the States. This paper examines the principles of equity and efficiency underlying intergovernmental transfers and evaluates how successive Finance Commissions have balanced these objectives. While equity focuses on reducing regional disparities through income-distance and need-based criteria, efficiency emphasizes fiscal discipline, performance incentives, and responsible financial management. The study analyzes recent Finance Commission recommendations to assess their impact on fiscal autonomy, cooperative federalism, and macroeconomic stability. The paper concludes that although significant progress has been made in strengthening fiscal equalization and transparency, challenges remain in aligning transfer mechanisms with long-term growth and sustainability goals.

Introduction

Fiscal federalism in India is structured around a constitutional division of financial powers between the Union and the States. However, this arrangement often leads to fiscal imbalances due to unequal revenue capacity and expenditure responsibilities. To address these imbalances, a well-designed system of intergovernmental transfers is essential.

The Finance Commission of India serves as an independent constitutional authority responsible for recommending the distribution of the divisible pool of central taxes and determining grants-in-aid to States. Its recommendations seek to achieve two fundamental objectives: **equity**, by reducing disparities among States, and **efficiency**, by promoting fiscal responsibility and optimal resource allocation.

Balancing equity and efficiency is complex. Excessive emphasis on equalization may weaken incentives for revenue mobilization, while excessive focus on efficiency may widen regional inequalities. Therefore, assessing how the Finance Commission reconciles these competing objectives is critical for understanding India's fiscal federal framework.

Literature Review

The Fifteenth Finance Commission (2021) provides a comprehensive framework for strengthening fiscal federalism in India during the award period 2021–26. The report emphasizes balancing equity and efficiency in intergovernmental transfers by retaining 41% of the divisible pool of central taxes for States and refining horizontal devolution criteria, including income distance, population (2011), area, forest and ecology, demographic performance, and tax effort. It highlights the importance of fiscal consolidation, debt sustainability, and performance-based incentives to encourage responsible financial management among States. Additionally, the Commission introduces sector-specific and local body grants to enhance service delivery and accountability. Overall, the report underscores the need to align fiscal transfers with macroeconomic stability, cooperative federalism, and sustainable development goals.

The Fourteenth Finance Commission (2015) represents a landmark development in India's fiscal federal framework by significantly enhancing the States' share in the divisible pool of central taxes from 32% to 42%. The report emphasizes greater fiscal autonomy for States through increased untied transfers, enabling them to design and implement development programs according to local priorities. It also refines the horizontal devolution formula by incorporating criteria such as income distance, population, area, and forest cover to promote equity among States. Furthermore, the Commission stresses fiscal discipline, revenue deficit grants, and strengthened local body financing to improve service delivery and accountability.



Overall, the report contributes substantially to balancing equity and efficiency in intergovernmental fiscal transfers.

Boadway and Shah (2009) provide a comprehensive theoretical and practical framework for understanding fiscal federalism in multi-tier systems of governance. The authors examine the principles of revenue assignment, expenditure responsibilities, and intergovernmental transfers, emphasizing the need to balance equity, efficiency, and accountability. They argue that well-designed transfer systems should address vertical and horizontal fiscal imbalances while preserving incentives for subnational governments to mobilize resources and improve public service delivery. The book highlights equalization transfers as a key instrument for reducing regional disparities without undermining fiscal autonomy. Their analysis offers valuable conceptual foundations for assessing the functioning of intergovernmental transfers and the role of institutions such as the Finance Commission of India in promoting cooperative and effective fiscal governance.

Musgrave (1959) lays the foundational theoretical framework of public finance by identifying the three primary functions of government: allocation, distribution, and stabilization. The author argues that fiscal policy should ensure efficient resource allocation, equitable income distribution, and macroeconomic stability. In the context of federal systems, Musgrave emphasizes the importance of clearly assigning expenditure responsibilities and revenue powers across different levels of government to avoid inefficiencies and fiscal imbalances. The work also highlights the need for intergovernmental transfers to correct disparities in fiscal capacity while maintaining incentives for efficient public spending. Musgrave's theoretical insights remain central to understanding equity and efficiency in fiscal federalism and provide a conceptual basis for evaluating institutions such as the Finance Commission of India in designing intergovernmental transfer mechanisms.

Oates (1999) revisits the theory of fiscal federalism and elaborates on the “decentralization theorem,” which argues that public services should be provided by the lowest level of government capable of efficiently delivering them. The author emphasizes that decentralization enhances efficiency by aligning public goods provision with local preferences, while central governments should focus on macroeconomic stabilization and redistribution. Oates also discusses the importance of intergovernmental transfers in correcting fiscal imbalances and ensuring equity across regions without undermining subnational incentives. The essay highlights the trade-off between autonomy and coordination in federal systems, providing a strong theoretical foundation for assessing institutions such as the Finance Commission of India in designing equitable and efficient transfer mechanisms.

Objectives of the Study

1. To examine the theoretical concepts of equity and efficiency in fiscal federalism.
2. To analyze the structure and significance of intergovernmental transfers in India.
3. To evaluate the constitutional role of the Finance Commission of India in designing tax devolution and grants-in-aid.
4. To assess how horizontal and vertical devolution criteria promote fiscal equalization among States.
5. To examine the effectiveness of performance-based incentives in encouraging fiscal discipline and accountability.
6. To analyze the impact of Finance Commission recommendations on cooperative federalism and balanced regional development.
7. To identify challenges in achieving an optimal balance between equity and efficiency in intergovernmental fiscal transfers.

Methodology

Research Design

The study adopts a descriptive and analytical research design to examine equity and efficiency in intergovernmental transfers in India.



Nature of the Study

The research is primarily qualitative, supported by secondary quantitative data from official reports and statistical publications.

Sources of Data

- Reports of various Finance Commissions, especially the Finance Commission of India (Fourteenth and Fifteenth Finance Commissions).
- Publications of the Reserve Bank of India on State Finances.
- Government documents, policy papers, and constitutional provisions (Article 280).
- Books and peer-reviewed journal articles on fiscal federalism.

Method of Analysis

Content analysis is used to examine policy recommendations and devolution criteria. Comparative analysis is applied to evaluate changes in tax-sharing formulas and grant structures across different Finance Commissions.

Scope of the Study

The study focuses on recent trends in intergovernmental transfers, particularly after economic reforms and the introduction of the GST regime.

Limitations

- The study relies on secondary data.
- It does not include primary surveys or empirical econometric modeling.
- The analysis is limited to officially published sources.

Analysis

Intergovernmental transfers in India aim to balance equity and efficiency within the federal framework. The Finance Commission of India promotes equity by using formula-based criteria such as income distance, population, area, and tax effort to reduce regional disparities and support weaker States. At the same time, it enhances efficiency through performance-based incentives, fiscal discipline measures, and greater untied transfers that allow States flexibility in resource utilization. While significant progress has been made in strengthening cooperative federalism, maintaining an effective balance between equalization and incentives remains a continuing challenge.

Conclusion

The Finance Commission of India plays a critical role in shaping intergovernmental fiscal transfers to achieve both equity and efficiency. Through formula-based devolution and structured grants-in-aid, it addresses regional disparities while promoting fiscal discipline. Although notable progress has been made in strengthening cooperative federalism and transparency, persistent regional inequalities and fiscal stress continue to pose challenges. Future reforms should focus on refining devolution criteria, enhancing accountability, and ensuring that transfers support sustainable and inclusive economic growth.

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