FISCAL DISTRIBUTION : POLITY

NEWS : *What is vertical fiscal imbalance?*

WHAT'S IN THE NEWS ?

The role of the 16th Finance Commission should be to eliminate vertical fiscal imbalance in federal relations. What should it do when revenues are concentrated with the Union government, and the States are burdened with expenditure responsibilities?

Vertical Fiscal Imbalance (VFI) in India

What is VFI?

- Vertical Fiscal Imbalance occurs when there's a mismatch between the revenue collection and expenditure responsibilities of different levels of government.
- In India, States are responsible for **61% of total expenditure**, but they collect only **38% of total revenue**, heavily depending on transfers from the Union government.

Why Does VFI Exist?

- **Constitutional Division of Duties**: The Union government collects key taxes like **Personal Income Tax** and **Corporation Tax**, while States manage critical expenditures related to public services such as health, education, and infrastructure.
- This imbalance leads to a gap between States' revenue and expenditure obligations, making them reliant on Union transfers.

Role of the Finance Commission

- The Finance Commission is tasked with ensuring the fair distribution of tax revenue between the Union and States. It primarily addresses VFI by:
  - Deciding the **share of Union taxes** to be devolved to States.
  - Allocating resources among individual States based on their needs and capacities.

Types of Financial Transfers

- **Tax Devolution**: Unconditional transfers where States can use funds without specific conditions; this is considered the most flexible form of transfer.
- **Grants**: Conditional transfers provided under **Article 275** (specific needs) and **Article 282** (centrally sponsored schemes), which come with spending conditions.

Measuring VFI

- VFI can be measured by the ratio of States' **own revenue receipts** plus **tax devolution** to their **expenditure**.
- If this ratio is **less than 1**, it indicates an imbalance, as States are not generating enough revenue to meet their expenditure obligations.

- **Need for Higher Tax Devolution**
  - To eliminate VFI, experts suggest increasing the States' share of tax devolution to about **48.94%**. However, the **14th and 15th Finance Commissions** recommended **42% and 41%** respectively.

- Many States are now pushing for the **16th Finance Commission** to increase tax devolution to **50%** to provide them with more untied resources, which would allow for greater flexibility in spending and better alignment with local needs.

Conclusion

- Addressing VFI through higher tax devolution would create a more **equitable fiscal framework** by providing States with greater financial independence. This would improve the efficiency of public spending and support the overall goal of **cooperative fiscal federalism** in India.
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FINANCE COMMISSION

BODIES	APPOINTMENT	TENURE	REMOVAL	QUALIFICATION
FINANCE COMMISSION (280,281)	PRESIDENT	They hold office for such period specified by president in his order Eligible for re-appointment	Pleasure of president	Chairman & 4 members Chairman: experience in public affairs. Members: 1) Judge of high court or eligible for it. 2) special knowledge on finance & account 3) special knowledge of economics 4) experience in financial matters & in administration.

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