

Measuring the Extent of Equalization in Fiscal Transfers in India: An Index-Based Approach

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Abstract : In the post-planning era, India's fiscal transfers from the central to state governments are solely determined by the Finance Commissions (FCs). While in some of the well-established federations such as Australia, Canada, and Germany, equalization serves as the guiding principle of fiscal transfers and is constitutionally mandated, in India, it is not explicitly mandated, and FCs attempt to implement it indirectly by a combination of a formula-based share in the divisible pool of central taxes supplemented by a set of grants. In this context, it is important to measure the extent of equalization that is achieved through FC transfers with a view to improving the design of such transfers. This study uses an index-based methodology for measuring the degree of equalization achieved through FC-transfers covering the period from FC12 to the first year of FC15 spanning from 2005-06 to 2020-21. The 'Index of Equalization' shows that the extent of equalization has remained low in the range of 30% to 37% for the four Commission periods under review. The highest degree of equalization at 36.7% was witnessed in the FC12 period and the lowest equalization at 29.5% was achieved during the FC15(1) period. The equalizing efficiency of recommended transfers also shows a consistent fall from 11.4% in the FC12 period to 7.5% by the FC15 (1) period. Further, considering progressivity in fiscal transfers as a special case of equalizing transfers, this study shows that the scheme of per capita total transfers when determined using the equalization approach is more progressive and is characterized by minimal deviations as compared to the profile of transfers recommended by recent FCs.

Keywords : fiscal transfers, index of equalization, equalizing efficiency, fiscal capacity, expenditure needs, finance Commission, tax effort

Conference Title : ICPFM 2024 : International Conference on Public Finance and Macroeconomy

Conference Location : Bengaluru, India

Conference Dates : January 29-30, 2024