

Revenue-Sharing with the Linear Distance Criterion

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The linear distance formula occupies a prominent position as an allocative criterion for revenue-sharing among State in India as well as internationally. In India, the Tenth Finance Commission has preferred this criterion to other competing criteria and has given it a predominant weight. This paper analyses analytical properties of the alternative versions of the distance criterion. A generalised version of the distance formula has been developed and the alternative versions have been shown to be its special cases. Alternative criteria are compared in terms of their progressivity and equity. Some of the recent Finance Commissions in India have used an arbitrary adjustment in the distance criterion under political constraints. This politically constrained version does not satisfy the requirement of maintaining vertical equity consistently. An alternative, based on the general version, is proposed that is progressive as well as satisfies equity. The distance criterion is also shown to be equivalent to a system of fiscal capacity equalisation grants under certain assumptions.

Introduction

In India, the volume and allocation of federal transfers among the States can be classified into three broad categories. First, the transfers recommended by the Finance Commission which is a statutory body set up after every five years for this purpose; second, the plan transfers by the Planning Commission for developmental plans of the States; and third, other discretionary grants and loans.

The Finance Commission transfers are divided among the States on the basis of three distinct considerations. For some taxes, the guiding principle is that of a tax rental arrangement wherein an attempt is made to return the tax revenue to the States in proportion to the amount that they would have raised in the absence of the revenue-sharing arrangement. Additional duties of excise duty in lieu of sales tax on specified commodities are being shared under the purview of this principle. Another portion of tax revenues is distributed among the States on the basis of "notional" deficits of the States estimated by the Finance Commission. A limited number of States are benefited by this provision. An overwhelming part of tax devolution, accounting for 81 per cent of the shared tax revenues, is distributed on the basis of need and equity criteria. There are three main criteria that have been utilised in this context. These are respectively based on population, distance of per capita income of a State from the highest per capita income among all States weighted by its population, and inverse of per capita income of a state weighted by its population. In addition, sometimes poverty ratio, index of backwardness or relative deficiency in infrastructure has also been used. While the

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