

## **Paradox of Fiscal Imbalances: Recommendations of Fourteenth Finance Commission**

**Motilal Mahamallik and Pareswar Sahu**

*The assignment of significant weight to equity criterion without any weight to efficiency criterion in the distribution of federal transfers across states by the Fourteenth Finance Commission may increase both vertical and horizontal fiscal imbalances. The imbalances have persisted mainly due to the assignment of significant weight to equity or efficiency criterion as well as the level of contradiction between the two. The use with significant weightage of either one of them is not feasible with the existence of high economic disparities across states. When the equity criterion is used with significant weight, high fiscal capacity states exhibit their status as 'deficient states' to avail of the benefit. Similarly the assignment of significant weight to efficiency criterion does not enable the poorer states to get their due share. These states try to maximize their share through the reduction of social and economic expenditure which further deteriorates their fiscal health. The simultaneous use of both criteria involves contradiction between themselves because when equity criterion is based on the deficiency in fiscal capacity, the efficiency criterion is based on the improvement of the fiscal capacity of the states. When equity is assigned significant weight rich states exhibit their status as 'deficient states' and when efficiency is assigned significant weight, poorer states show themselves as 'efficient states'. In both cases the criteria fail to achieve their objectives. An optimal weight is the only solution to minimize the level of effect of contradiction which may reduce fiscal imbalances. It assigns one-third weightage to efficiency and two-thirds to equity criterion.*

### **I Introduction**

The division of taxation powers and expenditure responsibilities between the Centre and States listed in seventh schedule of the constitution, differences in resource endowment and cost disadvantage of public provisioning across states are the structural reasons cited for the fiscal imbalances<sup>1</sup> in India. However, to

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<sup>1</sup> The vertical imbalance occurs to some extent due to asymmetric assignment of taxation and responsibilities between the Centre and States. The highly income elastic progressive taxation has been assigned to central government while the minor levies like sales tax, taxes on vehicles, taxes