Sixteenth Finance Commission

By IASToppers | 2023-08-03 14:00:00

Introduction:

- The recommendations made by the **Finance Commission** are only of **advisory nature** as the Union government may or **may** not implement its recommendations of **granting** money to the states, which undermines the **federal character** of the constitution.
    - They are **not binding** on the **government**.
    - It absolves the **Union administration** of responsibility for its **budgetary restraint** and dilutes the **Union's** and **States'** shared **accountability**.
- Till **2014**, the role of the Finance Commission (FC) in the **Centre-state fiscal relations** was undermined by the former **Planning Commission**, this reduces the **authority** of **Finance Commission**.
    - **Planning Commission** was a **non-constitutional** and **non-statutory** body.
- **Fiscal federalism** is affected and weakened if there are any **restrictions** imposed on **states'** capacity to borrow and it will have a **negative impact on state spending**, particularly on **development investment**.
- The 15th FC commission should have provided **performance-based initiatives** to the states to

perform better in the **population control reform**.
    - The 15th FC should have also included the **population census of 1971**.

What is Finance Commission?

- **Article 280** of the Constitution of India provides for a Finance Commission as a **quasi-judicial body**.
- **Finance Commission** is appointed by the **President** of **India** every **five** years to set the mechanism and formula for **allocating tax revenues** between the **Centre** and **states**, as well as among states.
- The **First Finance Commission** was established in **1951** under **The Finance Commission (Miscellaneous Provisions) Act, 1951.**
- **Article 281** deals with **recommendations** of the **Finance Commission**.

Composition of The Finance Commission:

- It consists of a **chairman** and **four other members** to be appointed by the **president**.
- The chairman should be a person having **experience** in **public affairs** and the four other members should be selected from amongst the following:
    - A **judge of high court** or one qualified to be appointed as one.
    - A person who has **specialised knowledge** of **finance** and **accounts** of the government.
    - A person who has wide experience in **financial matters** and in **administration**.
    - A person who has **special knowledge** of **economics.**

Functions of Finance Commission:

- The Finance Commission recommends to the **president** of India on the following matters:
    - The distribution of taxes to be shared between the **Centre** and the **States**, and the allocation between the States of the respective shares of such proceeds.
    - The principles that should govern the **grants-in-aid** to the **states** by the Centre (i.e., out of the consolidated fund of India).
    - To **augment** the **Consolidated Fund** of a **state** to supplement the resources of the **panchayats** and the **municipalities** in the **state** on the basis of the recommendations made by the **State Finance Commission**.
    - Any other matter referred to it by the **president** in the interests of **finance**.

Role of Finance Commission:

- The Constitution of India envisages the Finance Commission as the **balancing wheel** of **fiscal federalism** in **India.**
- **Dr. P.V. Rajamannar**, the Chairman of the **Fourth Finance commission**, has highlighted the overlapping of functions and responsibilities between the **Finance Commission** and the erstwhile **Planning Commission** in federal fiscal transfers.
    - In **2015**, the **Planning Commission** was replaced by a **new body called NITI Aayog** (National Institution for Transforming India).

Report of the 15th Finance Commission for 2021-26:

- The **15TH** Finance Commission was **appointed** in **2017**.
- It took into account the **2011 population figures** in determining the expenditure needs of a State.
    - Before this, **1971** population numbers were considered for state-wise tax distribution.
- The **15th Finance Commission** was chaired by **Mr. N. K. Singh**.
- He submitted two reports, one consisting of **recommendations** for the **financial year 2020-21**, and second report with **recommendations** for the **2021-26** period.

Key recommendations in the report for 2021-26 include:

Share of states in central taxes:

- The share of states in the central taxes for the 2021-26 period is recommended to be **41%, same** as that for **2020-21**.
- The **Fourteenth Finance Commission** had raised the share of States in the divisible pool of central taxes to 42% from 32%.
    - This was revised to 41% when the number of States in India was reduced to 28.
- The adjustment of **1%** is to **provide** for the **newly formed union territories** of **Jammu and Kashmir, and Ladakh** from the resources of the centre.

Vertical distribution:

- During **2020-21** to **2023-24 (BE),** the effective share of States in the Centre's **Gross Tax Revenues (GTR)** averaged close to 31%, which was lower than the corresponding share of nearly **35%** during **2015-16 to 2019-20.**
    - This was due to the **increase** in the share of **cesses** and **surcharges** to **18.5%** of the Centre's GTR during 2020-21 to 2023-24 (BE) from **12.8%** during 2015-16 to 2019-20.
- The Sixteenth Finance Commission needs to scrutinise this **heavy reliance** on **cesses** and **surcharges.**

Problems with horizontal distribution:

- The share of individual States in the Centre's **divisible pool** of **taxes** is determined by a set of **indicators** like:
    - Population
    - Per capita income
    - Area
    - Incentive-related factors such as forest cover and demographic change.
- In the case of **per capita income**, it is the **distance** of a State's **per capita income** from a **benchmark**, usually kept at the **average per capita income** of the top **three States** that is used as a **determining factor**.
- This **distance criterion** implies relatively **larger shares** for **relatively lower-income States**.
    - Presently, it has the **highest** weight of 45%
    - Many rich States have argued for **lowering** the **weight** given to this criterion.
- The Centre gives away **41%** of its **tax pool** to the **States**.

- States which had done well in **stabilising population growth rates** will get **less** tax proportion.

Revenue Deficit grants:

- The Finance Commission awards to States remain in **deficit** on the current account even **after-tax devolution**.

- Every State in a country should be able to provide **a minimum level of service to its residents** even if it involves an element of **cross-subsidisation**.
    - **Cross subsidization** is the practice of charging higher prices to one type of consumer to artificially lower prices for another group.
- Horizontal distribution is employed to apply **evenness** to the whole nation and to decrease the divide present between the states.
    - **Horizontal distribution** is the distribution of tax revenue from the centre to be divided among the states.

Suggestions for the 16th Finance Commission:

The Finance Commission should focus on two issues in particular: **Cess and surcharges**, and **Freebies**.

Cesses and surcharges:

- The **first** is the practice by the Centre of resorting to a **levy** of **cesses** and **surcharges** rather than raising taxes.
- The proportion of **cesses** and **surcharges** in the Centre's total tax revenue had doubled from 10.4% in 2011-12 to 20.2% in 2019-20.

Restraint on freebies:

- **Political parties** provide **freebies** like electricity, water etc to the poor to make their base strong and
- The restraints imposed by the **Fiscal Responsibility and Budget Management (FRBM) Act** checks on the populist spending, but governments have found ingenious ways of raising debt without showing it in the **budget books**.
- It is not possible to categorise **freebies** and any check on this will be considered against the **sovereignty** of **elected governments**.
- The next Finance Commission shall lay down **guidelines** on the **spending** on **freebies** in the interest of **long-term fiscal sustainability** and lay down guidelines on the spending on freebies.

Equalisation principle:

- The equalisation principle refers to the **transfer** of **financial resources** to and between sub-**central governments** with the aim of mitigating **regional differences** in **fiscal capacity** and **expenditure** needs.
- **Equalisation** of the **provision** of **education** and **health services** should be prioritised in the overall scheme of resource transfers.
- Instead of using a large number of **tax devolution criteria**, the **transfer** of resources to individual

States may be guided by the **equalisation principle** using a limited criteria such as **population, area** and **distance**, supplemented by a **suitable scheme of grants**.

- The equalisation principle is **consistent** with **both equity** and **efficiency**.
  - It is used in federations such as **Canada** and **Australia**.
- The basic consideration of reflecting **needs, costs** of **providing services**, and equity considerations can all be reflected through these **three** criteria, provided there is more **fine-tuning**.

Conclusion:

India has a **federal structure** where centre and states divide resources for inclusive growth and development of the country. Finance Commission help in dividing the tax between the centre and states (**vertical distribution**) and also among the states (**Horizontal distribution**). This tries to create evenness in the country. Finance Commission helps improve the finances of states to supplement the resources of panchayats and municipalities.

