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Daily Editorial Analysis

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FINANCE COMMISSION & ITS CRITICAL TASK

Syllabus: GS2/ Polity and Governance

In Context: The Union Cabinet chaired by the Prime Minister has recently approved the Terms of Reference for the Sixteenth Finance Commission.

FINANCE COMMISSION

- ◆ **About:** The Finance Commission is a Constitutionally mandated body that is at the center of fiscal federalism. Each of these facets requires careful consideration when conceptualising action for equity.
- ◆ **Article 280:**
- ◆ The Finance Commission is Set up under Article 280 of the Constitution to recommend how tax revenue should be shared between the Union and states (and among states themselves).
- ◆ It empowered the President to, after 5 years from the commencement of the Constitution, constitute a Finance Commission every 5 years consisting of a Chairman and 4 other members.
- ◆ Parliament would determine the qualifications of the Commission's members and procedures.
- ◆ Draft Article 260 also laid down the duties of the Finance Commission.
- **Amendment to Article 280:**
 - ◆ In 1992, Article 280 was amended to expand the duties of the Finance Commission – to make recommendations to the President on increasing funds in the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State based on the recommendations made by the Finance Commission of the State.

16th Finance Commission - Terms of Reference

The Finance Commission shall make recommendations as to the following matters, namely:

- The **distribution between the Union and the States** of the **net proceeds of taxes** which are to be, or may be, divided between them and the allocation between the States of the respective **shares of such proceeds**;
- The **principles** which should **govern the grants-in-aid** of the revenues of the States out of the Consolidated Fund of India and the **sums to be paid to the States** by way of grants-in-aid of their revenues under article 275 of the Constitution for the purposes other than those specified in the provisos to clause (1) of that article; and
- The **measures needed to augment** the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.

FINANCE COMMISSION & FISCAL FEDERALISM

- **About Fiscal Federalism:**
 - ◆ It deals with the **division of financial powers** as well as the **functions** between multiple levels of the federal government.
 - ◆ It has within its ambit the **imposition of taxes** as well as the **division of different taxes** between the Centre and the constituent units.

- ◆ Similarly, in the case of **joint collection of taxes**, an objective criterion is determined for the fair division of funds between the entities.
- ◆ Usually, there is a **constitutional authority (like the Finance Commission in India)** to ensure fairness in the division.
- **Significance of fiscal federalism:**
 - ◆ Fiscal federalism broadly considers the vertical structure of the public sector, fiscal policy institutions and their interdependence.
 - ◆ Fiscal federalism is significant broadly due to **the following reasons:**
 - ◆ To determine at which level of government to assign different expenditure responsibilities.
 - ◆ To determine the strategy to finance a given level of public goods and services.
 - ◆ To adopt strategies to cap excessive spending and borrowing at each level of government

CHALLENGES AND LIMITATIONS OF FINANCE COMMISSION

- ◆ One of the major limitations to Finance Commissions is that the resources are limited while the demands on them are virtually unlimited.
- **Challenge of change is Political Power:**
 - ◆ If the term of an FC coincides with a basic shift in the fiscal relationship between the Union and states—as with the 15th FC, which saw GST launched in 2017—then its functions become strenuous.
 - ◆ The task before the 16th FC will be truly difficult.
 - ◆ This is because a Lok Sabha constituency rejig may overlap with its span of coverage from 2026-27 to 2031-32.
- **Intersecting domains:**
 - ◆ There is the intersecting domain of the **Finance Commission** and Goods and Services Tax (**GST Council**).
 - ◆ The latter's decisions impact the **own tax revenue flows of states** and, more importantly, the **size of the central tax revenue pool** which is to be shared among the central and state governments as per the recommendations of Finance Commissions.
 - ◆ **Finance Commission projections of state and central tax revenues**, and recommendations based on them will be **impacted by decisions taken by the GST Council**.

DEMANDS FOR CENTRALIZATION OF EXPENDITURE:

- ◆ Recent demands for greater **centralization of expenditure assignment** is another issue.

- ◆ India has a **quasi-federal system**.
- ◆ For purposes of legislation, regulation and administration, Schedule 7 of the Constitution assigns 97 subjects to the Union List.
- ◆ If there is any conflict between Union and State legislation, Union laws prevail.
- ◆ Even **for State subjects**, the **Union government can and does intervene** through centrally sponsored schemes in which it incentivizes states to take up the Centre's chosen schemes by financing a part of the cost of these programmes.
- ◆ **Equity considerations may require greater centralization** to enable the provision of comparable levels of public or merit services for all citizens in a country.
- **Third tier of government:**
 - ◆ Though the Constitution referred to the importance of local governments and Panchayati Raj institutions, it left it to the state legislatures to decide which functions, funds and functionaries should be assigned to PRIs and ULBs.
- **Capacity building:**
 - ◆ State governments have pointed out that **it is difficult to transfer functions to PRIs and ULBs**, which typically have **very low capacity**.
 - ◆ However, the **capacity of these institutions cannot be strengthened** unless they are **provided the resources to build** such capacity.
 - ◆ To help break this conundrum, the 13th, 14th and 15th FCs have all attempted in different ways to ensure substantial fund flows to PRIs and ULBs.
- **No reforms for PRIs:**
 - ◆ Chairman of the 13th FC, suggested that consolidated funds should be created for PRIs and ULBs, funded by earmarking a share of the central GST and state GST for them.
 - ◆ So far, except in one or two states, there have been no serious reforms to empower the third tier of government.

WAY AHEAD

- PSU investments have thinned out and the Planning Commission was abolished in 2014 with the result that the Finance Commission remains virtually the sole architect of India's fiscal federalism.
 - ◆ Its responsibility and influence are, therefore, much larger.
- Recommendations of **PV Rajamannar committee of 1971** needs to be considered which suggested that the **Finance commission be made a permanent body**

Daily Mains Question

[Q] Examine the Terms of Reference of 16th Finance Commission for the effective implementation of fiscal federalism in India. What are the challenges & limitations?

