Finance Commission of India

Mains: *GS II – Constitutional Bodies*

Why in News?

Recently there has been a growing concerns among the states regarding the devolutions of the finance commission.

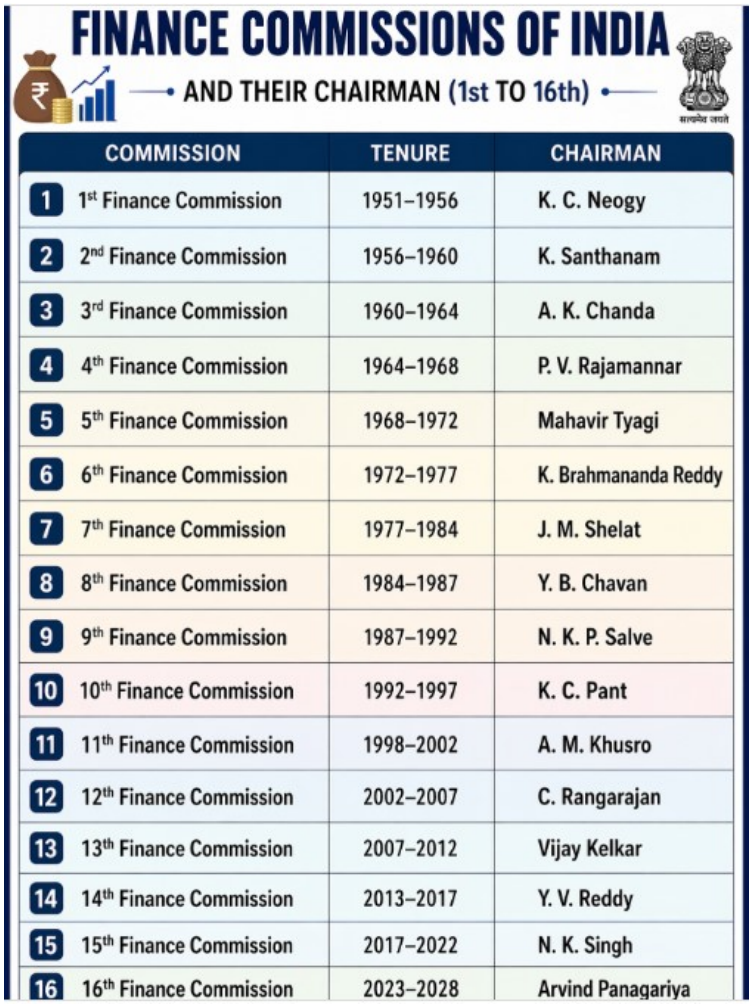
What is Finance Commission?

- **The Finance Commission (FC)** – The Finance Commission of India is a constitutional body established by the *President* under *Article 280* of the Constitution.
- **Key Functions –** The Commission is designed to ensure fair fiscal federalism and address the gap between the revenue powers and expenditure responsibilities of the Centre and the States.
- **Tax Distribution –** Recommending the share of net proceeds of taxes to be divided between the Centre and the States, and allocating those shares among the States themselves.
- **Grants-in-Aid –** Formulating principles governing the grants-in-aid of the revenues of the States out of the Consolidated Fund of India.
- **Local Finances –** Recommending measures needed to augment the Consolidated Fund of a State to supplement the resources of Panchayats and Municipalities based on the recommendations made by the State Finance Commissions.
- **Other Matters –** Making recommendations on any other matter referred to it by the President in the interest of sound finance.

What are the Structure & Composition of FC?

- **Appointment –** Constituted every fifth year (or earlier if deemed necessary by the President).
- **Structure –** Consists of a Chairman and 4 other members appointed by the President.
- **The Chairman –** The Chairman must be a person with extensive *experience in public affairs.*
- **Qualification** – The qualifications for members of the Finance Commission of India are determined by the Parliament through the *Finance Commission (Miscellaneous Provisions) Act, 1951.*
- The four other members are selected from individuals who meet at least one of the following criteria:
    - **Judicial –** They are, have been, or are qualified to be appointed as a Judge of a High Court.

    - **Accounts & Finance –** They have specialized knowledge of the finances and accounts of the Government.
    - **Administration –** They possess wide experience in financial matters and administration.
    - **Economics –** They possess special knowledge of economics.
- **Disqualifications –** Under the same 1951 Act, a person is disqualified from being appointed or continuing as a member if they:
    - Are of unsound mind.
    - Are an undischarged insolvent.
    - Have been convicted of an offense involving moral turpitude.
    - Hold any financial or other interest that is likely to prejudicially affect their functions as a member.



	COMMISSION	TENURE	CHAIRMAN
1	1st Finance Commission	1951–1956	K. C. Neogy
2	2nd Finance Commission	1956–1960	K. Santhanam
3	3rd Finance Commission	1960–1964	A. K. Chanda
4	4th Finance Commission	1964–1968	P. V. Rajamannar
5	5th Finance Commission	1968–1972	Mahavir Tyagi
6	6th Finance Commission	1972–1977	K. Brahmananda Reddy
7	7th Finance Commission	1977–1984	J. M. Shelat
8	8th Finance Commission	1984–1987	Y. B. Chavan
9	9th Finance Commission	1987–1992	N. K. P. Salve
10	10th Finance Commission	1992–1997	K. C. Pant
11	11th Finance Commission	1998–2002	A. M. Khusro
12	12th Finance Commission	2002–2007	C. Rangarajan
13	13th Finance Commission	2007–2012	Vijay Kelkar
14	14th Finance Commission	2013–2017	Y. V. Reddy
15	15th Finance Commission	2017–2022	N. K. Singh
16	16th Finance Commission	2023–2028	Arvind Panagariya

What are the recommendations and criteria of the 16th finance commission?

- **Vertical devolution** – The 16th Finance Commission retained the *41% vertical devolution* share.
- **Cess & Surchrges** – The FC accepted the Centre's argument that cesses and surcharges should remain outside the divisible pool because they finance welfare and infrastructure programmes benefiting States indirectly.
- **Abolition of certain grants** – The Commission also abolished revenue-deficit grants as well as sector-specific and State-specific grants.
- **Restrictions on borrowing power of states** – It recommended that States should

discontinue off-budget borrowings, bring all liabilities onto their budgets, and maintain fiscal deficits below 3% of Gross State Domestic Product (GSDP).

- **Horizontal devolution** – The Commission used six criteria for horizontal devolution:
  - Income distance – 42.5%
  - Population – 17.5%
  - Area – 10%
  - Forest cover – 10%
  - Demographic performance – 10%
  - Contribution to national GDP – 10%

What are the concerns raised on vertical devolution?

- **The GDP criterion** – Instead of using actual GSDP shares, the Commission adopted a square-root transformation formula.
- This reduced the relative advantage of economically stronger States such as Maharashtra, Tamil Nadu, and Karnataka while increasing the shares of smaller States.
- **Increase of vertical share** – Several States demanded that the vertical share should be increased to 50% because their fiscal pressures have increased substantially in recent years.
- **Cess & surcharges** – One major concern relates to the growing share of cesses and surcharges in the Union government's tax revenues.
- Since these revenues are not included in the divisible pool, States do not receive any share from them.
- The share of cesses and surcharges has crossed 15% of gross tax revenues, thereby reducing the effective transfers to States.
- Consequently, States demanded either their inclusion in the divisible pool or a cap of around 8% to 10%.
- **Non tax revenue** – States also argued that the Centre enjoys substantial non-tax revenues from sources such as natural resource extraction, asset monetisation, and surplus transfers from the Reserve Bank of India.
- These revenues further strengthen the Centre's fiscal position while the States continue to face increasing expenditure responsibilities.
- **Mounting fiscal pressures on states –** The fiscal position of States has deteriorated due to multiple factors.
- The COVID-19 pandemic increased public expenditure while simultaneously reducing revenue collections.
- **GST reforms** – In addition, structural changes introduced under the Goods and Services Tax (GST) regime reduced the taxation autonomy of States.
- The recent rationalisation of GST rates from four slabs to two principal rates has further constrained revenue flexibility.
- **Growing dominance of Centrally Sponsored Schemes (CSS)** – These schemes increasingly require States to contribute a larger share of expenditure.
  - **For example**, under the revised framework of the National Rural Employment Guarantee programme, States are required to bear 40% of programme costs.
  - Such arrangements reduce the fiscal autonomy of States because expenditure priorities are increasingly determined by the Centre.

- **Slowdown in the buoyancy of central taxes** – It has reduced the pace of revenue growth available for devolution.
- As a result, States fear that their fiscal space will continue to shrink in the coming years.

What are the debate over horizontal devolution?

- **Arguments of economically stronger states** – Traditionally, Finance Commissions have emphasised equity by allocating larger shares to poorer and fiscally weaker States.
- The 16th Finance Commission continued this approach by assigning the highest weight of 42.5% to the income-distance criterion.
- However, economically stronger States have criticised this method because they believe it excessively rewards poorer States while penalising States that have performed better in economic growth, fiscal discipline, and population control.
- Over time, the share of major beneficiary States such as Uttar Pradesh, Bihar, Madhya Pradesh, and West Bengal has increased significantly.
- Their combined share rose from 42.5% during the Sixth Finance Commission period to nearly 51% under the 15th Finance Commission.
- In contrast, the combined share of southern States such as Andhra Pradesh, Karnataka, Kerala, and Tamil Nadu declined from 24.8% to 15.8%.
- This trend has intensified concerns among southern States that they are being penalised for successful governance and economic performance.
- **Limited Impact of Fiscal Transfers on Development –** Despite increasing transfers to poorer States, regional disparities in public service delivery continue to persist.
- Large differences remain in health and education expenditure across States.
    - **For instance,** Bihar spent only Rs.937 per person on health in 2022-23, while Arunachal Pradesh spent Rs.10,148 per person.
    - Similarly, Bihar's per-student expenditure on elementary education was far lower than that of States such as Sikkim.
- These examples suggest that unconditional fiscal transfers alone may not ensure convergence in development outcomes.
- Critics argue that excessive equalisation transfers can weaken incentives for revenue mobilisation, governance reforms, and fiscal discipline in poorer States.
- **Alternative Devolution Scenarios –** The alternative weighting schemes could have produced significantly different outcomes.
- If GDP contribution had received a 25% weight instead of 10%, and the weight assigned to income distance had been reduced, economically stronger States would have received substantially larger transfers.
    - **For example**, Maharashtra, Karnataka, and Tamil Nadu would have gained additional transfers amounting to lakhs of crores over the award period.
- Given that the total vertical transfers during the Commission's award period are estimated at Rs.104 lakh crore, even small percentage changes in devolution shares have enormous fiscal implications.
- This debate reflects the broader tension between equity and efficiency in India's fiscal federal structure.
- **The Political Economy Dimension –** The issue also has an important political

dimension.

- In India, unlike federations such as Australia or China, economically stronger States are not necessarily the most politically influential in terms of parliamentary representation.
- Consequently, States with larger populations often receive greater fiscal transfers despite weaker economic performance.
- The issue may intensify further after delimitation because northern States are expected to gain greater representation in Parliament.
- This could strengthen political incentives for larger fiscal transfers toward populous States.

What lies ahead?

- The recommendations of the 16th Finance Commission reveal the continuing challenge of balancing equity and efficiency in Indian fiscal federalism.
- While poorer States require greater support to overcome developmental disadvantages, economically stronger States seek recognition for their contribution to national growth, fiscal discipline, and demographic management.
- Future Finance Commissions must therefore adopt a more balanced and data-driven approach.
- Greater emphasis should be placed on fiscal capacity, tax effort, governance quality, and developmental outcomes rather than relying predominantly on non-fiscal indicators.
- Mechanisms such as principal component analysis can help create a more objective and transparent framework for assigning weights.
- Ultimately, a sustainable fiscal federal system must combine equity with incentives for efficiency so that all States remain motivated to contribute to India's long-term economic development.

Reference

[The Hindu| FC & Devolution Issues]

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