Sixteenth Finance Commission

Why in news?

The Finance ministry is likely to initiate the process to set up Sixteenth Finance Commission.

What is Finance Commission?

- **Constitutional body –** The Finance Commission is a constitutional body formed by the President of India to give suggestions on centre-state financial relations.
- **Autonomous body –** The Finance Commission (FC), an autonomous body which is governed by the government of India.
- **Article 280 –** It was established by the President of India in 1951 under Article 280 of the Indian Constitution.
- It was formed to define the financial relations between the central government of India and the individual state governments.
- As per the Constitution, the Commission is appointed every 5 years and consists of a chairman and 4 other members.

How the role of Finance Commission has changed over the years?

- **Pre-reforms –** In the pre-reform period, the Finance Commission recommendations were not that critical.
- This is because the Centre had other ways to compensate States, or indeed to play favourites, through plan financing and public sector undertaking (PSU) investments.
- **Post-reforms –** Post reforms, fresh PSU investments have thinned out and the Planning Commission was abolished in 2014.
- This virtually made the Finance Commission the sole architect of India's fiscal federalism.
- Its responsibility and influence are, therefore, much larger.

What is horizontal and vertical tax devolution?

- Article 280 of the Constitution mandates that each FC make recommendations about the distribution of net proceeds of taxes between the Union and states and among the states.
- **Vertical devolution –** The distribution of net proceeds of taxes between the Union and States is called vertical devolution.
- **Horizontal devolution –** The distribution of net proceeds among states is called horizontal devolution.
- The FC has wide powers under the Constitution to redefine financial relations between and among the Union and states.

Why the 16th Finance Commission will face an issue in horizontal distribution?

- **Tax pool –** Currently, the Centre gives away 41% of its tax pool to the States and the States will demand that this proportion be raised.
- **Borrowing Limit –** However, there is not much room for stretching this further, given the Centre's expenditure needs and the constraints on its borrowing limit.
- **Fiscal incapacity –** Historically, Finance Commissions have struggled to determine how much a State's deficit is due to its fiscal incapacity and how much is due to fiscal irresponsibility.
- **Distribution formula –** They have tried to tweak the distribution formula to support deficit States without penalising responsible States.
- This is regarded as a mathematically impossible task since it is not possible to give more to a State without giving less to another.
- **Inefficient & unfair –** The net result is that every horizontal distribution formula has been criticised as being inefficient or unfair or both.
- The bottom-line though is that it is in the very nature of horizontal distribution that *richer States compensate poorer States*.
- This will challenge the government in defining the terms of reference of the 16th FC, and of the FC itself in delivering on those terms of reference.

How will the 16th FC deal with Cesses and Surcharges?

- The terms of reference of the FC enjoin it to take into account the expenditure needs and revenue earning capacity of the Centre and States.
- The 16th FC should use this leverage to focus on 2 issues in particular.
- The first is the bad practice by the Centre of increasingly resorting to a levy of cesses and surcharges rather than raising taxes.
- The FC should also lay down guidelines for when cesses and surcharges might be levied, and suggest a formula to cap the amount that can be raised.

How should freebies dealt in the 16th FC?

- Another issue of focus for the 16th FC should be government spending on what has come to be called freebies.
- All political parties are guilty on this count, some more than others.
- In a poor country, where millions of households struggle for basic human needs, it sounds cruel to argue against safety-nets for the poor.
- However, it is precisely because India is a poor country that we need to be more circumspect about freebies.

What is the way forward?

- In theory, the restraints imposed by the Fiscal Responsibility and Budget Management (FRBM) Act should have acted as a check on such populist spending.
- However, the governments have found ingenious ways of raising debt without it appearing in the budget books.
- The next Finance Commission should bite the bullet in the interest of long-term fiscal sustainability and lay down guidelines on the spending on freebies.

- Good governance can trump the lure of freebies and the 16th FC should embolden itself to formalise a mechanism for a restraint on freebies.

Related articles – 14th Finance Commission & 15th Finance Commission.

References

1. The Hindu │The next Finance Commission will have a tough task
2. The Economic Times │ Government to set up 16th FC
3. The Hindu │ Process to set up 16th FC

