2.SIXTEENTH FINANCE COMMISSION RECOMMENDATIONS - POLITY

The Sixteenth Finance Commission presented its recommendations amid concerns over rising cess and the balance between efficiency and equity, raising questions about effective devolution and equalisation

1. Finance Commission of India

1. The Finance Commission (FC) is a constitutional body that maintains fiscal balance between the Union and the States in India.
2. It plays a crucial role in India's fiscal federal structure by recommending how financial resources should be shared among different levels of government.

2. Constitutional Basis

1. The Finance Commission is constituted by the President of India under Article 280 of the Constitution.
2. It is generally reconstituted every five years, although the President may establish it earlier if required.
3. The Commission consists of one Chairperson and four other members appointed by the President.
4. Parliament determines the qualifications, powers, and service conditions of members through the Finance Commission Act, 1951.

3. Key Constitutional Articles

1. Article 280 – Establishes the Finance Commission and outlines its functions.
2. Article 270 – Deals with the distribution of taxes between the Centre and States.
3. Article 275 – Provides for grants-in-aid to States from the Consolidated Fund of India.
4. Article 281 – Requires the President to place the Finance Commission's recommendations before Parliament along with an explanatory memorandum.

4. Core Functions of the Finance Commission

A. Distribution of Tax Revenues

1. The Finance Commission recommends how the net proceeds of Union taxes should be distributed between the Centre and States.

Vertical Devolution

1. Refers to the share of States in the total divisible pool of central taxes.
2. Determines what percentage of Union tax revenue should be transferred to all States collectively.

Horizontal Devolution

1. Refers to the distribution of the States' share among individual States.
2. Allocation is based on criteria such as:
    1. Population
    2. Income distance
    3. Area
    4. Forest and ecological factors
    5. Demographic performance
    6. Fiscal capacity or discipline.

B. Grants-in-Aid to States

1. The Commission recommends grants under Article 275 for States with special financial needs.
2. These grants aim to reduce regional disparities and promote balanced development.

C. Strengthening Local Governments

1. After the 73rd and 74th Constitutional Amendments, the Finance Commission also recommends measures to augment the Consolidated Fund of States.
2. These funds support Panchayats and Municipalities.

D. Fiscal Consolidation and Stability

1. The Commission suggests measures to improve fiscal discipline, debt sustainability, and efficient public expenditure.

5. Divisible Pool of Taxes

1. The divisible pool refers to the total net tax revenues of the Union government that are shareable with the States.

Taxes Included

1. Income tax
2. Corporate tax
3. Central share of GST
4. Customs duties
5. Union excise duties.

Taxes Excluded

1. Cesses
2. Surcharges
3. Increasing reliance on cesses and surcharges allows the Centre to retain revenue that would otherwise be shared with States.

6. Sixteenth Finance Commission (16th FC)

A. Overview

1. The Sixteenth Finance Commission was constituted in December 2023.
2. It is chaired by Arvind Panagariya, former Vice-Chairman of NITI Aayog.
3. Its recommendations cover the award period 2026–27 to 2030–31.

B. Composition

1. Chairperson – Arvind Panagariya
2. Other members include experts in public finance, economics, administration, and fiscal policy.

7. Key Recommendations of the 16th Finance Commission

A. Vertical Devolution

1. The Commission retained the States' share at 41% of the divisible pool.
2. The 14th Finance Commission had earlier increased the share to 42%.
3. It was later reduced to 41% after the reorganisation of Jammu and Kashmir into Union Territories.

Rationale

1. Maintaining the same share ensures fiscal stability and predictability for States.
2. It prevents sudden fiscal shocks to State budgets.

B. Issue of Cesses and Surcharges

1. The Commission recommended that a substantial portion of cesses and surcharges be merged with shareable taxes.
2. However, no strict limits or timelines were imposed.

Implication

1. Growing reliance on cesses and surcharges reduces the effective share of States even if the official devolution percentage remains unchanged.

C. Discontinuation of Certain Grants

The 16th Finance Commission discontinued several grants earlier recommended by the 15th Finance Commission, including:

1. Revenue deficit grants
2. Sector-specific grants
3. State-specific grants.

Impact

1. Reduces the equalisation role of the Finance Commission.
2. States with weaker fiscal capacity may face greater financial constraints.

D. Horizontal Devolution Formula

1. The Commission introduced changes in the criteria used to distribute funds among States.

Introduction of Efficiency Criterion

1. A new criterion based on economic contribution was introduced.
2. It measures a State's share in total Gross State Domestic Product (GSDP).

To prevent large states from dominating allocation:

1. The square root of GSDP is used instead of raw GSDP.

Objective

1. Encourage economic productivity and growth-oriented policies.
2. Reward States contributing more to national economic output.

E. Removal of Tax Effort Criterion

1. Earlier Finance Commissions included tax effort or fiscal discipline as a criterion.
2. The 16th Finance Commission removed this factor.

Implication

1. Some analysts argue that removing this factor weakens incentives for States to improve tax mobilisation and fiscal management.

8. Concerns Regarding the 16th Finance Commission

A. Growing Use of Cesses and Surcharges

1. Cesses and surcharges are not shared with States.
2. Their increasing share in Union revenue reduces the effective divisible pool.

Concern

1. Even with a formal 41% share, the actual transfers to States may decline.

B. Weakening of Equalisation Role

1. The Finance Commission traditionally reduces fiscal disparities between richer and poorer States.
2. Removal of revenue deficit and state-specific grants reduces targeted financial support.

C. Underutilisation of Article 275 Grants

1. Article 275 grants allow targeted support to States facing special developmental challenges.
2. Reduced emphasis on these grants limits the Commission's equalisation function.

D. Balance Between Equity and Efficiency

1. The new GSDP-based efficiency criterion may favour economically stronger States.
2. Poorer States may face difficulties in catching up with development levels.

9. Significance for Indian Federalism

A. Promotes Cooperative Federalism

1. Ensures predictable fiscal transfers from the Centre to States.
2. Facilitates coordination between different levels of government.

B. Addresses Regional Inequality

1. Horizontal devolution and grants help reduce disparities among States.

C. Ensures Fiscal Discipline

1. Encourages responsible fiscal management and sustainable public finances.

10. Conclusion

1. The Sixteenth Finance Commission retained the 41% vertical share of States, ensuring continuity in fiscal transfers.
2. However, its reduced reliance on grants and greater emphasis on formula-based transfers indicates a shift toward efficiency-oriented fiscal federalism.
3. At the same time, unresolved issues such as the increasing use of cesses and surcharges and weakening equalisation mechanisms raise concerns about equity and the constitutional spirit of cooperative federalism in India.

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