



# IAS PARLIAMENT

*Information is Empowering*  
A Shankar IAS Academy Initiative

## 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 16<sup>th</sup> 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 16<sup>th</sup> FC, and of the FC itself in delivering on those terms of reference.

### How will the 16<sup>th</sup> 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 16<sup>th</sup> 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 16<sup>th</sup> FC?

- Another issue of focus for the 16<sup>th</sup> 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 16<sup>th</sup> FC should embolden itself to formalise a mechanism for a restraint on freebies.

Related articles - [14<sup>th</sup> Finance Commission](#) & [15<sup>th</sup> Finance Commission](#).

## References

1. [The Hindu | The next Finance Commission will have a tough task](#)
2. [The Economic Times | Government to set up 16<sup>th</sup> FC](#)
3. [The Hindu | Process to set up 16<sup>th</sup> FC](#)



**IAS PARLIAMENT**  
*Information is Empowering*  
A Shankar IAS Academy Initiative