



Finance Commissions

This editorial is based on [Why normative recommendations of finance commissions remain on paper](#) which was published in The Indian Express on 13/07/2023. It talks about finance commissions and associated issues.

For Prelims: [Finance Commissions](#), [Fiscal Federalism](#), [Lok Adalat](#), [Alternate Dispute Resolution](#), [Parliament](#), [GST Council](#), [Covid-19 pandemic](#), [Climate Change](#)

For Mains: Challenges of Finance Commission

Finance Commissions (FCs) **play a crucial role** in shaping the **fiscal federalism** and development trajectory of India. They make **recommendations on how to distribute the financial resources** between the Union and the states, as well as among the states, for a period of five years. FCs also **provide guidance and advice** on various issues related to public finance, governance and development, such as **fiscal consolidation, debt management, local bodies, disaster relief, health, education, justice delivery, statistical system**, etc. FCs have made significant contributions to enhancing the fiscal autonomy, equity and efficiency of the Union and state governments, as well as promoting cooperative and competitive federalism in the country. However, they also face several challenges and limitations in fulfilling their mandate, especially in the context of a dynamic and complex political economy environment.

What are Finance Commissions?

- FCs are constitutional bodies set up **under Article 280** of the Constitution **every five years** to make recommendations on the distribution of financial resources between the Union and the states.
- Recommendations cover three main aspects:
 - **Vertical Devolution:**
 - The share of states in the divisible pool of central taxes.
 - **Horizontal Distribution:**
 - The allocation of resources among states based on a formula that reflects their fiscal needs, capacities and performance.
 - **Grants-in-aid:**
 - The additional transfers to specific states or sectors that are in need of assistance or reform.
 - Among the grants made by the 13th FC, two important ones were justice delivery and the statistical system.
 - The Department of Justice **identified several initiatives** that needed support, including increasing the **number of courts working hours**, enhancing support to [Lok Adalat](#), providing additional funding to **State Legal Services Authorities**, promoting the [Alternate Dispute Resolution](#)

- mechanism, enhancing the capacity of judicial officers and public prosecutors through training programmes, and supporting the creation of a judicial academy in every state to facilitate such training.
- Similarly, for equitable horizontal distribution, the measurement of cost disabilities is important, and the cost of services varies across states due to a large number of factors.

What are Some of FCs' Successful Recommendations?

- FCs have made several recommendations over the years that have had significant impact on various aspects of public finance, governance and development in India. Some examples are:
 - Introducing tax devolution as a major component of vertical transfers, **increasing the share of states from 10% to 42% over time.**
 - Introducing performance-based incentives for states to encourage **fiscal discipline, population control, forest conservation, power sector reforms, etc.**
 - **Introducing disaster relief funds for states and local bodies** for enhancing their preparedness and response capacity for natural calamities.
 - **Introducing grants for local bodies** strengthening their fiscal autonomy and accountability for delivering basic services.
 - Introducing **grants for specific sectors** such as health, education, justice delivery, statistical system, etc. addressing critical gaps and needs in these areas.

How are the Recommendations of FCs Implemented and Monitored?

- The recommendations of FCs are **advisory in nature and not binding** on the Union government. However, they are **usually accepted with minor modifications** or deviations.
- The Union government **notifies the acceptance** of the recommendations **through a Presidential Order**, which also specifies the period for which they are valid (usually five years).
- The Union government also **tables an explanatory memorandum in Parliament**, stating the action taken on the recommendations and the reasons for any deviation.
- The implementation and monitoring of the recommendations are **done by various ministries and departments** at the Union and state levels, **depending on the subject matter and the conditions** attached to the transfers.

What are the Challenges of FCs?

- **Data Gaps and Quality Issues:**
 - FCs rely on official data sources to assess the fiscal situation and performance of the Union and states, but these **data are often incomplete, inconsistent or outdated.**
 - For instance, there is no reliable data on inter-state trade flows, unit costs of public services, or outcomes of various schemes and programmes.
- **Political Economy Factors:**
 - FCs have to balance the competing interests and demands of various stakeholders, such as **the Union government, state governments, local bodies, civil society groups, etc.**
 - They also have to take into account the changing political and economic scenarios in the country and the world.
- **Implementation Challenges:**
 - FCs have to ensure that their recommendations are feasible, acceptable and effective in achieving the desired objectives.
 - However, they have **no direct control over how their recommendations are implemented** or monitored by the Union and state governments.
 - They also have to deal with issues such as delays, deviations, non-compliance or misuse of funds by the recipients.
- **Evaluation Difficulties:**
 - FCs have to assess the impact and outcomes of their recommendations on various indicators of fiscal health, governance quality and development performance.
 - However, they face difficulties in attributing causality, isolating effects, measuring outcomes and attributing value to their interventions.

What are Some New Issues for the 16th FC?

- **The Co-existence of the GST Council:**
 - The [GST Council](#) is a permanent constitutional body that decides on tax rates and other matters related to GST.
 - Its decisions **can affect the revenue projections and calculations** made by FCs for sharing fiscal resources.
 - There is a need for a mechanism for FCs to revisit their numbers due to GST Council's decisions or vice versa.
- **The Funding of Defence and Internal Security:**
 - As an afterthought, [the Fifteenth FC](#) was given an additional term of reference to determine whether a separate mechanism for funding defence and internal security should be set up.
 - It recommended **creating a non-lapsable fund for this purpose, which was accepted by the government in principle**, but its implementation still has to be worked out.
- **The Impact of Covid-19 Pandemic:**
 - The [Covid-19 pandemic](#) has caused unprecedented disruption and uncertainty in the economy and public finances.
 - It has also highlighted the need for **strengthening the health system** and social protection measures.
 - The **Sixteenth FC will have to take into account the impact** and implications of the pandemic on the fiscal situation and performance of Centre and States, as well as their expenditure needs and priorities.

What Should be the Way Forward?

- **Enhancing Fiscal Autonomy and Equity:**
 - FCs should aim to provide adequate and predictable resources to the Union and state governments, based on their respective constitutional responsibilities and expenditure needs.
 - They should also **ensure a fair and transparent distribution of resources among** states, taking into account their fiscal capacities, performance and special circumstances.
- **Promoting Fiscal Efficiency and Accountability:**
 - FCs should encourage the Union and state governments to adopt sound fiscal policies and practices, **such as fiscal consolidation, debt sustainability, revenue mobilisation, expenditure rationalisation, etc.**
 - They should also incentivise them to improve the quality and effectiveness of public spending, especially in priority sectors such as health, education, infrastructure, etc.
- **Addressing Emerging Issues and Challenges:**
 - FCs should be responsive and proactive to the changing economic and social scenarios in the country and the world.
 - They should address the issues and challenges posed by the **GST implementation, Covid-19 pandemic, climate change, digital transformation, etc.**
 - They should also explore new avenues and mechanisms for enhancing cooperative and competitive federalism in the country.
- **Strengthening Institutional Capacity and Credibility:**
 - FCs should improve their analytical and advisory capabilities, by using **reliable and updated data sources, applying robust** and innovative methodologies, engaging with experts and stakeholders, etc.
 - They should also **enhance their communication and outreach strategies**, by disseminating their reports and recommendations widely, soliciting feedback and suggestions, creating awareness and consensus among various actors, etc.

Drishti Mains Question:

Discuss the challenges and limitations faced by Finance Commissions in fulfilling their mandate, especially in the context of a dynamic and complex political economy environment.

UPSC Civil Services Examination Previous Year's Question (PYQs)

Prelims:

Q. Consider the following: (2023)

1. Demographic performance
2. Forest and ecology
3. Governance reforms
4. Stable government
5. Tax and fiscal efforts

For the horizontal tax devolution, the Fifteenth Finance Commission used how many of the above as criteria other than population area and income distance?

- (a) Only two
- (b) Only three
- (c) Only four
- (d) All five

Ans: (b)

Mains

Q. Discuss the recommendations of the 13th Finance Commission which have been a departure from the previous commissions for strengthening the local government finances. (2013)

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