Issues before the Sixteenth Finance Commission

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The finance commission's expanding responsibilities have led to an increased workload. This has resulted in the distribution of transfers across states with minor changes, causing fiscal imbalances. It is crucial to define the Sixteenth Finance Commission's scope carefully to prevent such imbalances.

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The transfers of revenue from the union to the state governments for effective performance through an independent body serve the objectives of equity and efficiency relatively better than those of a political body (Khemani 2007). The finance commission in India is treated as an independent, impartial, competent and semi-judicial body that has dealt with revenue transfer tasks from the union to state governments over more than seven decades. The transfers of the finance commission achieve equity and efficiency objectives to a greater extent compared to transfers of the political bodies like the Planning Commission and central ministries (Khemani 2007). However, rising fiscal imbalances persist (Mahamallik and Sahu 2015). These imbalances are due to structural and methodological inconsistencies as well as unwanted changes in the scope of the finance commission.

The scope of the Fifteenth Finance Commission was significantly expanded compared to previous commissions. The commission was given additional tasks besides determining tax and grants devolution to states.[1] The commission kept the vertical sharing proportion the same as the Fourteenth Finance Commission and distributed union shared taxes across states with an increased weight of neutral criteria and decreased weight of equity criteria compared to the Fourteenth Finance Commission. A marginal weight was assigned to efficiency criteria to reduce fiscal imbalances.

However, when the average revenue expenditure and total expenditure shares of states increased by 0.44% and 0.38%, respectively, from the Fourteenth to the Fifteenth Finance Commissions, the use of constant vertical sharing proportion did not enable a reduction in vertical imbalance (Table 1, p 23). The horizontal imbalance increased with the provision of proportionately more shares to rich states by the neutral criteria (Table 2, p 23); these corroborate GoI (2020).

Table 1: Vertical Fiscal Imbalance

Union Finance Commission	ORS as % of CoRRCS	RES as % of CoRECS	TORS as % of CoTRCS	TES as % of CoTECS	Per 1% of ORS: RES as % of CoRECS	Per 1% of TORS: TES as % of CoTECS
Seventh	37.85	57.82	47.63	NA	1.53	NA
Eighth	36.62	55.32	45.77	53.98	1.51	1.18
Ninth-1	35.61	52.97	46.85	52.90	1.49	1.13
Ninth-2	38.50	56.89	47.46	57.68	1.48	1.22
Tenth	38.13	56.05	46.76	57.39	1.47	1.23
Eleventh	37.73	54.94	42.86	59.99	1.46	1.40
Twelfth	36.12	52.72	47.77	56.99	1.46	1.19
Thirteenth	37.95	53.65	49.03	57.06	1.41	1.16
Fourteenth	36.78	60.75	43.11	64.71	1.65	1.50
Fifteenth	36.58	61.19	42.31	65.09	1.67	1.54
Average	37.37	55.98	46.15	58.42	1.50	1.30

ORS = own revenue of state, CoRRCS = combined revenue receipts of centre and state, RES = revenue expenditure of state, CoRECS = combined revenue expenditure of centre and state, TORS = total own receipts of state, CoTRCS = combined total receipts of centre and state, TES = total expenditures of state, and CoTECS = combined total expenditures of centre and state.
Source: Reserve Bank of India.

Unwanted additional tasks, implicit conditions, and some centrally biased areas of scope (Reddy 2018) added confusion to the activities of the commission.

The union government is preparing to constitute the Sixteenth Finance Commission for five years beginning from 2026–27. This article attempts to re-examine the terms of reference (ToR) of the 15 finance commissions. It had been observed that certain factors, such as the exclusion of examination of plan account from the finance commission (Chelliah et al 1992) and centrally biased areas (Reddy 2007, 2018) as well as the directives and implicit conditions related to basic areas and unwanted tasks, had created difficulties for the commissions to adopt suitable methods with weights for the distribution of tax and grants to reduce imbalances. When defining the scope of the Sixteenth Finance Commission, these factors should be given due consideration.

Table 2: Horizontal Fiscal Imbalance across 14 Undivided Major States

States	ORS as % of RES	TORS as % of TES	RES as % of TES
Andhra Pradesh	63.41	72.88	78.03
Bihar	36.72	43.51	77.41
Gujarat	72.71	74.20	75.75
Haryana	76.69	77.59	78.54
Karnataka	71.19	73.44	77.77
Kerala	60.08	58.08	83.42
Madhya Pradesh	56.65	56.86	77.17
Maharashtra	75.14	74.54	80.19
Odisha	45.26	54.83	76.66
Punjab	66.66	62.35	77.53
Rajasthan	53.73	86.18	76.68
Tamil Nadu	67.13	74.32	80.54
Uttar Pradesh	46.77	44.60	76.17
West Bengal	44.17	54.09	81.18
Average	59.73	64.82	78.36
SD	12.82	13.08	2.19
CV	21.46	20.18	2.80

Acronyms are the same as in Table 1.
Source: Same as Table 1.

Constitutionally Assigned Scope

The finance commission is constitutionally assigned a scope under three sub-clauses of clause (3) of Article 280 to achieve the desired goals of the transfer system. The three sub-clauses (a), (b), and (c) confine to vertical and horizontal sharing of shareable union taxes, grants-in-aid to states in need of assistance out of the Consolidated Fund of India under Article 275, and any other matter referred for sound finance of the country (Vyasulu 1996).

Continuity and Change

The unwanted change in scope through directives and implicit conditions imposed on sub-clauses (a) and (b) lead to contradictions and asymmetries that create confusion in determining the appropriate share of states in tax and grant devolution and methods for inter se distribution of shared tax. This interferes with the commission's ability to reduce fiscal imbalance.

Anything that helps achieve an objective should be continued, while anything that adversely affects its progress should be discontinued. Deciding what to continue and what not to is a matter of policy prescription. Change is always expected to bring about reform in any subject matter. When something leads to dislocation, change is inevitable. Change can be brought about either through (i) replacement of the old by the new; (ii) adding something new to the old; (iii) deleting something from the old; and (iv) modifying the old.

In the case of the first option, if the new removes the demerits without reducing the merits of the old, then it has a greater chance of achieving the desired objectives. However, if the new option reduces the merits of the old one without resolving its demerits, it can lead to failure. Similarly, the success or failure of the other three options also depends on how well they address the disadvantages while preserving the advantages of the old system. It is important to evaluate the effectiveness of any policy by analysing its continuity and changes over time.

Successive commissions have witnessed continuity and change under the three constitutionally assigned sub-clauses. The first two exhibit admirable continuity by attempting to offset fiscal imbalances and provide basic public goods to people according to their preferences across regions. The change in areas under clause (a), which includes all central taxes in the shareable category since the Constitutional Amendment Act of 2000, is a positive step. This change replaced income taxes (compulsorily) and union excise duties (maybe shareable) under Articles 270 and 272, respectively. It increased the share of states in the net proceeds compared to the sharing of just two taxes. This is due to the low tax mobilisation effort of the central government on these two taxes.

Article 280, clause (4) assigned the power to finance commissions to use methods for the vertical and horizontal sharing of tax proceeds as well as grants determination (Vyasulu 1996). However, the Fifth Finance Commission has faced criticism due to the inclusion of implicit conditions in clause (b). Implicit conditions were also linked to areas under clause (a) since the Seventh Finance Commission and the number of such conditions increased over the successive commissions. The use of the words "shall" and "shall have regard to" in the scope has implied directions since the Fifth Finance Commission (Thimmaiah 2002).

Population figures from the 1971 Census from the Seventh to the Fourteenth Finance Commissions and the 2011 Census in the Fourteenth and Fifteenth Finance Commissions for tax and grants devolution were used. However, there are certain directions and implicit conditions that discourage members from performing these activities effectively. In the Fourteenth Finance Commission, demographic changes since 1971 (Bhaskar and Subrahmanyam 2014) and the 2011

Census population figures (Bhaskar 2018) during the Fourteenth and Fifteenth Finance Commissions for tax devolution criteria in the TORs increased horizontal imbalance (Bhaskar 2018).

The expansion of the scope under clause (b) from the Second to the Fourth Finance Commissions is a welcome development for the improvement of backward states. Grants can help achieve revenue stability of the state, equity and achievement of specific objectives, which are not fulfilled by tax devolution (Rangarajan 2005). The areas increased from grants out of the Consolidated Fund of India and under Article 275 of the Constitution from the First Finance Commission to include the tax efforts of states during the Fourth Finance Commission. Grants to states in need of assistance under Article 275 implicitly linked to tax revenue generation capacity and non-plan expenditure of state made the commission use the gap filling approach (GFA) for grant distribution.[2] GFA increased horizontal imbalance by providing proportionately lower shares to poorer states and larger shares to richer states due to the small size of the budget of the former (Mahamallik and Sahu 2015). Yet, it is continuously used by successive commissions till the Fifteenth Finance Commission. The comprehensive analysis of state finances and fiscal management requires the synchronisation of the expenditure base of GFA to both plan and non-plan expenditures from the Third to the Twelfth Finance Commissions (Chelliah et al 1992; Thimmaiah 2002). Grants linked to tax efforts can increase the efficiency of states. The abolition of grant under clause (1) of Article 275 since the Second Finance Commission was meant for the development of backward states that have a larger proportion of the Schedule Tribe population. The continuous reduction in the share under clause (b) from the Fifth to the Fifteenth Finance Commissions (except during the Twelfth Finance Commission[3]) increases regional disparity.

The number of conditions linked to grants over successive commissions increased since the Sixth Finance Commission. Implicit condition linked to grants itself was also linked to some other conditions during the Seventh Finance Commission. Certain areas of implicit conditions are to be assessed with due consideration. For instance, the non-plan expenditures of the state are to be considered on the basis of national policies and priorities. Out of the non-plan expenditures of the state, the assessing salaries of government employees with objective criteria and commitments on interest and fund transfers to local bodies and aided institutions should be given due consideration. However, this practice was discontinued from the Ninth Finance Commission onwards. The "states which are in need of assistance" is not observed under clause (b) of the Fifteenth Finance Commission indicating consideration of grants beyond the need of the state (Bhaskar 2018).

Like clauses (a) and (b), the change in some areas in clause (c) in the name of sound finance creates confusion for the commission. "Any other matters" referred to in clause (c) involve directives which increased in number from the Second to the Fifteenth Finance Commissions. For instance, the Second Finance Commission was asked to distribute the net proceeds of taxes under Article 269 and additional excise duties and determine the rate of interest of the union government loans given to states. During the Third to the Eighth Finance Commissions, it was required that a specific sum be distributed in place of tax on railway fares, in addition to the first two matters included in the scope of the Second Finance Commission. This clause assigned tasks that were not related to the basic objective of transfers, which increased the work burden of the commissions. For example, tasks such as determining the rate of interest of the union government loans given to the state during the Second Finance Commission, studying problems of overdraft during the Fifth Finance Commission, reviewing the Calamity Relief Fund (CRF) during the Tenth and Eleventh Finance Commissions, preparing road maps for fiscal adjustment for the centre and financing for disaster management relating to National Calamity Contingency Fund (NCCF) and CRF during the Thirteenth Finance Commission, public expenditure management and financing for disaster management in the Fourteenth Finance Commission, and financing for disaster management in the Fifteenth Finance Commission were given to the finance commissions.

The task to ensure budgetary balance and macroeconomic stability through revising union and state finance was included in the scope of the commission during the Eleventh Finance Commission and continued till the Fifteenth Finance Commission. Although this is useful, the number of conditions linked to it increased over successive commissions. For example, debt reduction and promoting equitable growth were added during the Twelfth Finance Commission, while ensuring sustainable macroeconomic stability was included during the Thirteenth Finance Commission. During the Fifteenth Finance Commission, the focus was on inclusive growth and revenue deficit grants.

The finance commissions face difficulties in performing these multiple tasks within a short period. The tenure of the commission ranged from 360 days during the Third Finance Commission to 914 days during the Ninth Finance Commission (GOI 2021). In the absence of the constitutional stricture, the personal judgment of either the council of ministers headed by the Prime Minister or bureaucrats determines these tasks.

Fiscal Imbalances

Vertical and horizontal fiscal imbalances are seen to persistently rise over the successive commissions (Tables 1, 2, and 3).

State's lower receipts (own revenue [37.37%] and total own receipts [46.15%]) and higher expenditures (revenue expenditure [55.98%] and total expenditure [58.42%]) in the combination of the centre

Table 3: Commission-wise Horizontal Imbalance

Finance Commission	ORS as % of RES	TORS as % of TE	RESas % of TES	Average
Seventh	22.00	20.25	7.00	16.42
Eighth	20.08	18.55	6.22	14.95
Ninth-1	20.82	22.44	4.71	15.99
Ninth-2	24.47	22.88	4.16	17.17
Tenth	26.39	26.39	3.47	18.75
Eleventh	27.44	21.55	3.53	17.51
Twelfth	25.58	22.65	5.07	17.77
Thirteenth	20.85	21.02	5.03	15.63
Fourteenth	20.63	47.45	3.85	23.98
Fifteenth	23.32	30.62	4.48	19.47

Acronyms are the same as in Table 1.
Source: Same as Table 1.

and states in their corresponding variable show the persistence of vertical imbalance. The rising vertical imbalance is reflected by a decline in receipts (own revenue [1.27%] and own total receipts [5.32%]) and an increase in expenditures (revenue expenditure [3.37%] and total expenditure [11.11%]) in the share of the states from the Seventh to the Fifteenth Finance Commissions. The increase in revenue expenditures (0.14%) and total expenditure (0.36%) of state per 1% of its own revenue and own total receipt, respectively, from the Eighth to the Fifteenth Finance Commissions also reveal a rising vertical imbalance (Table 1).

Horizontal fiscal imbalance exists across 14 major undivided states in terms of the coefficient of variation of own revenue (21.46%), own total receipts (20.18%) and revenue expenditures (2.19%). Own revenue as a percentage of revenue expenditures ranges from 36.72% in Bihar to 76.69% in Haryana. Similarly, own total receipt as a percentage of total expenditure varies from 43.51% in Bihar to 86.18% in Rajasthan (Table 2). The inequality increases over successive commissions in a fluctuating manner (Table 3). This is attributed to the inconsistency in the methods and their weights used in the distribution of shared taxes across states (Mahamallik and Sahu 2015), which in turn is the outcome of the multiplicity of conditions linked to the basic TORs.

Horizontal fiscal imbalance declined to a greater extent from the Seventh to the Eighth Finance Commissions due to changes in the weights of equity (inverse income and distance method) and neutral criterion (population), respectively. The incorporation of the area of examination of revenue generated from taxes and duties under Articles 268 and 269 in the scope of the Eighth Finance Commission helped the commission to know the exact revenue potential of the states. The imbalance continuously increased from the Eighth to the Tenth Finance Commissions. The weights of the equity principle declined and that of the neutral criteria increased during the period. The TORs emphasised the adoption of a normative approach for the distribution of shared taxes. This approach is aimed to assign more weights to neutral criteria, which helped reduce inequality from the Tenth to the Thirteenth Finance Commissions. This was achieved by merging the weights of equity and efficiency criteria towards an optimum weight during the Thirteenth Finance Commission (Mahamallik and Sahu 2015). However, during the Fourteenth Finance Commission, the inequality increased again.

The TOR required the commission to recommend fiscal restructuring measures for the states during the Eleventh, Twelfth and Thirteenth Finance Commissions. However, there was no mention of restructuring state finances during the Fourteenth Finance Commission, and hence, the commission did not assign any weight to the efficiency criterion. During the Fifteenth Finance Commission, imbalance declined from the previous finance commission period because a marginal weight was assigned to the efficiency criterion when the TORs asked to provide performance-based incentives to the states. On average, the imbalance increased from 16.42% in the Seventh Finance Commission to 19.47% in the Fifteenth Finance Commission (Table 3).

Conclusions

Various finance commissions have been assigned the duty of revenue transfers from the union to state governments over the past seven decades. Its scope is expanded over successive commissions. Although the basic areas continue, changes in some areas have created too much work for the commission. The finance commissions could not examine all the issues effectively within a short duration and distributed transfers across states with minor changes in the formulae and their weights leading to an increase in fiscal imbalances. While defining the scope of the Sixteenth Finance Commission, due consideration should be given to different areas.

NOTES

1 Considerations regarding requirements of state government for socio-economic development and balanced regional development, compensation of goods and services tax, the consequence of increased tax devolution by the Fourteenth Finance Commission, national development programme, conditions under Article 293(3), population control, direct benefit transfers, intermediaries between government and beneficiaries, labour intensive growth, grants-in-aid to local bodies, control of populist measures, sanitation facilities, progress on flagship programmes, disaster management, sustainable goals, digital economy, and doing business for tax and grants devolution were added to the existing considerations of the previous commissions during the Fifteenth Finance Commission.

2 Under the gap filling approach, grants equal the gap between the sums of own revenue and central shared tax as well as non-plan revenue expenditures of state.

3 The proportion of grants in total transfers increased by 6 percentage points from the Eleventh Finance Commission (13%) to the Twelfth Finance Commission (19%) (Rangarajan 2005).

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