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Research Paper

Role of Finance Commission in Maintaining the Fiscal Federalism in India

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ABSTRACT: *In India the Constitution provides for the elaborate and complete separation of taxing power between the both set of government, as in all other federal countries the Centre is more favored by our framers in the allocation of financial resources, due to various reasons prevailed over that period. But they realized that the position of States can be enhanced only the massive fund transfers and Fiscal Aids from the Centre to match their responsibilities given under Constitution. So they adopted a concept to have a body which is to be an independent, non political on lines of Common wealth grants Commission of Australia. They therefore provided a mechanism for the transfer of Central resources to the States, which can be adjusted on like of experience, economic position of Centre and States and financial situation. The most important feature is it can be reviewable periodically and it works automatically without causing any intergovernmental friction. Over the period of time the working of finance commission has been reviewed in this research paper to maintain the fiscal federalism in India.*
Keywords: *federalism, finance commission, resources transfer and Grant in aids.*

I. INTRODUCTION

The basic structure of federalism provides for the division and distribution of powers and authority between the two sets of governments' i.e. State or Provincial government and the Union or Federal government. The division or distribution of powers and authority are provided by the Constitution itself, the field of governance is divided in divided into two levels of governments. The two levels of government divide and share the governmental functions and powers between them as provided by the Constitution i.e. the Legislative Powers, Executive or Administrative Powers and Financial Power.

In any of the modern Government the finance plays the important role because it the pre requisites for good governance. A sound federal system of governance would envisage that financial resources are allocated between the both set of governments in such way there exist the balance in the functions and resources, but however it is found with the working of all federalism in the world there is no such scheme of allocation of taxation powers, because it is very difficult to creates such equilibrium between the Centre and State, due the tendency of the each governments to get more powers, so some sought of maladjustments always arises. In the Federalism along with the division of functions there is also the division of taxing powers between the Centre and State Governments, but no federalism in the world has found a possible method to provide for the allocation of resources in corresponding with their functions.

In the earlier federalisms the taxing powers where divided as to make both the Federal and the States more viable with the resources to meet their respective functional needs. The federal Government where given only the enumerated powers, where the State has all the developing and elastic sources of revenue resources, so there no need and possibility for the federal governments to grant or allocate the revenues for the general administrations or specific purpose to the states. But however with the changing trend in trade and commerce and of political relations there was the change and that led to gradual increase of federal revenues and the revenue resources of the States starts to sink, this creates imbalance between the financial needs and functions of the State. In India the financial position of Centre has been favored by our Constitution framers with the allocation taxing power tilled more toward Centre and Financial position of the States are more dependent on the Centre to meet their responsibilities. The two main feature of Indian Financial federalism is the complete separation of taxation power and massive inflow of funds from Centre to States, to create the balance of equilibrium between the sources and responsibilities.

II. FINANCE COMMISSION

The scheme of allocation of taxing power provided in our Constitution fails to create financial equilibrium between the responsibilities and resources at the State level, because most of the expansive and lucrative sources of taxation lies with the Centre, but on the other hand the State's fiscal needs are huge due to their responsibilities to provide welfare, development and social service activities like providing educations, housing, health, etc., so the framers of our Constitution, thought to establish non-political body to determine the scheme for the transfer of the Central revenue to the states.

They realized that the permanent or immutable formula for the determination of the scheme would be hard to meet the situations for all times to come due to changing social economic conditions in the country. Before the Indian Constitution came into forces there was no such body for assistance or sharing the specified taxes, the grants where made entirely on the discretionary basis arbitrarily, so they felt that in order to protect the autonomy of the state there must be independent and impartial body to access the changing needs of the States and take into account the economics condition or imbalance between the richer states and poorer one. Without this kind of independent agency in making the recommendations in determining the scheme for the transfer of Centre revenues the regional disparities cannot be removed.

Older federalism like American and Canadian Constitution doesn't provide any provision for the independent agency or body for the transfer of Federal revenues to the state, In the absence of well laid down and Constitutionally recognized body to provide the mechanism of revenue sharing, the tax sharing is mostly decided more by customs and negations embodied in the statues or agreement. Whereas in Australia, Australian Commonwealth grants Commission established by the Act of the parliament makes the recommendation on special grants to the claimant states.

2.1 Difference between the Finance Commission and it Australian counterpart Commonwealth grants Commission

Australian Commonwealth Grants Commission is the statuary body which is established by the act of the Parliament; whereas the Finance Commission is the Constitutional Body, which is established under Article 280 of Indian Constitution. Commonwealth Grants Commission is the permanent and continuous body and recommends grants to the deflect States every year. On the other hand the Finance Commission is not the permanent or Continuous agency, it sit once in five years. The Finance Commission has more functions that it counterpart in Australia, because Commonwealth Grants Commission merely just put forwards or suggest only the grants to the claimant States, it has no role in providing the scheme for the transfer of Central tax revenues Between the Federal and State Government. However the scheme for Central Tax sharing is always negotiated between the governments, from time to time. However the Finance Commission recommends not only the fiscal need but also provides the scheme for the tax sharing between the Centre and State Government and between the States inter se. Besides any mater relating to intergovernmental financial relationship in the interest of sound finance may be also referred to the Finance Commission.

2.2 Constitutional Assembly Debates and the Finance Commission:

The Expert Committee on the Financial Provisions which was set by the drafting committee, made a recommendation for the setting up of a Finance Commission. The Report observed: "We recommended for this purpose, among others, the appointment of a high level Tribunal of five members including a Chairman who has been, or is, holding high judicial office, not lower than that of a judge of a High Court. This tribunal may be called the 'Finance Commission', the members should be appointed by the President in his discretion if only because a Commission of this kind would have frequently occasion to deal with points of conflict between the Centre and Units. While we would not lay down any conditions in the Statute as to how these members should be selected, we recommend that two should be selected from a panel of nominees of Union Government and two others from a panel of nominees of the Central Government, the Chairman being selected by the President himself'. One out of the five should possess close knowledge of the finances and accounts of Governments, while another at least should have a wide and authoritative knowledge of economics. The appointments might be made for 5 years and be renewable for another five years".

By this recommendation, Article 280 was instead, clause (1) of this Article provides for the appointment of Commission by the President within expiry of two years from the commencement of Constitution and thereafter every five year or early if he considers essential, guided by the advice of the Central Council of Ministries (Article 74). The Commission is to consist of a chairman and 4 members appointed by the President. Article 280(2) Parliament is empowered to determine by the required qualifications for the appointment as the member of the Commission. Accordingly, the Finance Commission Act 1951 was enacted by the Parliament; the Act was subsequently amended in the year 1955.

The chairperson is to the person having the experience in public affairs. The other members are to be selected form the persons qualified to be appointed as high court judge having the special knowledge in governance, administration, economics and accounts. A person is disqualified to be a member of the Commission if he is of unsound mind, is an discharged insolvent, has been convicted of an offence involving moral turpitude, or having financial or other interests which prejudicially affecting his function as the member. The Commission has the all power of the civil court such as summoning the witnesses, examination on oath, requiring the production any documents, requiring any person to furnish information.

In the words of Dr. Ambedkar, the role of the Commission is “to do justice between Province and Province and between Centre and the Provinces”. He again said that “the Commission would be acting as a bumper between the President and the Provinces which might be clamoring for more revenue from income-tax”. T.T. Krishnamachari, founder member of National Council of Applied Economic Research was of the opinion that “the institution of the Finance Commission was incorporated 'to assure the States that they will have a fair deal”.

The much need flexibility in the area financial relations between the Centre and State is provided by this Commission by distributing the national resources to the needy States; this flexible system helps to bring down the intergovernmental frictions and helps to remove the regional disparities’. It helps to strengthen the financial resources of the State, through the development activities in the States can be promoted, all this can be done without compromising with the autonomy of the States.

III. FUNCTION OF THE COMMISSION

The functions of the Commission under Indian Constitution are to make recommendation to the President with regard to following matters:

a) To determine the scheme that governs the matters relating to the distribution of net proceeds of taxes which are in the divisible pool, between the Centre and States.

b) To make recommendations, to determine the principle that would regulate or govern the revenues to the States from the Central Revenue in the form of Grant in Aid to the needy States

c) This function of the Commission is included by the way of 73rd and 74th Constitutional Amendment to strengthen the financial Status of the local bodies by providing the supplement to the resources of the Panchayats and Municipalities in the States on the basis of the recommendation of State Finance Commission from the Consolidated fund of the State.

d) The last function of the Commission as provided by the Constitution under Article 280 3(d) is very vast any matter relating to the Fiscal interest between the intergovernmental bodies can be referred to the Commission by the President, These function or Terms of Reference, which broadly fixed by the Constitution itself; while at the same time an element of flexibility is built into these terms of reference under sub clause (d) of Article 280(3). Under this Clause the President has a power to refer any matter to the Commission 'in the interests of sound finance.

The functions of finance Commission is intended to assure the states that the scheme of distribution of national financial resources will not be made by Union arbitrarily, but based on the recommendations of the finance Commission. The recommendations are not binding on the Central Government, because the Commission is only the advisory body. The Constitution accords to Parliament the supreme authority to oversee the implementation of the recommendations made by the finance Commission.

The Central Government requires to present the recommendations made by the Commission before both Houses of Parliament alone with the explanatory memorandum as to the actions taken by the Central Government thereon. However the convention has been developed over the period of time under which the Central Government invariably accepts the recommendations made the Commission.

3.1 Role of Finance Commission in Tax sharing:

3.1.1) Distribution of tax in the divisible pool:

Prior to 2000, the scheme of taxing sharing was that only the two taxes are in the divisible pool between the Centre and State under Article 270 and Article 272. Article 270 provides for the compulsory tax sharing between the Centre and States, the net proceeds of income tax which is levied and collected by the Union, such proceeds which are assigned to the States are not part of the Consolidated Fund of India, the percentage of such proceeds are assigned to the States on the basis of recommendations made by the Finance Commission. Article 272 allows the Centre to share the Union Excise Duties to the States, if the Parliament by law provides for the sharing of resources.

First Ten Finance Commission where restricted to make recommendation for tax sharing to the net proceeds of Income Tax under Article 270 and Union Excise Duty under Article 272. With the recommendation of Finance Commission there has been gradual increase in the percentage of tax sharing in the proceeds of Income Tax from 55% (First Commission) to 85% (ninth Commission).

In the case of distribution of proceeds of Union Excise duties was concerned, originally the share of State were restricted to certain Commodities, only from the Fourth Commission onwards the States where given share in the proceeds of tax on all Commodities, in the year 1951-52 during the schedule of First Finance Commission, there were 12 important commodities under the Union Excise Duty. The First Commission has recommended the share 40% of Excise Duty on 3 Commodities, which yield the sizable income for the States.

The Second Finance Commission has increased the commodities to 8 but decreased the share of the States to 25%. The Third Finance Commission has increased the commodities to 25 but the share was reduced to 20%. During the period of Fourth to Sixth Commission the share of the States on Excise duty were same at 20 % on all commodities. The Seventh Commission has increased the share of States in the Union Excise Duty from 20% to 40%, however the share of States in Union Excise was consistently increasing with the recommendation of Finance Commissions, there were recommendation made by Commission to make addition share in Excise Duty to the deficits States. Tenth Finance Commission has increased the share to 47.5% and addition share of 7.5% to the deficits States. The Commission has steadily increased the share of States in divisions of Union Excise duties which has become the predominant in the financial resources of the States, and through the bulk transfer of resources to the grants were reduced on the other hand.

This Scheme of tax Sharing has undergone a major reconstruction with the 80th amendment of Constitution in the year 2000, by the recommendation of the 10th. The New scheme of distribution allows the States to get share in the total tax revenue of the Central Government. Accordingly Article 272 was repealed and Article 270 was replaced by the new Article. The new Article seeks to achieve the following:

All the duties and taxes of Central Government are divided between the Centre and State.

However the certain levies were exempted from the divisible pool i.e.

- Stamp duties and duties on medical and toilet and medicinal preparations which are levied by the Union but collected used by the States.
- Service tax which are imposed by the Union Government but are collected and used by the Union and States in accordance with the principle formulated by the laws of the Parliament.
- Taxes imposed by the Union on interstate trade are not under the divisible pool.
- And any cesses imposed by the laws of the Parliament are outside the divisible pool.

The new Article 270 does not fix the percentage of the net proceeds of the Central taxes which must be distributed among the states. The percentage, manner and form of distribution are prescribed by the President on the Recommendation of the Finance Commission. The eleventh Finance Commission has fixed this percentage at 29.5%, the Twelfth Finance Commission has increased to 30.5% percent, the thirteenth Finance Commission increased the net proceeds for sharable tax between the Centre and States to 32%, the present (Fourteenth Finance Commission) has made a drastic improvement in enlarging the share of States in the tax devolution. The reason for this constant increase of share of the States is to sever two purposes to maintain the autonomy of the States because only the financial resources are not devaluated to the States the dependency of the States to the Union increases, which will affect the development activities of the States and the other purpose is to level the appropriate fiscal space and remove the horizontal and vertical disparities' among and within the States.

3.1.2) Fiscal Grants in aids to the States:

Under Article 275 of Indian Constitution, it is the duty conferred on the Union Government to provide Fiscal Grants to the needy and poor States as may be determined by the Parliament, Grants are paid out the Consolidated Fund of India. Clause (2) of this Article empowers the Finance Commission the task of finding out the states which are in need of assistance; and to frame principles governing the scheme of providing fiscal Grants to the States are left to the Finance Commission under Article 280(3) (b), which is one of the pre-requisites for providing grants to the needs of the States. Grants-in aid have been used as a balancing factor in all political systems, in one form or another, to correct the maladjustments arising from the Allocation of Important and relatively elastic sources of revenue to the Central Government and entrusting welfare functions to the Units.

As we discussed earlier this idea of providing grants to the needy states has been borrowed from Australia. As earlier as 1936, the Commonwealth Grants Commission expounded this idea thus "Special grants are justified when a states through financial stress from any cause is unable efficiently to discharge its functions as a member of the federalism and should be determined by the amount of help found necessary to make it possible that state by reasonable effect to function at a standard not appreciably below that of the other states". Every year, therefore, the commission seeks to assess the sums necessary to bring the claimant States to the level of the non-claimant States, necessary adjustments being made for the relative tax effort of the States and difference in standards of social services so that these may be brought to a corresponding level.

The Finance Commission in India has adopted a somewhat similar approach laid down a few guiding norms, five broad principles which are gave in by the Finance Commission to determine the Grants are as follows:

- Budgetary needs of the State.
- Extent of tax effort taken by the State to increase the revenue.
- Third was to analyze how the Grants would help in equalizing the standards of basis service provided by the States.
- Fourth was any special burden or obligations that the States has, which are of national concern.
- Last principle is that the grants should be given to the less advanced states to bring them to the main stream of development.

Generally these principles have led the Finance Commission to the recommendation for providing the grants in aid to the needy States. The Grant in Aid which are recommended by the Finance Commission are general purpose in natures, to meet the difference between the assessed expenditure of the non plan revenue account of the each states and the income revenue of the each including the share in the Central tax devolution. Generally the Grant in aids is known as gap filling revenues to meet the all non plan expenditure deficiencies in the State Budget. From the Sixth Finance Commission onwards, the Grant in Aids where given to the States for some specific Purpose like upgrading general Administration, upgrading the standards in non development sectors and service, girl child education, welfare of backward people in the States, and for providing the basis development activities in the States.

Panchayats and Municipalities have been recently formally made as an integral part of our federal democratic structure, this has added an addition function to the Finance Commission to make recommendation for the transfer of funds to these local bodies, to make them financially empower 10th Finance Commission has recommended for the devolution of Central resources in the form of Grants in aids to meet their specific problems, there after every Finance Commission has recommended for the devolution of resources to the urban and rural local bodies.

On the Recommendation of the Ninth Finance Commission, a Calamity Relief Fund has been established in each State to which Centre contributes 75% of the amount, which will be settled by the Finance Commission, in addition to this Tenth Finance Commission has recommended for the establishment of National Fund for Calamity Relief (NFCR) to deal with a calamity of rare severity, to this fund both the Centre and State subscribe in the ratio of 75:25. However with the enactment of the Disaster Management Act in 2005, the National Disaster response fund was created under section 46 of the Act, however the Thirteen Finance Commission has recommended the merger of National Fund for Calamity Relief to National Disaster Response Fund in the year 2010. In the same line based on the 13th Finance Commission recommendation, Calamity Relief Fund was renamed and merged with State Disaster Response Fund

1. Regulatory Reform – Recommendations

The major shortcoming with the Structure of Financial Commission, which is expressed by the majority of the States, is that the Commission doesn't have a proper representation from the States, because all the members of the Commission are nominated members of the Centre only, the State being the part of federalism does not have an opportunity to have its representation in the Commission. Another major lacuna is that while determining the terms of reference views voiced by the States are not considered. This standard has to be changed will determining the terms of reference of the Finance Commission States position should be discussed and any disagreement should be brought to Interstate Council, for the proper settlement.

The political influence has been increased in the resource transfer system, mainly due to the emergency of coalition government at the Centre, with the support of other regional parties. This practice has to be stopped because it affects core idea of establishing this Commission as an independent and non political body. The grants awarding parameters should be updated, till 13th Finance Commission (2010-2015) has used the 1971 population data to allocate the revenue resource; however the present 14th Finance Commission has used 2011 population data. On the line of other Federal System in the World there should be more research based programs on intergovernmental revenue devolution.

IV. CONCLUSION

On the whole, it can be said that the mechanism of Finance Commission has helped and strengthens the Centre State financial relationship which the critical element in federalism, by providing the scheme for tax sharing in the divisible pool and as well through fiscal grants to the needy States. The role of Finance Commission has a greater significance by increasing economic position or status of the weaker States on par with richer States. The Commission has also played a momentous work in removing the regional disparities in India, by making necessary award by giving to due weight age to backwardness of a State important criterion for

resource transfer. This approach of Finance Commission strengthen the new concept of Co-Operative Federalism that the federal country is one and indivisible economic unit, that every citizens should be able to get a minimum national social service irrespective of the fact whether he belong to poor or rich State.

In spite the fiscal environment has been drastically changed over the year and the work load of the Finance Commission has been increased by subsequently Constitutional amendments, it has ensured smooth functioning of Centre State fiscal relations, all the merits has to go to framers of our Constitution, for providing such neutral and independent body, which have stood the test of time. It has been proved adequate enough to satisfy the fiscal needs of both States and Union, by preventing no breakthrough in the fiscal federalism in India.

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