Centre State Relations in India

Prof. Uday Shankar

Rajiv Gandhi School of Intellectual Property Law

Indian Institute of Technology, Kharagpur

Week 06: Financial Relations: Allocation of Taxing Power; Distribution of Revenue, Goods and Services Tax, GST Council

Lecture 27: Finance Commission under Article 280

Greetings to all of you. We have been discussing financial relations in this study on Centre State Relations and in that we have discussed the evolution of goods and services tax that how this tax regime has introduced common national market in India and along with that we have also discussed that how fiscal imbalance is addressed under the Constitution what is the arrangement done under the Constitution to address the issue of fiscal imbalance be it vertical imbalance or horizontal imbalance. Now in today's session we will be studying that what role the Finance Commission plays on the matter of Distribution of Revenue between the Centre and the States and for taking up an important aspect of federal system that is mitigating imbalances between the Centre and the States so that revenue shall be ensured with every government to make a necessary planning to revenue to plan the expenditure and to fulfill the responsibility which is entrusted under the Constitution. So in this session we will be talking about Finance Commission, what is the composition, what is the nature of power or functions, what are the working principles. We will also look at it that what is been debated in the Constitution Assembly on the matter of the Finance Commission, how recommendation of the Finance Commission gets implemented what are the issues connected with that and how Finance Commission addresses the issue of Centre State federal relation that is what we will look into it. Now when you look at the very institutional identity of this body Finance Commission which is a constitutional body, Constitution suggest that it shall be an export body which has been entrusted with the responsibility of suggesting distribution of revenues between the Union and the States. So Article 280 of the Constitution provides for establishment of Finance Commission.

So Finance Commission is a constitutional body unlike what we studied NITI Aayog or National Development Council or erstwhile Planning Commission which were more like executive body, body came into effect through executive instruction. Article 280 gives a constitutional status to Finance Commission and which is interested with the responsibility to suggest a plan for distribution of revenues. So it is a kind of institutional arrangement where they suggest for distribution of revenues and Finance Commission apart from that is also been suggested also been interested in the responsibility to suggest the augmentation of resources of third tier government. When you look at the debate in the Constitution Assembly that what exactly was debated on the powers and function of the Finance Commission because it is an important constitutional body.

Draft Articles 260 and 261 discusses on this important constitutional body and there were two important points of difference amongst the members on the structuring of Finance Commission. One was that what kind of functions are to be assigned to the Finance Commission and whether the function in a sense that whether when we talk about distribution of revenue should it be solely the prerogative of the Finance Commission to suggest the distribution or should it go with the president or to the Parliament because they are the accountable body particularly the Parliament in the parliamentary democracy is the accountable body towards the legislature. So why not interest this responsibility upon the Parliament or with the President which is ultimately acting through a council of ministers and Council of Ministers are responsible again towards the legislature. So, these were differing views on the important task which was assigned to the Finance Commission and on this matter you find that the members gave their opinion prominent ones were like Dr. Ambedkar suggested two amendments.

First it says that let the Finance Commission comes into existence right after two years of the commencement of the Constitution and it also suggested that recommendation of the Finance Commission were to be laid down on the floor of the house so that the Parliament can have a kind of complete examination on the parameters on which the Finance Commission has made the recommendation. Mr. Hriday Nath Kunzru has suggested that instead of commission the allocation of share to be done by the Union government in consultation with the State government which was suggested based on cooperative model that where it is the State which should be consulted before deciding on what kind of revenue model what kind of revenue distribution model to be followed between the Centre and the State. In this regard the reference was also made of the Canadian scheme where provinces agree to the appointment of a Finance Commission. So there is a say of the province on the matter of the appointment of Finance Commission.

Mr. Thakurdas Bhargava argued that the State should have the say as the proposal of a Finance Commission rightly affects the State. It is important to highlight that some of the members were very clear that on the matter of appointment of the Finance Commission, it is the State government which should also be involved because State government is an important stakeholder in the matter of fiscal federalism. Mr. Shibban Lal Saxena also argued that it is wrong to assume that the recommendation made would be binding on both the Houses. So he was of the opinion that the Parliament shall have some kind of say on the recommendation made by the Finance Commission. Therefore it is not that the Finance Commission whatever it recommends would be binding on the Parliament and hands of the Parliament or the parliamentarians would be tied on this matter. So learned member proposed that the ultimate authority to determine the question of distribution should be there of the Parliament and it should not be entirely the authority of the Finance Commission.

Parliament can look into the recommendation made by the Finance Commission that is what Mr. Saxena has suggested. Now this is what the Constitution Article 280 provides for in terms of Finance Commission. It says that Finance Commission is to be established within two years from the commencement of the Constitution and the Finance Commission shall be constituted for every five year. There is no duration, once the Finance Commission gives the report its functions comes to a halt it ceases to be in operation. It says that if President deems necessary then President can also establish Finance Commission even earlier than fifth year.

Reading of Article 280 categorically makes that State has got no role to play on the matter of the establishment of Finance Commission on the matter of appointment of Finance Commission. It is solely the authority of the Union government. So when it comes to members it says Article 280(1) that the President by order constitutes a Finance Commission which consists of a Chairman and four other Members. The qualification of the Members of the Finance Commission is determined by the Parliament and Parliament has made a law named as Finance

Commission Miscellaneous Act of 1951. Now this is the qualification which is been let down in this 1951 law which says that Chairman shall be among the persons having experience in public affairs and other four Members shall be selected who are or have been or are qualified to be appointed as a judges of a High Court have a special knowledge of the finances and accounts of government or have wide experience in financial matters and in administration or have a special knowledge of economics. So this is a kind of broad criteria which has been suggested in the Act to appoint the Members of the Commission.

The 1951 law also suggests for disqualification of the Members. It says that the person shall not be appointed and if he has got some personal interest in order to avoid any kind of conflict. A person shall not be appointed if he is of unsound mind, if he is undischarged insolvent and then if he is convicted of an offence involving moral turpitude and financial or other interest as is likely to affect previously his function as a Member of Commission. So this is disqualification criteria which is also clearly let down in the 1951 Act. What is the nature and power of function when you look at it? It says that the Finance Commission shall determine its own procedure because in autonomous body it did not go by any procedure let down under any law or going by any kind of direction from the government on this matter. It has got a power of a civil court for limited purposes for the purpose of summoning and enforcing the attendance of witnesses, requiring the production of any document and requisitioning any public record from any court or office. This power has been given so that there should not be any situation of handicapping with the Commission on deciding on certain issues.

So they should have all the necessary information and mandate has been given that they can ask for that information and the law has made it that for asking for those information they have been entrusted with the power of a civil court as per the CPC. What is the working principle of Finance Commission? Finance Commission as I said that it is responsible for distributing revenue between the Centre and the States. So it is into an important task of strengthening fiscal federalism in this country. It is into the task of addressing the issue of financial imbalances be it vertical, be it horizontal. And Finance Commission has also been interested in the task of suggesting measures to strengthen the Consolidated Fund of the State and to supplement the sources of Panchayat and Municipalities.

Though, we have a provision under the 73rd and 74th amendments talks about a State Finance Commission. Here you would find that even the Finance Commission has been given a responsibility to suggest the measures so that Panchayats and Municipalities can also become a kind of financially more strong. Then important part is that Finance Commission becomes functus officio after submitting the recommendation meaning thereby it is not a permanent body. One argument which has been given in favor of making it functus officio is that that Finance Commission like Inter-State Council does not have a permanent secretariat and it does not always remain in existence. Once it gives the recommendation it jobs get over and then it ceases to be in effect. The benefit of this scheme is that that Finance Commission shall have no interest whatsoever that whether its recommendation is getting implemented or not because once it gives recommendation it is no more into business it is no more into any kind of role.

So therefore it is to be expected that they would be acting in a very impartial way, they will be looking into all factors which are very objective in nature and they will not go by preferences of one State over another State or a kind of preferences over the Union vis-a-vis the States. So this is the argument which is generally been advanced favoring this functus officio character of Finance Commission that the members they do not continue to be part of the body once they submit the recommendation that is that something which is very critical and I believe that is that is very thoughtful proposition let down under the Constitution where no permanent secretariat has been suggested for the Finance Commission. It is been suggested that once their work is over let them not have any role to play let them be the domain of the Parliament to implement the recommendation. So they are considered to be impartial arbiter on the claim of revenues by the States and the Centre and possibly this responsibility of carrying out their duties in impartial way is possible because of no interest in ensuring that the recommendations are getting implemented or not because of this character of functus officio. There are two kind of duties which are been interested upon the Finance Commission is specific duty and the general duty. What are the specific duties? It is specific duties are distribution between the Union and the States of the net proceeds of taxes that is what is there which is given in Chapter I of Part XII and the allocation between the States of the respective States of such proceeds then the principles we should govern the grants in aid of revenues of the States out of Consolidated Fund of India then the measures needed to strengthen the Consolidated Fund of a State to strengthen the financial power of the Panchayats or the Municipalities that is what is the specific duty.

What are the general duties? It says what is referred by the President in the interest of sound finance. So the some of the subject matters which has been entrusted to them like setting the fiscal rules and targets for the Union and the taxes, measures to be taken for sustainable development and the production of ecology and environment, rescheduling and writing off of a State loans, examination of public expenditure management systems, review of disaster management systems, strategic approach to public enterprise reform and incentivizing the States to undertake tax reform. So these are the general duties which are there under Article 280(3)(d). When it comes to recommendation of the Finance Commission it is said that Article 281 provides that the recommendation shall be let down on the floor of the House and it is to be done through the presidential reference they submit it and the President ensures that it is been let down in before each House of Parliament and then what it says is that every recommendation has to be placed on the floor of the House with an explanatory memorandum on action taken. So this is something which is very significant to note and understand that when you say explanatory memorandum on action taken it in a way indicates that whatever is been suggested by the Finance Commission the government has already acted upon and that is what the government is apprising the Parliament.

So in a way that recommendation becomes binding upon the government and decision taken by the government in pursuant to the recommendation is informed to the Parliament. So what is the approach of transfer which Finance Commission follows? It estimates the overall budget available as per the total resource requirement of the Union and the States then it assesses what is the current revenue, what is the sources of revenue, what is the kind of estimate non-planned expenditure of the State then estimating the proportion of Union tax proceeds to be assigned to the States and allocation of these among them that how the amongst the State it is to be distributed and then providing grants in aid to close any gaps between non-planned grant expenditure and revenue. These are the approaches which is been followed. The distribution criteria among the State are like this one is income distance which is all about how the income is there between the rich State and the poor State. So they keep that into mind for the purpose of distribution of revenue then area they consider population, demographic performance, forest cover forest and ecology tax and fiscal effort these are the factors they consider for distribution of revenues. Obviously over a period of time it has been noticed that the weightage assigned to population has been in decline because somewhere it has been brought into an argument that the States where population is more it is an indicator that the State is poorly governed and therefore, that the State should not be unduly incentivized.

So that is one reason why we find that weightage assigned to income distance and efficiency factors are increasing in recent times. This is one table which shows that how the devolution has happened between the between the States horizontal devolution among the States done in last five Financial Commission’s recommendation. Let’s us look at the last one which says that 45 percentage was there on the income distance and then 12.5 percent was there on demographic performance and then population no factor was taken into account 2011 census taken into account and 15 percent and area was 15 percent. So this is how when you look at it the devolution was done in last 5 years.

Now with the GST Council coming into existence which is also given in the task of distribution of revenue that is what we have studied. So obviously a question comes in that how this functioning of Finance Commission and GST Council comes into kind of coordination or whether they are into a kind of conflict. So what is required is that there shall be a symmetry between the functioning of the GST Council and the Finance Commission because Finance Commission recommends the distribution of revenues between the Union and the State and thereafter amongst the States they do and Commission looks at the projection of expenditure and revenue but issues are entirely within the domain of the GST Council. So this in a way is leading to a kind of unsettled position on the ways that to how to monitor, how to scrutinize and optimize a kind of revenue outcomes and how it shall be done because both Finance Commission and GST consoles are constitutional bodies. Therefore it is suggested that they work in a kind of coordination but one important difference is Finance Commission is not a permanent body, so it suggests a recommendation and then its job gets over whereas GST Council is a permanent body and they go for a regular meeting and they resolve on a regular basis on tax lapse on different goods and services.

Let us look at the federal issues connected with the Finance Commission. One is Article 281 provides for recommendation as I said with the explanatory memorandum which in a way makes it very clear that the government considers the recommendation as a binding one and action taken report is been suggested. Now if you go by this then what it means is that whatever Commission suggests is irreversible in nature and that has to be implemented. Now the question comes with regard to this judgment which the court has given in 2022 with regard to binding nature of recommendation of the GST Council in Mohit Mineral Case where the court has said that GST Council recommendation is not binding on the Legislature. If you go by the same principle then one may ask this question that whether something similar can also be read for the purposes of Finance Commission because when you look at the constitutional scheme the power to control purse, power to control the money lies with the Legislature.

They have got a control on money, on accounting. So therefore, should the findings of the Mohit Mineral Case be also imported on the issue of bindingness of the recommendation made by the Finance Commission? As I highlighted right at the beginning that when you look at the involvement of the State in the formation of the Finance Commission there is no involvement and which certainly raises a question that State being an important stakeholder on the matter of fiscal federalism they need to get involved and if they are not getting involved how do you really see that Finance Commission working in a very impartial way. So these are certain questions to be looked at because when it says that President constitutes Finance Commission then we need to always keep in mind it is the President which is doing on the aid and advice of the Council of Ministers. So in a way there is a kind of complete control of the Union on the matter of the establishment of Finance Commission who shall be the Chairman, who shall be the Member.

There are other issues with regard to functioning of the Finance Commission for example, politicization of constitutional body that whether it is going more with the kind of political agenda of the government whether it is on the matter of distribution of revenue or on the matter of what kind of criteria to be opted for. Then emergence of regional parties they are like kind of asserting more on making their claims on the revenue. Then issues related to selection of members of the Commission. Then how the entire agenda of regional interest has been taken up by the Finance Commission how the Union government is finalizing the terms and references for the Finance Commission which involves regional agenda. The language of the terms and reference are formulated under any other matter and then it says that narrowing the scope of recommendation relating to the State.

So, these are some of the issues which connects with the functioning of the Finance Commission which has got a direct connect with the Centre State relations. Then the use of 2011 census by the Commission for financial devolution has caused a sort of stir on the matter of control population on the matter of the very fact that the States which are better governed. One indicator of better governance is the control of population and therefore, as I said that they demanded for incentivization instead of getting penalized and that is something which became a matter of discussion and debate on the issue of population as criteria for distribution of revenue between the Centre and the States. These are the references for this module. Thank you very much.