Centre and state Finance

Fiscal Federalism

By Richard Musgrave

✓ a term introduced by Richard Musgrave, deals with the division of governmental functions and financial relations among the different levels of government.

✓ Federalism is an institutional arrangement to accommodate **two sets of government** — one at the national level and the other at the regional level. Each government is autonomous in its own sphere.

Central

Central or Federal Govt. should be responsible for Functions related to Income Redistribution & Economic stabilization

State & Local

state & local Govt. should be responsible for Functions related to Allocation of Resources.

states 28

UTI 8

An independent judiciary is established to resolve dispute between central & state on division of Power.

Allocation of Power

Article 246

of the constitution demarcates the powers of the union & state by classifying their power into 3 lists.

Union

Union list contains items on which the Parliament alone can legislate.

State

State list contains items on which state legislative assemblies alone can legislate.

Concurrent

Concurrent list contains items on which Both Parliament & state assemblies can legislate.

In the event of conflicting legislation in concurrent list, the law passed by the centre prevails.

Allocation of Revenue

- ✓ *Allocation of revenue and expenditure to different levels of government is a fundamental matter in a federation.*
- ✓ *Sources of revenue for both the centre and states are clearly demarcated with regard to the financial relationship and the responsibilities between them.*
- ✓ *Taxes are levied by the centre and the states. The central government has greater revenue raising powers.*

The union government can levy taxes such as tax on income, other than agricultural income, customs and export duties, excise duties on certain goods, corporation tax, tax on capital value of assets excluding agricultural land, terminal taxes, security transaction tax, central GST, union excise duty, taxes other than stamp duties etc.

The state governments can levy taxes on agricultural income, lands and buildings, mineral rights, electricity, vehicles, tolls, professions, collect land revenue and impose excise duties on certain items. The property of the union is exempt from state taxation.

The property and income of the states are not liable to be taxed by the centre.

Distribution OF Revenue

Distribution of revenue between the union and states is based on the constitutional provisions as follows:

Article

268 Duties levied by the union but collected and appropriated by the states.

269 Taxes levied and collected by the union but assigned to the states.

270 Taxes levied and collected by the union and distributed between the union and states as prescribed in clause 2and the States.

271 Surcharge on certain duties and taxes for purposes of the union

275 Statutory Grants - in-aid from the union to certain states.

282 Grants for any public purpose

293 Loans for any public purpose

Finance Commission

Article 280

The Article 280 provides for an institutional mechanism, namely the Finance Commission, to facilitate revenue transfers.

The Finance Commission is a constitutionally mandated body that is at the centre of fiscal federalism.

It is responsible for evaluating the state of finances of the union and state governments, recommending the sharing of taxes between them and laying down the principles determining the distribution of these taxes among states.

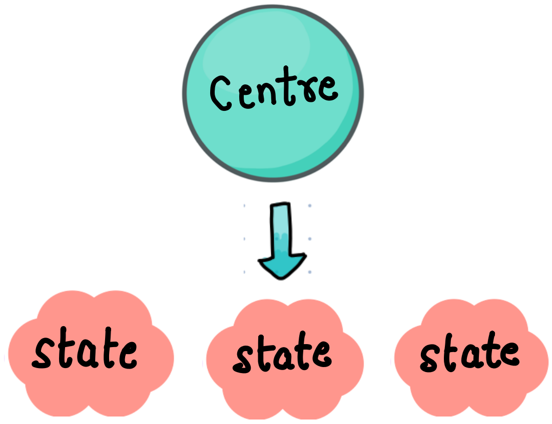
The Finance Commission helps in maintaining fiscal federalism in India by performing following functions:

- *The* ***distribution*** *between the union and the states of the net proceeds of taxes which are to be divided between them and the allocation between the states of the respective shares of such proceeds.*
- ***Determination*** *of principles and quantum of grants-in-aid to states which are in need of such assistance.*
- *To make* ***recommendations*** *to the President on measures needed to augment the consolidated fund of a state to supplement the resources of the panchayats and municipalities in the state on the basis of the recommendations made by the Finance Commission of the state.*
- *Any other matter* ***referred*** *to the Commission by the President in the interests of sound finance.*

While recommending transfers Finance commission considers issue related to

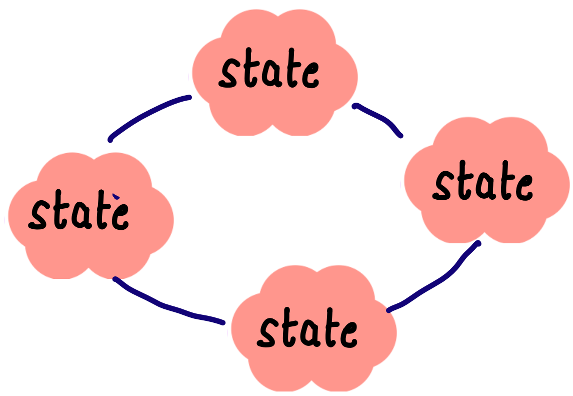
VERTICAL Equity

Deciding about shares of all states in revenue collected by centre.



Horizontal Equity

Allocation among states their share of central Revenue.



The Finance Commission broadly assesses the overall gross tax revenues of the union; cesses, surcharges and non-tax revenue are netted out from gross tax revenue to arrive at the net divisible pool (NDP). Following a constitutional amendment in year 2000, the divisible pool now consists of all taxes of the union.

> *Considering the needs of the central and the state governments, the Commission determines what percentage out of the net divisible pool should be assigned to the state governments. The balance remains with the central government*

The 15th Finance commission

- ✓ It was constituted on 27, November 2017 against the background of the abolition of Planning Commission (as also of the distinction between Plan and non-Plan expenditure) and the introduction of the goods and services tax (GST).
- ✓ The commission recommended the share of states in the central taxes (vertical devolution) for the 2021-26 to be 41%, which is the same as that for 2020-21. This is less than the 42% share recommended by the 14th Finance Commission for 2015-20.
- ✓ The adjustment of 1% is to provide for the newly formed union territories of Jammu and Kashmir, and Ladakh from the resources of the centre.

The criteria for distribution of central taxes among states for 2021-26 period

- Income Distance
- Area
- Population 2011
- Demographic Performance
- Forest and Ecology
- Tax & Fiscal Efforts

Goods & Service tax

✓ The introduction of **GST**, which was rolled out across the country on **1 July 2017,** has significantly changed the state of affairs of financial relations between the centre and states.

✓ The GST subsumes the majority of indirect taxes – excise, services tax, sales tax, octroi (entry tax).

✓ The GST has made India's indirect tax regime unitary in nature.

✓ The states levy and collect state GST (SGST) and the union levies and collects the central GST (CGST).

✓ For any particular good or service or a combination of the two, the SGST and CGST rates are equal.

✓ An integrated GST (IGST) is applied on inter-state movement of goods and services and on imports and exports.

✓ IGST is simply a combination of SGST and CGST administered and collected by the union government, kept in a separate account, and distributed between the union and states after settlement of input tax credit and verification of the destination of the goods and services.

✓ With many taxes subsumed under it, GST accounts for 35 per cent of the gross tax revenue of the union and around 44 per cent of own tax revenue of the states.

✓ As per the supreme court verdict in May 2022, the Union and state legislatures have "equal, simultaneous and unique powers "to make laws on Goods and Services Tax (GST) and the recommendations of the GST Council are not binding on them.

✓ The GST system replaced the then prevailing **production-based taxation system with a consumption based one.**

✓ Since the manufacturing states had apprehension about loss of revenue, it was decided to provide compensation to states for loss of revenue arising on account of implementation of the Goods and Services Tax for a period of **five years** from the date of its implementation.

✓ For providing compensation to states, a cess is levied on some luxury goods and demerit goods and the proceeds are credited to the compensation fund.

✓ GST compensation was extended beyond five years to enable states to tide over the pandemic induced economic slowdown.

✓ During the five-year transition period, the top five GST compensation-receiving states were Maharashtra, Karnataka, Gujarat, Tamil Nadu, and Punjab.

✓ The total amount of compensation released to the states and union territories during the year 2022-23 is Rs. 1,15,662 crore.

Allocation of Expenditure

Central

Central govt. entrusted with the responsibilities of provision of Nationally important areas like Defence, Foreign affair, Trade, money banking cross border transport, communication, Forex etc.

State

State govt. entrusted with responsibilities of Facilitating agriculture Industry, Provide social security services like health, Education, Police Protection etc.

Local

Local govt. entrusted with responsibility of Providing Public utility Services such as Water supply & sanitation, local roads, electricity etc.

For items that fall in the concurrent list, both central and state governments are responsible for providing services.

Borrowings

Article 292 — Borrowings by Government of India

centre may borrow within limits fixed by Parliament upon the security of Consolidated fund of India or give guarantees within such limits, if any.

centre may gives loan to state and give guarantees in respect of loans raised by the states.

Article 293 — Borrowings by States

state may borrow within territory of India upon the security of the consolidated fund of state within such limits, fixed by legislature of such state by law orgive guarantee with such limit

state need to obtain centre's Consent in order to borrow in case the state is indebted to the centre over a previous Loan.