

# Fiscal Federalism and Finance Commission

# INTRODUCTION

- Fisc literally means public treasury or exchequer
- Federal means a government where there are two or more tiers Each tier has jurisdiction , defined by the constitution, over specific matters of legislation , taxation and administration
- The term “fiscal federalism” was introduced by the German-born, American economist Richard Musgrave in 1959.
- Wallace E. Oakes, in 1999, defined it as, “*Fiscal Federalism is concerned with understanding which functions and instruments are best centralised and which are best placed in the sphere of decentralised levels of government.*”
- This concept applies to all forms of government: unitary, federal and confederal

# Federalism in India, pre-independence

- The federal system is essentially a post-industrial revolution phenomenon. India, as a federal system, is about 70 years old, compared to the federal systems of the United States, Switzerland or Canada, which are more than two centuries old. There is a wide variety of international experiences in fiscal federalism based on: 1) the division of functions among different tiers of government; 2) the design of fiscal transfers; 3) principles of assessment; and 4) institutional arrangements . Furthermore, intergovernmental fiscal transfers are either constitutionally or legally mandated.

# CONT.....

- The Government of India Act, 1935, established a federal system with provinces and Indian states as two distinct units.
- Under the act, legislative powers were distributed under three lists:
  - the Federal List,
  - the Provincial List
  - and the Concurrent List.

# Finance Commission

- The **Finance Commission (FC)** is a **constitutional body**, that determines the method and formula for **distributing the tax proceeds between the Centre and states**, and among the states as per the constitutional arrangement and present requirements.
- Under **Article 280 of the Constitution**, the **President of India** is required to constitute a Finance Commission at an interval of five years or earlier.
- The 15<sup>th</sup> Finance Commission was constituted by the President of India in November 2017, **under the chairmanship of NK Singh**. Its recommendations will cover a **period of five years from the year 2021-22 to 2025-26**.

# Recommendations of the 14th Finance Commission APRIL 02, 2016 06:16 IST

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**SOURCE:** THE HINDU

- **1)** The 14th Finance Commission is of the view that tax devolution should be the primary route for transfer of resources to the States.
- **2)** In understanding the States' needs, it has ignored the Plan and non-Plan distinctions
- **3)** According to the Commission, the increased devolution of the divisible pool of taxes is a ``compositional shift in transfers'' – from grants to tax devolution
- **4)** In recommending an horizontal distribution, it has used broad parameters – population (1971), changes in population since then, income distance, forest cover and area, among others.
- **5)** It has recommended distribution of grants to States for local bodies using 2011 population data with weight of 90 per cent and area with weight of 10 per cent

# Recommendations of the 14th Finance Commission

- 6) Grants to States are divided into two
- 7) One, grant to duly constituted gram panchayats
- 8) Two, grant to duly constituted municipal bodies
- 9) And, it has divided grants into two parts
- 10) A basic grant, and a performance one for gram panchayats and municipal bodies
- 11) The ration of basic to performance grant is 90:10 for panchayats; and 80:20 for municipalities

# Recommendations of the 14th Finance Commission

- **12)** The total grant recommended is Rs. 2,87,436 crore for a five-year period. Out of which, the grant to panchayats is Rs.2,00,292 crore. And, the remainder goes to municipalities
- **13)** The Commission has significantly departed from previous commission vis-à-vis recommendation of the principles governing grants-in-aid to the States by the Centre
- **14)** It has chosen to take the entire revenue expenditure for this purpose. Hence, it has decided to take into account a state's entire revenue expenditure needs without making a distinction between plan and non-plan expenditure
- **15)** The Commission is of the view that sharing pattern in respect to various Centrally-sponsored schemes need to change. It wants the States to share a greater fiscal responsibility for the implementation of such schemes.
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## Chairman Message

The Finance Commission is a Constitutionally mandated body that is at the centre of fiscal federalism. Set up under Article 280 of the Constitution, its core responsibility is to evaluate the state of finances of the Union and State Governments, recommend the sharing of taxes between them, lay down the principles determining the distribution of these taxes among States. Its working is characterised by extensive and intensive consultations with all levels of governments, thus strengthening the principle of cooperative federalism. Its recommendations are also geared towards improving the quality of public spending and promoting fiscal stability. The first Finance Commission was set up in 1951 and there have been fifteen so far. Each of them has faced its own unique set of challenges.

The Fifteenth Finance Commission was constituted on 27 November 2017 against the backdrop 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), which has fundamentally redefined federal fiscal relations.

The Terms of Reference of the current Commission have some distinctive features, including recommending monitorable performance criteria for important national flagship programmes and examining the possibility of setting up a permanent non lapsable funding for India's defence needs. The reorganisation of the State of Jammu and Kashmir into two Union Territories – one of Jammu and Kashmir and one of Ladakh – presents a new dynamic. On the whole the Finance Commission faces new challenges in the process of the evolution of our federal polity. As an important Constitutional entity, the Commission is committed to balancing competing claims and priorities among all three tiers of government in a credible manner.

**Shri N.K. Singh**

Chairman of 15th Finance Commission of India

# 15th Finance commission Recommendations

- **Vertical Devolution (Devolution of Taxes of the Union to States):**

- It has recommended **maintaining the vertical devolution at 41%** - the same as in its [interim report for 2020-21](#).
  - It is **at the same level of 42% of the divisible pool** as recommended by the 14<sup>th</sup> Finance Commission.
- It has **made the required adjustment of about 1%** due to the changed status of the erstwhile State of Jammu and Kashmir into the new [Union Territories of Ladakh and Jammu and Kashmir](#).

- **Horizontal Devolution (Allocation Between the States):**

- For horizontal devolution, it has suggested **12.5% weightage to demographic performance, 45% to income, 15% each to population and area, 10% to forest and ecology and 2.5% to tax and fiscal efforts.**

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# 15th Finance commission Recommendations

- **Revenue Deficit Grants to States:**

- Revenue deficit grants **emanate from the requirement to meet the fiscal needs of the States** on their revenue accounts that remain to be met, even after considering their own tax and non-tax resources and tax devolution to them.
- Revenue Deficit is **defined as** the difference between revenue or current expenditure and revenue receipts, that includes tax and non-tax.
- It has recommended post-devolution **revenue deficit grants amounting to about Rs. 3 trillion over the five-year period** ending FY26.
  - The **number of states qualifying** for the revenue deficit grants **decreases from 17 in FY22**, the first year of the award period to 6 in **FY26**, the last year.

- **Performance Based Incentives and Grants to States:**

- These grants **revolve around four main themes**.
- The first is the **social sector**, where it has focused on **health and education**.
- Second is the **rural economy**, where it has focused on **agriculture and the maintenance of rural roads**.
  - The rural economy plays a significant role in the country as it **encompasses two-thirds of the country's population, 70% of the total workforce and 46% of national income**.
- Third, **governance and administrative reforms** under which it has recommended grants for **judiciary, statistics and [aspirational districts](#) and blocks**.
- Fourth, it has developed **a performance-based incentive system for the power sector**, which is not linked to grants but provides an important, additional borrowing window for States.

# 15th Finance commission Recommendations

- **Fiscal Space for Centre:**

- Total **15<sup>th</sup> Finance Commission transfers (devolution + grants)** constitutes about **34% of estimated Gross Revenue Receipts** to the Union, **leaving adequate fiscal space** to meet its resource requirements and spending obligations on national development priorities.

- **Grants to Local Governments:**

- Along with grants for municipal services and local government bodies, it includes **performance-based grants for incubation of new cities** and **health grants** to local governments.
- In grants for Urban local bodies, **basic grants are proposed only for cities/towns having a population of less than a million**. For **Million-Plus cities**, 100% of the grants are performance-linked through the **Million-Plus Cities Challenge Fund (MCF)**.
  - MCF amount is linked to the performance of these cities in **improving their air quality** and meeting the service level benchmarks for **urban drinking water supply, sanitation and solid waste management**.

# GOODS AND SERVICE TAX In INDIA

# What is GST in India?

- GST is known as the Goods and Services Tax. It is an indirect tax which has replaced many indirect taxes in India such as the excise duty, VAT, services tax, etc. The Goods and Service Tax Act was passed in the Parliament on 29th March 2017 and came into effect on 1st July 2017.
- In other words, [Goods and Service Tax \(GST\)](#) is levied on the supply of goods and services. Goods and Services Tax Law in India is a **comprehensive, multi-stage, destination-based tax** that is levied on every **value addition**. GST is a single domestic indirect tax law for the entire country.
- Under the GST regime, the tax is levied at every point of sale. In the case of intra-state sales, Central GST and State GST are charged. All the inter-state sales are chargeable to the Integrated GST.

# The Journey of GST in India

- The GST journey began in the year 2000 when a committee was set up to draft law. It took 17 years from then for the Law to evolve. In 2017, the GST Bill was passed in the Lok Sabha and Rajya Sabha. On 1st July 2017, the GST Law came into force.
- There are three taxes applicable under this system: [CGST, SGST & IGST](#).
- **CGST**: It is the tax collected by the Central Government on an intra-state sale (e.g., a transaction happening within Maharashtra)
- **SGST**: It is the tax collected by the state government on an intra-state sale (e.g., a transaction happening within Maharashtra)
- **IGST**: It is a tax collected by the Central Government for an inter-state sale (e.g., Maharashtra to Tamil Nadu)

# Issues in Indian Tax System

- **1. High Rate and Low Yield of Direct Taxes**
- **2. Low Contribution of Income Tax:**
- **3. Double Taxation of Dividends**
- **4. Absence of Agricultural Income Tax**
- **5. Importance of Indirect Taxes**
- **6. Progressive Taxes on Income**
- **7. Widening the Indirect of Tax Net**
- **8. Regressive Nature**

