

Irregularities in Vertical Devolution

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Background

- Agitations by different State governments in New Delhi have highlighted many disquieting issues in the practice of fiscal federalism in India.
- In light of this, the 16th Finance Commission must take initiative to proceed innovatively to justly address complaints of increasing vertical and horizontal inequalities in devolution.
 - Vertical devolution that is the sharing of resources between the Union and States.
- Within the domain of vertical devolution, there are two disturbing trends that need urgent redressal.

- First, the Union government has sought to keep an increasing share of its proceeds out of the divisible pool so that they need not be shared with States.
- Secondly, it has also not been devolving the shares of net proceeds to the States as mandated by successive FCs.

Shrinking of Divisible Pool of Taxes

- The net divisible pool, or net proceeds, is that part of the gross tax revenue from which a share would have to be vertically devolved by the Union to all States.
- Such shares are assigned by each FC for a five-year period.
- Earlier, all corporation taxes and customs duties were fully absorbed by the Union, and only income taxes and excise duties were shared with the States.
- However, with changes over the years, culminating in a constitutional amendment in 2000, all taxes of the Union were added to the net proceeds.
 - But there was a catch — cesses and surcharges under Article 270 and Article 271 were kept out of the net proceeds.
- In the past, such exclusion of cesses and surcharges were based on specific FC recommendations. But the amendment in 2000 provided a constitutional basis for it.
- Presently, the net proceeds consist of the gross tax revenue after the deduction of cesses, surcharges and the cost of collection of taxes.

Cess, Surcharge & GST

- Over the past decade or more, several cesses and surcharges were introduced by the Union government.
- When the Goods and Services Tax (GST) was initiated in 2017, the expectation was that many cesses and surcharges would be discarded and subsumed into the GST system.
- On the contrary, new cesses and surcharges continued to be introduced, and many old cesses and surcharges remained outside the GST system.
 - For instance, the Agriculture Infrastructure and Development Cess was introduced as recent as in 2021-22.
 - Similarly, when the Health and Education Cess was introduced in 2017-18, it just replaced the Primary Education and Secondary Education cess on direct taxes.
- The expansion of cesses and surcharges have led to the exclusion of an increasing share of the gross tax revenue from net proceeds.

Rise in Tied Transfers

- Cesses and surcharges have also been subjected to critical scrutiny by the Comptroller and Auditor General (CAG).
- All cesses must be transferred to a reserve fund in the Public Account of India after their collection.
- In its reports the CAG has uncovered numerous instances of either non-transfer or short transfer of the collected amounts to the respective funds.

- A CAG report in 2023 noted that if ₹52,732 crore was collected towards the Health and Education Cess in 2021-22, only ₹31,788 crore (or 60%) was transferred to the reserve fund of Prarambhik Shiksha Kosh.
- The Research and Development Cess must be transferred to the Fund for Technology Development and Application.
 - A CAG report in 2019 noted that the total collection of Research and Development Cess between 1996-97 and 2017-18 was ₹8,077 crore, but only ₹779 crore (or 9.6%) was transferred to the Fund.
- The Swachh Bharat Cess must be transferred to the Rashtriya Swachhata Kosh.
 - The extent of short transfer to the Kosh between 2015-16 and 2017-18 was ₹4,891 crore.
 - The extent of short transfer between 2010-11 and 2017-18 under the Road Cess was ₹72,726 crore and under the Clean Energy Cess was ₹44,505 crore.
- Non-transfers and short transfers of cesses defeat the logic of their collection.
- It also reaffirms the view that cesses and surcharges are just a ruse to divert increasing quantum of funds away from the divisible pool to meet other financial requirements of the Union government.

Way Forward

- Sharing of resources from the divisible pool, and the extent of cesses and surcharges, must be matters of critical importance for the 16th FC.
- The FC must take initiative to correct historical wrongs in vertical devolution through compensations to the States.
- It must instruct the Union government to publish accurate estimates of “net proceeds” in the budget documents.
- It must also arrange to provide shortfalls in devolution over the last decade as a lump sum untied grant to States.
- The Union government must legislatively act to have strict limits on the collection of cesses and surcharges.
 - Cesses and surcharges should automatically expire after a short period and must not be rechristened under another name.
- Apart from addressing rightful complaints on the inequalities in horizontal devolution, the stance of the 16th FC on vertical devolution would be critical to the survival of fiscal federalism in India.

Q1) What do you mean by Fiscal Discipline?

Fiscal discipline is defined as an ideal balance between revenues and expenditures of the government and the government's ability to maintain smooth monetary operations and long-term fiscal conditions. It serves as a model for tax devolution.

Q2) What is Fiscal Deficit?

When the government spends more than its total income, such a situation is called a fiscal deficit. It is calculated by subtracting the total income from the total expenditure and is either expressed in absolute terms or as a percentage of the GDP (Gross Domestic Product).

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