TAX DEVOLUTION TO STATES IN UNION BUDGET 2025-26 - ECONOMY

NEWS: *The Union Budget for the financial year 2025-26 has projected tax devolution to states at approximately ₹14.22 trillion.*

WHAT'S IN THE NEWS?

- This amount constitutes **around one-third (33.1%) of the gross tax receipts of the Central government**.
- Compared to the **revised estimate for the current financial year (FY25)**, this proportion is only slightly higher.
- Despite this increase, **the actual devolution remains significantly lower than the 15th Finance Commission's recommendation of 41%**.
- The tax devolution as a percentage of **gross tax receipts** for FY26 will be the **highest since FY21**, which was affected by the Covid-19 pandemic.

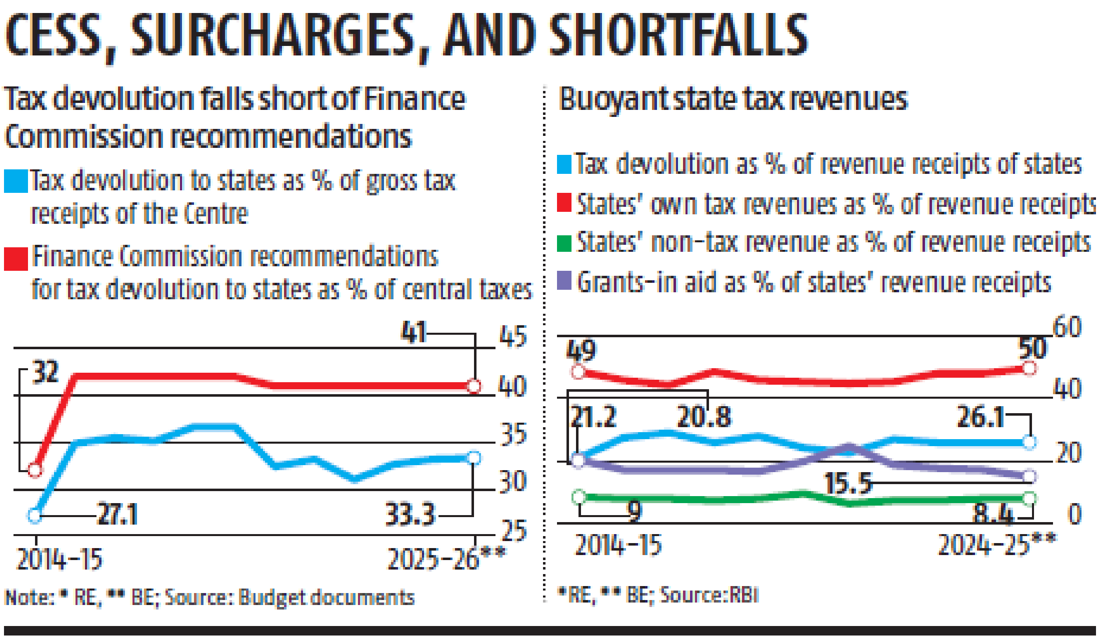
Historical Trends in Tax Devolution

- In the **pre-Covid period (2015-16 onwards)**, tax devolution to states was relatively higher than post-Covid years.
- However, even during this period, **the actual devolution remained below the 14th Finance Commission's recommendation of 42%**.
- The **14th Finance Commission's recommendations** were applicable for the five-year period from **FY16 to FY20**.
- The **15th Finance Commission's recommendations** were given in two phases:
    - **For FY21 (one-year period).**
    - **For the five-year period from FY22 to FY26.**
- During the financial year **2014-15**, tax devolution was even lower because it was based on the **13th Finance Commission's recommendation** of **32% of gross tax receipts**.
- However, the **actual devolution to states during FY15** was even less than the recommended 32%.

Centre's Use of Cess and Surcharges to Circumvent Devolution

- The Central government has increasingly relied on **cess and surcharges** as a means to **bypass Finance Commission recommendations** on tax devolution.
- **Cess and surcharge collections do not form part of the divisible pool**, which means they are not shared with states.
- As a result, states receive a lower share of central tax revenues than they would if these revenues were part of the divisible pool.
- Since FY21, several new **cesses and surcharges** have been introduced, including:
    - **A health cess of 5%** imposed on **imports of certain medical equipment** in the Union Budget for 2020-21.
    - **Agriculture Infrastructure and Development Cess (AIDC)** introduced in the 2021-22 Budget on various imported products such as:
        - Gold
        - Silver
        - Alcoholic beverages
        - Crude edible oils
    - **Excise cess on petrol and diesel** introduced in the same period:

    - ₹2.5 per litre on petrol
    - ₹4 per litre on diesel



Impact of Reduced Tax Devolution on States

- Due to the growing reliance on cess and surcharge collections, **the share of tax devolution to states has dropped significantly** in recent years.
- As a result, the tax devolution now constitutes **only 26% of states' own tax revenues**, a figure that is **considerably lower** than in the pre-Covid years.
- Concerned by this declining share, several states have demanded:
    - **An increase in tax devolution to at least 50% of the gross tax receipts of the Centre.**
    - **A cap on cess and surcharge collections at 10% of gross tax receipts.**
- Tamil Nadu **Chief Minister M.K. Stalin**, in a formal representation to the **16th Finance Commission**, highlighted that:
    - **Cess and surcharge collections currently account for 16.83% of the Centre's gross tax revenue.**
    - Since these funds are **not shared with states**, they effectively diminish **states' rightful share** of tax revenues.
    - He proposed that **cess and surcharge collections above 10% of gross tax receipts should be merged into the divisible pool** to ensure a fairer distribution.

Centre's Response and Fiscal Support to States

- In response to states' financial pressures, the Centre has **advanced tax devolution payments** in recent years to **help states manage liquidity issues**.
- In addition, **buoyant state GST revenues** have provided some relief, with **states' own tax revenues contributing 50% of their total revenue receipts in 2024-25** (the highest in the past 11 years).
- A portion of the **cess and surcharge collections** is also used by the Centre to fund **Centrally Sponsored Schemes (CSS)** related to:
    - **Education**

- **Healthcare**
- **Infrastructure (e.g., roads, public works, etc.)**

Changes in Centrally Sponsored Schemes (CSS) Funding

- In 2015, a committee led by **Shivraj Singh Chouhan** recommended changes in **Centre-State cost-sharing ratios** for CSS.
- As a result, the funding pattern for several schemes was **revised as follows**:
  - **Previously:** The Centre-State ratio was **70:30 or 75:25** for various schemes.
  - **Currently:** The Centre-State ratio has been **reduced to 60:40**.
- Some states have expressed **concerns about the continued relevance of certain CSS programs**.
  - **Example:**
    - The **Sarva Shiksha Abhiyan (SSA)**, aimed at improving literacy, is no longer as crucial for Kerala as it once was.
    - While SSA remains essential for states like **Bihar**, Kerala argues that it **does not align with its current educational priorities**.

Special Assistance via Interest-Free Capital Loans

- To help states finance capital expenditure (capex), the **Union government has been providing special 50-year interest-free loans**.
- The budget allocation for these loans is **₹1.5 trillion for FY26**, the same amount as was proposed for **FY25 (Budget Estimates)**.
- However, due to **the limited capacity of states to absorb these funds**, the **revised allocation for FY25 has been lowered to ₹1.25 trillion**.

Challenges in State Borrowing and Fiscal Management

- States face **restrictions on borrowing** due to **a cap on their fiscal deficit**:
  - **States are allowed to borrow up to 3% of their Gross State Domestic Product (GSDP).**
  - **An additional 0.5% borrowing leeway** is available for states that implement **power sector reforms**.
  - **The capital loans provided by the Centre are included in this borrowing limit**, further restricting states' ability to raise funds independently.
- **Key implications for state finances:**
  - If states adhere to the borrowing cap, they **may need to cut capital expenditure (capex)**, affecting infrastructure and development projects.
  - If they prioritize capex, their **revenue deficit will increase**, leading to **higher borrowing from the market** at interest-bearing rates.
- **Expert Opinions:**
  - **Govinda Rao (NIPFP & 14th Finance Commission member):**
    - **Interest-free capex loans reduce borrowing costs but do not fully meet states' funding requirements.**
    - **Sunil Kumar Sinha (Institute for Development and Communication, Chandigarh):**
    - States primarily **spend on revenue expenditures**, while the Centre collects most of the tax revenues.
    - **Capex loans do not solve the problem of revenue shortfalls**, forcing states to **borrow from the market** for operational expenses.

Conclusion

- **The share of tax devolution to states remains lower than recommended levels**, impacting states' ability to finance development programs.
- The **Centre's increasing reliance on cess and surcharges has reduced the funds available to states**, leading to financial strain.
- **States are demanding higher tax devolution (50%) and a cap on cess/surcharge collections (10%).**
- **Interest-free capex loans provide some relief but do not address states' fiscal constraints in managing revenue expenditures.**
- The ongoing debate over **Centre-State financial relations** highlights **the need for a more balanced revenue-sharing mechanism**.

What are the Issues of Centre-State Relations?

- **Background:**
  - Continuing **Economic Reforms** since 1991 has led to the **relaxation of many controls on investments**, giving some room to States, but the autonomy regarding public expenditure policies is not **absolute as State governments depend on the Centre** for their revenue receipts.
  - Several States have recently pushed back as a result of which the 'give and take' equation between the Centre and the States has given **way to a more hardened stand by both,** leaving little room to negotiate.
  - The increasingly fractious Centre-State ties have **chipped away at the edifice of Cooperative Federalism.**
- **Complexities of Contemporary Disputes:**
  - The areas of contention include the **homogenisation of social sector policies,** functioning of regulatory institutions and the powers of central agencies.
  - Ideally bulk of the policies in these spheres should be at the discretion of States, with an apex central body overseeing the process of resource allocation.
  - However, the **apex bodies have often attempted to increase their influence and push States** in directions that are amenable to the Centre.

What are the Constitutional Provisions Related to Centre-State Relations in India?

- **Legislative Relations:**
  - **Articles 245 to 255 in Part XI of the Constitution** deal with the legislative relations between the Centre and the states.
    - Given the federal nature of the Indian Constitution, it divides the legislative powers between the Centre and the states with respect to both the territory and the subjects of legislation.
  - Distribution of **Legislative Subjects (Article 246):** Indian Constitution provides for a division of the subjects between the Centre and the states through three **lists – List-I (Union), List-II (State) and List-III (Concurrent)** in the Seventh Schedule.
  - **Parliament Legislation in State Field (Article 249):** In abnormal times, the scheme of distribution is either modified or suspended.

- **Administrative Relations (Article 256-263):**
  - Articles spanning from **256 to 263 in Part XI** of the Constitution deal with the administrative relations between the Centre and the states.
- **Financial Relations (Article 256-291):**
  - Articles spanning from **268 to 293 in Part XII** of the Constitution deal with Centre – state financial relations.
    - Because India is a federal country, it adheres to the division of powers when it comes to taxation, and it is the responsibility of the Centre to allocate funds to the states.
  - **Schedule VII** describes the ability of the **Centre and states to levy taxes.**
    - The **Goods and Services Tax**, a dual structure tax, is a recent example of a financial centre-state relationship.

How Fiscal Federalism has been Compromised in Recent Times?

- **Centre Dominance and Investment Shifts:**
  - The expanded scope of the Centre's activities can lead to a scenario where it **encroaches upon States' investment territory.**
    - For example, the Centre launched the PM Gati Shakti, where all States and UTs had to prepare and operationalise a State master plan in line with the national master plan for seamless implementation.
  - However, the flexibility of States in formulating their master plan is **curtailed by the centralisation of planning** and implementation of the national master plan, leading to **underinvestment by States.**
    - Consequently, States witnessed a **decline in capital expenditure on roads and bridges**, falling to a meagre 0.58% of the gross state domestic product.
- **Peculiar Fiscal Competition:**
  - While federal systems typically witness fiscal competition between regions/states, India has seen states engaging in competition not only amongst themselves **but also with the Centre.**
  - This scenario arises **due to the Centre's augmented fiscal space,** granting it more spending power, while states **face limitations in raising non-tax revenues**.
    - Furthermore, **spending has become more concentrated** within the three largest States of **Uttar Pradesh, Maharashtra and Gujarat**, accounting for nearly half of the expenditure by 16 States between 2021-22 and 2023-24.
  - This imbalance leads to **reduced financial autonomy for states** and skews welfare provisioning dynamics.
- **Inefficiencies from Parallel Policies:**
  - Federal abrasions between the Centre and states have resulted in the emergence of 'parallel policies.'
    - For instance, the **National Pension System (NPS)** heralded a shift from a defined benefit scheme to a defined contribution scheme.
    - While most states initially adopted the NPS, some are reverting to the old pension scheme due to perceived fiscal implications.
  - The lack of trust within the federal system drives states to duplicate policies, leading to **inefficiencies and long-term fiscal repercussions on the economy.**

Source: https://www.business-standard.com/economy/news/cess-surcharges-and-shortfalls-the-great-centre-state-revenue-tug-of-war-125020900676_1.html