Center State Finances

> Mains Syllabus: GS III - Indian Economy and issues relating to planning, mobilization, of resources, growth, development and employment.

Why in the News?

In the past years, the share of states in centre's revenue has declined.

What are the challenges in centre-state finances?

- **Shrinking Divisible Pool of Taxes** – The divisible pool includes all tax revenues collected by the Centre, excluding cesses, surcharges, and the cost of collection.
- Given that the share of cesses and surcharges has increased, the divisible pool has shrunk, and since the pandemic year 2020-21, it has fallen to less than ₹90 for every ₹100 that the Centre collects.
- **Decline in Vertical Devolution** – As the share of revenue collected through cesses and surcharges, which are kept outside the divisible pool, is rising, the amount of vertical devolution has declined.

> *As decided by the 15th FC, currently, 41% of the divisible pool of taxes is shared by the Centre with all the States.*

- The share of cesses and surcharges, along with the cost of collection, reached a high of Rs. 13.5 for every ₹100 collected as taxes by the Centre in 2021-22 — the highest ratio in at least over a decade.

> *Article 271 empowers the Union government to levy cesses and surcharges.*

- Over the past year, 14 out of the 15 States that met with the 16th FC demanded that the devolution share be increased to 50% from 41%.
- **Dilution of Finance Commission Recommendations** - The consistent rise in the share of cesses and surcharges has meant that the FC's recommendations have been rendered less effective, as the divisible pool, upon which the FC's formula is applied, itself is shrinking.
- **Loss in States' Own Tax Revenue (SOTR)** – States' avenues for independent revenue generation are shrinking, and growth in SOTR remains sluggish, especially among many advanced States, limiting their fiscal autonomy.
- **Tight Borrowing Rules** – The rules governing how States can borrow have become

another flashpoint, and States are subject to limits set by the Centre.

- **Borrowings made by State's entities** — such as public sector undertakings — are being counted as part of the State's debt, tightening the fiscal leash further.

What are the challenges in horizontal devolution?

Horizontal distribution was based on several criteria — such as population, demographic performance (i.e. population control), forest cover, geographical area, and efficiency in tax collection.

- **Skewed Weightages in Horizontal Devolution**– The first three high-weightage factors of the horizontal devolution formulae— income distance, population, and area together accounted for 75% of the total.
- **Income Distance** – Due to the high weightage of 45% assigned to income distance criteria, States with lower per capita income receive a larger share to promote equity.
- **Population and Area** - 15% each for a State's population and area, meaning, the larger the population and land area, the higher the share.
- **Forest and Ecology** – It got 10%, based on a State's share of dense forests in India's total forest cover.
- **Inadequate Consideration of Development Factors** - Population control and tax efficiency factors collectively carried only 15% weight.
- If a State has successfully controlled its population and improved its economy, it ends up receiving a lower share, essentially disincentivising those States.
- This makes the better-performing and efficiently administered states state in the lower rankings.

Horizontal Devolution among States
• The share of all the southern States has fallen with Kerala's share fell from 3.08% in FY02 to 2.5% in FY17 and is estimated to fall even further to 1.9% in FY26 (BE). • Tamil Nadu's share shrank from 5.46% in FY02 to 4.02% in FY17 and is expected to remain at the same level in FY26. • Karnataka's has come down from 4.98% in FY02 to 3.6% in FY26 BE. • The share of Andhra Pradesh and Telangana together declined from 7.7% in FY02 to 6.75% in FY17 and is expected to drop to 6.1% in FY26. • West Bengal and Odisha's shares have also come down consistently in the period. • In contrast, the shares of Madhya Pradesh, Maharashtra, Rajasthan, and Gujarat have increased in this period. • States such as Uttar Pradesh and Bihar continue to receive the bulk of the share. • Bihar is expected to get 10.1% in FY26, slightly lower than 11.49% in FY02 and Uttar Pradesh is expected to get 17.9% in FY26, slightly lower than 19.15% in FY02.

Why has the state's own revenue been declining?

- **Sources of Own Tax Revenue of States** – It includes money raised through stamp duty, registration fees, motor vehicle tax, and other taxes, along with the State GST (SGST).
- **Decline in State Tax Revenue** – It's share in total revenue has remained considerably below the 50% mark, while in the 2000s and the early 2010s, it had

crossed the 50% mark for many years or remained close to it.

- **Decline in Non-GST Revenue** - While the share of SGST in States' total revenue has increased from 15% in FY18 to 22%, the share of own tax revenue, without the contribution from SGST, has declined from 34% to 28%.
- **Decline in Taxation Autonomy of States** – As SGST is earned based on rates set by the GST Council, states have complained of GST limiting their autonomy in deciding how tax revenue is collected.

Sales tax was giving States the buoyancy, before the GST was introduced, by contributing almost 60% of the tax revenues.

- **GST Impact on Producing States** - As the GST reform has made the consumption tax destination-based, the production-based states like Tamil Nadu, Karnataka, Maharashtra got affected.
- **Decline in Non-Tax Revenue** - The share of non-tax revenue in States' total revenue is likely to go below the 24% mark in FY25 for the first time in the past 25 years.

Non-tax revenue of States includes grants from the Centre, earnings from social, fiscal, economic, and general services rendered by the States, interest receipts, and dividends/profits from State public sector enterprises.

- **Slump in Tax Receipts** - Interest receipts have not exceeded 5% of States' non-tax revenues in the last decade compared to the 2000s and first half of 2010s when it formed 5-9% of non-tax revenue.
- **Low Contribution from State PSUs** - The share of dividends and profits garnered from State public sector enterprises has remained under 1%.
- **Stagnant Revenue from Services** - Earnings from services rendered, such as public health (social service) and power (economic service), did not cross the 30% mark in the last decade.

Status of Revenue Creation of States
• In the last decade (FY16 to FY25), 23-30% of the total revenue of States was collected from the Centre as transfers. • In the 2000s and the first half of 2010, the share was lower at 20-24%. • Close to 65-70% of the non-tax revenue of States was collected from the Centre as grants in the last decade, compared to the 2000s and the first half of the 2010s, when the share was lower at 55-65%.

What are the limits on state's borrowing capacity?

- **Constitutional Provision** - Article 293 allows the Centre to set a Net Borrowing Ceiling (NBC) for the States.
- It states that the States can borrow domestically, but if they are indebted to the Union government, they have to seek the latter's permission.
- **Borrowing Limit** - The ceiling is determined by the Centre based on the Fiscal Responsibility and Budget Management Act and the Finance Commission

recommendations that allows States to borrow up to 3% of their GSDP.

- **Purpose** - The Centre sees this limit as a way to achieve fiscal consolidation by minimising the fiscal deficit.
- **View of States** - They see it as their liberty to borrow being curtailed, and their avenues to balance their budgets being limited.
- The FRBM Act for each State is passed by that State setting the limit.
- **Off-budget borrowings** - Centre wants the off-budget borrowings accounted for in the State's budget and the limit be applicable on their final debt position.

Off-Budget Borrowing
• Off-Budget borrowings are loans obtained by government entities, such as PSUs or special purpose vehicles, on behalf of the government to finance its expenditure. • These borrowings are typically not included while computing the debt and the fiscal deficit of the State governments. • However, the State government is responsible for repaying the loan and servicing the debt from its Budget. • But now States have to show them in their books.

What lies ahead?

- States have also been demanding the Finance Commission to recommend a cap on the cesses and surcharges to a specific percentage of the gross tax revenue.
- It has also been demanded to consider anything above the cap as constituting a part of the divisible pool.
- Commission may consider suggesting tests for the cess and surcharges to qualify for exclusion from the divisible pool.
- Some states have demanded inclusion of state GDP , state's contribution to national economy and achievement in SDG goals as criteria for horizontal devolution.
- Improving tax administration and enforcement, reducing the number of tax rates under GST and including petroleum products in the GST calculation can boost tax revenues for the States.

Reference

The Hindu | Are the States being squeezed out of funds by the Centre?