Tax Devolution

For Prelims: Tax Devolution, Finance Commission, Article 280(3)(a), Million-Plus Cities Challenge Fund, Fiscal Federalism.

For Mains: Tax Devolution its significance and its Constitutional Mandates.

Why in News?

Recently, the Union government has released the 3rd Installment of **Tax Devolution** to state governments amounting to Rs 1,18,280 crore in June 2023, as against the normal monthly **devolution of Rs 59,140 crore.**

- It will **enable states to speed up capital spending,** finance their development/ welfare related expenditure and also to make available resources for priority projects/ schemes.
- **Uttar Pradesh received the highest** (Rs 21,218 crore) followed by Bihar (Rs 11,897 crore), Madhya Pradesh, West Bengal and Rajasthan.

What is Tax Devolution?

- **About:**
  - Tax devolution refers to the distribution of tax revenues between the central government and the state governments. It is a constitutional mechanism **established to allocate the proceeds of certain taxes among the Union and the states** in a fair and equitable manner.
  - **Article 280(3)(a)** of the Constitution of India mandates that the Finance Commission (FC) has the responsibility to **make recommendations regarding the division of the net proceeds of taxes** between the Union and the states.
- **Key Recommendations of 15th Finance Commission:**
  - **Share of States in Central Taxes (Vertical Devolution):**
    - The share of states in the central taxes for the 2021-26 period is **recommended to be 41%**, same as that for 2020-21.
      - This is less **than the 42% share recommended by the 14th Finance Commission for 2015-20** period.
      - 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.
  - **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.
  - **Revenue Deficit Grants to States:**
    - 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.
    - **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.
    - **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.

What is the Role of the FC in Maintaining Fiscal Federalism?

- **Distribution of Tax Proceeds:**
    - The Finance Commission recommends the **distribution of the net proceeds of taxes** between the Union government and the state governments.
    - This ensures a **fair and equitable sharing of tax revenues**, taking into account the fiscal capacities and needs of the states.
- **Allocation of Taxes Among States:**
    - The Finance Commission determines the **principles and quantum of grants-in-aid to states** that require financial assistance.
    - It assesses the **financial needs of states and recommends measures** to allocate funds from the consolidated funds of the states.
- **Augmenting Resources of Local Governments:**
    - The Finance Commission **suggests measures to augment the consolidated fund of a state** in order to supplement the resources of **Panchayats and Municipalities** in that state.
- **Cooperative Federalism:**
    - The Finance Commission's functioning is **characterized by extensive consultations with all levels of** governments, promoting the principle of cooperative federalism.
    - It engages in consultations **with the central government, state governments, and other stakeholders** to gather inputs and ensure a participatory approach in decision-making.
- **Public Spending and Fiscal Stability:**
    - The recommendations of the Finance Commission are aimed at improving the quality of **public spending and promoting fiscal stability.**
    - By evaluating the financial position of the Union and state governments, the **Commission provides guidance on fiscal management**, resource allocation, and expenditure priorities.

What is the 15th Finance Commission?

- The Finance Commission 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 **15th 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.**

UPSC Civil Services Examination, Previous Year Question (PYQ)

Prelims

Q. Consider the following: (2023)

1. Demographic performance
2. Forest and ecology
3. Governance reforms
4. Stable government
5. Tax and fiscal efforts

For the horizontal tax devolution, the Fifteenth Finance Commission used how many of the above as criteria other than population area and income distance?

(a) Only two
(b) Only three
(c) Only four
(d) All five

Ans: (b)

Mains

Q. Discuss the recommendations of the 13th Finance Commission which have been a departure from the previous commissions for strengthening the local government finances. **(2013)**

Source: TH