Shrinking of States' share in divisible pool

Why in news?

The share of the States in divisible pool is shrinking despite their carrying a higher burden of expenditure.

What is the issue?

- Chief Ministers of various states expressed their concern about dwindling State revenues in a NITI Aayog meeting chaired by the Prime Minister.
- They sought a higher share in the divisible pool of taxes and an extension of GST compensation, both of which have long remained a bone of contention between the Union government and the States.
- States' financial health had taken a turn for the worse with the implementation of the Ujwal DISCOM Assurance Yojana, farm loan waivers, as also the slowdown in growth in 2019-20.

What is vertical fiscal imbalance?

- There is vertical asymmetry in the distribution of resources (revenues) and responsibilities between the centre and states, which often referred to as vertical fiscal imbalances.
- This imbalance is that the central government enjoy some important and fast-growing tax revenues like corporate income tax and personal income tax.
- On the other hand, the states that doesn't have such vibrant tax resource, have the responsibility to provide fast growing expenditure under items like health.
- Article 280 of the Constitution provided solution to this vertical imbalance.
- It proposes for the creation of Finance Commission in every five years to recommend the transfer of resources from the centre to the states.
- Finance commissions reviews the fiscal conditions of the centre and states from time to time and suggests resource transfer from the centre to the states.
- For the transfer of central resources, the constitution itself points out what tax resources of the centre have to be shared with the states.
- These tax sources of the centre that must be shared with the states is known as the divisible pool.
- In the constitution, Article 270 describes about the tax resources to be transferred from the centre to the states.

What is the divisible pool?

- Divisible pool is that portion of gross tax revenue which is distributed between the Centre and the States.
- The divisible pool consists of all taxes, except surcharges and cess levied for specific purpose, net of collection charges.

What was the status of divisible pool before the 80th Constitutional Amendment?

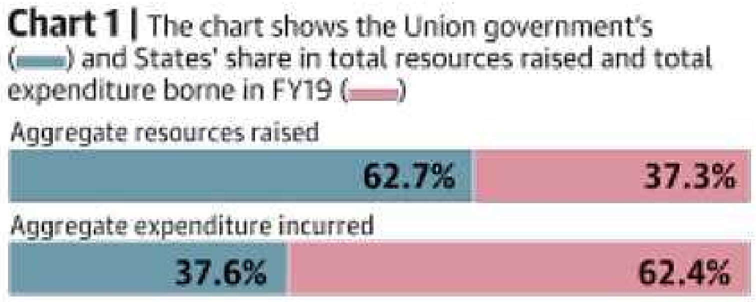
- Before the 80th Constitution Act, 2000, the sharing of the Union tax revenues with the states was in accordance with the provisions of articles 270 and 272.
- During that time, two main taxes of the centre, corporate income tax and customs duties were not placed under the divisible pool.
- So, till the 10th Finance Commission recommendations, these two taxes remained outside the divisible pool.
- Separate criteria were used for the transfer of union excise duties and personal income taxes.

What was the status of divisible pool after the 80th Constitutional Amendment?

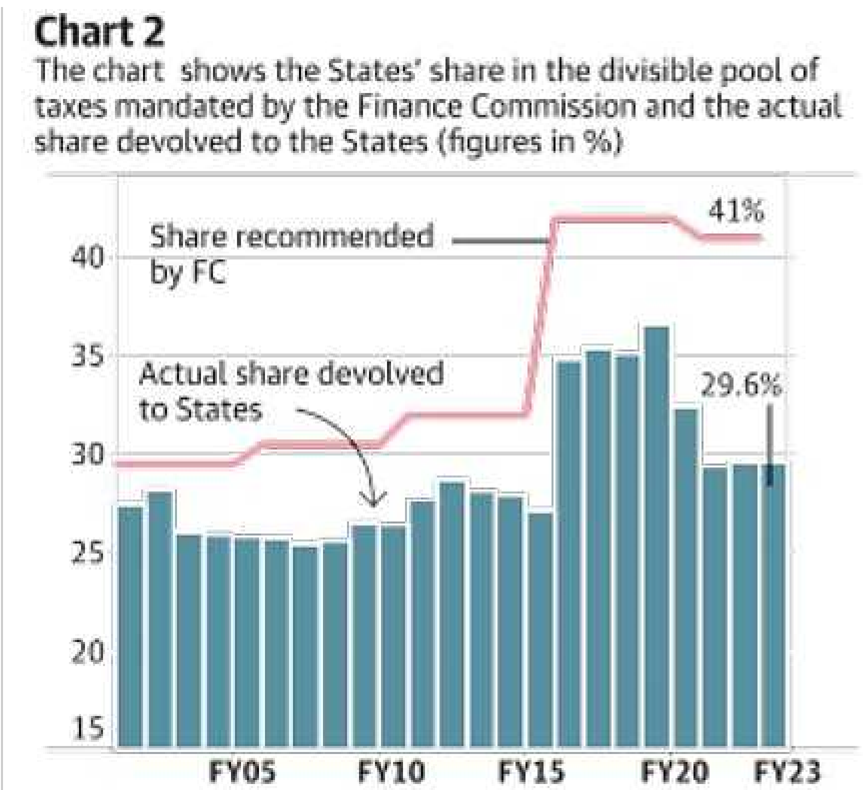
- The 10th Finance Commission suggested an alternative scheme of devolution.
- The Commission suggested that all of the central taxes should be shared with the states.
- This recommendation fundamentally altered the pattern of sharing of Central taxes between the Centre and the States.
- To alter the divisible pool in accordance with the bold recommendations of the 10th Finance Commission, the Parliament amended the constitution through the 80th amendment.
- The 80th amendment brought changes in article 270 that is related with the divisible pool.
- After the amendment, Article 270 provides for sharing of all the taxes and duties referred to in the Union list.
- The amendment provides exception to the taxes and duties referred to in articles 268 and 269, respectively, and surcharges on taxes and duties referred to in article 271 and any cess levied for specific purposes.
- As a result of the 80th amendment, article 272 was dropped.
- The 80th amendment of the Constitution thus altered the pattern of sharing of Union taxes in a fundamental way.

What is the current position of the divisible pool?

- According to the 15th Finance Commission's report, in FY19, the Union government raised 62.7% of the total resources raised by the Union government and States, while States had borne 62.4% of the aggregate expenditure.
- **Union government and States' share in total resources -** Chart 1 shows the Union government and States' share in total resources raised and total expenditure borne in FY19.

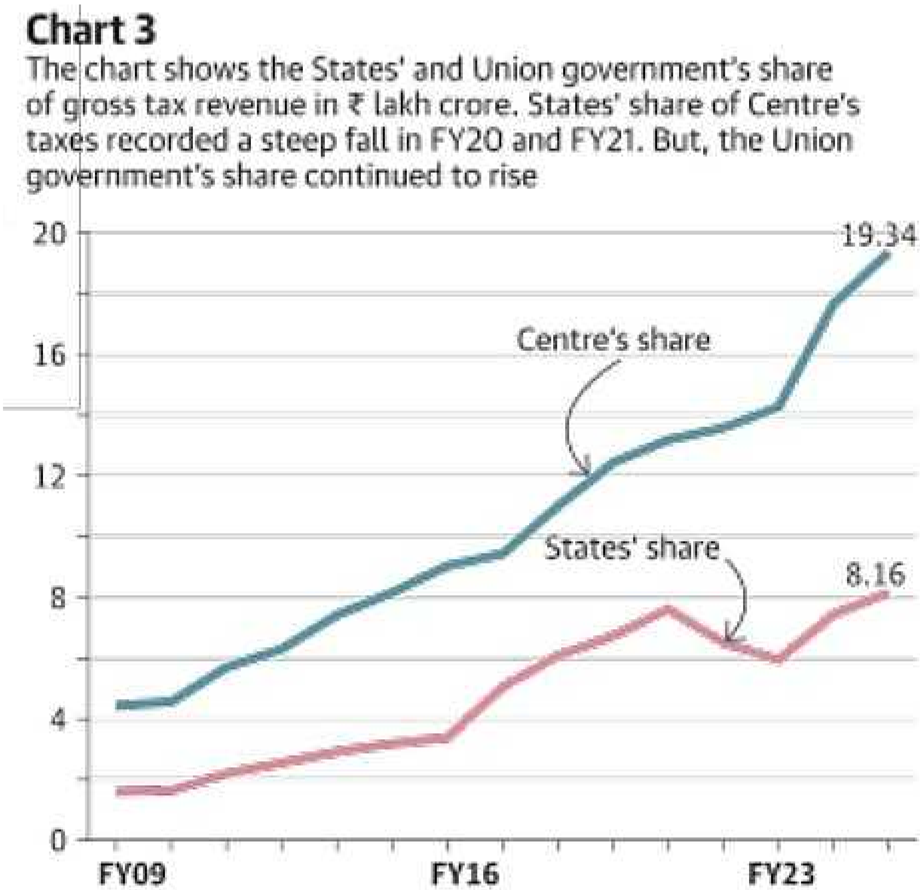


- Successive Finance Commissions (FC) have attempted to reduce the imbalance by increasing the States' share in Central taxes.
- Although the 14th and 15th FC raised the share of States in gross taxes to over 40%, the actual share never reached this mandated level.
- After reaching a peak of 36.6% in FY19, States' share fell and has since stagnated at around 29%.
- At the same time, the gap between the share recommended by the FC and the actual devolution has widened to more than 11 percentage points, the highest in at least two decades.
- **States share in divisible pool of taxes -** Chart 2 shows the States' share in the divisible pool of taxes mandated by the FC and the actual share devolved to the States.



- Even though FC raised the States' share in Central taxes, it didn't translate into an increase in the actual share devolved as the divisible pool shrank.
- This can be explained by illustrating the revenue sharing during the pandemic.
- As the gross tax revenues took a hit during the pandemic, the States' share of the Union government's taxes recorded a steep fall of 15% and 9% in FY20 and FY21, respectively.
- However, the Union government's share continued to rise.

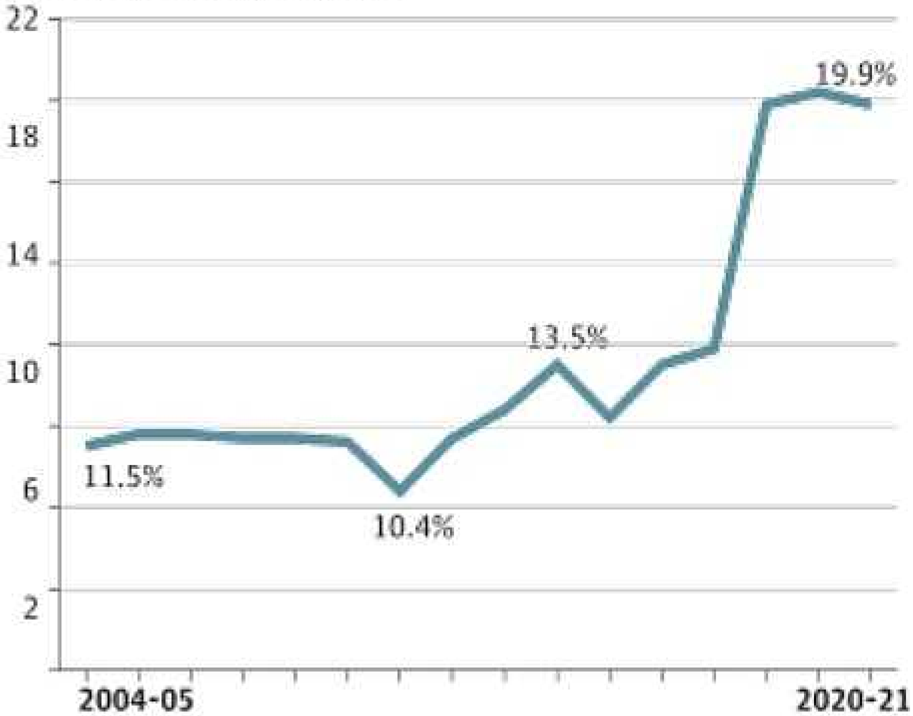
- This is because the Centre beefed up its revenue by levying cesses and surcharges which are not shareable with the States.
- **Centre and State's share of gross tax revenue -** Chart 3 shows the States' and Union government's share of gross tax revenue.



- In the past few years, the share of cesses and surcharges in gross tax revenue has risen significantly.
- From 10.4% in FY12, their share climbed up to 20% by FY21, suggesting the Union government's excessive reliance on these instruments to raise revenue.
- While the surge in cess/surcharge revenue, largely through duties on fuel has swelled the Union government's coffers, this has also shrunk the divisible pool of resources.
- **Share of cess and surcharges -** Chart 4 shows the share of cesses and surcharges in gross tax revenue.

Chart 4

The chart shows the share of cesses and surcharges in gross tax revenue. From 10.4% in FY12, their share climbed up to 20% by FY21, suggesting an excessive reliance by the Centre on these instruments to raise revenue



- Various cesses and charges are imposed by the government to raise resources.
- They are transferred to Reserve Funds to ensure that they are being used for the intended purpose.
- Worryingly, in FY20, about 40% of the cesses levied, worth Rs. 78,000 crore, were not transferred to the Reserve Funds.
- Between FY10 and FY20, Rs. 1.28 lakh crore was collected as a cess on crude oil.
- However, not a single penny was transferred to the Oil Industry Development Board (OIDB).
- **Issues flagged by Comptroller and Auditor General -**
- Table 5 lists the issues flagged by the Comptroller and Auditor General with respect to cesses and levies.

Table 5

The table lists the issues flagged by the Comptroller and Auditor General with respect to cesses and levies

Year of audit	Issue
FY20	In FY20, cesses worth ₹78,376 crore – about 40% of the cesses – were not transferred to the reserve funds for which they were levied
FY20	During FY10 and FY20, nearly ₹1.28 lakh crore was collected through cess on crude oil but no funds were transferred to Oil Industry Development Board. The funds were retained in the Consolidated Fund of India and there is no assurance if they were used for the intended purpose
FY19	In FY19, cesses worth ₹1.1 lakh crore or 40% of the cesses were not transferred to the Reserve Funds and were retained by the CFI
FY19	₹8,871.19 crore were collected from Social Welfare Surcharge on customs. However, no dedicated fund was created to ensure that amount was spent for the intended purpose
FY19	₹414.51 crore were collected from abolished cesses (cesses subsumed under the Goods and Services Tax) and deposited in the Consolidated Fund of India

SOURCE: FINANCE COMMISSION REPORTS, UNION BUDGET, CAG

How does the future look?

- The shrinking of the divisible pool despite a higher burden on expenditure on States suggests that the Chief Ministers' grouse appears to be valid.

- States' financial health had taken a turn for the worse with the implementation of the Ujwal DISCOM Assurance Yojana, farm loan waivers, as also the slowdown in growth in 2019-20.
- The heightened expenses during the pandemic and a revenue shortfall further strained their finances.
- The situation demands redressal measures at the earliest.

Reference

1. https://www.thehindu.com/todays-paper/tp-opinion/a-centre-state-skew-further-widened/article65799838.ece
2. https://www.indiabudget.gov.in/budget2015-2016/es2014-15/echapvol1-10.pdf