



## Reshaping Fiscal federalism through 16th Finance Commission

This editorial is based on the Article [THE NEW SHARING](#) which was published in The Indian Express on 14/09/2023. It talks about challenges faced by the fiscal devolution mechanism and also suggests the terms of reference for the upcoming 16th Finance Commission.

**For Prelims:** [Finance Commission](#), [GST](#), [GST council](#), [Integrated GST](#), [Vertical and Horizontal devolution](#), [Input tax credit](#), [Article 275](#), [GST compensation](#)

**For Mains:** 101st Amendment Act and its Impact; Challenges of Fiscal Federalism, Terms of Reference(TOR) for the 16th Finance Commission

The 16th [Finance Commission](#) (SFC), due to be constituted soon, must be mandated to re-examine the tax-sharing principles in light of the altered landscape of [fiscal federalism](#) in India. The Terms of Reference (ToR) should be based on combining the authority of the central government and the state governments in collecting and merging their respective indirect taxes.

### What was the 101<sup>st</sup> Constitutional Amendment ?

- The 101st Constitutional Amendment of 2016 **giving the Union and states concurrent powers of indirect taxation** has been the **most far-reaching change from a fiscal standpoint**, since the setting up of the **First Finance Commission** in 1951.
- The amendment introduced a national [Goods and Services Tax \(GST\)](#) in India from 1 July 2017.
- **GST is based on a system of concurrency of indirect taxes**, where every transaction attracts central as well as state GST.
- The inter-state transactions, as well as imports, are levied an **integrated GST**.
- With this, a consumption-based taxation system has **replaced a production-based one**.

### What have been the Impacts of this Amendment?

- The collection of indirect taxes in the state where goods or services are consumed, and not in the state where they are produced, changes both the vertical as well as the horizontal dynamics of **federalism**.
- Previously, the central sales tax was based on the origin of goods, which meant that the tax burden was shifted from rich and manufacturing states to consuming states, leading to horizontal imbalances.
- However, now with the destination principle for cross-border trading, the poorer and consuming states are benefiting at the expense of more affluent and industrialized ones.
- The [IGST](#), for instance, **charged during the inter-state supply of goods or services** has been

transferred to the destination state. This move from the principle of origin to the principle of destination is reconfiguring the balance of power amongst states.

## What are the Challenges for Fiscal Federalism?

- The **federal fiscal transfer system still continues to be designed for, and is based on, the principles of jurisdictional separation that is germane to the origin-based tax era.** Its distributional criteria is also based on the earlier regime.
- The **disconnect between the operational tax regime and the principles and criteria of tax sharing is inimical to the fiscal federal system** and can create fault lines in the political economy of federalism.

## What should be the Mandate of the 16th Finance Commission to ensure better devolutions?

- **Re-examine the Tax-Sharing Principles:** The 16th Finance Commission (SFC) needs to be directed to review tax-sharing principles in the context of India's changing fiscal federalism. Its terms of reference should be based on the consolidation of the indirect tax base by the Union and the states.
- **Redesign the Statutory Sharing of Indirect Taxes:** The changes necessitate that the statutory sharing of the indirect taxes, both **vertical and horizontal**, is re-examined and redesigned.
  - **Vertical Devolution:** To align the principle of vertical sharing with the new system, it is important to start by redefining the divisible pool. For instance, the SFC will be required to specify the modalities of making **IGST** completely a part of the pool.
    - As of now, only IGST with no **input tax credit** gets shared with the states. There must be a normative basis for credit-in-transition unsettled IGST to be included in the divisible pool.
    - This also holds for the frequency of settlements, which needs to be stipulated as it has caused a lot of cash flow issues for state governments.
  - **Horizontal Devolution:** The criteria for the distribution of the divisible pool among states, will have to be revisited. The existing criteria, especially for equalizing grants, have evolved into a production-based tax system. **This needs to be redesigned for a consumption-based tax system.**
    - The change from production to consumption will make a significant difference to the distribution of tax revenues as well as the need, nature, and distribution of equalizing grants.
    - The order of states is likely to change significantly because their ranking by per capita income differs greatly from their ranking by per capita consumption.
- **Recommend a method to calculate and allocate the cost of collecting:** The new administration of **GST**, where both the Union and states collect the same taxes, has resulted in a significant increase and wide variation in the cost of tax collection. This cost ranges from 7 to 10 percent.
  - Therefore, the SFC should be tasked with recommending a method to calculate and allocate the cost of collecting indirect taxes.
  - Additionally, they should suggest ways to reduce these taxes and improve their collection efficiency.
- **Redesign the Grant Mechanism:** The “gap-filling” approach devised by British Banker Otto Niemeyer in 1935 and continued under **Article 275**, should be redesigned in light of the compensation law brought in by the **GST Council**.
  - With the **GST compensation** grants extended to March 31, 2026, the fiscal year after that will be the base year for the SFC award that will be operative from 2027 to 2032.
  - It is very much **evident that every state will seek the extension of the compensation scheme.** Therefore, it is best to enjoin upon the SFC to examine the need for compensation, the *raison d’être* for which was to “compensate losses in transition to GST”.
  - It is **important to review the need, viability, and desirability of the compensation scheme in light of the revenue performance of GST** during the past six years.
  - The principles of assigning the balance amount of GST compensation cess collection over

the compensation released to states to the divisible pool of taxes also need to be laid down.

- **New Institutional Structure of Federal Finance:** In the new federal finance institutional structure, the **GST council** and the finance commission must have a formal relationship since they decide the size of the divisible and distribute it. The SFC should investigate how the **GST Council** can act as the Fiscal Council to oversee the implementation of its award during the period when it is not operational.

## Conclusion

The important thing to note is that the SFC needs to rethink its approach conceptually, methodologically, and operationally. To achieve this, its terms of reference should not only allow and assist it in doing so, but also encourage and direct it towards this objective.

### Drishti Mains Question:

India's Fiscal Federalism needs to be reformed to ensure better resource allocation and fiscal autonomy for states. In this light, discuss the terms of reference for the sixteenth Finance Commission to bring about those reforms.

## UPSC Civil Services Examination, Previous Year Questions (PYQs)

**Q. Which one of the following in Indian polity is an essential feature that indicates that it is federal in character?**

- (a) The independence of judiciary is safeguarded.
- (b) The Union Legislature has elected representatives from constituent units.
- (c) The Union Cabinet can have elected representatives from regional parties.
- (d) The Fundamental Rights are enforceable by Courts of Law.

**Ans: (a)**

**Q. Which one of the following is not a feature of Indian federalism? (2017)**

- (a) There is an independent judiciary in India.
- (b) Powers have been clearly divided between the Centre and the States.
- (c) The federating units have been given unequal representation in the Rajya Sabha.
- (d) It is the result of an agreement among the federating units.

**Ans: (d)**

**Q. Local self-government can be best explained as an exercise in (2017)**

- (a) Federalism
- (b) Democratic decentralization
- (c) Administrative delegation
- (d) Direct democracy

**Ans: (b)**

**Q. Consider the following items: (2018)**

1. Cereal grains hulled
2. Chicken eggs cooked
3. Fish processed and canned
4. Newspapers containing advertising material

**Which of the above items is/are exempted under GST (Good and Services Tax)?**

- (a) 1 only  
(b) 2 and 3 only  
(c) 1, 2 and 4 only  
(d) 1, 2, 3 and 4

**Ans: (c)**

**Q. What is/are the most likely advantages of implementing 'Goods and Services Tax (GST)'? (2017)**

1. It will replace multiple taxes collected by multiple authorities and will thus create a single market in India.
2. It will drastically reduce the 'Current Account Deficit' of India and will enable it to increase its foreign exchange reserves.
3. It will enormously increase the growth and size of economy of India and will enable it to overtake China in the near future.

**Select the correct answer using the code given below:**

- (a) 1 only  
(b) 2 and 3 only  
(c) 1 and 3 only  
(d) 1, 2 and 3

**Ans: (a)**