# Concerns Over Cess and Surcharges in India

**For Prelims:** **16th Finance Commission**, **cess**, **surcharge**, **income tax**, **Consolidated Fund of India**, **Goods and Services Tax**, **Divisible Pool of Taxes**, **State List**

**For Mains:** Indian Taxation System, Fiscal Federalism, Challenges in Government Revenue Collection

**Source: TH**

### Why in News?

**Arvind Panagariya,** Chairman of the **16th Finance Commission,** recently called the issue of the **Centre's increasing reliance on cesses and surcharges** a "complicated issue."

### What are Cess and Surcharges?

- **Cess:** A **cess** is a form of tax that is levied for a specific purpose. It is a **tax on tax,** imposed in addition to an existing tax like **excise or income tax,** and the revenue is **earmarked for a particular use.**
  - Cesses are typically charged for a **specific time period,** or until the government has gathered enough funds for the designated purpose.
  - The **80th Amendment formally amended Article 270,** explicitly excluding cesses and surcharges from the **divisible pool** (revenue from cesses is not shared with states).
    - Cesses are recognized in the Constitution under **Article 277** and **Article 270** (which outlines the revenue-sharing framework between the Union and States).
  - **Examples: Education Cess** (for financing primary education), **Swachh Bharat Cess** (for cleanliness initiatives), and **Fuel Cess** (for road development).
- **Surcharge:** A surcharge is an **additional tax or levy imposed on existing duties or taxes.** It is essentially a **"tax on tax"** and is discussed under **Articles 270 and 271** of the Indian Constitution.
  - Surcharges are often applied to individuals, companies, and other taxpayers who fall within income brackets. The rate of **surcharge can vary based on income level.**
    - They are designed to be **progressive,** ensuring that higher earners **contribute more,** promoting **social equity** and addressing **income disparity.**
  - Surcharge increases the **total tax liability of individuals or entities** who are already subject to tax, particularly higher-income earners or certain sectors.
  - The funds collected from surcharges **go into the government's general fund and can be used for a variety of purposes,** such as financing infrastructure projects, social welfare programs, and other governmental activities.
  - **13th and 14th Finance Commissions** upheld exclusion of surcharges from the divisible pool; recommended reducing Centre's reliance on these levies.
- **Cess vs. Surcharge:** Cess and surcharge both go to the **Consolidated Fund of India (CFI)** but differ in usage. Surcharge is spent like other taxes, while cess must be allocated separately and used only for its specific purpose.

## What are the Concerns Regarding Cess and Surcharges?

- **Centre's Fiscal Constraints:** The increase in the share of states in the **divisible tax pool** from **32% under the 13th Finance Commission** to **42% under the 14th** and **41% under the 15th Finance Commission** has reduced the **Centre's fiscal space**.
    - To counterbalance this, the Centre increasingly relies on cesses and surcharges, which are not shared with the States.
    - Originally envisioned as a **temporary measure,** surcharges and cesses have become a **permanent fixture in India's tax system,** which has raised concerns about their long-term impact on fiscal federalism.
- **State Concerns:** Cesses and surcharges increased from 10.4% in 2011-12 to 20% in 2021-22. This trend effectively **shrinks the pool of taxes** that are shared with States, limiting their **fiscal flexibility** and undermining the spirit of **fiscal federalism.**
    - States have consistently **demanded a cap on cesses and surcharges,** and the **inclusion of any excess collections into the divisible pool** to ensure fairer revenue distribution.
    - This issue underscores the challenge of **balancing power** and financial autonomy between the Centre and States, **potentially impacting states' ability to fund critical programs** and achieve developmental goals**.**
- **Lack of Transparency and Vagueness**: Since cesses are collected for specific purposes, they **reduce transparency in the allocation and distribution** of tax revenues.
    - States argue that this method of taxation **bypasses the principles of equitable revenue sharing.**
    - Many cesses, like the **Swachh Bharat and Krishi Kalyan Cess,** are broadly defined. They aren't subject to the **same parliamentary oversight as general taxes**.
        - There are discrepancies in how cess proceeds are used. For example, the **Research and Development Cess** was partly used to finance the Union's revenue deficit rather than its intended purpose.
- **Inequitable Taxation:** Cesses and surcharges tend to disproportionately affect the wealthier segments of society, as they are the primary contributors.
    - Critics argue that this creates fairness issues and may drive **wealthy individuals and businesses to relocate to more tax-friendly countries.**

## What is the Divisible Pool of Taxes?

- **About:** The **Divisible Pool of Taxes** refers to the portion of the total tax revenue collected by the Union government that is shared with the States in India.
    - It is a key component of fiscal federalism, ensuring that both the Centre and the States have access to resources for their respective functions.
- **Key Features**:
    - **Taxes:** The divisible pool includes taxes that are collected by the Union government such as **Corporation Tax, Personal Income Tax, Central and Goods and Services Tax (GST)**.
    - **Finance Commission:** The distribution of the divisible pool is based on the recommendations of the **Finance Commission,** which is constituted every **five years.**
        - The Commission suggests the percentage share for both the Union and the States.
        - The **15th Finance Commission recommended** that states receive 41% of the divisible pool of central taxes for the period 2021–2026
    - **Vertical and Horizontal Devolution**:
        - **Vertical Devolution**: Refers to the proportion of the divisible pool allocated between the Union and the States.
        - **Horizontal Devolution**: Refers to how the States' share of the divisible pool is distributed among the individual States, based on factors such as **population, income disparity, and tax efforts.**
- **Exclusion of Cesses and Surcharges**: Cesses and surcharges levied by the Union are **excluded** from the divisible pool.

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# Finance Commission

The Finance Commission is the balancing wheel of fiscal federalism in India

*~ Indian Constitution*

## Article 280
**(Indian Constitution Part XII)**

Constitution of FC as a **Quasi Judicial Body**

## Constituted by

**President** of India **quinquennially** (or earlier)

## Members

- Chairman + 4 members **(including an HC judge)** – appointed by President
- Authority to **decide qualifications – Parliament**
- Tenure – as **specified by the President**
- **Reappointment – Eligible**

## Makes Recommendations to President about

- Distribution of **net tax proceeds** between Centre and States
- Principles for **grants-in-aid** to the states by the Centre
- Evaluates the rise in the **Consolidated Fund of a state** to affix the resources of Panchayats/Municipalities
- Other **financial matters referred** to it by President

**Recommendations of the FC are **only advisory and not binding** on the Government*

## Powers of a Civil Court

As per Code of Civil Procedure 1908

**First FC** → **Second FC** → ... → **Fifteenth FC** → **Sixteenth FC**

| First FC | Second FC | Fifteenth FC | Sixteenth FC |
|---|---|---|---|
| Chairman - KC Neogy | Chairman - K Santhanam | Chairman - NK Singh | Chairman - Dr. Arvind Panagariya |

## State Finance Commission

- Constituted by **Governor** every $5^{th}$ year **(Article 243)**
- Reviews the financial position of **Panchayats and Municipalities**

Drishti IAS

## International Practices on Cess and Surcharges

- **Surcharges:**
  - **Germany:** The solidarity surcharge was introduced in 1991 to fund German reunification and Gulf War expenses. Initially temporary, it was reintroduced in 1995 and continues today.
  - **France:** Surcharges are imposed temporarily to address fiscal challenges.
- **Cess Taxes:**
  - **United States:** States like Alabama earmark substantial tax revenue for specific purposes.
  - **Australia: Medicare Levy (introduced in 1984)** is a personal income tax to fund Medicare. Other temporary taxes, like the gun buyback and Ansett ticket levies, have been short-lived and contribute minimally to total revenue.
    - Australia's constitutional structure limits consistent use of earmarked taxes.

## What Can be Done to Address Concerns Regarding Cess and Surcharges?

- **For Cesses:**
  - **Imposition**: The Union Government should refrain from levying cesses for issues under the State List, **such as health and education,** as it undermines federal principles.
    - **Set a ceiling on cess collection and avoid exceeding it**.
  - **Transparency**: Ensure clear allocation of funds and transparency in cess collection. A **structured, periodic review** process should be instituted to evaluate the effectiveness and necessity of cesses.
    - If **misuse occurs,** shift **cess funds to a general tax**, allowing states a **share based on Finance Commission recommendations.**
  - **Abolition**: Cesses that generate **very minimal revenue** can be abolished, as they are economically inefficient and add to tax complexity.
    - **Impose cesses for a maximum of 5 years,** with one possible extension, after which they should be abolished. Include sunset clauses in cess legislation to limit indefinite continuation.
- **For Surcharges:**
  - **Rationalization of Income Tax**: Surcharges often act as a **proxy for progressive income tax.** This can be addressed by **rationalizing the income tax structure** itself, rather than adding surcharges, especially on higher income slabs.
  - **Temporary Nature of Surcharges**: Surcharges can be made temporary, used only during **financial distress,** with sunset clauses to prevent their perpetual use and become permanent tax instruments.

## Conclusion

The reliance on cesses and surcharges in India has raised efficiency, and transparency concerns. Clear guidelines, periodic reviews, are needed to limit their use and prevent permanence. Surcharges should be used only in exceptional circumstances. Accountability must be enhanced to ensure they serve their intended purposes.

***Drishti Mains Question:***

Discuss the increasing reliance on cesses and surcharges by the Centre and its implications for fiscal federalism in India.

### 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)

**Q.** What is the meaning of the term ‘tax expenditure’? Taking the housing sector as an example, discuss how it influences the budgetary policies of the government. **(2013)**