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ANALYSIS**

TOPIC

**Fiscal Federalism in India:
Bridging North-South Gaps**

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FISCAL FEDERALISM IN INDIA: BRIDGING NORTH-SOUTH GAPS

Context

- Recent Lok Sabha verdict has brought back regional parties from Andhra Pradesh and Bihar to pole positions in the country's governance looking for strengthening the federal polity and making decision-making more democratic.

About the Fiscal Federalism

- It is a critical aspect of governance that deals with the division of financial powers and responsibilities between the Union and State governments within the framework of a federal system.
- It focuses on responsibilities (including finances) among federal, state, and local governments to improve economic efficiency and achieve various public policy objectives.

Federal Government

- It is a form of government that has a **multi-layered structure**, with all orders of government having **some independent** as well as **shared responsibilities of decision-making**.
- Federalism represents either a '**coming together**' or a '**holding together**' of constituent geographic units.
 - ♦ '**Coming together**' has been the guiding framework for mature federations such as the United States, Canada, and, more recently, the European Union.
 - ♦ The '**holding together**' view of federalism, also called '**new federalism**' represents an attempt to decentralise responsibilities to state-local orders of government to overcome regional and local discontent with central policies.
- It is the driving force behind the current interest in principles of federalism in unitary countries and in **relatively newer federations such as Brazil and India** and **emerging federations such as Iraq, Spain and South Africa**.

Fiscal Federalism in India

- **Shifts in Fiscal Landscape:** The fiscal landscape has been altered by several factors, including the **shift from a planned economy to a market-mediated economic system**, the transformation of a **two-tier federation into a multi-tier fiscal system** following the **73rd and 74th Constitutional Amendments**, the abolition of the **Planning Commission** and its replacement with NITI Aayog, the passing of the **Fiscal Responsibility and Budget Management (FRBM) Act**, and the introduction of the **Goods and Services Tax (GST) Act**.
 - ♦ These changes have had varying consequences on India's federalism.
- **Vertical and Horizontal Imbalances:** The Indian Constitution, while expressly vesting the **Centre with greater powers of taxation**, also provides for an institutional mechanism — **the Finance Commission** — to determine the **share of the States in the Central tax revenues** by way of **correcting the vertical imbalance (between the Centre and the States)** as well as the **horizontal imbalance**, the one between the States with varying fiscal capacities but similar responsibilities in the provision of public services.
 - ♦ The founding fathers of the Constitution provided that the Centre shall share its tax revenues with the states as well as provide grants from the Consolidated Fund as per a formula decided by the **Finance Commission** every five years.
- **Federal Tax System:** India has a **three-tier federal tax system**, with the powers of the Centre, states, and local bodies to collect taxes clearly demarcated.
 - ♦ The **Central government** has the **power to collect taxes** on incomes of individuals and businesses, as well as indirect taxes such as the central goods and services tax, integrated goods and services tax, and customs. The Centre also **collects surcharges and cesses on taxes**.

- ◆ **States collect state GST**, stamp duty, land revenue, state excise, and professional tax.
- ◆ **Local bodies** collect property/house tax, tolls, and taxes on utilities such as electricity and water.

Constitutional Provisions

- The Constitution of India delineates tax bases between the Union and States listing them in the **Union List and the State List** respectively (as provided in the **Seventh Schedule under Art 246**).
 - ◆ There was/is **no taxation provision in the Concurrent List**.
- However, when GST had to be introduced, it needed to be provided for a concurrent base for which **Article 246A was inserted** (as **101st Amendment in August 2016**).
 - ◆ It enabled the Union to make law for **CGST (central GST) and IGST (integrated GST) and the States could legislate for SGST**.
- **Article 270** of the Constitution provides for the scheme of **distribution of net tax proceeds** collected by the Union government between the Centre and the States.

Do You Know?

- The **net divisible pool, or net proceeds**, is that part of the gross tax revenue from which a share would have to be vertically devolved by the Union to all States.
- Annual estimates of net proceeds can be obtained by deducting cesses, surcharges, and costs of collection of taxes from the gross tax revenue.
 - ◆ Such shares are assigned by each FC for a five-year period.
 - ◆ Cesses and surcharges under **Article 270 and Article 271** were kept out of the net proceeds.

Challenges related to Fiscal Federalism in India

- **Centralization and Market-Mediated Economic System:** The shift from a planned economy to a market-mediated economic system, the transformation of a two-tier federation into a multi-tier fiscal system following the 73rd and 74th Constitutional Amendments, and the introduction of the Goods and Services Tax (GST) Act have **altered the fiscal landscape**.
 - ◆ It led to dissatisfaction due to the highly centralised system, impediments to a common market, and regional aspirations for statehood.
- **GST and Fiscal Autonomy:** The introduction of GST has transformed fiscal federalism in the country. While it has led to steady growth of GST revenue, indicating the success of the reform, it has also been cited as a restriction on the powers of the states.
 - ◆ Critics argue on the autonomy of states with the introduction of GST.
- **Equity and Income/Growth Disparities:** There has been a long-term stability in the shares of the Centre and the States in the combined tax revenues.
 - ◆ However, the actual experience in India has been astounding with the top 1% earners in India capturing less than 21% of the total income in the 1930s, but this was drastically reduced to 6% in the early 1980s and then rose to 22% during the liberalisation era.
 - ◆ It led to an **increasingly divergent trend in per capita income** across states.
- **Political Centralization:** The **asymmetric federalism** inherent to the Constitution was only accelerated and mutually reinforced with political centralization since 2014, making the Union Government extractive rather than enabling.
 - ◆ It led to states losing their capacity to generate revenue by surrendering their rights in the wake of the GST regime.
- **Post-Pandemic Fiscal Policies:** In the post-pandemic world, there is a need to rethink existing principles that guide the country's fiscal policy, including debt, which is expected to remain high.
- **North-South Divide in India:** It has been a topic of intense discussion, especially in the context of fiscal federalism.
 - ◆ The southern states of India have often expressed concerns about the alleged unfair devolution of tax money, claiming they were deprived of their legitimate share from central taxes.

- ◆ States such as Karnataka, Kerala, Tamil Nadu, and West Bengal have also complained and protested against the alleged denial of their dues under central schemes, flagged the Centre's tight control on their borrowing limits and lack of adequate support in times of disasters.

Strengthening Fiscal Federalism

- Strengthening fiscal federalism in India is a complex task that involves multiple aspects. It is crucial for addressing these concerns and fostering cooperation and accommodation between the North and South.
- **Cooperative Federalism:** NITI Aayog has been constituted to actualize the important goal of cooperative federalism and to enable good governance in India. It acts as the quintessential platform for the Government of India by bringing States together as 'Team India' to work towards the national development agenda.
 - ◆ A number of steps have been taken by NITI Aayog to foster cooperative federalism through structured support initiatives and engagement with the States/UTs on a continuous basis.
- **16th Finance Commission:** It, headed by Arvind Panagariya, has been given more freedom to determine the scope of its recommendations, providing it more room to strengthen fiscal federalism.
 - ◆ Its job is to ensure balance in resource transfers between the Centre and states, and among states.
 - ◆ However, states grudgingly relinquish their resource-raising capacity and resent any loss of agency over expenditure.
- **Addressing Inequities:** The concerns of the founding fathers — addressing socio-economic inequities — are being forgotten in today's fiscal policy.
 - ◆ The original intention of addressing inequities was turned on its head as it metamorphosed into one of the world's most regressive taxation systems due to a centralised fiscal policy.
 - ◆ India's intergovernmental transfer system should be decidedly more equity-oriented.
- **Granting State Governments the Powers to Levy Income Taxes:** One tangible solution to restore the balance in fiscal federalism is to grant State governments the powers to levy income taxes.
- **New Fiscal Federal Architecture:** India will be able to truly actualize the 'grand bargain' and see the GST as an enduring glue holding the four pillars together by creating the new fiscal federal architecture and strengthening India's unique cooperative federalism.

Future Directions

- The future of fiscal federalism in India likely to involve further reforms to address these challenges and imbalances that includes making the **intergovernmental transfer system** more **equity-oriented**, addressing the resource asymmetry between the Centre and the States, and **managing growing regional tensions**.

Conclusion

- Fiscal federalism in India has faced numerous challenges, including the transition from a planned economy to a market-based system, globalisation, and the changing political environment. The system had to be reoriented to create a competitive environment. There has been dissatisfaction due to the highly centralised system, impediments to a common market, and regional aspirations for statehood.

Mains Practice Question

[Q] How does fiscal federalism contribute to bridging the economic disparities between the northern and southern regions of India? Discuss with relevant examples.

