



# **DAILY EDITORIAL ANALYSIS**

**TOPIC**

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**EVOLVING FISCAL SPACE OF  
INDIAN STATES**

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## EVOLVING FISCAL SPACE OF INDIAN STATES

### Context

- India needs to ensure equitable fiscal federalism by strengthening states' financial autonomy and restoring balance in tax devolution and grants.

### About India's Fiscal Federalism

- Fiscal federalism is the **division of governmental functions and financial relations** among levels of government in a **federal system**. In India, it involves:
  - ♦ **Vertical Devolution:** Sharing of central taxes with states, determined by the Finance Commission.
  - ♦ **Horizontal Devolution:** Distribution among states based on criteria like population, income distance, and fiscal discipline.
  - ♦ **Grants-in-aid:** Targeted transfers for specific purposes or to address fiscal imbalances.

### 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 Constitutional Amendment).
  - ♦ 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.

### Evolution of Fiscal Federalism in India

- Pre-2015: Planning Commission** played a key role in resource allocation.
- Post-2015: NITI Aayog replaced the Planning Commission**, and the **14th Finance Commission** increased states' share in central taxes to 42%.
- Post-GST:** States surrendered many taxation powers, expecting compensation and cooperative fiscal management.

### Changing Dynamics of Fiscal Transfers

- 14th Finance Commission (2015–20):** It increased the **states' share in the divisible pool of central taxes from 32% to 42%**, significantly enhanced the states' autonomy over resources. During this period:
  - ♦ The **share of states in central taxes** rose from **15% (13th FC)** to **19.2%** of combined revenue receipts — a **4.25 percentage point** increase.
  - ♦ Consequently, the **post-transfer fiscal share** of states increased from **63.85% to 68.08%**, reversing the earlier balance between the Centre and the states.
  - ♦ Both **Finance Commission (FC)** and **non-FC grants** remained largely stable, maintaining the overall composition of transfers.
- 15th Finance Commission (2020–25):** States' aggregate revenue receipts fell from **68.08% (14th FC)** to **67.39%** of combined revenue receipts — a **0.70 percentage point** reduction.
  - ♦ The **share of tax devolution** declined by **1.05 percentage points**, from **19.2% to 18.2%**, though partially compensated by slightly higher FC and non-FC grants.
  - ♦ The **states' own revenue receipts** also dipped marginally from **37.72% to 37.35%**.
  - ♦ **Several structural changes** contributed to this decline:
    - The **number of states** reduced to 28 following the bifurcation of Jammu and Kashmir.
    - The Centre increased the **use of cesses and surcharges**, which are **non-sharable** with the states.

- **High-Income States:** The situation is more concerning for **high-income states** such as **Haryana, Karnataka, Kerala, Maharashtra, and Tamil Nadu**.
  - ♦ Between the **13th and 14th FC** periods, there was **no net gain** in their fiscal space — increases in transfers were offset by declines in own revenues.
  - ♦ However, from the **14th to 15th FC** period, their fiscal space **fell by 0.38 percentage points** of combined revenue receipts.

### Underlying Causes in Changing Dynamics of Fiscal Transfers

- Rising **non-sharable cesses and surcharges** limited the divisible pool.
- The **horizontal devolution formula** may have disadvantaged high-income states by giving greater weight to equity criteria.
- The recent **GST 2.0 reforms**, involving extensive rate reductions and the **end of GST compensation cess**, further threaten states' fiscal capacity.

### Policy Implications and the Way Forward

- **Need for Balanced Fiscal Federalism:** The experience since the 14th FC underscores the need to **strike a balance between equity and fiscal autonomy**.
  - ♦ States require adequate resources not only for development but also to fulfill constitutional responsibilities in health, education, and infrastructure.
- **Rethinking Cesses and Surcharges:** The Centre's increasing reliance on **non-divisible revenue instruments** undermines cooperative federalism.
  - ♦ Reining in cesses and surcharges would restore fiscal trust and expand the divisible pool.
- **Enhancing Tax Buoyancy:** Both the Centre and the states must focus on **increasing tax efficiency and compliance**.
  - ♦ Stronger GST collections and rationalized direct taxes can expand the overall fiscal pie.
- **Role of the 16th Finance Commission:** The **16th Finance Commission**, having submitted its report recently, faces the challenge of **correcting recent imbalances**. It is expected to:
  - ♦ Revisit the '**distance criterion**' in horizontal devolution to ensure fairer treatment of high-income states.
  - ♦ Safeguard fiscal space through a **more equitable sharing framework**.

### Conclusion

- India's fiscal federal architecture has evolved toward greater state empowerment since the 14th Finance Commission.
  - ♦ However, the **15th FC period reveals emerging strains**, particularly for high-income states facing erosion of fiscal autonomy.
- As the **16th Finance Commission's recommendations** await implementation, the future of **fiscal federalism** depends on ensuring that both the Centre and the states have the resources and flexibility needed to meet shared developmental goals.

Source: IE

### Daily Mains Practice Question

[Q] Discuss the evolving fiscal space of Indian states. How have changes in tax devolution, GST implementation, and the use of cesses and surcharges impacted the financial autonomy and developmental capabilities of state governments?

