

Fiscal Federalism

Why in News?

Recently, the Chief Minister of Bihar and Andhra Pradesh have demanded special financial packages for their respective States.

How States receive finance from centre?

Fiscal federalism deals with the division of governmental functions and financial relations among levels of government.

- **Distribution of revenues** <u>Articles 268 to 272</u> of the Indian Constitution define the distribution of revenues between the Union and the states.
- As per *Article 268*, certain duties are levied by the Centre but collected and retained by the States.
- <u>Article 269</u> mentions about those taxes and duties that are levied and collected by the Centre but assigned in whole to the States.
- **Article 270** deals with sharing of the proceeds of all Union taxes between the Centre and the States.
- Grants-in-Aid The Constitution provides for grants-in-aid to the states from the Central resources.
- **Statutory grants** *Article 275* provides for compulsory statutory grants-in-aid to the revenues of States.
- **Discretionary grants Article 282** empowers both the Centre and the states to make any grants for any public purpose, even if it is not within their respective legislative competence.
- Under this provision, the Centre makes grants to the states.
- Other grants These grants were to be given for a period of ten years from the commencement of the Constitution.
- These sums were charged on the Consolidated Fund of India.
- **Finance through schemes** A significant proportion of fiscal transfers to states from the Centre is taken up by *centrally sponsored schemes (CSS)*.

Centrally Sponsored schemes (CSS) are designed and partially funded by the central government, are implemented by state governments in accordance with the terms fixed by the Centre.

• CSSs have been **implemented via Article 282** of the Indian Constitution.

What is the role of finance commission in fiscal federalism?

- **Finance Commission** It is a constitutional body set up under <u>Article 280</u>.
- It is constituted by the President every fifth year or even earlier.
- **Role in fiscal federalism** It is constituted, mainly to give its recommendations regarding revenue sharing between centre and states and also regarding allocation of grants to the states.
- **Distribution of net proceeds of taxes** Finance commission recommends the distribution of the net proceeds of taxes to be shared between the Centre and the States.
- **Principles governing grants-in-aid** Finance commission determines the principles which should govern the grants-in-aid to the states by the Centre out of the Consolidated Fund of India.
- The statutory grants under Article 275 (both general and specific) are given to the states on the recommendation of the Finance Commission.
- Other temporary grants-in-aid were also made to the states on the re commendation of the Finance Commission.

15th Finance Commission on fiscal devolution

- **Vertical devolution (between centre and states)** States should be given 41% of the divisible tax pool.
- **Horizontal devolution (between states)** Uttar Pradesh and Bihar in 2020-21 got the largest amount of funds and Karnataka and Kerala saw the largest decrease in the share of funds.
- There is a formula applied by the commission which is based on
 - Income
 - Population
 - Area
 - Forests and ecology
 - Demographic performance, etc.
- So, in other words, the criteria that the Finance Commission use can change the amount of funds going to different States.

Critically analyse on special financial packages?

- **Special financial packages** They are financial support to the states which are in need rather than to all the states.
- They are granted under Article 282 ('Miscellaneous Financial Provisions')

70% of the funds that the Centre spends is non-discretionary. But the remaining 30% are discretionary.

- Need It is demanded by a specific state for a specific purpose concerned to that state.
- **Recent demands** *Bihar's demand* for a special financial package often revolves around the need to address backwardness, improve infrastructure, boost agricultural productivity, and enhance educational and healthcare facilities.

- Bihar, being one of the less developed states in India, seeks additional funds to bridge the development gap with more prosperous states.
- <u>Andhra Pradesh</u> demand for a special financial package is primarily linked to the state's bifurcation in 2014, which resulted in significant economic and infrastructural challenges.

Pros of Special Financial Packages

- Address specific needs Certain states might face unique challenges like natural disasters, insurgencies, or economic disadvantages.
- This targeted approach helps in delivering quicker and accurate relief measures.
- **Promote regional equity** It can help in bridging the development gap between richer and poorer states, promoting regional development and ensuring that no state is left behind.
- **Promotes development** It can incentivise states to undertake significant reforms or projects that align with national priorities (like green energy, digital infrastructure, or health initiatives).

Cons of Special Financial Packages

- **Undermine the fiscal discipline** It can lead to *misuse of funds* with the already growing concern of corruption.
- **Creates inequity and favouritism** Special packages could be allocated <u>based on political considerations</u> rather than genuine needs, leading to favouritism and inequity among states.
- **Lead to duplication** It can overlap with existing schemes and can <u>reduce the</u> <u>overall effectiveness</u> of government spending.
- Macroeconomic instability Unplanned and Outside budget expenditures can *strain the centre's finances* and contribute to fiscal deficits.
- This can have a cascading effect on the entire economy.

What lies ahead?

- Channelise more resources for higher capital investment in the poorer regions of the country for balanced regional development.
- Reduce leakages and collect a lot more from direct taxes and reduce collections from indirect taxes, which are having a negative effect on the backward States as compared to the advanced ones.
- Deliberate at the national level involving all the stakeholders to understand which schemes the Centre should intervene in, and which it should leave to the States.
- Follow the recommendations of the 14th Finance Commission, the Centre should intervene in schemes where there are large externalities or national priorities involved.
- Improve governance of states and the quality of expenditures on various development activities.

Reference

The Hindu | Special Financial Packages

