Fiscal federalism – The Evolving Dynamics

Mains: *GS II – Functions and Responsibilities of the Union and the States, Issues and Challenges Pertaining to the Federal Structure, Devolution of Powers and Finances up to Local Levels and Challenges Therein.*

Why in News?

The recent GST slab rationalisation has ignited debates over fiscal autonomy, with some states raising concerns over potential revenue losses and demanding adequate safeguards.

What is fiscal federalism?

- **Fiscal federalism** – It is the financial relationship and division of fiscal powers (taxation, spending, revenue sharing) between different levels of government within a federal system, such as central and state governments.
- **Constitutional provisions** – Articles 268 to 293 of the Indian Constitution govern the distribution of financial powers between the Union and state governments.
- The Seventh Schedule of the Constitution (Article 246) delineates the tax base between the centre and states.
- **The Finance Commission** – It is under Article 280, and has been bestowed with the exclusive power to recommend the distribution of intergovernmental finance, including tax devolution and grants-in-aid.
- The erstwhile Planning Commission, with overlapping functions, also played a decisive role in revenue allocation and disbursal of grants-in-aid to states.
- **Grants-in-aids** – The Constitution provides for grants-in-aid to states from the consolidated fund (Article 275) and regulates state borrowings (Article 293).

How the centre-state fiscal relation evolved?

- **3 phases of evolution** – Former RBI Governor Duvvuri Subbarao, in his reflections on India's fiscal federalism, traced the evolution of centre-state financial relations through 3 distinct phases.
- **The first phase** – This phase is described as 'docile federalism' (1947 to early 1970s).
- It was characterised by the domination of the centre in decision-making, facilitated by the single party rule and centralised allocation of resources.
- During this formative phase, states remained heavily dependent on the centre despite their growing contributions to the national tax pool.
- **The second phase** – This phase is termed 'cooperative federalism' (1970s to mid-1990s).
- It witnessed greater state involvement in economic decision-making and development

planning.
- **The third phase** – It is the ongoing phase (mid-1990s to present).
- It is described as 'combative federalism', is marked by frequent contention between the union and state governments.
- This trajectory highlights how the nature of financial relations between the centre and states has significantly changed alongside the broader reforms, moving from planned development to competitive federalism.

What are the impact of reforms on fiscal federalism?

- **Enhanced competitive federalism** – The formation of NITI Aayog in 2015 underscored a shift away from planned development towards institutional mechanisms for competitive federalism.
- The Governing Council of NITI Aayog has emerged as a deliberative platform for the political leadership in both the centre and states.
- **Increased participation of states** – The introduction of Goods and Services Tax (GST) in 2017 created a new institutional framework for greater participation of states in fiscal matters.
- **Reduced state control** – However, the GST considerably curtailed states' control over revenue generation.
- Critics argue that the GST regime has tilted the balance of fiscal authority in favour of the centre.
    - **For instance**, the weighted voting system in the GST Council, in which the central government holds one-third of the total votes, has been viewed as inconsistent with the spirit of federalism.
- Thus, the centralisation of taxation powers erodes the fiscal autonomy of states.
- **Suggestive nature of GST council** – In Union of India versus Mohit Minerals Pvt. Ltd., the Supreme Court observed that recommendations of the GST Council are only suggestive.
- It therfore reaffirmed the state autonomy in fiscal matters.

What are the issues with the recent GST slab rationalization?

- **Lesson from Covid-19** – The pandemic exposed the financial vulnerability of states that have been heavily dependent on central transfers.
- **Interruption of disbursement** – During this period, the Central government failed to disburse GST compensation, originally designed to offset revenue loss of states, citing the situation as an "Act of God".
- This deepened the trust deficit between the centre and states.
- **Demands from the states** – Several states demanded an extension of the GST compensation period, which was set to expire in June 2022, citing financial stress caused by the pandemic.
- **Rejection from the Union government** – The GST Council had decided to continue the collection of the GST Compensation Cess until March 2026 to serve the debt incurred by the centre used for compensating state revenue shortfalls during the Covid-19 pandemic.
- But the Union government rejected this demand

- **Issues with recent rationalisation of GST** – The recent GST slab rationalisation has raised concerns among opposition-ruled states regarding the potential revenue loss.
- **Fear of decreased autonomy** - States expressed apprehension that such measures could undermine states' fiscal autonomy unless adequately compensated by the centre.
    - **For instance**, Karnataka Revenue Minister, cautioned that without adequate compensation, states would be reduced to "glorified municipalities".
- Eight opposition-ruled states also jointly demanded protection against future losses arising from the slab rationalisation.
- **Refutation from the union government** – Union Finance Ministry rejected these demands, clarifying that the impact of rate cuts would be equally shared between the centre and states.
- The Union government also expects that increasing consumption, spurred by lower tax rates, would offset the revenue shortfall in the long run.

What are the issues between centre and states?

- **Issues with cess and surcharges** – Many have voiced concerns about the Union government's reliance on cesses and surcharges, which fall outside the divisible tax pool.
- **Decrease in divisible tax pool** – The divisible tax pool had shrunk from 88.6% in 2011-12 to 78.9% in 2021-22.
- **Issues over centrally sponsored schemes** – States such as Tamil Nadu and Kerala have also raised concern over the rigid conditions attached to Centrally Sponsored Schemes (CSS).
- They are required to contribute a larger share to CSS despite having little role in their formulation.
- This has accentuated a horizontal disparity among states.
- **Delay in disbursement** – In addition, Karnataka, Kerala and Tamil Nadu have been fighting with the centre over delays in the disbursal of essential aid in response to natural disasters.
- **Concerns over grant-in-aid** – Fiscally stronger states have also been challenging the principles governing the grants-in-aid, which they call discriminatory.
- **Limit on borrowing power of states** – Kerala has moved the Supreme Court to challenge the centre's imposition of a Net Borrowing Ceiling (NBC) that restricts states from even open market borrowing.
- States have argued that invoking Article 293, the Fiscal Responsibility and Budget Management Act, 2003, to curtail their borrowing amounts to encroachment on their fiscal autonomy.
- **Controversy over finance commission** – The working of the Finance Commission, a constitutional body under Article 280, has long been a source of contention between the Union and state governments.
- For instance, some states, particularly southern states, questioned the terms of reference of the 15th Finance Commission for its adoption of 2011 census data as the basis of devolution.
- They argued that this approach would penalise states that had performed better in demographic and developmental indicators.
- **Demand for increase in share** – Some states are demanding that the 16th Finance

Commission increase their share to 50 per cent from the current 41 per cent.

Indian states are often regarded as **enjoying more autonomy** in terms of spending power compared to their counterparts in many federal countries like Brazil and Indonesia.

What can be done to build to strengthen the fiscal federalism?

- **Devising a proper mechanism** – A proper mechanism for coordination between the Finance Commission and GST Council is essential, as opined by Y V Reddy, chairman of the Fourteenth Finance Commission.
- **Reducing the political issues** – The existing mechanisms for state consultation, like the NITI Aayog Governing Council and the GST Council, should not be reduced to arenas of political battle.
- **Building consensus** – Meaningful state participation requires not only institutional reform but also genuine political will.
- Fiscal reforms that have implications for the federal balance must be built on consensus between the Union and state governments.
- **Reducing the advantage of union government** – Measures like weighted voting, risks undermines the federal nature of institutions and deepens the trust deficit.
- Building trust needs to underpin both the design and implementation of fiscal reforms.
- **Ensuring timely compensation** – The compensation to states for revenue losses incurred by states during the first five years of implementation of GST was a strong gesture of trust building while introducing structural reforms.
- States' demand for compensation needs serious and fair consideration by the Finance Commission in line with the constitutional mandate to protect fiscal federalism.
- **Implementing tailored approach** – The one-size-fits all approach may not help address the problem of horizontal imbalance.
    - **For instance**, small northeastern states are demanding a 25% increase in tax devolution, considering their unique challenges.
    - The Himalayan states like Uttarakhand seek compensation for ecological service costs and more weightage to forest cover in the tax devolution formula in line with a spirit of 'environmental federalism'.
- The standardised solutions to states' fiscal problems are neither desirable nor feasible.
- The underlying spirit of future reforms needs to be fiscal federalism grounded in consensus-driven formulation and trust-driven implementation.

Reference

[The Indian Express| Fiscal federalism]

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