Reassessing Fiscal Federalism in India

What is the issue?

With new developments in tax sharing, it is high time that the Constitution is amended to fix the proportion of shareable taxes for the States.

Why is federalism significant?

- The efficiency of a government depends on, among other factors, its structure.
- In large countries, it has been felt that only a federal structure can efficiently meet the requirements of people from different regions.
- Underlying this proposition is the premise that preferences vary across regions.
- This is why even provincial autonomy was regarded as an integral part of the freedom movement.

How is federalism at present?

- After Independence, the Centre assumed greater importance due to compulsions of defence and internal security.
- Also in the years soon after Independence, the Centre and all States were ruled by the same party and many of the powerful provincial leaders migrated to the Centre.
- Moreover, economic planning at a nation-wide level helped this centralising process.

What are the challenges in fiscal federalism?

- Fiscal federalism is the economic counterpart to political federalism.
- It assigns functions to different levels of government and also offers appropriate fiscal instruments for carrying out these functions.
- Determination of these specific fiscal instruments is a challenging task. E.g. the ‘tax-assignment problem’
- Building the principles into an actual scheme of assignment of taxes to different levels of government in a Constitution is difficult.
- In India, income tax is levied only by the Central government though shared with the States.
- Given the possibility of imbalance between resources and responsibilities,

many countries have a system of inter-governmental transfers.

What is the concern in India?

- The Indian Constitution lays down the functions as well as taxing powers of the Centre and States.
- It is against this background that the issues relating to vertical and horizontal imbalances are addressed by every Finance Commission.
- However, Central transfers to States are not confined to the recommendations of the Finance Commissions.
- There are other channels such as those through the Planning Commission until recently and the discretionary grants of the Central government.
- Resultantly, in 2010-11, in the combined revenue receipts of the Centre and States, the share of the Centre was around 64%.
- But after transfer, the share came down to nearly 40%. Thus the shares of Centre and states got reversed after the transfers.
- In 2016-17, the share of the Centre after transfers was around 33% and that of the States was 66%.
- In comparison, in the case of total expenditures, the share of the Centre in 2014-15 was nearly 41% and that of the States was 58%.
- Moreover, Fourteenth Finance Commission recommendation to raise tax devolution to 42% of the divisible pool has introduced new challenges to fiscal federalism.

What is to be done?

- The Constitution can be amended and the proportion of shareable taxes that should go to the States should be fixed at the desired level.
- The shareable tax pool must also include cesses and surcharges (now with Centre), as these have sharply increased in the recent years.
- Fixing the ratio at 42% of shareable taxes, including cesses and surcharges, seems appropriate.
- Otherwise, as in the U.S. and Canada, States could be allowed to levy tax on personal income, with some limitations.
- Given the concern that resources do not match functions, this may be a way out.
- But, as in the U.S., it should be simple and ride on federal income tax i.e. just a levy on the income assessed by federal authorities.
- Also, on giving this power to the States, the transfers from the Centre need to be adjusted.
- As far as India is concerned, there has to be a study to assess the feasibility and benefits of the two alternatives to adopt one.
- This will go a long way in avoiding friction between the Centre and the

States.

- However, the ability of bringing about equalisation across States in India has limitations, and the concerns with horizontal distribution continue.
- Even the relatively richer States have their own problems and they feel being deprived of their due share due to the overuse of the equity criterion.

Source: The Hindu

