Another Look At Fiscal Transfers

(This editorial is based on the article 'Another Look At Fiscal Transfers' which appeared in 'The Hindu' on 25th March, 2019. The article talks about the fiscal relationship shared by state and the centre and the challenges associated with it.)

Federalism is not an alien concept in political lexicon of nations and is relatively an old concept. It is a system of government in which entities such as states or provinces share power with a national government.

It is well known that the efficiency of a government depends on its structure; in large countries like ours federal structure can efficiently meet the requirements of people from different regions as preferences vary across regions and can best be addressed through local leadership.

However, after Independence several compulsions led to a scheme of federalism in which the Centre assumed greater importance. The process of centralisation in economic sphere has resulted in reduced fiscal autonomy for states.

Economic planning at a nation-wide level has resulted in the vertical fiscal imbalance between the federation and the provinces.

Breaking The Term: Fiscal Federalism

Fiscal federalism can best be understood as the economic counterpart to political federalism. It is concerned with assigning functions to different levels of government, and providing appropriate fiscal instruments for carrying out these functions.

It is generally believed that the Central government should provide national public goods that render services to the entire population while sub-national governments are expected to provide goods and services whose consumption is limited to their own jurisdictions.

Governments often find it difficult to determine the specific fiscal instruments that enable the different levels of government to carry out their functions.

However Indian Constitution lays down the functions as well as taxing powers of the Centre and States providing clarity in financial relations shared by state and the centre.

Centre State Financial Relations

- Indian Constitution has made elaborate provisions, relating to the distribution of taxes as well as non-tax revenues and the power of borrowing, supplemented by provisions for grants-in-aid by the Union to the States.
- Article 268 to 293 deals with the provisions of financial relations between Centre and States.

The Constitution divides the taxing powers between the Centre and the States as follows:

- The Parliament has exclusive power to levy taxes on subjects enumerated in the Union List,
- The state legislature has exclusive power to levy taxes on subjects enumerated in the State List,
- Both can levy taxes on the subjects enumerated in Concurrent List whereas residuary power of taxation lies with Parliament only.

Evolution of Fiscal Relationship

- **In India, substantial sources of revenue remains with the centre and major expenditure obligations lies with the states, creating vertical fiscal imbalance between the federation and the provinces.**
- This economic relationship can best be attributed to colonial legacy of centralisation under the British. The imperial government had all the powers related to revenue and ordered discontinuation of the assignment of expenditure and revenue functions to the provinces. It was in this situation that the provinces had to give away a portion of their surplus to the imperial government to finance the deficits of the latter.
- A clear delineation of powers between the centre and the provinces was attempted through the Government of India Act, 1935. It had a substantial centralising tilt with discretionary powers for the governor general and governors, and the retaining of major revenue sources with the imperial government.
- Later, when the Constitution was framed under extraordinary circumstances after partition, most of the fiscal provisions of the Government of India Act, 1935, found a place in it without any changes. This is the basic reason for the strong centralising trends in Indian polity, including in the fiscal division of powers and intergovernmental fiscal transfers.

Tussle Between The State and The Centre

- **Overtime, the non-shareable revenue of centre such as surcharges and cesses has increased which has made states demanding for more fiscal powers and share of all taxes collected by the centre from time to time.**
- With respect to their own tax revenue, states have substantially lost the power to fix tax rates of items, de facto after value added tax (VAT) was implemented on intra-state trade of goods, and de jure when goods and services tax (GST) got introduced.
- On the expenditure side, rise in the share of conditional and tied grants that essentially deal with items in the state list of the seventh schedule of the Constitution has restricted the freedom of the states in spending according to their priorities that takes into account the local specifications.
- Challenges also arise from **Fiscal Responsibility and Budget Management (FRBM)** acts, which lay down uniform targets across states ignoring the different fiscal needs.
- In short, the domain of the states, which should be given due autonomy in so far as their constitutional assignment is concerned; it is being restricted in more than one way.

Recent Developments

- Central governments have tried to address these issues of vertical and horizontal imbalances through various Finance Commissions, taking into account the prevailing set of circumstances.
- The Fourteenth Finance Commission has broken new ground in terms of allocation of resources. It has recommended increasing the share of tax devolution to 42% of the divisible pool.
- It does not necessarily affect the overall transfers but only enhances the share of unconditional transfers as it looks to address the increasing central encroachment in states through conditional and centrally sponsored schemes.
- Increased allocation in unconditional transfers however suffers from two challenges; firstly the total transfers that need to be made to the states, secondly who will be suggesting all the transfers.
- Replacement of Planning Commission (entrusted to allocate resources to states) with NITI Aayog, which is simply a think-tank with no powers of resource allocation makes the process all the more difficult.

Harmonising The Relation

- The proportion of shareable taxes that go to the States should be fixed at the desired level. The shareable tax pool must also include cesses and surcharges as these have sharply increased in recent years.

- Another possible route can be to follow the practice in the U.S. and Canada: of allowing the States to levy tax on personal income, with some limitations, which is as of now collected by Centre.
- Any reform aimed at rationalising the sharing of taxes between state and centre should also address issues related to horizontal distribution and should take into consideration the question of equity amongst states as states often feel 'cheated' because of the overuse of the equity criterion.

It is time that the nation arrived at an appropriate solution giving effect to fiscal federalism so that the provincial aspirations are taken care of, meanwhile extending the provincial autonomy that our constitution talks about.

To correct the horizontal fiscal imbalance between the States and bring more equity, Finance Commission undertakes few steps while horizontally distributing revenue.

The criteria used by the Finance Commissions can be broadly grouped under:

- Factors reflecting needs, such as population and income measured either as distance from the highest income or as inverse.
- Cost disability indicators, such as area and infrastructure distance.
- Fiscal efficiency indicators, such as tax effort and fiscal discipline.

While the weightage assigned to population has declined considerably, weightage assigned to income distance and efficiency factors has increased considerably in recent years.