Rethink India’s Fiscal Federalism

This editorial is based on “**Rethink the emerging dynamics of India’s fiscal federalism**” which was published in The Hindu on 26/08/2023. It talks about the Need of Rethinking India’s Fiscal Federalism.

For Prelims: 73rd and 74th Constitutional Amendments, Planning Commission, NITI Aayog, Fiscal Responsibility and Budget Management (FRBM) Act 2003, Mahatma Gandhi National Rural Employment Guarantee Act 2005, Right of Children to Free and Compulsory Education Act 2009, National Food Security Act 2013, GST compensation cess, Articles 246 and Seventh Schedule, Off-Budget Borrowing, Human Development Index (HDI)

For Mains: Fiscal Federalism: Need to rethink and measures through which India can strengthen its Fiscal Federalism.

The Indian Constitution can be thought of as a "holding together federation" that leans slightly towards unity. It was created to address the forces pulling the country apart before Independence. Over the past 73 years, it has proven to be very strong and adaptable. However, nowadays, it's important to think again about how money and resources are shared between the central government and the states. This is because the country's economy is changing, and its needs are different now.

What is Fiscal Federalism?

- **Fiscal federalism** is a term that describes how the financial powers and responsibilities are divided between different levels of government in a country.
- It involves questions such as which functions and services should be provided by the central government or the state governments, how the revenues should be raised and shared among them, and how the transfers or grants should be allocated to ensure efficiency and equity.

What are Some Tools to Achieve Fiscal Federalism?

- **Constitutional Assignment of Taxation and Expenditure Powers:** The Constitution of India defines the powers and functions of taxation and expenditure for different levels of government, with clear demarcation between the central government and the state governments.
- **Finance Commission:** The **Finance Commission** is a constitutional body (Art 280) responsible for recommending the distribution of tax revenues between the central government and the state governments. It also suggests ways to augment the financial resources of states, promote fiscal discipline, and ensure stability in fiscal matters.
- **Goods and Services Tax (GST):** The **GST** is a comprehensive indirect tax that replaces multiple central and state taxes on goods and services. It's administered by a GST Council consisting of representatives from the central and state governments.
- **Grants-in-Aid System**: The **grants-in-aid system** (Art 275) involves the discretionary transfer of funds from the central government to state governments for specific purposes or schemes.

These grants aim to supplement the resources of states and address regional disparities and developmental gaps.

Why India's Fiscal Federalism needs a Rethinking?

- **Shift from Planned Economy to Market-Mediated System:** The transition from a planned economy to a market-mediated economic system **marked a shift from centralized decision-making to a more decentralized approach** where market forces play a more significant role. This change has had implications on resource allocation, investment, and overall economic growth. It has also led to greater autonomy for states in economic decision-making.
- **73rd and 74th Constitutional Amendments:** The 73rd and 74th Constitutional Amendments in India led to the establishment of Panchayats and Municipalities as local self-governing bodies. This decentralization aimed to enhance local governance, empower grassroots institutions, and ensure more effective implementation of development policies.
    - The amendments have not ensured adequate and predictable transfers of funds from the state governments to the local bodies.
        - The state governments have often used their discretion to withhold or delay the grants-in-aid to the local bodies, thereby affecting their financial autonomy and accountability.
- **Abolition of** Planning Commission **and Introduction of** NITI Aayog**:** The Planning Commission was replaced by the National Institution for Transforming India (NITI Aayog) in 2015. This change represented a shift from a top-down planning approach to a more collaborative and flexible policy-making process. NITI Aayog's role is to provide strategic and technical advice to the central and state governments, promoting cooperative federalism.
    - Unlike the Planning Commission, NITI Aayog has no say in centre-state transfers, which could motivate states to reform with plan grants.
- **Fiscal Responsibility and Budget Management (FRBM) Act, 2003:** The FRBM Act was introduced to ensure fiscal discipline by reducing fiscal deficits and managing public debt. The Act applied to both the central and state governments, fostering a more responsible fiscal approach. However, its implementation has sometimes led to challenges in balancing growth-oriented spending with fiscal prudence.
- Goods and Services Tax (GST) Act **and** GST Council: The introduction of the GST Act in 2017 marked a significant tax reform. It replaced a complex web of indirect taxes with a unified tax structure, promoting ease of doing business and reducing tax cascading. The introduction of GST reduced the tax collection powers of the states.
    - Some state finance ministers have alleged that the **GST Council's** decisions are influenced by political considerations and not by economic rationality.
        - They have also complained that their views are not given due weightage and that they are often outvoted by the majority .
- **Use of** Cess **and Surcharges:** The use of cess and surcharges has become a common practice for raising revenue for specific purposes. However, it can affect the size of the divisible pool, impacting the funds available for distribution to states. This can lead to imbalances in resource allocation and fiscal autonomy.
    - For instance, **GST compensation cess** has often attracted controversy for inadequate and untimely payments.
- **Central Legislations**: Several pieces of central legislation such as the **Mahatma Gandhi National Rural Employment Guarantee Act 2005**, the **Right of Children to Free and Compulsory Education Act 2009**, the **National Food Security Act 2013** and many others impose an extra burden on the States.
- **Evolved Political Discourse:** India is no longer the one-party governance of post-Independence times. It has become a truly multi-party system. The nature of polity, society, technology, demographic structure and the development paradigm itself have significantly changed. As a result of these changes, India's political arena has become more competitive and dynamic which has opened new fiscal dimensions.

How India could Strengthen its Fiscal Federalism?

- **Equity-Oriented Intergovernmental Transfers:** Intergovernmental transfers, like the funds allocated from the central government to states, should be designed to promote equity.

    - **Horizontal and Vertical Fiscal Imbalances:** Addressing both horizontal imbalances (disparities among states) and vertical imbalances (between the central and state governments) is crucial. The devolution formula should be designed to account for both sets of imbalances to ensure that resources are allocated fairly.
  - **Use of Performance-Based Grants:** Introduce performance-based grants that reward states for achieving certain developmental targets, such as improving health and education indicators. This encourages states to focus on effective governance and results.
  - **Constitutional Reforms**: Revisit **Articles 246 and the Seventh Schedule** to redefine the division of powers and responsibilities between the central and state governments. This can help clarify which functions should be carried out at each level, reducing confusion and enhancing efficiency.
  - **Empowering Local Governments:** Strengthen the third tier of government by providing them with adequate resources, functions, and autonomy. This can involve creating a clear framework for responsibilities and finances, ensuring that local bodies have the power to make decisions that affect their communities.
  - **Uniform Financial Reporting System**: Implement a standardized financial reporting system that encompasses all levels of government. This helps maintain transparency, accountability, and efficient fiscal management.
  - **Review Off-Budget Borrowing**: Address the issue of off-budget borrowings by ensuring that all financial transactions are included in the budget. This prevents hidden liabilities and increases transparency in fiscal management.
  - **Convergence of Development Indicators:** Use a combination of economic and social indicators, like per capita income and Human Development Index (HDI), to allocate funds. This approach ensures that states are not only economically developed but also focused on improving the overall well-being of their citizens.
  - **Fiscal Responsibility and Budget Management (FRBM) Act**: Align the FRBM Act provisions for both central and state governments to maintain fiscal discipline while accommodating their unique fiscal situations.
  - **Devolving Tax Powers**: Provide states with more flexibility and control over taxation, enabling them to generate revenue according to their local economic conditions and priorities.
  - **Cooperative Federalism**: Foster a spirit of cooperative federalism where the central and state governments collaborate to design and implement policies that benefit the nation as a whole.
  - **Regular Review and Dialogue**: Establish mechanisms for regular review and dialogue between the central and state governments to discuss fiscal issues, policy challenges, and potential improvements to the fiscal federalism framework.

Drishti Mains Question:

Examine the need to rethink India's fiscal federalism in the light of recent developments. Suggest some measures to improve the principles and practices of fiscal federalism in India.

UPSC Civil Services Examination, Previous Year Questions (PYQs)

Q. Which one of the following in Indian polity is an essential feature that indicates that it is federal in character?

(a) The independence of judiciary is safeguarded.

(b) The Union Legislature has elected representatives from constituent units.

(c) The Union Cabinet can have elected representatives from regional parties.

(d) The Fundamental Rights are enforceable by Courts of Law.

Ans: (a)

Q. Which one of the following is not a feature of Indian federalism? (2017)

(a) There is an independent judiciary in India.

(b) Powers have been clearly divided between the Centre and the States.

(c) The federating units have been given unequal representation in the Rajya Sabha.

(d) It is the result of an agreement among the federating units.

Ans: (d)

Q. Local self-government can be best explained as an exercise in (2017)

(a) Federalism

(b) Democratic decentralization

(c) Administrative delegation

(d) Direct democracy

Ans: (b)

Q. Consider the following items: (2018)

1. Cereal grains hulled
2. Chicken eggs cooked
3. Fish processed and canned
4. Newspapers containing advertising material

Which of the above items is/are exempted under GST (Good and Services Tax)?

(a) 1 only
(b) 2 and 3 only
(c) 1, 2 and 4 only
(d) 1, 2, 3 and 4

Ans: (c)

Q. What is/are the most likely advantages of implementing 'Goods and Services Tax (GST)'? (2017)

1. It will replace multiple taxes collected by multiple authorities and will thus create a single market in India.
2. It will drastically reduce the 'Current Account Deficit' of India and will enable it to increase its foreign exchange reserves.
3. It will enormously increase the growth and size of economy of India and will enable it to overtake China in the near future.

Select the correct answer using the code given below:

(a) 1 only
(b) 2 and 3 only
(c) 1 and 3 only
(d) 1, 2 and 3

Ans: (a)