



Impact of the New Economic Measures on Fiscal Ties Between the Union and States in India

Monetary Policy is Like Juggling Six Balls, It is not Interest Rate Up, Interest Rate Down. There is the Exchange Rate, There are Long Term Yields, There are Short Term Yields, There is Credit Growth.

— Raghuram Rajan

The fiscal relationship between the Union and the states in India is a complex and dynamic arrangement shaped by the federal structure of governance. This relationship has evolved significantly since India's independence in 1947, guided by **constitutional provisions, economic policies, and political considerations**. Recent economic measures, particularly those introduced in the last decade, have had a profound impact on this relationship.

The fiscal ties between the **central** and **provincial governments** during the **British colonial era** were characterised by centralised control and limited financial autonomy for provinces. The **Government of India Act, 1935** marked a significant step towards **fiscal federalism**, introducing the concept of **provincial autonomy** and revenue sharing between the centre and provinces.

After independence, the Indian Constitution established a **federal system** with a **strong unitary bias**. The Constitution delineated the fiscal powers and responsibilities of the Union and state governments through the **Union List, State List, and Concurrent List**. The **Seventh Schedule** of the Constitution assigned exclusive powers to the Union and state governments, while the Concurrent List allowed for shared responsibilities. Additionally, the **Finance Commission** was established to recommend the distribution of **tax revenues** between the Union and the states.

The introduction of the **Goods and Services Tax (GST)** in **2017** was a landmark reform aimed at creating a **unified national market** by replacing a plethora of central and state taxes with a single tax. GST subsumed several **indirect taxes**, including **excise duty, service tax, and state-level value-added tax (VAT)**.

The **implementation of GST** has significantly altered the **fiscal landscape** in India. By subsuming a large number of state taxes, GST has reduced the fiscal autonomy of states. However, the creation of the **GST Council**, where both the Union and states have representation, has introduced a collaborative decision-making process in tax matters. This has fostered cooperative federalism but has also led to tensions over revenue sharing and compensation.

The **GST compensation mechanism**, which guarantees states compensation for any revenue shortfall arising from the implementation of GST for the first five years, has been a contentious issue. Delays in compensation payments have strained the fiscal position of states and highlighted the dependence of states on central transfers.

The **Fourteenth Finance Commission (2015-2020)** recommended increasing the share of states in the **central tax pool** from **32% to 42%**. This significant increase aimed to enhance the fiscal autonomy of states and empower them to undertake development activities.

While the increased devolution has provided states with greater financial resources, it has also shifted the

onus of fiscal management to states. States are now required to manage their finances more prudently and prioritise their expenditures. The impact of this measure has been mixed, with some states effectively utilising the additional resources for development, while others have struggled with fiscal discipline.

Centrally Sponsored Schemes (CSS) are schemes funded by the central government and implemented by states. The rationalisation of CSS, initiated by the government, aimed to reduce the number of schemes and increase flexibility for states in utilising funds. This measure sought to address the issue of one-size-fits-all schemes that did not account for regional variations and needs.

The rationalisation of CSS has provided states with **greater flexibility** in designing and implementing programs tailored to their specific needs. However, the dependency on central funding for these schemes continues to limit the **financial autonomy of states**. Moreover, the conditionalities attached to central funding often constrain states' ability to innovate and prioritise according to local requirements.

The **Fiscal Responsibility and Budget Management (FRBM) Act, 2003**, aimed to institutionalise fiscal discipline and reduce fiscal deficits. Amendments to the **FRBM Act** have introduced more **flexible fiscal targets**, allowing states greater leeway in managing their **fiscal deficits**, particularly in times of economic stress.

The amendments to the FRBM Act have provided states with a framework for prudent fiscal management while allowing for flexibility in exceptional circumstances. This has enabled states to undertake **counter-cyclical fiscal measures** during economic downturns. However, the effectiveness of these measures depends on the commitment of states to adhere to fiscal discipline and the quality of fiscal governance at the state level.

The transition to GST and the dependency on central transfers have created revenue uncertainty for states. The delays in **GST compensation payments** have exacerbated **fiscal stress for states**, particularly those with weaker revenue bases.

The increased devolution of taxes has not fully addressed the issue of **fiscal imbalances** among states. States with stronger economic bases continue to have higher revenue capacities, while poorer states remain dependent on central transfers.

Despite efforts to enhance state autonomy, the central government retains significant control over financial transfers through conditionalities attached to CSS and other grants. This limits the ability of states to exercise full financial autonomy.

The **GST Council** and other collaborative forums provide an opportunity to strengthen cooperative federalism in India. By fostering dialogue and consensus-building, these platforms can address issues of fiscal federalism and promote a more balanced and equitable fiscal relationship between the Union and states.

The increased devolution of taxes and amendments to the FRBM Act provide states with greater financial resources and flexibility. This presents an opportunity for states to enhance fiscal prudence, improve expenditure management, and undertake sustainable development initiatives.

The rationalisation of CSS and increased flexibility in fund utilisation allow states to design and implement programs that cater to regional needs and priorities. This can promote balanced regional development and reduce disparities among states.

The new economic measures introduced in India over the past decade have significantly impacted the fiscal ties between the Union and the states. While these measures have provided states with greater financial resources and flexibility, they have also introduced new challenges in terms of revenue uncertainty, fiscal imbalances, and central control. The effectiveness of these measures in enhancing fiscal federalism depends on the commitment of both the Union and state governments to foster cooperative federalism, adhere to fiscal discipline, and promote balanced regional development. As India continues to evolve its federal structure, it is imperative to address these challenges and seize the opportunities to create a more equitable and sustainable fiscal relationship between the Union and the states.

Federalism is no Longer the Fault Line of Centre-State Relations but The Definition of a New Partnership of Team India. Citizens now have the Ease of Trust, not the Burden of Proof and Process.

—Narendra Modi

PDF Refernece URL: <https://www.drishtias.com/printpdf/impact-of-the-new-economic-measures-on-fiscal-ties-between-the-union-and-states-in-india>

