Fiscal Federalism: Major Aspects

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Abstract: *India is a federation where functions of Union and State' governments are well explained in the Constitution. This division of responsibilities are aimed to achieving political, economic and administrative efficiency. Fiscal imbalances, both vertical and horizontal, are common to federations and India. The Indian Constitution provides for instruments like shared taxes and grants-in-aid to address such imbalances and an institutional mechanism called the finance commissions with specified terms of reference to negotiate such imbalances. There are a number of challenges facing India's fiscal federalism. The paper deals with Fiscal federalism and major aspects.*

Key Words: Fiscal federalism, Government, Finance Commission, State, Constitution, Democracy.

Introduction

Fiscal federalism is financial relations between units of governments in a federal government system. Fiscal federalism is part of broader public finance discipline. The term was introduced by the German-born American economist Richard Musgrave in 1959. Fiscal federalism deals with the division of governmental functions and financial relations among levels of government.

Fiscal federalism refers to the financial relations between the country's federal government system. It is the study of how expenditure and revenue are allocated across different vertical layers of the government administration. Article 246 and Seventh Schedule of the Indian Constitution distributes powers to the Union and the states with a threefold classification type:

a. **List I**: The Union is responsible for functions of national importance, including but not limited to communications, constitution, defence, elections, external affairs and organisation of the Supreme Court and the High Courts.

b. **List II**: States are responsible for touching on the life and welfare of the people, for instance, through public order, police force, agriculture, local government, public health, water land, etc.
c. **List III**: The Concurrent list includes the administration of justice, economic and social planning, and more.

In accordance with the lists, the Parliament has reserved exclusive powers to create laws with regards to anything from List I. Contrarily; the Legislature of any state reserves the power to make laws for their respective states in relation to anything from List II. However, for any subject matter that falls within List III both, the Parliament and State Legislature can create laws, however, in the event of any conflict, the law made by the Parliament will prevail. Residuary functions listed in neither lists I or II are vested in the Union.

The Union and State lists also include the powers of taxation. The main sources of income for the Union are direct taxes, mainly income tax. However, they are also entitled to collect various other taxes such as customs and corporate tax. States normally derive their income from indirect taxes. Besides this, State List also includes land revenue, excise on alcoholic liquor, estate duty, tax on vehicles and more. The Concurrent List does not comprise any tax power. The distribution of revenues and approaches for determining grants between the States and Union are legislated by various Articles of the Indian Constitution.

a. The Finance Commission's role in providing conditional and unconditional transfers to the states;
b. The use of the transfer system to achieve development and policy outcomes; and
c. The future framework of state government borrowing.

Issues Under the Current Fiscal Federalism Structure

Based on recent changes, there is a serious need for redefining India's current fiscal federalism structure. The concepts of fiscal federalism are related to horizontal and vertical fiscal relations. There has been a resurgence of horizontal and vertical imbalances in the structure, which will be discussed below.

A. **Horizontal Imbalances**

Finance commissions, post 1990s, have essentially grown to become a vehicle for enforcing states to implement fiscal reforms as part of economic liberalisation. This has been exacerbated by the replacement of the Planning Commission with the NITI Aayog. This move has reduced the policy outreach of the government as they now solely rely on the finance commission, which in turn, leads to a serious problem of increasing regional and sub-regional inequities. It has caused an unfortunate surge in horizontal imbalances because of the differing levels of attainment by the states, resulting from the differential growth rates and their developmental status in terms of the state of social or infrastructure capital. The Terms of Reference of the 15th FC has exacerbated this process which, if implemented along with the Fiscal Responsibility and Budget Management Bill review committee recommendations, may potentially reduce the states' capacity to intervene in economic and social sectors.

B. **Vertical Imbalances**

The creation of vertical imbalances is a result of the fiscal asymmetry in powers of taxation vested with the different levels of government in relation to their expenditure responsibilities prescribed by the Indian Constitution. The central government is given a much greater domain of taxation, with a collection of 60% of the total taxes, despite their expenditure responsibility only amounting to 40% of the total public expenditure. These imbalances are further exacerbated in cases of third tiers, comprising elected local bodies and panchayats. Vertical imbalances can have a hostile impact on India's urbanisation, the quality of local public goods, which thereby, would further aggravate the negative externalities for climate change and the environment.

The introduction of the GST is a demonstrative example of the working of cooperative federalism. However, it is questionable as to how far this conforms to actual practice. Under article 279A of the Indian Constitution, two-thirds of the voting rights belong to the states while the centre has one-third voting rights at the GST Council. But passing a resolution required three fourths majority. In effect, this confers a veto power for the centre, even when states jointly propose a change. The states should be able to adopt a change in their tax structure without the centre's consent, given that each state is governed differently based on local legislations.

Furthermore, the GST's apportionment has raised some concerns. The suggested apportionment between the states and the centre by the committee on revenue neutral rates of the central government was a 60:40 ratio, as almost 44% of the states' own tax revenue was subsumed under the GST as compared to 28% for the centre. The centre still retains their power to levy additional excise duty on, for instance, tobacco products, even though it has been brought under the GST. States, on the other hand, have no such right. This deprives the state of their main source of income, being indirect taxes, thereby slowly causing the state government to fail in upholding their end of the bargain in relation to their responsibilities. This showcases the importance of providing state governments with fiscal freedom in order to better the governance of state governments and to enhance the economic and social wellbeing of states.

Benefits and Drawbacks of Fiscal Federalism

Fiscal Federalism has assisted the funding of lower-level government entities. It has both benefits and drawbacks. It also has some major drawbacks that can lead to a strained relationship between states and the federal government.

Drawbacks of Fiscal Federalism

There are several drawbacks of fiscal federalism and they are as follows:

- Lack of accountability of state and local governments to constituents
- Lack of availability of trained and qualified staff
- A certain degree of independence of the local governments from the national governments
- Unavailability of infrastructure of public expenditure at the local level.

Benefits of Fiscal Federalism

The benefits of fiscal federalism are many, and the major ones are:

- Consideration of regional and local differences - The national government can learn more about state and local level governments by being involved in policies affecting those specific areas. The national government can shift funds to areas the need it most.
- Minimized planning - States and local governments usually get to manage most of the project that is being funded. This relieves the national government from having to implement and administer every small government program.
- Administrative costs - Fiscal federalism relieves the central government from having to micromanage states and local governments, costs go down considerably at the national level. The human resources needed to fund an agency or department large enough to oversee each federal funded program would be astronomical. This would also require a large amount of administrative costs.

Conclusion

The relationship between central and state government bodies has a profound effect on efficiency and equity within the government and on macroeconomic stability of the country. Given the replacement of the Planning Commission, there is more changes necessitated in relation to the treatment of grants outside the Commission's purview. States need to be able to fulfil their promises upon which they were democratically elected; otherwise this can have detrimental effects not just on the fiscal federalism principles, but on the social and economic state by and large. For this, the division of direct and indirect taxes needs to be considered, especially after the implementation of the GST. While fiscal federalism in India has a long history, its practice has grown increasingly over the years. Serious action is required to improve its principles and practices. Socio-economic trends such as technological change, rising mobility and market integration will affect the future of fiscal federalism in India.

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