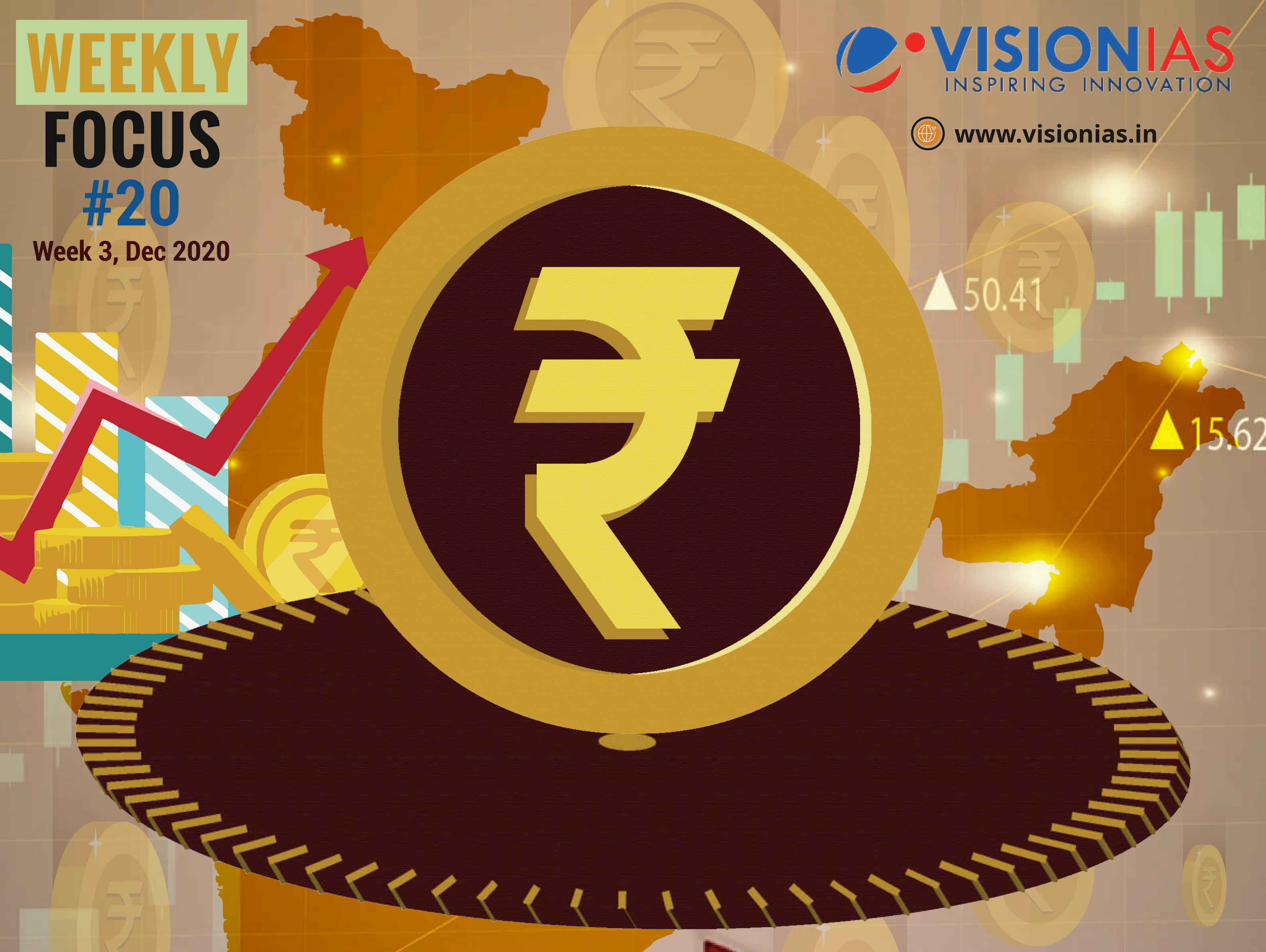
WEEKLY FOCUS #20
Week 3, Dec 2020



CHANGING DYNAMICS OF fiscal federalism in India

Introduction

A tussle has ensued between the Centre and States as there was an estimated shortfall of Rs. 30,000 crores in the GST Compensation Cess. The GST Compensation Cess was a mechanism provided by the Centre to compensate for any revenue loss of the states on account of implementation of GST. The cess served as marker of trust between the Centre and the States. Erosion of this trust has made the states wary of all recent changes made by the Centre from abolition of the Planning Commission to Terms of Reference of the 15th Finance Commission, fearing that all these steps collectively are weakening the structure of Fiscal Federalism in India. On the other hand, Centre negates these apprehensions citing the increased devolution in 14th Finance Commission and reasoning that GST Compensation Cess is an independent matter of contention and not a part of any larger plan.

Before we attempt to analyze this debate, it is pertinent that we try to understand what fiscal federalism is and how it affects the functioning of a country? How did Fiscal Federalism evolve in India and what are its essential facets? What are the changes that have impacted Fiscal Federalism in the recent past? And do apprehensions felt by the States have merit? Moving beyond the debate, we try to understand the persistent challenges faced by Fiscal Federalism in India and what can be done to overcome these challenges and further strengthen the Fiscal Federalism in India.

What is Fiscal Federalism and how it affects the functioning of a country?

Fiscal federalism can be simply defined as financial relations between units of governments in a federal government system. In case of India, these units are the Centre and the States. The financial relations encompass fiscal resource management of both Centre and States, collective fiscal stability and consolidation and **most importantly intergovernmental transfers.**

Intergovernmental fiscal relations usually reflect fundamental societal choices and history and affect the behavior of firms, households and governments and thereby economic activity. This can be illustrated by analyzing the role played by fiscal federalism in following areas:

- **Political decentralization:** The nature of Fiscal Federalism in a country plays a key role in determining the extent of potential political decentralization. Not only the extent of intergovernmental transfers but nature of these transfers affixes the level of autonomy, financial and otherwise, provided to lower tiers of government. For example, on an average, close to 90% of the transfers to third tier of government in India are conditional, thus effectively limiting the decentralization at that level.
- **Nature of economic growth:** The structure of Fiscal Federalism in a country dictates the expenditure priorities based on the tier of government that spends the money. This in turn affects the nature and direction of national economic growth. For example, the centralized nature of fiscal dynamics in Russia has tilted its economy more towards central priorities like defense industries.
- **Governance structures:** The nature of financial relationship between the tiers of government considerably affects the administrative functioning of the Government. For instance, the fiscal autonomy of a governmental unit is co-existent with certain level of accountability towards people. Thus, the structure of fiscal federalism indirectly influences the accountability arrangements in the overall governance.

Several studies have indicated that fiscal decentralization is positively correlated with GDP per capita levels, educational outcomes and investment in physical and human capital. In the light of this, it becomes important for every country to find its optimal fiscal balance among all the tiers of government.

How did Fiscal Federalism evolve in India and what are its essential facets?

The post-independence evolution of fiscal federalism happened in the background of under-development, large disparity among states, a clear objective in the government to make a more egalitarian society and a perennial fear of disintegration of the Indian Union. Keeping this in mind, the essential facets of India's structure of fiscal federalism **revolves around three key ideas:**

- **7th Schedule acting as constitutional base for division of resources:** The 7th schedule of the constitution clearly lays down the subjects for the union list (functions assigned to the federal government), the concurrent list (shared functions between federal and state governments), and the state list (functions exclusively assigned to the state governments).

Pre-independence evolution of fiscal federalism

India's first budget in 1860	The idea of federal division of finances in India took root.
The Government of India (GoI) Act, 1919	The Act brought about the division of subjects into central and provincial lists.
The Government of India (GoI) Act, 1935	The Act divided powers between the centre and units in terms of 3 lists- Federal, Provincial and concurrent. It consolidated the idea of fiscal federalism in the form of sharing of Centre's revenues and for the provision of grants-in-aid to provinces.

- **India is a 'Union of States' rather than a 'Federation of States':** Since independence, India has faced several issues with regard to a possible disintegration to secessionist tendencies in several parts of the country. This accompanied with a preference for planned economy immediately post-independence has tilted the control of fiscal relations more towards the Centre. The manifestation of this can be seen in following observations:
  - **2/3rd- 1/3rd distribution:** On an average, States spent about 2/3rd of the overall public expenditure done by both Centre and States, but States control only about 1/3rd of the total tax levying sources.
  - The erstwhile **planning commission** (an executive body created by the Union Government and not a constitutional body) played an integral role in **intergovernmental transfer of resources** from Union to the States.
  - The transfers under **Central Sector Schemes and Centrally sponsored schemes** constitute a significant share of transfers from Centre to States. The State just plays the role of an implementing agency in relation to these transfers.
- **Finance Commission as a primary channel of fiscal devolution (FFC):** The Finance Commission, set up under Article 280 of the constitution, has been bestowed with the exclusive power to make recommendations to the President as to the distribution between the Union and the states of the net proceeds of taxes which are to be, or may be, divided between them and the allocation between the states of respective shares of such proceeds. The nature of these recommendations is guided by following features:
  - Increasing **financial autonomy of states** and **balancing the fiscal space** between the Centre and the States acts as core principle of **vertical devolution of resources.**
  - **Difference in the fiscal capacities** among States and the **objective of equitable development** acts as the core principle of **horizontal devolution of taxes.**
  - The sharing shall be of net proceeds of **all union taxes (except** a few mentioned in Articles **268, 269 and 271** of the Constitution).

Channels of Intergovernmental Transfers in India

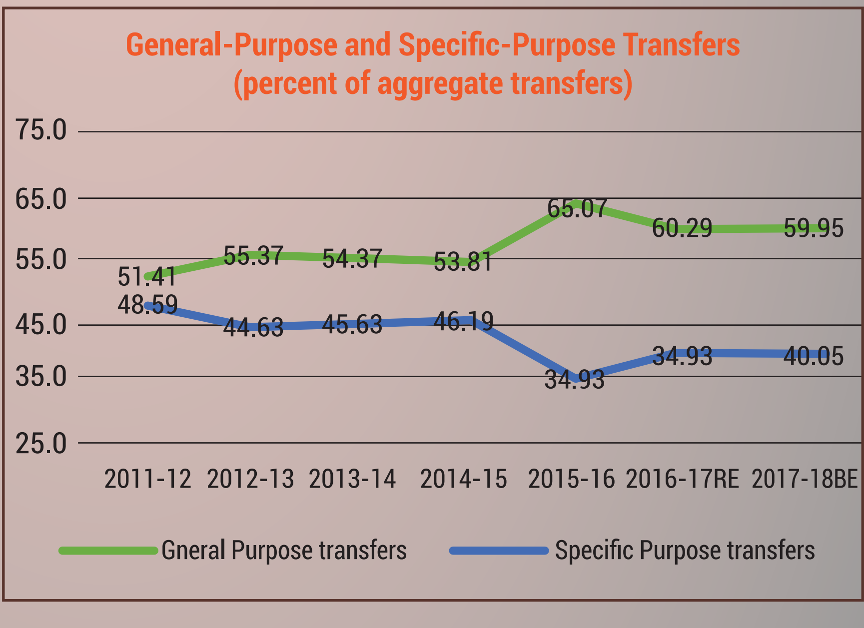
These transfers constitute about 1/3rd of total fiscal space available to States (including borrowing and own resources). The Distribution of intergovernmental finance primarily happens through three channels:

- **Tax devolution** as a share of divisible pool of taxes, which is in the nature of entitlement of the Union and States based on assessment of their resources and needs by the Finance Commission.
- **Grants-in-aid** in the recommendations of Finance Commission, which are in the nature of transfer of funds from Union to States, unlike devolution which is sharing of funds.
- The third channel is **transfer of resources by Union to States outside the award of Finance Commission,** essentially by the Union Government which in the past was, on the advice of Planning Commission.

What changes have impacted Fiscal Federalism in the recent past?

Over the course of time, there have been several developments which have altered the nature of Fiscal Federalism in India. These include the market reforms initiated during 1991 and enactment of 73rd and 74th Constitutional Amendment Act among others. In the recent past, following can be cited as paradigm shifting changes:

- **Recommendations of the 14th Finance Commission (FFC):** The FFC altered the fiscal dynamics in following ways:
  - **Higher vertical devolution:** Increased vertical devolution may not have increased the overall fiscal space of the States, but it has **increased the fiscal autonomy available to States by increasing the share of General purpose transfers vis-a vis the Specific purpose transfers.** (as can be seen in the infographic).
  - **Doing away with concept of Plan and Non-Plan expenditure:** The removal of a distinction could enable reversal of the neglect of non-Plan activities like maintenance. Also, removing this artificial distinction could help create classification of Government expenditure solely on capital and revenue basis.



- **Moving away from the idea of Special category States:** This could help remove the political discretion exercised by granting some States the Special Category status and thus higher devolution.

Issues arising from the Terms of Reference of 15th Finance Commission

The Terms of Reference (ToR) of the 15th FC has generated friction between Centre-State relations due to its following provisions:

- **The Commission may examine whether revenue deficit grants be provided at all:** Even though financing of revenue deficit is not considered progressive but completely doing away with revenue deficit grant may put considerable financial pressure on the states, especially the poor states.
- **The Commission shall use the population data of 2011 while making its recommendations:** The 15th Finance Commission has been mandated to use data from the 2011 Census, instead of 1971 Census, as the base for determining revenue share across states.
    - This, southern states have argued, may penalize them for their successful efforts in controlling population growth, by decreasing their share in the overall resource pool. Although the argument has political salience, it overlooks the core redistributive principle of the revenue transfers.
- **The Commission may consider proposing measurable performance-based incentives for States** like achievement of 'Flagship schemes', 'creation of disaster resilient infrastructure' and 'controlling expenditure on populist measures' among others.
    - Although, these incentives could lead to healthy competition among states but tying State's fiscal space to a mandate decided by the Centre may indirectly increase centralization and micro-management of States by the Centre.
- **Separate mechanism for funding of defense and internal security needs:** In an amendment to the ToR of the 15th FC, the Commission shall also examine whether a separate mechanism for funding of defense and internal security ought to be set up. This was done in the light of declining defense expenditure (from 2% of GDP in 2014-15 to 1.43% in 2019-20).
    - The States have been opposing this citing that special measures like this will lead to reduction in the overall vertical devolution of taxes to the States.

- **Moving from Planning Commission to NITI Aayog:** Planning Commission was one of the primary channels to enable intergovernmental transfers outside the Finance Commission. Thus, its rekindling into NITI Aayog has affected Fiscal Federalism in following ways:
    - **Tilt towards the idea of Cooperative Federalism and Competitive Federalism:** The mandate of NITI Aayog as a policy research entity strives to provide both Centre and States adequate institutional space with a decentralized and shared national agenda.
    - **Shift of some functions from Finance Commission to NITI Aayog:**
        - The **indicative ceiling on transfers outside the Finance Commission has been removed** due to abolition of plan and non-plan differentiation which will indirectly shift the burden of increased transfers outside Finance Commission on NITI Aayog.
        - Some of the **overlap between the Finance Commission and the Planning Commission** has been addressed by the Finance Commission by **relinquishing most of the State specific or project specific grants-in-aid and associated conditionalities, in its recommendations.** For example, incentives or disincentives or rewards to States for appropriate policies have been left out of the Finance Commission's considerations and thus, they legitimately fall under NITI Aayog.
- **Implementation of GST:** GST was implemented through the GST (101st Amendment Act), 2016 as a long pending indirect tax reform. It is a single tax that replaces multiple other indirect taxes. The Centre lost out on its power to levy taxes such as excise duty, while the States could no longer levy entry tax, VAT etc.The advent of GST has altered the dynamics of Fiscal Federalism in the following ways:

- **Pooled sovereignty via GST Council:** As the GST is implemented through a process of collective decision-making, both the Centre and the States have lost out on their autonomy to unilaterally determine their indirect tax policies. This is reflected in clause (9) of Article 279A, which lays down the voting pattern that shall be adhered to before any recommendation of the GST Council is ratified.
- **Mutual Trust on ensuring justified sharing of revenues:** One of the primary reasons for the country wide consensus on enactment of GST was assurance from the Centre that any shortfall in the tax revenue of the States shall be compensated. To ensure this, a GST Compensation Cess was created through GST (Compensation to States) Act, 2017.The act states that-
  - Under the Act, the percentage of **annual revenue growth of a State has been projected to be 14%.** If the annual revenue growth of a State is less than 14%, the State is entitled to receive compensation under the statute.
  - **The compensation payable to a State** shall be provisionally calculated and **released at the end of every two months period.**

GST Compensation Cess and COVID-19: Are State's apprehensions regarding changing fiscal dynamics real?

The pandemic has given an economic shock to the Indian Economy which has dented the tax collection expectations (including the collections from GST Compensation Cess) of both Centre and States. Resultantly, the **Centre has refused to immediately compensate the states** citing this revenue shortfall.

Since the GST Compensation acts as a **harbinger of State's trust on Centre,** non-compliance on this agreement has the potential to erode the trust between the Centre-State relationship. Also, the estimated **Rs 30,000 crore shortfall has come at a time when waning fiscal federalism is a burning issue.** For instance, Centre's latest decision to suspend the Members of Parliament Local Area Development (MPLAD) Scheme and divert that money to the Consolidated Fund of India is being cited as a step towards the centralization of country's financial resources. In this context, several States have expressed following apprehensions:

- **Centre not honoring its moral and legal obligation:** Finance Ministers of both Kerala and Punjab have argued that the Central Government has a legal, and a moral obligation to compensate the State Governments for the revenue shortfall. A deadlock so early in the implementation of GST has made States skeptical about the future of Fiscal Federalism.
- **Ineffectiveness of the GST Council:** Any dispute regarding GST is to be handled by the GST Council but in the recently concluded 39th GST Council meeting, no steps were taken to create such a dispute resolution mechanism.With a 1/3rd voting power, the Centre has a virtual veto over the decision making in the council (since 3/4th majority is needed to pass a decision). This has made the States question the functioning structure of the Council itself.
- **Resort to legal proceedings:** In the absence of an alternate remedy, the only option left for states like Kerala and Punjab is to approach the Supreme Court under Article 131 of the Constitution. Such a judicial remedy to establish fiscal federalism of the states would erode even the limited institutional capital present between Centre and States.

The stand of the Centre on these issues should not be viewed solely as a response to the States but in the background of **abysmal economic growth and negative tax buoyancy rates** (percentage change in tax revenue to percentage change in GDP) which is in addition to almost 25% reduction in collection of Corporate taxes. In this background, the Centre has taken following stands:

- The Centre has refused to compensate the States immediately but has **provided the States with an option to borrow** (to make good either the shortfall in compensation arising from GST implementation or the overall shortfall).

- The Centre has alongside contended that the revenue shortfall is on account of the COVID-19 pandemic, which is an **'Act of God'**, stating that it has **no legal obligation to compensate the States.** It has also argued that the inflows to the **GST Compensation Fund are to be made from the GST Compensation Cess** and if that is inadequate, the Centre is not obligated to supplement it by diverting flows from other sources.

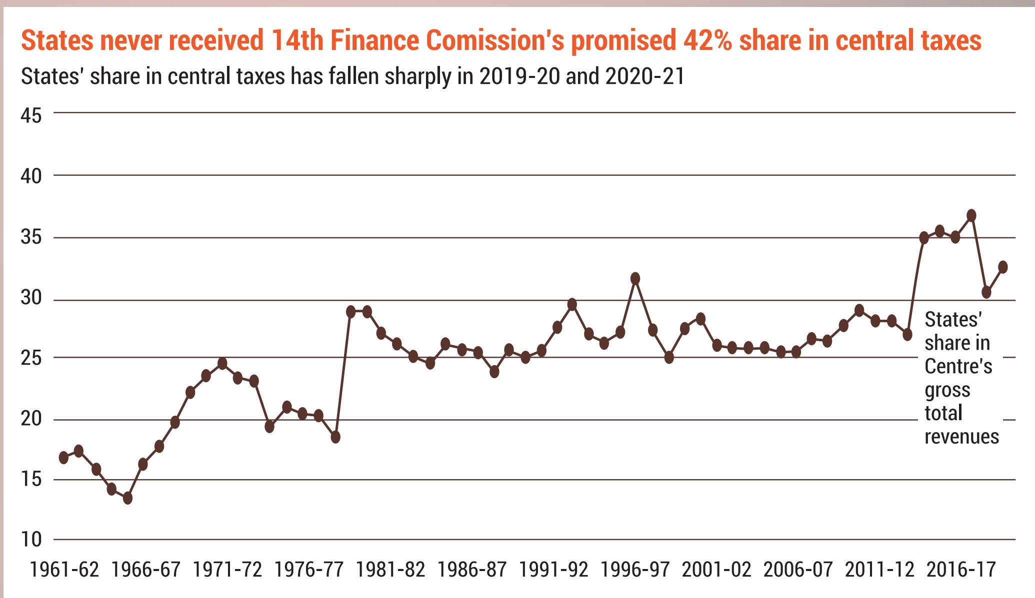
The stalemate has been finally broken with all **28 States and 3 UTs with legislatures going with the borrowing option provided by the Centre.** Under this option, the Centre has operationalized a special borrowing window of 1.1 lakh crore of which 30,000 crore has been already borrowed by Centre on behalf of the States.

The primary advantage states have here is that the interest on the borrowing under the special window will be paid from the cess as and when it arises until the end of the transition period. After the transition period, principal and interest will also be paid from proceeds of the cess, by extending the cess beyond the transition period for such period as may be required. **The states will not be required to service the debt or to repay it from any other source.** As this being the debt of the State, it will not reflect in the fiscal balance sheet of the Centre thus creating a win-win in the short term for both sides.

Although the immediate issue has been resolved but the helplessness experienced by the States and Centre's response on its apprehensions has made the threat of changing fiscal dynamics seemingly real for the future. Not much can be said about the intention of the Central dispensation vis-à-vis changing Fiscal Federalism, but looking at the aforementioned developments solely through the lens of their impacts and not intentions provide merit to the apprehensions of the States.

What are the persisting challenges to Fiscal Federalism in India?

- **Implementation of the 14th Finance Commission:** The promise of 42% vertical devolution of taxes has not been realized. States' share reached a peak of 36.6% in 2018-19 and has fallen sharply since.
  - Also, it has been observed that much **confusion** has been generated by the FFC regarding the **'continuation' and 'discontinuation' of the provisions and privileges associated with Special Category States.**



- **Principles of Grant-in-aid:** Since its inception, states have aired conflicting views on the principles that govern the grants-in-aid to the revenues of the states. The relatively better off states like Karnataka, Tamil Nadu, Goa, Maharashtra and Gujarat have suggested an **incentive-based grant-in-aid** for better fiscal management. The less developed states like Madhya Pradesh and Orissa have suggested that the **grants-in-aid should be given to meet the deficits in revenue expenditure.**
- **The future of the 7th Schedule:** The division of fiscal powers derived from the 7th schedule has its socio-economic realities in the pre-independence era. Since then, there have been changes in the economy, society and governance structures in the country, indicating towards a revision of the 7th Schedule.

- Also, some economic experts argue that **"entitlement-based central legislations"** (for instance, the Mahatma Gandhi National Rural Employment Guarantee Act of 2005, the Right of Children to Free and Compulsory Education Act of 2009, and the National Food Security Act of 2013) are in conflict with the 7th schedule of the constitution.The States share a substantial financial burden in fulfillment of these entitlements, without the accompanied fiscal and decision-making powers.

Misuse of Article 282: Article 282 of the Constitution says, "The Union or a State may make any grants for any public purpose, notwithstanding that the purpose is not one with respect to which Parliament or the Legislature of the State, as the case may be, may make laws. "Constitutional debates highlight that the objective of the article was to enable the Union to deal with unforeseen contingencies.

- This provision seems to be misused as it is used as a basis for **transgressions of the central government into state subjects** through **Centrally Sponsored Schemes (CSS) and the Central Sector Schemes** on the grounds that such spending will better serve national priorities.
- Also, according to analysis by the Fifteenth Finance Commission **there are approx. 211 schemes/ sub-schemes** under the 29 umbrella core and core of the core schemes. The total outlay of the Central Government on these Centrally Sponsored Schemes has been approx. 3.3 lakh crores in 2019-20.

Overuse of Cesses and Surcharges: They are outside the divisible pool of taxes and the Centre need not share their proceeds with State Governments. In recent times they have increasingly become important instruments of revenue mobilization. Just to illustrate, while the total transfer to states and UTs was Rs 4.1 lakh crore in 2017-18, revenue mobilization by the central government through cess and surcharge alone stood at 3 lakh crore or 15.7 % of Centre's gross tax revenue.

Issue of finances of third tier of government: The primary issues of the third tier of the Government(especially Rural Local Bodies) are negligible own revenue and complete dependence on State Governments. As a result, there is an increasing concern about the arbitrariness and ad-hocism of fiscal transfers at the third tier of the Government.

Fiscal stability and discipline: Fiscal discipline of both Centre and the States is necessary to maintain a healthy fiscal balance in federal structures.The Central Government debt is estimatedat 48.4% as a percentage of GDP for 2018-19 and is expected to come down to 48% of GDP in 2019-20. This is way beyond 40% debt level suggested by the Fiscal Responsibility and Budget Management (FRBM) Act by the end of 2024-25.

- The outstanding liabilities of the State Governments stood at **25.1% of GSDP in 2017** (compared to 20% suggested by the FRBM Act), with a wide range of 42.8% in Punjab and 17% in Chhattisgarh.

What can be done to overcome these challenges and further strengthen Fiscal Federalism in India?

In this light, the **Chairman of the 15th Finance Commission, Shri N K Singh** has highlighted following recommendations to strengthen fiscal federalism:

Symmetry in the working of the GST Council and the Finance Commission: The Finance commissions whilst giving their recommendations look at projections of the expenditure and revenue, but issue of GST rates exemptions, changes, and implementation of the indirect taxes are entirely within the domain of the GST Council. This leads to unsettled questions on the ways to monitor, scrutinise and optimise revenue outcomes. Since both the Finance Commission and the GST Council are constitutional bodies, the coordination mechanism between the two is now an inescapable necessity.

- To further improve this coordination and to address the issues arising out of implementation of the Finance Commission, the option of **giving Permanent status of the Finance Commission can be explored.**

- **Relook at the 7th Schedule:** The nature of polity, technology, increasingly aspirational society, the demographic profile and the power of technology has dramatically altered the contours of the Constitution. As a result, the entries of List I and List III in the 7th Schedule of the Constitution can be examined and a more suitable redistribution of entries can be adopted.

- **Need for a more credible policy for rationalisation of CSS and Central outlays:** Since the role of NITI Aayog is primarily of a Think Tank institution and not a financial body, there is no present central entity to provide an over-view of the CSS and how these could be amalgamated with central sector outlays. A mechanism needs to be created for detailed financial rationalization of these schemes preferably in consultation with State Governments.

- **Rebuilding institutional capital:** Several economists and policy makers have argued that abolition of Planning Commission has created an institutional vacuum. **Efforts could be made to rejuvenate and rekindle the Inter-State Council** as the body not only has constitutional backing but its mandate and nature of participation is ideally suited for a larger federal role.
  - Alongside the Inter-State Council, efforts could be made to increase political capital through institutions like Chief Minister's Conference. For instance, if the Terms of Reference of 15th Finance Commission were actively discussed in the forum, the political misunderstandings could have been avoided.

- **More effective devolution of funds to local bodies:** It is important that a steady financial flow is guaranteed in order to provide effective fiscal autonomy. To ensure this, local bodies could be provided with more taxation powers for independent revenue streams and efforts could be made to improve tax collection efficiency of local bodies. (E.g.- Collection of property tax by Urban Local Bodies)
  - In addition to this, it is important that **State Finance Commissions are constituted** as stipulated in the Article 243 (I) of the Constitution of India and arrangements are made for their robust functioning.

- **Adopting a fiscal consolidation roadmap for sound fiscal management:** Adhering to the roadmap charted by the amended FRBM Act and alongside creating a differentiated debt path of States which recognises the present constraints and issues of legacy debt and ensures judicious use of the available resources.

- **Widening the ambit of GST for revenue augmentation:** The primary reason for the tussle between Centre and States over GST Compensation Cess was shortage of revenue. The current coverage of GST excludes electricity, petrol, diesel and real estate, as also agriculture. Widening the ambit of GST could provide a larger base for taxation in the long run.

Conclusion

The essence of changing dynamics of fiscal federalism in India lies majorly in two questions- who controls the fiscal resources? and what is the availability of the overall fiscal space? The competition among the Centre and the States over control of resources is central to the issues related to fiscal federalism. This competition needs to be nudged towards coordination with mechanisms like GST Council.

Along with coordination in collective fiscal sharing and management, there will always be the need for increasing the available resources.This can be ensured by ensuring structural reforms like reviewing of GST on continuous basis and increasing tax compliance.

TOPIC AT A GLANCE

Changing dynamics of Fiscal Federalism in India

Evolution of Fiscal Federalism

- **India's first budget in 1860-** Idea of federal division of finances.
- Concrete division of subjects through **GoI Act, 1919 and GoI Act, 1935.**
- Post-independence evolution happened in the background of **under-development, large disparity** among states, a clear objective in the government to make a more **egalitarian society** and a perennial **fear of disintegration.**

Fiscal Federalism and its effect on functioning of the country

It can be defined as financial relations between units of governments in a federal government system. It plays following role in the country's functioning-

- The nature of Fiscal Federalism plays a key role in determining the **extent of potential political decentralization.**
- The structure of Fiscal Federalism in a country **dictates the expenditure priorities** based on the federal control structure.
- The nature of financial relationship between the tiers of government **affects the administrative functioning** of the Government.

Essential features of Fiscal Federalism

- **7th Schedule** acting as constitutional base for division of resources between governments.
- India is a 'Union of States' rather than a 'Federation of States' indicating a **unitary tilt in financial control.**
- **Finance Commission acts as a primary channel** of fiscal devolution via its constitutional role in providing recommendations.

Changes that have impacted Fiscal Federalism in the recent past

- **Recommendations of the 14th Finance Commission:** The FFC altered the fiscal dynamics by providing for a higher fiscal devolution for the states, doing away with concept of Plan and Non-Plan expenditure and moving away from the idea of Special category States.
- **Moving from Planning Commission to NITI Aayog:** This has created a tilt towards cooperative and competitive federalism alongside transferring some of the functions of the Finance Commission to NITI Aayog.
- **Implementation of GST:** GST completely overhauled the indirect taxation structure and created a mechanism of pooled sovereignty via GST Council. Also, the arrangements like GST Compensation Cess has created apprehensions among states and a trust issue vis-à-vis the changing structure of Fiscal Federalism.

Persisting Challenges to Fiscal Federalism

- Recommendations of the **14th Finance Commission have not been properly implemented.**
- States have **conflicting views on the principles that govern the grants-in-aid** to the revenues of the states.
- The division of fiscal powers derived from the **7th schedule** has its Socio-economic realities **based in the pre-independence era.**
- **Misuse of Article 282** through Centrally Sponsored Schemes and Central Sector Schemes.
- **Overuse of Cesses and Surcharges** to the tune of 15.7% of Centre's Gross tax revenue (2017-18).
- **Negligible own revenue and complete dependence on states** of third tier of government (especially Rural Local Bodies).
- **Healthy fiscal balance continually gets disturbed due to poor fiscal discipline** as is evident from the fact that there is large variance between debt levels and FRBM Act targets.

Way forward for overcoming these challenges and strengthening Fiscal Federalism

- Generating **symmetry in the working of the GST Council and the Finance Commission** to better monetize, scrutinize and optimize revenue targets.
- **Relook at the 7th Schedule** accounting for changed nature of polity, technology, increasingly aspirational society, the demographic profile.
- A **more credible policy for rationalization of CSS and Central outlays** can be created.
- **Rebuilding institutional capital** by reviving institutions like Inter-State Council after abolition of Planning Commission.
- **More effective devolution of funds to local bodies** through measures like more taxation powers, reforming the functioning of State Finance Commissions etc.
- **Adopting a fiscal consolidation roadmap for sound fiscal management** with FRBM targets as guiding light.
- **Widening the ambit of GST for revenue augmentation.**