

INDIA'S FISCAL FEDERALISM: STRUCTURAL DYNAMICS AND INTERGOVERNMENTAL FINANCIAL RELATIONS"

Raj Rattan Singh

MA Public Policy and Governance, Centre for Federal Studies, Public Policy and Governance, Jamia Hamdard, New Delhi

ABSTRACT

Intergovernmental transfers are part of a system of Centre-State fiscal agreements that help in coordinating fiscal decision-making at the central and state level of the government. Centre-state fiscal relations largely consist of a series of financial transfers from the Union government to the states, as well as a series of agreements for coordinating and pooling certain tax bases. This paper aims to examine India's present fiscal - decentralisation and devolution scenario, by focusing on the Centre-State fiscal arrangement. The primary task here is to understand – what constitutes the intergovernmental fiscal space and its intrinsic subtleties. Emphasis would be laid on the current scenario and on structures that mark the relational space between the Centre and the States.

KEYWORDS: Fiscal, Intergovernmental Transfers, States, Tax, Finance Commission, Grants

The analytical literature on 'fiscal federalism' has emphasised the benefits of fiscal decentralisation since Charles Tiebout's seminal paper in 1959. Everything in fiscal federalism, including boundaries, tax and expenditure allocations, intergovernmental and inter-jurisdictional ties, and Intergovernmental transfer systems are theoretically based on economic reasons. Fiscal federalism, much like democracy, is seen as the best administrative arrangement for delivering public utilities, as it not only facilitates a decentralised form of allocation of rights and responsibilities related to taxation and expenditure between the various jurisdictions/levels of government (Centre, State and Local) but it also combines the advantages of devolution and cost-savings that come with scale.

Historically, Intergovernmental fiscal transfers have been used to achieve a variety of goals, including resolving vertical fiscal imbalances and affecting regional and local economic stabilisation. In an economy with such vast regional inequities and considerable divergences in economic performance as India's, the function of fiscal transfers becomes even more important. The restructuring of intergovernmental fiscal relationships in India as a result of the economic liberalisation measures implemented since 1991 heralded a new age in which governmental entities had to be reoriented to deliver public services in order to meet the diverse demand circumstances that existed in different locations, as well as to control and monitor market functioning. This increasing role for the market in economic activity entailed a dispersal of the Central government's economic power and a more active involvement for the sub-national governments in the regulatory framework.

Currently, the tender for this dispersal mechanism is given to the Finance Commission which recommends the portion of the taxes to be devolved to the states by the Union government. According to consecutive FCs, tax devolution should be the principal means of transferring resources to states since it promotes healthy fiscal federalism. However, the worldwide pandemic's large-scale problems (Covid 19) represent a pivotal juncture at which

revolutionary shifts in inter-governmental interactions occurred, resulting in more centralization in budgetary ties. Today, India has a greater (and growing) vertical gap than other federations, owing to significant vertical imbalances resulting from the effective allocation of expenditure and income powers between the Union and the States. States' demands for enhanced borrowing limits from 3 percent to 5 percent under the Fiscal Responsibility and Budget Management Act, as well as GST compensation beyond the five-year term ending June 2019, have gone unmet.

It is on this premise that this paper aims to examine India's present fiscal - decentralisation and devolution scenario, by focusing on the Centre-State fiscal arrangement. The primary task here is to understand – what constitutes the intergovernmental fiscal space and its intrinsic subtleties. Emphasis would be laid on the current scenario and on structures that mark the relational space between the Centre and the States, like intergovernmental transfers, tax devolution mechanisms, and the XVth finance commission recommendations. Assistance would be taken from recent primary data reports issued by both public and private entities so that a robust assessment could be put forward.

THEORETICAL AND CONCEPTUAL UNDERPINNINGS

Fiscal federalism's structure mandates expenditure priorities dependent on which tier of government spends the money. Having an impact on the type and trajectory of national economic growth. It has its origins in a succession of fiscal crises brought on by destabilising budgetary behaviour at the state and local levels. Several nations' powerful provincial governments effectively 'raided the fiscal commons' by running massive deficits and building massive debt stocks, resulting in a national financial catastrophe.

The concept of ideal fiscal federalism encompasses various dimensions, and scholars have endeavoured to define and quantify its parameters. One key aspect is the programmatic autonomy granted to sub-central governments (SCGs), empowering them with exclusive authority over a specific set of economic policies, allowing for the creation, repeal, and adjustment of programs and regulations. Additionally, SCGs operate within a stringent budget restriction, relying predominantly on autonomous revenues generated through taxes over which they have jurisdiction in terms of rate, base, or both, without unlimited access to credit. The presence of a unified market imposes restrictions on SCGs, barring them from impeding the free movement of products, capital, and labour across their borders. Crucially, the fiscal federalism system must be institutionalised, preventing arbitrary changes by the central authority. In the case of India, a nation comprising states within a unitary framework, a vertical imbalance arises due to fiscal asymmetry in taxation powers and expenditure responsibilities outlined in the constitution. Therefore, a nuanced understanding of constitutional provisions, coupled with an awareness of financial realities, is imperative for comprehending India's fiscal structure.

There are different Union and State Lists (Seventh Schedule of the Constitution) in the legislative arena, but there is also a Concurrent List, where the national government has overriding powers. In addition, the Centre is in charge of the Residuary Powers. The Centre has the authority to legislate on issues on the State List (Article 249) and to issue directives to the States in this case (Articles 256, 257 and 355). Even when they have a major impact on the issues covered by the State List, the Centre does not need to confer with States before entering into international treaties. In terms of administration, the federal government's authority to meddle in the states is practically unrestricted. The central government has broad authority to provide directives to the state administration under Articles 256 and 257. Article

356 grants the federal government the authority to dissolve elected state governments if it detects a “*constitutional collapse*” in the state.

The Governor, who serves as the formal head of state government, is nominated by the federal government, sometimes without consulting state governments and based solely on party considerations. Finally, in the financial arena, as in other institutions, there is a significant misalignment between the Union’s functions and funds and those of the federal States in India. In India, it is seen that in the aggregate, the States raise about 43 percent of total revenues, but incur about 54 percent of total expenditures. The FCs define the percentage of taxes that will be devolved to the states, as well as the principles that will be used to distribute those revenues among the states. Tax devolution accounts for around 90 percent of the FCs’ overall pay-out. Since the Xth FC, the rest has consisted of special grants to states with revenue deficits notwithstanding tax devolution, modest particular purpose grants, disaster management, and grants to municipal governments. In addition, the assignment of concurrent jurisdiction for the levy of GST to the Union and the States and the subsequent formation of the GST Council is another pillar in the financial arena.

Several acknowledged theories give compelling justifications for decentralised fiscal constitutions based on efficiency, accountability, manageability, and autonomy. Over time, several points of view and concepts have evolved in the field of fiscal federalism. Discussed below are some of these key concepts:

i) Decentralisation Theorem: According to Oates (Oates 2008) – decentralisation thesis, “each public service should be delivered by the authority with control over the smallest geographic region that would internalise the benefits and costs of such provision.” Contrary to popular belief, a larger degree of spillovers may diminish the value difference between centralization and decentralisation.

ii) Subsidiarity Principle: According to the subsidiarity principle, duties should be done at the lowest level of government. The principle implies hierarchy, if not openly, then tacitly. The most fundamental problems are who will decide and for whom, as well as whose functions will be given to whatever level.

iii) Tax Devolution: According to Article 280 (3) (a) of the Constitution, one of the fundamental responsibilities of a Finance Commission is to offer recommendations on how the net profits of taxes should be distributed between the Union and the states. The proportion of states in the net revenues of Union taxes is the most significant conduit of resource transfer from the Centre to states, hence this is the most essential responsibility for each Finance Commission. Vertical devolution refers to the distribution of the union’s net tax profits between the union and the states, whilst horizontal devolution refers to the allocation of the states’ respective portions of such proceeds amongst the states.

iv) Divisible Pool: The divisible pool is the share of total tax revenue that is split between the federal government and the states. The divisible pool includes all taxes, net of collection charges, with the exception of surcharges and cess collected for a specified purpose. Except for the taxes and duties referred to in articles 268 and 269, as well as surcharges on taxes and duties referred to in article 271 and any cess imposed for specified reasons, Article 270 allows for the sharing of all taxes and duties referred to in the Union list.

v) Terms of Reference (ToR): The terms of reference are directives from the central government to the respective finance committee on which the finance committee prepares the

report. The main directions of the ToR concern the principles governing the vertical decentralisation of taxes between the union and the states; the principles governing the horizontal distribution between states; the Grants in aid to the states, additional resources of Panchayati Raj Institutions, Urban Local Bodies from the consolidated funds of the State; and performance-based incentives for states.

vi) Fiscal Capacity: It may be described as the state government's perspective ability to generate income from its own sources in order to supply public goods and other state activities. It is a crucial consideration when allocating intergovernmental funding to ensure that the quantity of resources available to each state is equitable.

vii) Fiscal discipline: Fiscal discipline as a criterion for tax devolution refers to was used by XIth and XIIth FC to provide an incentive to states managing their finances prudently. The criterion was continued in the XIIIth FC as well without any change. The index of fiscal discipline is arrived at by comparing improvements in the ratio of own revenue receipts of a state to its total revenue expenditure relative to the corresponding average across all states (Rao 1995).

LOGIC AND CONFIGURATIONS OF INTERGOVERNMENTAL TRANSFERS

Intergovernmental transfers are part of a system of Centre-State fiscal agreements that help in coordinating fiscal decision-making at the central and state levels of the government. Centre-state fiscal relations largely consist of a series of financial transfers from the Union government to the states, as well as a series of agreements for coordinating and pooling certain tax bases. Intergovernmental transfers are advised to:

- i. Offset fiscal imbalances and close fiscal gaps*
- ii. Create horizontal equity*
- iii. Balancing inter-jurisdictional cost and benefit spillovers*

Intergovernmental transfers constitute a pivotal mechanism for addressing fiscal imbalances and rectifying disparities in revenues and expenditures among various levels of government. These imbalances can be broadly categorised as 'horizontal' or 'vertical'. Vertical fiscal imbalances, prevalent in multilevel governance systems, emerge due to the inherent mismatch between optimal spending assignments and efficient tax assignments. Although state governments are adept at catering to diverse public service needs, the central government holds a comparative advantage in revenue generation and overseeing intergovernmental competition. This juxtaposition inevitably leads to vertical fiscal imbalances, exacerbated by factors such as intergovernmental tax competition and variations in fiscal management.

Conversely, horizontal fiscal imbalances manifest within a single level of government, illustrating discrepancies between the revenues and expenditures of different governmental units. To address these inequities on a national scale, balancing transfers from the central government are implemented. The objective is to foster fiscal equilibrium among diverse regions and government entities.

Furthermore, the rationale for interstate transfers extends beyond mere fiscal balancing. Equity considerations underpin the argument, focusing on the assurance of horizontal equity among individuals residing in different states or achieving broader inter-regional equity. Advocates of this approach propose unconditional or general-purpose transfers from the

federal government to states, scaled to offset budgetary constraints arising from variations in revenue capacity and spending demands. The overarching goal is to establish an equitable fiscal system nationwide, ensuring that individuals maintain comparable economic well-being before and after federal and state interventions—a principle encapsulated in the concept of horizontal equity.

Intergovernmental transfers also play a crucial role in addressing the complex issue of inter-jurisdictional cost and benefit spillovers. These transfers serve as a tool to reconcile disparities in the provision of public goods and services across jurisdictions. When a state's public services extend beyond its borders, it may overlook the benefits accruing to non-residents, resulting in suboptimal service delivery. Central grants, akin to 'Pigouvian' subsidies, become necessary to compensate for these spillovers. Notably, purpose-specific transfers, accompanied by matching contributions from states, ensure a nuanced and balanced approach, with the matching rate tailored to the extent of spillovers.

FISCAL TRANSFER TYPOLOGIES

The transfer system's design is based on the above-mentioned logic. Thus, transfers made to compensate for budgetary imbalances, promote horizontal fairness, or stabilise intergovernmental competition should be unconditional. To eliminate the moral hazard of states considering such transfers as 'blank cheques' from the federal government, the amount of such payments might be related to the states' tax efforts. Grants granted to counteract spillovers or to assure minimum outlays on certain services (for meritorious reasons) must be purpose-specific, with equivalent criteria from the states. In what follows, we will go through the designs of unconditional and specified purpose transfers with the least amount of disincentive effects in detail. Intergovernmental transfers or grants can be broadly classified into two categories: general-purpose (unconditional) and specific-purpose (conditional or earmarked) transfers. For a cursory glance look at Table 1.

General Purpose Transfers	Specific Purpose Transfers
a) Typically, no conditions allowed	a) Could be attached with conditions
b) Aim to close vertical fiscal imbalances	b) Either input based or output based
c) Typically mandated by law	c) Aim to promote national priorities/objectives
d) Usually formula based with need based allocation criteria	d) Typically discretionary
e) Preserve state/local autonomy	e) Influences state/local programmes and performance

Table 1: Types of Intergovernmental transfers

Source: XVth Finance Commission Report

General purpose transfers (which include both tax devolution and unconditional block grants) are provided to help sub-national governments balance budgetary disadvantages caused by a lower revenue capacity and a greater unit cost of delivering public services. These transfers can address both vertical and horizontal imbalances – vertical imbalance through the progressive distribution of tax revenues to subnational units based on a formula that accounts for the subnational units divergent tax and fiscal capacity, and horizontal imbalance based on a set of objective criteria that typically include economic indicators such as per capita income. As a result, general-purpose transfers improve governments' ability to decide their spending priorities and distribute budgetary resources accordingly. This is accomplished by providing unconditional transfers in a number of methods, the least distorting of which is to

provide transfers equal to their ‘need-revenue’ gap. The need-revenue gap is the difference between what a state should spend to deliver certain levels of public services and the money that can be raised at a certain standard level of tax effort.

Specific purpose transfers are intended to alter the recipient’s cost of provision to ensure the optimal provision of sub-central services having spillovers (Rao 1998). These are generally grants connected to specific activities carried out by sub-national bodies. ‘Equalisation grants’, in most cases, aim to address the gap in per capita spending on social and economic services including health, education, and infrastructure. Specific-purpose transfers are also intended to alleviate ‘cost disabilities’, or the higher unit costs that sub-national governments experience while delivering services like health in specific areas of the country, such as hilly terrain or nomadic communities distributed across a broad geographic area. Specific purpose transfers, if not correctly constructed, can be arbitrary, discretionary, and ad hoc, resulting in a weakening of the essential principles of intergovernmental fiscal transfers.

Following the dissolution of the Planning Commission in 2015, there are two operating channels for transferring resources from the central government to the states in India: Statutory transfers through the FC awards, which include (a) formula-based tax devolutions; (b) deficit grants based on the post-devolution current deficit (c); and discretionary transfers by various union ministries for CSS and specific-purposes. For a cursory glance look at Figure 1.

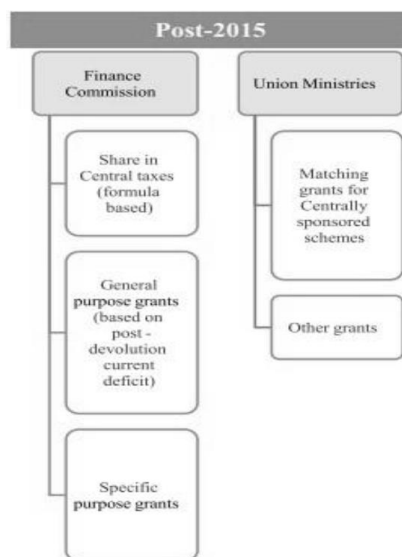


Figure 1: Resource-transfer operating channels

Source: XVth Finance Commission Report

The FC decides the proportion of the divisible pool that is to be given to the states (vertical distribution) and the percentages that are to be allocated to states (inter se) under Article 270 and Article 280(3)(a) of the Indian Constitution (horizontal distribution). No conditions may be placed on the state’s right to receive such monies after the formula with varied weights to parameters is implemented. The divisible pool has been established as a set proportion of all federal government taxes to be divided starting with the XIth FC to rectify for the vertical imbalance between state revenue and expenditure obligations.¹ Under the Eighth Amendment

to the Constitution, the net revenues of all taxes collected by the Union (after subtracting cess, surcharge, and cost of collection) are divided with the states.

Prior to the implementation of GST on July 1, 2017, the federal government hiked 60.7 percent of overall taxes on average from 2011-2015. Before central government transfers, state revenue receipts amounted to 38.1 percent of overall government revenue receipts, while state net revenue receipts after devolution and grants from the centre accounted for 63.7 percent. The XIVth FC advocated increasing states' portion of the central divisible pool from 32 percent to 42 percent, allowing them more spending authority while reducing transfers through sources like CSS. During the XIVth FC period, aggregate transfers to states suggested by the XIVth FC as a percentage of all states' gross state domestic product (GSDP) were about 7.3 percent, while the states' tax-to-GSDP ratio was calculated at 8.7 percent.

The main approach of previous FCs to horizontal sharing between states was to identify important criteria and provide weights for the allocation of shareable tax income across states to solve horizontal imbalances. Although the weights assigned to factors have largely remained subjective and do not appear to be based on any comprehensive theoretical framework, India's fiscal devolution formulas have evolved over time based on consensus and have flexibly incorporated various indicators covering three key principles. Earlier FCs employed metrics such as population size, area, forest cover, and infrastructure index distance (from the average of top three states) to determine fiscal demands and cost disability.

Recent FCs have tried to establish a balance between fiscal requirements, equality, and performance goals while minimising the possibility of moral hazard. The suggestion in the XIth FC to lower the weight of the population to 10 percent and to provide a 62.5 percent weight to per capita income substantially reduced the percentages of high-income and middle-income states in tax devolution. Because some states objected to being penalised, the subsequent XIIth and XIIIth FCs increased the weight of population from 10 percent to 25 percent and reduced the weight assigned to distance of per capita income as an equalisation measure from 62.5 percent for the XIth FC to 50 percent for the XIIth FC and to 47.5 percent for the XIIIth FC. The XIVth FC decided that allocating resources based on an outdated population census would be unfair, so it reduced the weight assigned to the 1971 population to 17.5 percent and added a 10 percent weight to the 2011 population to account for demographic changes in terms of fertility, age structure, and migration. The most recent XIVth FC reduced the weight given to fiscal performance indicators while increasing the weight given to cost disability elements like acreage and forest cover. Forest cover was included in the devolution formula to represent compensation for the expense of preserving forest land for ecological advantages as well as the opportunity cost of having an area unavailable for other economic pursuits.

Horizontal inequalities are handled by the Finance Commission using a combination of tax devolution (which is mostly utilised) and grants-in-aid. Finance Commissions are obliged by Article 275 of the Constitution to suggest the principles as well as the amount of grants to those States in need of help, and various sums may be determined for different States. As a result, assessing the requirements of the states is one of the prerequisites for receiving funding. The majority of the grants proposed by the Finance Commissions are general purpose grants that cover the gap between the assessed expenditure on each State's non-plan revenue account and the predicted revenue, including the State's share of Central taxes. Grants to states have grown in scope over time to cover a wider range of issues. For example, following the Constitution's seventy-third and seventy-fourth amendments, Finance

Commissions were given the additional task of suggesting methods to supplement a State's Consolidated Fund with funds from local governments

i. *Gap-filling grants*: are mostly general-purpose grants to cover the current deficit, which is the gap between the assessed spending on each state's non-plan revenue account and the forecast revenue, which includes the state's portion of central taxes.

ii. *Local bodies grants*: Following the 73rd and 74th Amendments to the Constitution, the FCs recommend grants to local bodies to enhance their resources. These funds are input-based for certain types of spending like roads, drinking water, sanitation, and so on, as well as output-based for improving local capacity and keeping accurate records.

iii. *Specific purpose grants*: These are conditional transfers given to states to ensure minimum standards of certain basic services, (ii) provide grants in the event of natural disasters, (iii) cover capital expenditure needs of states in specific sectors, and (iv) encourage better fiscal management and planning among states. Selected states received upgrades in areas such as general administration, law enforcement, elementary education, public health, and the care of the poor.

iv. *State-specific grants*: During the XIVth FC period, the states' portion of central taxes amounted to around 28.6 percent of gross central revenue, accounting for almost 60 percent of total transfers (budget estimate). During the XIVth FC era, grants-in-aid amounted for 19.2 percent of gross central revenue and over 40 percent of total transfers. This increases states' reliance on central government financial transfers and raises the possibility of moral hazard at the state level.

v. *Matching grants for Centrally sponsored schemes and other discretionary grants*: Central government ministries provide input-based conditional matching subsidies to states for CSS and central sector programmes under Article 282 of the Constitution to maintain minimum standards in 'merit' services or services with substantial interstate spillovers. After the CSS was rationalised in 2015, they were divided into three categories: 'core of the core', 'core', and 'optional', with states contributing a progressively greater amount of the cost of the schemes in each category.

At the moment, there are six 'core of the core' schemes, which are mostly for social protection and social inclusion, and 22 'core' schemes, which are predominantly on the concurrent list or state list under the Constitution. In FY2017, the total amount of monies spent on all central sector programmes including CSS amounted to around 1.5 percent of GDP, accounting for 24 percent of total transfers. Five schemes accounted for 66 percent of all subsidies under central schemes: (i) the National Rural Employment Guarantee, (ii) the National Health Mission, (iii) Elementary Education, (iv) Rural Roads, and (v) Housing projects.

AN ENQUIRY INTO THE XVTH FINANCE COMMISSION

In India's overall federal structure, the Finance Commission (FC) plays a critical function. Its *raison d'être* is derived from Articles 275 and 280, as well as their sub-clauses, which address horizontal and vertical imbalances. In praxis, the FC evaluates the union's overall gross tax receipts by subtracting cesses, surcharges, and non-tax revenue from gross tax revenue to arrive at the net divisible pool (NDP). Following a constitutional amendment in 2000, the divisible pool now includes all union taxes, not only income tax and excise duty (OECD 2020). As a result, the Commission chooses what proportion of the net divisible pool (NDP)

should be given to subnational governments, leaving the remainder to the central government. However, certain propositions guide the FC's exercise of allocation. To begin, the primary concept of vertical resource devolution is to increase state financial autonomy while balancing fiscal space between the centre and the states. Second, the basic concept of horizontal tax devolution is the disparity in fiscal capability between states and the objective of equitable development. Third, with the exception of those indicated in Articles 268, 269, and 271, all union taxes will be shared.

The impact of the Finance Commission on improving India's fiscal federalism may be gauged by the fact that the XIIth FC, led by Dr. Rangarajan, improved the budgetary stability of the States by tying funds to verifiable fiscal discipline by the states. These restricted grants were in addition to the statutory devolution of cash that was unconditional and untied. This had a significant impact on the states' budgetary conditions. The XIIIth FC made formulaic tax devolution to the third Tier a possibility in order to deepen and empower the democratic decentralisation process through an interesting/innovative approach (Mehrotra 2020). Local governments received much-needed 'revenue buoyancy' as a result of this. The XIVth FC increased the percentage share of revenues delegated to the states while effectively abolishing conditional transfers via Planning Commission grants or grants under Central Sector/Sponsored Schemes.

In terms of interstate resource distribution among subnational governments, the Finance Commission established the parameters (population², demographic change, income distance, geographic area, forest cover, and fiscal compliance) and then gave weights to them. These grounds for distributing central taxes among the individual proportion of states may yet alter. Some interesting bits in this devolution scenario are: i. the use of the Population of 2011 census and doing away with the Population of 1971 census, while simultaneously adopting the demographic performance criterion³, effectively rewarding states' efforts to control their population; ii. A shift away from forest cover to forest and ecology which is calculated by dividing each state's thick forest by the total dense forest of all states; iii. The setup of a new category – 'Tax and fiscal efforts' to reward states that are more efficient in collecting taxes. It is calculated as the ratio of average per capita own tax revenue to average per capita state GDP between 2016-17 and 2018-19.

Criteria	XIVth FC 2015-18
Income Distribution	50.0
Area	15.0
Population	17.5
Population	10.0
Demographic Performance	-
Forest Cover	7.5
Forest and Ecology	-
Tax and Fiscal Efforts	-
Total	100

Table 2: Grounds for distributing central taxes among states

Source: Successive Finance Committee Reports⁴

Besides, the XVth Finance Commission predicted that 17 states will experience income shortfalls after devolution. The Commission has proposed revenue deficit assistance totalling

Rs 2.9 lakh crores to these 17 states to make up for this shortfall. States would also receive Rs 1.3 lakh crores in sector-specific payments for health, education, and agriculture, among other things. The total grants to local authorities for the period 2018-2019 have been set at Rs 4.36 lakh crore. The funding will be distributed in a 90:10 ratio across states depending on population and area. The funds will be offered to Panchayats at all three levels: village, block, and district. If a state does not form a State Finance Commission and execute on its recommendations by March 2018, no funding will be provided to local governments. Likewise, The Commission recommended approximately Rs 50,000 crore in state-specific grants. These will be allocated to the following areas: (i) water and sanitation, (ii) high-cost physical infrastructure, (iii) social requirements, (iv) cultural and historical monument preservation, (v) administrative governance and infrastructure, and (vi) tourism (Table 3). The Commission proposed that each state form a high-level committee to examine and supervise the use of state-specific and sector-specific funding. Finally, the XVth FC suggested that a threshold for yearly CSS allocation be set below which financing for CSS should be discontinued. All CSS should be evaluated by a third party within a set timeline, and the financing pattern should be established and maintained upfront in a transparent way.

Grants	Amount
Revenue deficit grants	2,94,514
Local government grants	4,36,361
Urban Local Bodies	1,21,055
Rural Local Bodies	2,36,805
Health Grants	70,051
Other Grants	8,450
Disaster management grants	1,22,601
Sector-specific grants	1,29,987
Health	31,755
School Education	4,800
Higher Education	6,143
Implementation of agricultural reforms	45,000
Maintenance of PMGSY roads	27,539
Judiciary	10,425
Statistics	1,175
Aspirational districts and blocks	3,150
State specific grants	49,599
Total	10,33,062

Table 3: XVth FC grant recommendations

Source: The Union Budget (2018-19)

In spite of the fact that the state's share of devolution is 41 percent of the divisible pool (according to the XVth Finance Commission), the actual percentage of tax devolution has been lower. In Budget 2018, it was 3.1 percent of the GDP, coming down from 4.03 percent pre-pandemic (in 2018-19). This is owing, in part, to a significant increase in cesses and surcharges. In just a few years, the share of total cess and surcharge in total taxes collected by the Union government climbed from 12 percent to 23 percent. The Constitution authorises the Centre to levy a cess for particular categories of spending, such as war or natural disasters. Nonetheless, it has also become an ad-hoc source of money for the Centre for some time. In

addition, grants to states have increased from 2.53 percent to 3.64 percent of the GDP, but CCS funding has decreased for the same time period from 65.14 percent to 44.71 percent of the GDP. (Figure 2) The rollout of direct benefit transfers (DBT) through the Public Finance Management System has been a major endeavour in public finance management (PFMS).

Moreover, the state's revenue is being stifled by the Goods and Service Tax (GST). The state's choice to relinquish income-raising powers was legally safeguarded for a five-year transition period (2017- 2019), assuming a constant annual growth rate of 14 percent over the 2015-16 revenue base. Any shortfall was to be covered by a compensation cess levied by the Centre. Ironically, numerous states have asked for GST reimbursement beyond the five-year term (ended June 2018) due to present deficiencies (as a result of the epidemic), but have thus been overlooked and ignored. Instead, the Centre has borrowed from the market and made sporadic loans to the states in lieu of compensatory cess for revenue shortfalls, resulting in a gross fiscal deficit of states. Similarly, notwithstanding the significant increases in capital expenditure in Budget 2018, a portion of the increase was due to an allocation of Rs 1 lakh crore to assist states in increasing capital expenditure through a 50-year interest-free loan – in addition to the normal borrowings allowed to them. This does not immediately raise state obligations, but it should be considered in light of Article 293 of the Constitution, wherein states must obtain authorization from the Centre to borrow if they are owed to it. The increased usage of loans to states (even if they are interest-free) has a direct impact on the Centre's ability to maintain control over state borrowings.

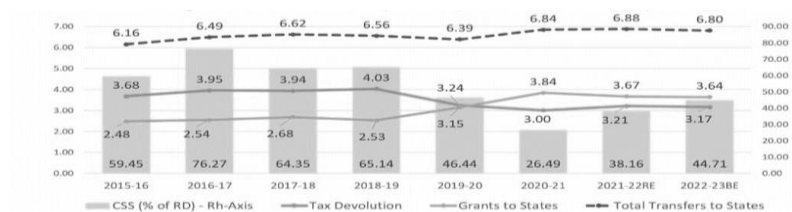


Figure 2: Central transfers to States (% of GDP): 2015-16

Source: Pinaki Chakraborty | NIPFP

WAY FORWARD

In recent years, India has experienced a progressive process of fiscal decentralisation, with a change in the distribution of spending and revenue toward state and local governments. This is seen in the increasing vertical devolution of shared taxes to states and other subnational entities. The growing vertical, on the other hand, reflects the fact that many States have depended primarily on transfers from the Union to support their expenditures rather than their own tax receipts. This reflects the significant vertical imbalances that result from the Union's and States effective allocation of expenditure and income capabilities. Unfunded expenditure requirements, poor provision of public services (both at the subnational level), and excessive subnational government borrowing are typical signs of inefficiency in addressing the vertical gap (resulting in vertical imbalance). Such imbalances are exacerbated by crises that produce a wider gap between subnational income and expenditure obligations, as we are witnessing with the Covid issue.

Despite increasing tax devolution from the Union, sub-national governments have been dealing with a 'scissors' effect, with declining revenues (due to tax bases linked to the economic cycle, as well as tax policy decisions to limit the impact on businesses and individuals) and rising spending pressures in critical areas of their responsibility, such as

health, education, and social security. Borrowing restrictions and fiscal limitations that apply to sub-national governments have exacerbated these impacts.

Clearly, counter-federal tendencies have been prominent in the fiscal domain. According to the constitutional structure of things, the Centre has robust sources of revenue and the States have bigger expenditure duties, particularly in the social sector. The states that collect an average of 38 percent of total taxes incur 60 percent of total spending. The FCs' constitutional process is being used to address this vertical imbalance. This constitutional structure would be rejected 'in spirit' if the central government attempted to undercut the function of the FCs.

Thus, untied resource flow from the Centre is preferable for a strong federal framework over tied and conditional grants, which limit the spending freedom of states in topics included in the State List of the Seventh Schedule of the Constitution. This goes against the nature of a functioning federal government. Flexible and untied resource flows in India dropped throughout the XIIth and XIIIth FC periods, but the XIVth FC reversed this tendency. However, the XVth FC indicates a change in awards.

Apart from that, the untied flow of resources (90 percent of which is tax devolution) is being reduced by central government activities, at a time when there is growing consensus that tax devolution has been 'substantially' increased to 41 percent by the XVth FC award, compared to 32 percent in the XIIIth FC award. This is accomplished in a variety of ways, including raising surcharges and cesses, as well as obfuscating net revenue computations. Apart from the reduced resource transfer, these measures are contrary to the principle of fiscal federalism enshrined in the Constitution.

Similarly, the XVth FC has created concern amongst states as better-off states suggest an incentive-based transfer while poor states suggest it should be given to meet the deficits in revenue expenditure. Also, it is clear that the 7th schedule requires a revision due to the financial burden it lays on states for the fulfilment of the laid entitlements without giving them adequate fiscal power. Lastly, the XVth FC stated that there are approximately 211 schemes/sub-schemes under the 29-umbrella core and core of the core schemes under the Centrally sponsored schemes and Central Sector Schemes.²⁰ But ironically there is no central entity to provide an overview of the CSS and how these could be amalgamated in the central sector outlays.

Despite certain flaws, India's intergovernmental fiscal arrangements have served the country effectively for more than 50 years. It has contributed to achieving a degree of cohesiveness in a large and diverse country by achieving significant equalisation over time, instituting a workable system of resolving outstanding issues between the Center and the States, as well as among the States, and adapting to changing requirements. As a result, it is becoming increasingly clear that there is no other option than to change the federal government's budgetary institutions, and that the issue must be tackled head-on by the country. Indeed, fiscal decentralisation has been shown to be positively connected with GDP per capita, educational results, and investment in physical and human capital in several studies. As a result, it is critical for any country to discover its ideal fiscal balance across all levels of government.

ENDNOTES

1. Customs charges, income tax, corporate tax, and central GST have been assigned to the centre, whilst state taxes include state GST, motor vehicle tax, value-added tax

- (VAT) on petroleum, stamp duty and registration fees, state excise duties, and electricity duty.
2. Population addressed in the XIVth FC is as per 1971 census but is set to change to 2011 census starting with the XVth FC.
 3. The Fertility rate in a state is examined by the Demographic performance indicator. If a state's fertility rate is lower, it means that it has made significant efforts to minimise its population growth rate, and it will receive a larger share as a result.
 4. XIVth FC utilised the term “demographic change”, which was defined as Population in 2011. The word “tax effort” was used in the 2018-19 report; the description of the criterion remains the same.

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