

## **Re-imagining Fiscal Federalism**

**Fiscal federalism is the key underpinning of our Republic and the assignment of taxes and responsibilities, as well as correction of vertical and horizontal imbalances, lies at the very core of fiscal federalism.**

The extant model, as enshrined in the Constitution, has stood us in good stead for the first 75 years of our existence as an independent republic. But as the country moves from the low-income to middle-income category, albeit with balanced regional development, it is, perhaps, time to re-think and re-imagine the form of fiscal federalism.

What should the contours of the new fiscal federalism be? What are the learnings from how Finance Commissions (FCs) have tackled vertical imbalance (arising from asymmetry in taxation powers and expenditure responsibilities) and horizontal imbalance (arising from the differential tax capacity of States vis-à-vis the shared responsibility to provide access to public goods of comparable quantity and quality to all regardless of residence)? How can we take care of the needs of the third tier of government? Is there a case for a re-look at the lists in the Seventh Schedule to the Constitution, especially the Concurrent List, a unique feature of the Indian federation? What has the GST experience taught us?

Here is a brief background note on fiscal federalism in India – the state of play and ideas for the future.

All federations, India included, are characterised by two kinds of imbalance: vertical and horizontal. Vertical imbalance arises on account of the dis-connect between the capacity/ability/willingness of the Union Government and State Governments to raise revenue. Horizontal imbalance, on the other hand, arises among the States as a consequence, partly of their differing resource endowments, levels of development and standard of delivery of public service, and partly as a consequence, once again, of their differing capacity/ability/willingness to raise revenue. A third imbalance, often referred to as ‘Development Imbalance’, refers to regional disparities in terms of per capita incomes between States and within States, and is often a consequence of vertical and horizontal imbalance.

India’s fiscal federal architecture is derived from the distribution of powers between the Union and the federating units or States as laid down in the Constitution. It aims to match the taxation rights of the States and the Union with their expenditure responsibilities, and where, for a variety of reasons, we do not have the best fit, to try and compensate for the lacunae through institutional mechanisms like the quinquennial FCs.

### **Constitutional Provisions**

The Seventh Schedule under Article 246 of the Constitution deals with the division of powers between the Union and the States. It contains three lists: Union list, State List, and Concurrent List. The Union List details the subjects on which Parliament may make laws while the State List details those under the purview of State legislatures. The Concurrent List, on the other hand, has subjects in which both Parliament and State legislatures have jurisdiction. However, the Constitution provides federal supremacy to Parliament on Concurrent List items in case of a conflict.

Since 1950, the Seventh Schedule has seen a number of amendments. The Union and Concurrent Lists have grown while subjects under the State List have gradually

reduced. As on date, there are 100 (originally 97) subjects in the Union List, 61 (originally 66) in the State List and 52 (originally 47) in the Concurrent List. The Constitution, recognising the inherent vertical and horizontal imbalances in our Republic, provided for the setting up of a FC (article 280 of the Constitution) every five years.

The Commission is constituted by the President mainly to give its recommendations on distribution of tax revenues between the Union and the States, and amongst the States themselves. Two distinctive features of the Commission's work involve redressing the vertical imbalances between the taxation powers and expenditure responsibilities of the Centre and the States, respectively, and equalisation of all public services across the States.

It is the duty of the Commission 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 the respective shares of such proceeds;
- the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India;
- the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats in the State on the basis of the recommendations made by the FC of the State;
- the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Municipalities in the State on the basis of the recommendations made by the FC of the State;
- any other matter referred to the Commission by the President in the interests of sound finance.

Successive FCs have played an important role in strengthening fiscal federalism. Over the years, the share of States in overall taxes has steadily increased. Starting from the First FC that recommended that the share of States in the Union excise duties be 40 per cent of the proceeds of the tax on three commodities, 25 per cent of the proceeds of the tax on eight commodities and 20 per cent of the proceeds of the tax on 35 commodities, respectively to now the latest 15<sup>th</sup> FC recommending the States' share at 41%, each FC has put its distinct imprimatur on these reports.

The 10<sup>th</sup> FC combined all the taxes into one combined pool for the purpose of devolution rather than doing it based on some specific taxes. The 13<sup>th</sup> FC opened up the possibility of formulaic tax devolution to the third tier, the 14<sup>th</sup> FC increased the tax devolution of the divisible pool to states to 42% for years 2015 to 2020 (prima facie, 10% more compared to 32% set by the 13<sup>th</sup> FC, though it has been argued the real rise was less - from 39.3% to 42%). The 15<sup>th</sup> FC was constituted by the President on 27 November 2017 under the Chairmanship of Mr N.K. Singh to make recommendations for the period 2020- 2025. It recommended the share of States in the central taxes for the 2021-26 period at 41%. This is less than the 42% share recommended by the 14<sup>th</sup> FC for the 2015-20 period. The adjustment of 1% is to provide for the newly formed Union Territories of Jammu and Kashmir, and Ladakh from the resources of the Centre.

Many observers – former Chief Economic Advisor, Arvind Subramanian, Chairman, 13<sup>th</sup> FC, Vijay Kelkar, and Haseeb Drabu, former Finance Minister, J&K, among others, have called

for a New Fiscal Federalism to deal with the challenges post the abolition of the Planning Commission, introduction of GST, etc. The rise of regional political parties and increasing expectations from State governments, especially after the pandemic, have brought this issue to the front burner.

Haseeb Drabu (2019) has flagged three points: one, the need for a new model of fiscal federalism, focusing on revenue sharing and not expenditure underwriting; two, the need for resource sharing instead of revenue sharing, as India is a raw-material deficit economy; and three, the need for an institutional relationship between the GST Council and the FC.

Some of the issues that need to be fleshed out and debated include:

- Has policy autonomy been eroded at the State level? How do we address the trust deficit between the States and the Union Government?
- Has there been an increase in vertical fiscal imbalance over the years?
- Is there a need for an institution to redress spatial inequalities resulting from the vacuum created by abolishing the Planning Commission; does the formula for *inter-se* distribution of tax revenues need to be revised?
- Should FCs be made permanent? Or should they be abolished altogether by making the tax devolution share constant through a constitutional amendment?
- Should Article 282 of the Constitution: ‘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’, be repealed/amended, given that it has often been misused even though it envisages only a residuary power?
- Should there be any formal institutional mechanism linking the GST Council and FCs?
- Should India devise a mechanism of transfer that is predominantly based on sharing of grants for equalisation of services rather than tax sharing?
- Does Article 293 (3) put States in a disadvantageous position vis-à-vis the Union Government, in that while there is no constitutional check over borrowings by the Central Government, Article 293 (3) provides a constitutional check over State borrowings?
- What is a plausible framework for debt-deficit dynamics that keeps the fiscal autonomy of States intact and ensures output gap reduction and public investment at the subnational level without creating disequilibrium?
- How can we ensure that the 3<sup>rd</sup> tier of the government – Panchayati Raj institutions and local bodies—get sufficient funds?

Y.V. Reddy, Chairman of the 14<sup>th</sup> FC, and G.R. Reddy, in their book, *Indian Fiscal Federalism*, highlight the need for a fresh look at the challenges and possible answers to better suit our needs. Lekha Chakraborty, in her working paper for Levy Institute (October 2019), ‘Indian Fiscal Federalism at the Crossroads’, says, “These debates are significant, especially when a group of States came together for the first time ever to question the terms of reference of the 15<sup>th</sup> Finance Commission amid growing tensions in federal-State relations in India.’