India’s Fiscal Federalism

In India, the Finance Commission and the Planning Commission promote fiscal federalism by carrying out systemic fiscal transfers in the nature of devolution or conditional ones but with the replacement of Planning Commission by NITI Aayog there is an urgent need for revisiting and redefining the fiscal architecture of India.

India’s Fiscal Federalism:

- The Government of India Act 1919 and 1935 formalized the tenets of fiscal federalism and revenue sharing between the Centre and the states.
- The 14th Finance Commission chaired by Dr. Y V Reddy, recommended 42% devolution of revenue to the states.
- Goods and Services Tax was introduced in 2017 to streamline India’s indirect tax structure as a measure to promote cooperative federalism in India, giving the states an enhanced role in formulating and implementing the overhauled taxation system.
- The NITI Aayog established in 2015 was expected to address new realities of macroeconomic management that were missed by the Planning Commission.

Need for Redefining India’s Fiscal Federalism

Horizontal imbalances and rising regional inequalities: Replacing the Planning Commission (which was mandated to give grants to the states as conditional transfers using the Gadgil-Mukherjee formula) with NITI Aayog (Government think tank with no resources to dispense) has reduced the policy outreach of government by relying only on single instrument of fiscal federalism i.e Finance commission. This approach if not reviewed can lead to a serious problem of increasing regional and sub-regional inequities.

Restructuring the Fiscal Federalism

India’s Fiscal Federalism needs to be restructured around the four pillars namely Finance Commission, NITI Aayog, GST and decentralization in order to eliminate the inadequacies of vertical and horizontal imbalances.

1. **Finance Commission** must be relieved from the dual task of dealing with provision of basic public goods and services and capital deficits. It should be confined to focussing on removal of basic public goods imbalance (Type I).
2. **NITI Aayog** can serve as the second pillar for dealing in the realm of infrastructure and capital deficits (Type II).
   - It should be engaged with the allocation of capital in a way different than that used by the...
Finance Commission with different parameters for allocation.

- Regional Imbalances: NITI Aayog should receive significant resources (1% to 2% of the GDP) to remove regional and subregional disparities among states by reducing development imbalances in the areas of infrastructure deficit.
- Independent Evaluation Office: NITI Aayog should be mandated to create an independent evaluation office which will monitor and evaluate the efficacy of the utilization of revenue and capital grants.
- Decision-Making Body: It should also be an integral part of the decision making processes as it can effectively negotiate between the states for the transfer of resources.

3. Decentralization can serve as the third pillar of the new fiscal federalism by strengthening local finances and state finance commission. The creation of an urban local body/Panchayati Raj institutions consolidated fund.

- Centre and States should contribute an equal proportion of their Central GST (CGST) and State GST (SGST) collections and send the money to the consolidated fund of the third tier.
- One-sixth sharing of the CGST and SGST with the third tier can generate more than 1% of the GDP every year for the financing of public goods by urban-level bodies.
- State Finance Commissions should be accorded the same status as the Union Finance Commission and the 3Fs of democratic decentralization (funds, functions, and functionaries) should be implemented properly.

4. Goods and Services Tax should be simplified in its structure and can serve as the fourth pillar of our fiscal federalism, by ensuring:

- Single Rate GST: with suitable surcharges on “sin goods,” (goods that are harmful to society and individuals, for example, alcohol and tobacco, drugs, etc), zero ratings of exports and reforming the Integrated Goods and Services Tax (IGST) and the e-way bill.
- Transparency: The GST Council should undertake reforms in an informed and transparent manner, by creating its own secretariat and independent experts (as its staff).

Challenges of fiscal federalism

- Fiscal federalism is the economic counterpart to political federalism.
- It assigns functions to different levels of government and also offers appropriate fiscal instruments for carrying out these functions.
- Determination of these specific fiscal instruments is a challenging task.
- Building the principles into an actual scheme of assignment of taxes to different levels of government in a Constitution is difficult.
- In India, income tax is levied only by the Central government though shared with the States.
- Given the possibility of imbalance between resources and responsibilities, many countries have a system of inter-governmental transfers.
- There is huge economic and cultural diversity among the various States. It is a terrible mistake to presume that all of India can be governed from Delhi.
- Elected State governments and leaders cannot be made dummies without any fiscal powers for long.
- This fiscal federalism tension between the Centre and States can erupt into something more dangerous and spread wide.