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A CRITIC ON LEGAL STASIS OF FISCAL FEDERALISM IN INDIA

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ABSTRACT

This comprehensive analysis delves into the legal intricacies surrounding fiscal federalism in India, tracing its origins to the 1970s. The federal structure, enshrined in the Constitution, distributes financial powers among the central, state, and local governments to ensure efficient service delivery and promote economic activity. Examining resource-sharing mechanisms, challenges, and the role of the Finance Commission, the study critiques the current imbalance in resource allocation, exemplified by the Union's grant distribution. It scrutinizes the adverse effects of population-based budget allocation and advocates for reforms to uphold fiscal federalism's core principles. Ultimately, it warns against central encroachment on state autonomy, emphasizing the urgency of rectifying disparities to foster equitable development nationwide.

INTRODUCTION

The Roots of Fiscal Federalism in India, India's system of managing public finances through a federal structure has roots dating back to the 1970s. Even though India had a unitary government then, dividing responsibilities and financial powers between the central and state governments proved to be a practical necessity. This system, known as fiscal federalism, involves distributing the tasks of taxation and public spending across different levels of government: central, state, and local. It aims to achieve efficiency by providing public services at a larger scale (economies of scale) and tailoring them to better meet people's needs. Additionally, it fosters economic activity by creating a unified national market.[2]

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[2] Srivastava, D.K., Revenue Sharing Among the Sub-National Governments: A modified Formula, 'NIPFP Working Paper No. 1 cited by Agarwal, P.K., Fiscal federalism and Governance in India ,68, (New Delhi: Oxford Publications, 2000)

INDIA'S FEDERAL STRUCTURE AND FINANCIAL DISTRIBUTION

India's federal system relies on a federal finance system. The core principle is that both the central and state governments should be financially independent, with their own means to generate enough revenue to carry out their assigned duties. The Seventh Schedule of the Constitution (Article 246) outlines how these responsibilities are divided. It establishes three lists:

Union List (List I): Exclusive powers of the central government, including defense, foreign affairs, and national taxes (except for agricultural income).
State List (List II): Exclusive powers of state governments, encompassing areas like public order, healthcare, and agriculture.
Concurrent List (List III): Areas where both central and state governments can make laws, such as trade and commerce.

The division of authority extends to taxation as well. The Union List includes taxes on income (excluding agriculture), excise duties, customs duties, and corporate tax. State governments have the power to levy land revenue, taxes on alcohol, agricultural income, and various other goods and services.

RESOURCE SHARING MECHANISMS

The Constitution enables the transfer of resources from the center to states in various ways:

1. **Sharing of central tax revenue:** This includes a mandatory share of income tax and optional participation in excise duties.
2. **Grants:** These can be provided for specific purposes or general financial support.

CHALLENGES AND CONSIDERATIONS

Ahluwalia, Montek "Economic Performance of States in Post-Reforms Period",Economic and Political Weekly, May 6, pp 1637-1648. (2001),
Anand, Mukesh, Amaresh Bagchi and Tapas K. Sen "Fiscal Discipline at the State level: Perverse Incentives and Paths to Reform", Working Paper No. 1, January, (2002)

While states have responsibilities for public spending, their tax base might be limited. The document highlights a potential concern: changing the share of central resources requires a less stringent process compared to modifying state taxation powers.

This system acknowledges the need for financial autonomy for states while recognizing the central government's role in resource sharing. However, it also grapples with the inherent tension between legislative independence and potential financial dependence, especially in a developing economy where states' responsibilities might grow faster than their revenue sources.

DIVISIBLE POOL OF TAXES: OVERVIEW

1. ARTICLE 270: DISTRIBUTION FRAMEWORK

This article in the Indian Constitution establishes a framework for dividing the net proceeds (total revenue minus collection charges) of certain taxes between the central government and the states. It does not specify the exact share for each level but empowers the Parliament to enact laws determining the principles for sharing.

2. SHARED TAXES: DIVISIBLE POOL

The taxes included in the shared pool are those levied and collected by the central government but shared with the states.

Some examples include:

Corporation Tax: Profit tax for corporate institutions.

Income Tax (except agricultural income): Tax on individual income.

Central GST (CGST): The central component of the Goods and Services Tax (GST) levied on the supply of goods and services within a state.

Centre's Share of Integrated Goods and Services Tax (IGST): A portion of the IGST levied on interstate transactions goes to the central government.

3. FINANCE COMMISSION: BALANCING ACT

The Finance Commission is a critical body established under **Article 280** of the Constitution.
It is instituted for five years by the President of India.
The commission plays a crucial role in recommending the following:

Vertical Devolution: The percentage share of the central tax pool to be transferred to the states. This is currently around **41%** as per the **15th Finance Commission** recommendations.

Horizontal Devolution: How the share of taxes allocated to states should be further distributed amongst them. This considers factors like income distance, population, tax effort, fiscal discipline, poverty level, and economic development of each state.

Grants-in-aid: Additional financial assistance provided by the central government to states for specific purposes like social welfare programs or disaster relief.

4. 16TH FINANCE COMMISSION: LOOKING AHEAD

The 16th Finance Commission, chaired by Arvind Panagariya, is responsible for determining the principles of tax devolution and recommending grants for the period 2026-2031.
They will consider various factors like economic development, demographic changes, and fiscal needs of each state to recommend a fair and equitable distribution of tax resources.[3]

FACTORS THAT AFFECT THE ALLOCATION OF RESOURCES TO STATES

[3]. Explained: Financial Devolution among States - https://www.civilsdaily.com/story/finance-commission-issues-related-to-devolution-of-resources/

Consumption Patterns: As you mentioned, states with a higher propensity to consume goods and services will see a larger share of the GST pie. This is because GST is levied at the point of consumption. States with a larger and more affluent population tend to have higher consumption levels, leading to a greater contribution to the tax pool and a higher share in resource allocation.

Population and Demographics: Population size is a factor, but it is not the sole determinant. Larger states with a younger population and higher disposable income are likely to have a larger tax base and contribute more to GST revenue. However, this needs to be balanced with other factors like poverty levels to ensure equitable distribution.

Fiscal Capacity and Revenue Generation: States with a strong fiscal track record, meaning they can efficiently collect taxes and utilize resources, might be rewarded with a higher allocation. This incentivizes sound financial management practices.

Economic Development and Industrialization: States with a booming industrial sector and a diversified economy will generate more GST revenue due to higher production and consumption. This translates to a larger share in resource allocation, allowing them to further invest in infrastructure and development.

Geographical Location and Connectivity: States with strategic locations, well-developed ports, and good transportation networks act as hubs for trade and commerce. This can lead to higher economic activity and GST revenue generation, influencing their resource allocation positively.

Tax Compliance and Administration Efficiency: States with robust tax administration systems that ensure high levels of compliance will likely receive a fairer share of resources. Effective tax collection minimizes leakages and ensures a more accurate reflection of the state's economic activity in the GST pool.

State-Specific Needs and Priorities: The GST Council considers the specific needs and development priorities of each state. This could include factors like infrastructure development needs, spending on education and healthcare, or social welfare programs for vulnerable populations. States with greater social needs might receive a higher allocation to bridge those gaps.

Inter-State and Intra-State Supply Determination: Distinguishing between inter-state (between states) and intra-state (within a state) supplies is crucial for accurate revenue allocation. The location of the supplier and the place of consumption determine which state gets the credit for the collected GST. A robust system for identifying these categories ensures fair distribution.

GST Network (GSTN): The GST Network (GSTN) is a crucial IT infrastructure for seamless tax administration and data exchange across states. Effective utilization of this platform allows for transparent allocation decisions based on accurate data.

Special Category Status: States with special category status are those facing specific challenges such as hilly terrains, low-income levels, or other unique circumstances. These states receive additional incentives and benefits under GST. Some of the Incentives and Benefits for the states are:

Lower Tax Rates: States with special category status may enjoy reduced tax rates on certain goods and services.

Additional Grants: They receive additional financial grants from the central government to support development projects.

Priority Funding: Special category states receive priority funding for infrastructure, education, healthcare, and social welfare.

Tax Exemptions: Some goods and services are exempted from GST in these states.

The following is the list of Special Category States in India:

1) Arunachal Pradesh
2) Assam

3) Himachal Pradesh

4) Jammu and Kashmir (currently a union territory)

5) Manipur

6) Meghalaya

7) Mizoram

8) Nagaland

9) Sikkim

10) Tripura

11) Uttarakhand

ISSUES WITH GST ALLOCATION TO TAMILNADU[4]

ANNEX-4

STATEMENT SHOWING STATE-WISE DISTRIBUTION OF NET PROCEEDS OF UNION TAXES AND DUTIES FOR BE 2024-25

(₹ crore)

Sl. No.	State	Share (per cent)*	Corporation Tax (0020)	Income Tax@ (0021)	Wealth Tax (0032)	Central GST (0005)	Customs (0037)	Union Excise Duty (0038)	Service Tax (0044)	Other Taxes and Duties (0045)	Grand Total # (4 to 11)
1	2	3	4	5	6	7	8	9	10	11	12
1	Andhra Pradesh	4.047	15502.14	17081.54	-0.50	15092.15	1007.31	602.32	1.66	77.99	**49364.61**
2	Arunachal Pradesh	1.757	6730.24	7415.93	-0.22	6552.24	437.32	261.50	0.72	33.86	**21431.59**
3	Assam	3.128	11981.89	13202.63	-0.38	11665.00	778.57	465.54	1.28	60.28	**38154.81**
4	Bihar	10.058	38527.43	42452.72	-1.23	37508.50	2503.47	1496.93	4.12	193.82	**122685.76**
5	Chhattisgarh	3.407	13050.60	14380.24	-0.42	12705.45	848.01	507.06	1.40	65.65	**41557.99**
6	Goa	0.386	1478.58	1629.23	-0.05	1439.48	96.08	57.45	0.16	7.44	**4708.37**
7	Gujarat	3.478	13322.57	14679.91	-0.43	12970.23	865.69	517.63	1.43	67.02	**42424.05**
8	Haryana	1.093	4186.77	4613.32	-0.13	4076.04	272.05	162.67	0.45	21.06	**13332.23**
9	Himachal Pradesh	0.830	3179.34	3503.26	-0.10	3095.25	206.59	123.53	0.34	15.99	**10124.20**
10	Jharkhand	3.307	12667.55	13958.16	-0.41	12332.53	823.12	492.18	1.36	63.73	**40338.22**
11	Karnataka	3.647	13969.93	15393.23	-0.45	13600.47	907.75	542.78	1.50	70.28	**44485.49**
12	Kerala	1.925	7373.76	8125.02	-0.24	7178.75	479.14	286.50	0.79	37.09	**23480.81**
13	Madhya Pradesh	7.850	30069.63	33133.21	-0.96	29274.38	1953.89	1168.32	3.22	151.27	**95752.96**
14	Maharashtra	6.317	24197.44	26662.74	-0.77	23557.48	1572.32	940.16	2.59	121.73	**77053.69**
15	Manipur	0.716	2742.66	3022.09	-0.09	2670.12	178.22	106.56	0.29	13.80	**8733.65**
16	Meghalaya	0.767	2938.01	3237.35	-0.09	2860.31	190.91	114.15	0.31	14.78	**9355.73**
17	Mizoram	0.500	1915.26	2110.40	-0.06	1864.61	124.45	74.42	0.21	9.64	**6098.93**
18	Nagaland	0.569	2179.57	2401.63	-0.07	2121.93	141.63	84.68	0.23	10.96	**6940.56**
19	Odisha	4.528	17344.62	19111.74	-0.56	16885.91	1127.04	673.90	1.86	87.25	**55231.76**
20	Punjab	1.807	6921.76	7626.97	-0.22	6738.70	449.77	268.94	0.74	34.82	**22041.48**
21	Rajasthan	6.026	23082.75	25434.49	-0.74	22472.28	1499.89	896.85	2.47	116.12	**73504.11**
22	Sikkim	0.388	1486.24	1637.67	-0.05	1446.94	96.57	57.75	0.16	7.48	**4732.76**
23	Tamil Nadu	4.079	15624.72	17216.61	-0.50	15211.49	1015.28	607.08	1.67	78.60	**49754.95**
24	Telangana	2.102	8051.77	8872.10	-0.26	7838.82	523.20	312.84	0.86	40.51	**25639.84**
25	Tripura	0.708	2712.01	2988.32	-0.09	2640.29	176.22	105.37	0.29	13.64	**8636.05**
26	Uttar Pradesh	17.939	68715.81	75716.75	-2.18	66898.49	4465.09	2669.85	7.35	345.68	**218816.84**
27	Uttarakhand	1.118	4282.53	4718.84	-0.14	4169.26	278.27	166.39	0.46	21.54	**13637.15**
28	West Bengal	7.523	28817.05	31753.01	-0.92	28054.92	1872.50	1119.65	3.08	144.97	**91764.26**
	TOTAL	**100.000**	**383052.63**	**422079.11**	**-12.26**	**372922.02**	**24890.35**	**14883.00**	**41.00**	**1927.00**	**1219782.85**

\# The figures are provisional and may change in view of any outstanding dues payable or recoverable from the Union or State Governments.
* As per accepted recommendations of the Fifteenth Finance Commission, the States' share has been fixed at 41% of the net proceeds of shareable Central Taxes.
@ Income Tax includes Securities Transaction Tax (STT).

Receipts Budget, 2024-2025 23

Uttar Pradesh stand at the top as it is the most populous state and thereby receipting higher budget allocations than the other states but while comparing its tax contribution to the Union Funds through tax is less than State of Tamil Nadu. The states that are under the special category status is not taken into consideration for the analysis.

The central administration in the 15th Finance Commission has made the method of allocation by population which clearly unjust considering the level of industries and infrastructures developments in progress in the potential states. This method of allocation clearly collects major funds from many states and distributes it to few states which does not requires the quant allocated, leaving behind the contributing state which has a constitutionally righteous demand before the Central Government for its resource allocation.

[4] Indian Budget 2024-2025, https://www.indiabudget.gov.in/doc/rec/annex4.pdf (Last visited 19.03.2024)

Some of the states are demanding for special category status such as:

Bihar:

- **Resource Constraints:** Bihar attributes its poverty and underdevelopment to the scarcity of natural resources, erratic water availability for irrigation purposes, persistent flooding in the northern regions, and prolonged droughts in the southern parts of the state.
- **Industrial Transition:** The division of the state resulted in the migration of industries to Jharkhand, consequently generating unemployment and creating gaps in investment opportunities.
- **Per-Capita GDP:** Bihar's per-capita GDP consistently ranks among the lowest in India.
- **Social Welfare Funding:** Chief Minister Nitish Kumar claims that Bihar accommodates around 94 lakh impoverished families, and obtaining Special Category Status (SCS) would unlock essential funding for social welfare programs over the ensuing five years.

Andhra Pradesh: Seeking SCS due to revenue loss post-Hyderabad's transfer to Telangana

Odisha: Appeals for SCS due to vulnerability to natural disasters and a significant tribal population.

Similarly, if the above reasons justify the cause of giving increased allocation to other states the Tamil Nadu has also faced natural disasters such as Cyclone Michaung left Chennai and surrounding areas marooned. Torrential rains hit several districts in southern Tamil Nadu, affecting lives and livelihoods, which was not considered by the Union to increase the allocation

REVISITING INDIA'S FISCAL FEDERALISM:

Federalism vs. Reality: India's Constitution envisions a **"holding together federation"** with a strong central government. However, the article suggests that the system might be tilting towards excessive central control, impacting states' financial autonomy.

GST and Revenue Shortfall: The introduction of the Goods and Services Tax (GST) aimed to simplify the tax structure but may have reduced states' control over revenue collection. While a five-year compensation plan initially addressed this concern, its expiration in 2022 has left states potentially facing shortfalls.

Vertical Imbalance: The concept refers to a mismatch between states' responsibilities and their ability to generate revenue. The article suggests that states have greater spending requirements (healthcare, education) but rely heavily on central government transfers to finance them.[5]

Transparency and Predictability: Concerns exist regarding the complexity and opacity of the system for transfers and grants from the center to states. This lack of transparency makes it difficult for states to plan their budgets effectively.

What we can Suggest to Revisit:

- Strengthening institutions like the Finance Commission to ensure fair and transparent resource allocation.
- Reviewing the use of additional levies (cesses and surcharges) on top of existing taxes. Currently, states do not receive a share of this additional revenue.
- Increasing state autonomy in making taxation and expenditure decisions.

Overall, emphasizes the need to revisit India's fiscal federalism to achieve a better balance between central authority and state autonomy. This could lead to more efficient resource allocation and improved development outcomes across the country.

THE UNION GOVERNMENT'S VERTICAL IMBALANCE IN ALLOCATING CENTRAL GRANTS IN AID:

[5] Bagchi, Amresh, "Tax Harmonization in Federalism- A survey of theory and Practice', NIPFP Working Paper no.1, February. (1995)

The central government is not **"Quant-equipoise"** allocates or unevenly distributes its grants to state without a justifiable grounds for it, this has led to downsizing of potential states in their performance and growth, like wise we have considered the State of Tamil Nadu as a potential state economy to analysis this issues.

The central allocation of the tax receipts is uneven, unjust and, further the response of center to the aid and help to State of Tamil Nadu during the year 2023-2024 was reduced drastically even when the state suffered a major loss and disaster due to continues three floods by heavy rains which covered the major cultivating landscape and IT sector of the state but the center allocated only 3-4% of the claimed value for aid for the State of Tamil Nadu.

From the below chart we may observe the downsize of the Grants in Aids from center to fall below in negative of **-31%** during 2023-2024 financial year.[6] The present government is not neutrally framing the grant distributions among the states which are in need of funds to overcome their fiscal hindrances having greater potential in contribution more if aided adequately.

BREAK-UP OF THE TAMIL NADU STATE GOVERNMENT'S RECEIPTS (IN RS CRORE)

Sources	**2021-22 Actuals**	**2022-23 BE**	**2022-23 RE**	**% change from BE 22-23 to RE 22-23**	**2023-24 BE**	**% change from RE 22-23 to BE 23-24**
State's Own Tax	1,22,866	1,42,800	1,51,871	6%	1,81,182	19%
State's Own Non-Tax	12,117	15,537	15,309	-1%	20,224	32%
Share in Central	37,459	33,311	38,731	16%	41,665	8%

[6] PRS, State of Tamil Nadu Budget Analysis, (2023-2024), [Tamil Nadu Budget Analysis 2023-24 (prsindia.org)](https://prsindia.org) (last visited 19.03.2024)

Taxes						
Grants-in-aid from Centre	**35,051**	**39,759**	**39,748**	**0%**	**27,445**	**-31%**
Revenue Receipts	**2,07,492**	**2,31,407**	**2,45,660**	**6%**	**2,70,515**	**10%**
Non-debt Capital Receipts	5,355	5,230	1,141	-78%	2,731	139%
Net Receipts	**2,12,847**	**2,36,638**	**2,46,800**	**4%**	**2,73,246**	**11%**

WHETHER THE TERM OF REFERENCE (TOR) ON POPULATION BASIS TO ALLOCATE BUDGET FITS IN FISCAL FEDERALISM OF INDIA:

No, the Term of Reference based on population to allocate the Budget for the states from the Union budget is baseless and intends to centralize the control of the state fiscal autonomy which is against the principles of revenue sharing and federalism in India constitutionally. Even though the Union act in its starting point seems to be valid legally, on its impact factor at the root level is devastating by curbing the hands of the state to act freely in its developmental course.

The basis of population is an unfavourable factors for those state where the population is highly educated and the income earning capacity is higher in smaller population compared to the other highly populated states with low Average income levels. The contribution of one Doctor in a society is equal to 100 daily wage labourers, which is not being considered and this basis will only result in stagnation of the state's progress.

CONCLUSION

This research findings indicate a departure from the established principles and framework of Fiscal Federalism within the Indian context by the Central Government. This departure has resulted in a crisis concerning the autonomy of states in their developmental endeavours, as well as a reduction in the adequacy of grants allocated to states, particularly during times of emergency. For instance, during the floods of 2023-2024 in the State of Tamil Nadu, there was a notable inadequacy in the funds disbursed by the central government.

The Central Government's approach toward the states poses a significant threat to the foundational Basic structure of the Indian Constitution, particularly with regard to its federal character. Such actions contravene the established norms and principles governing the federal structure within the Indian economy, consequently exacerbating issues such as rising unemployment, underemployment, and inflationary pressures on essential commodities within the Indian market.

1. Fiscal Federalism Framework: However, recent trends suggest a deviation from these principles, with the central government exerting disproportionate control over fiscal matters, thereby undermining the autonomy of the states.

2. Grant Allocation Dynamics: However, empirical evidence indicates a decline in the adequacy of such grants, particularly during exigencies like natural disasters, as evidenced by the insufficient funds provided to Tamil Nadu during the 2023-2024 floods.

3. Constitutional Implications: The actions of the Union Government in disregarding the principles of Fiscal Federalism have grave constitutional implications, particularly concerning the basic structure of the Indian Constitution. By impeding the autonomy of states in fiscal matters, the federal structure enshrined in the Constitution is undermined, posing a significant threat to the democratic and federal fabric of the nation.

4. Socioeconomic Ramifications: The erosion of fiscal autonomy at the state level exacerbates socioeconomic challenges, including unemployment and underemployment. Furthermore, the inadequacy of central grants during emergencies contributes to inflationary pressures on essential commodities, thereby burdening the populace and disrupting market stability.

The deviation from the principles of Fiscal Federalism by the Central Government not only undermines the constitutional framework of the Indian state but also exacerbates socioeconomic challenges, thus necessitating urgent reforms to restore the balance of fiscal powers between the center and the states.[7]

[7] https://thewire.in/government/fiscal-federalism-finance-commission-states-taxes (Last Visited: 19.03.2024)