Poor state of India’s fiscal federalism

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[GS Paper 2 – Indian Constitution, Federalism]

Context – The centralisation of fiscal powers in India has been blamed for the poor fiscal health of the states.

Background of Fiscal Powers in India

- Jawaharlal Nehru believed that socio-economic inequalities could be addressed through the planning process. A degree of centralisation in fiscal power was required to address the concerns of socio-economic and regional disparities. As a result asymmetric federalism is inherent to the Indian Constitution.

- India was never truly federal — it was a ‘holding together federalism’ in contrast to the ‘coming together federalism,’ in which smaller independent entities come together to form a federation (as in the United States of America).

- In fact, the Government of India Act 1935 was more federal in nature than the Constitution adopted on January 26, 1950 as the first offered more power to its provincial governments.

- Historically, India's fiscal transfer worked through two pillars, i.e., the Planning Commission and the Finance Commission.

- But the waning of planning since the 1990s, and its abolition in 2014, led to the Finance Commission becoming a major means of fiscal transfer as the commission itself broadened its scope of sharing all taxes since 2000 from its original design of just two taxes — income tax and Union excise duties.

- Today, the Finance Commission became a politicized institution with arbitrariness and inherent bias towards the Union government.

- The Tamil Nadu government constituted a committee under Justice P.V. Rajamannar in 1969, the first of its kind by a State government, to look at Centre-State fiscal relations and recommend more transfers and taxation powers for regional governments.

Declining fiscal capacity of the states

- While States lost their capacity to generate revenue by surrendering their rights in the wake of the Goods and Services Tax (GST) regime, their expenditure pattern too was distorted by the Union's intrusion, particularly through its centrally sponsored schemes.

- The ability of States to finance current expenditures from their own revenues has declined from 69% in 1955-56 to less than 38% in 2019-20. While the expenditure of the States has been shooting up, their revenues did not.

- Stagnant revenue: Since States cannot raise tax revenue because of curtailed indirect tax rights — subsumed in GST, except for petroleum products, electricity and alcohol — the revenue has been stagnant at 6% of GDP in the past decade.

Implications of Fiscal Centralization

- Use of non-divisive cess: Even the increased share of devolution, mooted by the Fourteenth Finance Commission, from 32% to 42%, was subverted by raising non-divisive cess and surcharges that go directly into the Union kitty.

- This non-divisive pool in the Centre's gross tax revenues shot up to 15.7% in 2020 from 9.43% in 2012, shrinking the divisible pool of resources for transfers to States.

- Cut in the corporate tax: The recent drastic cut in corporate tax, with its adverse impact on the divisible pool, and ending GST compensation to States have had huge consequences.

- States paying high interest rates: States are forced to pay differential interest — about

10% against 7% — by the Union for market borrowings.

- Centrally sponsored schemes curbing autonomy: There are 131 centrally sponsored schemes, with a few dozen of them accounting for 90% of the allocation, and States required to share a part of the cost.
- They spend about 25% to 40% as matching grants at the expense of their priorities.
- These schemes, driven by the one-size-fits-all approach, are given precedence over State schemes, undermining the electorally mandated democratic politics of States.
- In fact, it is the schemes conceived by States that have proved to be beneficial to the people and that have contributed to social development.
- Driven by democratic impulses, States have been successful in innovating schemes that were adopted at the national level.
- The diversion of a State's own funds to centrally sponsored schemes, thereby depleting resources for its own schemes, violates constitutional provision.
- Deepening inequality: The World Inequality Report estimates that the ratio of private wealth to national income increased from 290% in 1980 to 555% in 2020, one of the fastest such increases in the world.
- The poorest half of the population has less than 6% of the wealth while the top 10% nearly grab two-third of it'.
- India's tax-GDP ratio has been one of the lowest in the world — 17% of which is well below the average ratios of emerging market economies and OECD countries' about 21% and 34%, respectively.
- Its income tax base has been very narrow. Indirect tax still accounts for about 56% of total taxes.
- Instead of strengthening direct taxation, the Union government slashed corporate tax from 35% to 25% in 2019 and went on to monetise its public sector assets to finance infrastructure.

Conclusion

In sum, India's fiscal federalism driven by political centralisation has deepened socio-economic inequality, belying the dreams of the founding fathers who saw a cure for such inequities in planning. It has not altered inter-state disparities either.