DAILY EDITORIAL ANALYSIS

TOPIC

The Erosion of Fiscal Federalism

THE EROSION OF FISCAL FEDERALISM

In Context

- The Kerala government has accused the Centre of pushing the State into a severe financial crisis by imposing a limit on its borrowings.

Development of fiscal federalism in India

- Fiscal functions are carried out by the different tiers of a government in a country.
- The number of tiers of government involved in the fiscal functions differ from one country to another depending upon the federal structure of the government.
    - For instance, the **USA, India and Australia have a three-tier federal structure.**
- At the core of fiscal federalism in India lie **fiscal transfers from the central government to subnational governments.**
- **Article 268 to 281** of the Indian Constitution deals with the distribution of revenue between the **Union and the States.**
- Transfers are predominantly based on the recommendations of the **Finance Commission a**nd consist of **tax devolution and grants.**

Do you know?

- **Article 280(1) of the Constitution**s lays down that the modalities for setting up of a **Finance Commission**
- It is appointed after every **five years or earlier** to make recommendations to the President regarding the distribution of shared taxes, grants-in-aid and any other matter referred to the Commission.
- Subsequent to the **73rd and 74th amendment of the Constitution** and insertion of clause (3) to Article 280, the Commissions started giving additional grants for local bodies as a measure to augment the consolidated funds of the States to supplement the resources of local bodies.

Various issues regarding fiscal federalism in India

- **Centre's ceiling rule:** Kerala has moved the Supreme Court contending that the Centre's imposition of a **Net Borrowing Ceiling (NBC)** on the State, which limits borrowings from all sources, violates **Article 293 of the Constitution.**
    - **According to Article 293(3)** of the Constitution, the State has to obtain the consent of the Centre to **raise 'any loan'**, if 'any part of the previous loan' extended by the Centre is outstanding.
    - **Parliament does not have the power** to legislate upon the '**Public Debt of the State'** as this finds place in **Entry 43 of the State List of the Constitution**.
- **Increasing dependency on Centre**: The reliance of states on central government revenue has grown, witnessing a decrease in the **share of revenue from independent sources from 55% in 2014-15 to 50.5% in 2020-21.**
    - This trend is partly inherent in India's fiscal structure, where **states are significant spenders** while the central government controls financial allocations.
    - The introduction of the GST has further compounded this situation, as **most indirect taxes, except for a few like petroleum products, property tax, and alcohol excise, have been absorbed into the GST framework**. This has diminished the states' capacity to generate their own revenue.
- **Post GST:** States no longer possess the authority to independently determine tax rates for subjects listed under the State List.
    - In the past, state governments had the flexibility to set tax rates based on factors such as their expenditure needs and revenue base.
    - The current situation, where states cannot adjust tax rates according to their developmental needs, results in increased reliance on central government funds.

- **Cess and surcharges:** Another emerging challenge is that cesses and surcharges are becoming a disproportionate proportion of the overall divisible revenue, withnon-tax revenues being kept outside the divisible pool.

Net Borrowing Ceiling (NBC)

- The NBC limits the borrowings of States from all sources including **open market borrowings.**
- The Centre has decided to deduct liabilities arising from the public account of the States to arrive at the NBC.
- In addition, borrowings by state-owned enterprises, where the principal and/or interest are serviced out of the Budget, or through assignment of taxes or cess or any other State revenue, are also deducted from the NBC.

Suggestions and Way Forward

- Disputes between the Centre and States regarding economic policies have a long history in India.
    - However, in recent years the frequency and intensity of such disputes have increased and assumed the character of 'persistent frictions' in the federal system.
- These issues needed urgent consideration to reinforce trust in **fiscal federalism.**
- Therefore, there is need to give serious consideration for a consultative forum for credible policy dialogue between the Centre and the States
- It is equally important to ensure all round efficiency in the deployment of public funds, in particular, investments in productive enterprises in the public sector.
- There is a need for a**ugmenting the resources both of the Centre and the States** and the cake has to grow before the slices can become bigger. This requires faster growth of the economy and restructuring the expenditure of the Centre and the States.
- The 15th Finance Commission has thus recommended a **slew of fiscal reforms to increase the tax-to-GDP ratio**, especially through an overhaul of the goods and services tax.
- It is time that the major political parties develop a broad consensus at the centre and the states and blend good economics with politics**.**

Mains Practice Question

State in brief the principles of federal finance. How far do the Centre-State financial relations in India adhere to these?