NEXT IAS

DAILY EDITORIAL ANALYSIS

TOPIC

Vertical Fiscal Imbalance in Federal Relations

VERTICAL FISCAL IMBALANCE IN FEDERAL RELATIONS

In Context

- India's financial structure is marked by a **Vertical Fiscal Imbalance (VFI)** between the Union government and the States.
    - The **16th Finance Commission** has an opportunity to address these fiscal disparities to ensure equitable federal relations.

What is Vertical Fiscal Imbalance (VFI)?

- VFI refers to the discrepancy in revenue collection and expenditure responsibilities between the central and state governments.
- In India, States are responsible for a significant portion of public expenditure, particularly in sectors like health, education, law enforcement, and public welfare, but their ability to raise revenues is limited compared to the Union government.
- The **15th Finance Commission** highlighted this imbalance, with States contributing **61%** of the revenue expenditure but only collecting **38%** of the revenue receipts.

Reasons for Vertical Fiscal Imbalance (VFI)

- **Revenue Generation Disparity:** The Union government has the authority to levy broad-based taxes like personal income tax and corporate tax, which generate significant revenues. On the other hand, States have limited taxation powers and rely heavily on consumption taxes like sales tax and GST, which are less productive in comparison.
- **Expenditure Responsibilities:** While the Union's revenue share has remained stable over time, States' expenditure responsibilities have increased, particularly in sectors such as healthcare, education, policing, infrastructure, and social welfare. This has led to a widening fiscal gap, with States struggling to meet the increasing financial demands of these sectors.

Financial Grants to States

To address the imbalance, the central government provides financial assistance to States through various grants:

1. **Finance Commission Grants:** These are constitutionally mandated based on the recommendations of the Finance Commission, which allocates a share of central taxes to States.
2. **Plan Grants:** These funds are allocated under various central schemes in sectors such as health, education, and infrastructure development.
3. **Discretionary Grants:** These are provided by the Union government at its discretion, often for specific projects or emergencies.

Constitutional Provisions for Centre-State Financial Relations

The Constitution of India contains several articles that govern the financial relationship between the Union and the States:

- **Articles 202-206**: These deal with the financial administration of the States, including their budget, taxation powers, expenditure, and borrowing.
- **Articles 268-272**: These outline how revenues are distributed between the Union and the States.
- **Article 280**: Provides for the establishment of a Finance Commission every five years to recommend how central tax revenues should be divided.
- **Article 28**2: Allows the Union government to provide financial assistance to States for public purposes, enabling flexibility in financial support.

Current Share of States

- The **14th Finance Commission** had recommended that the share of tax devolution to States be increased to **42%** of central taxes, up from 32%. However, the **15th Finance Commission**, under N.K. Singh, revised this to **41%** for the period until 2026.
- States with special geographical or economic circumstances, such as the northeastern and hill States, continue to receive funding under a **90:10** rule, where the Union contributes 90% of the funds. For other States, the funding ratio is **60:40**, with 60% being the central government's contribution.

Challenges in Addressing VFI

- **Rising Expenditure Responsibilities:** Over time, the States' responsibilities in critical sectors such as health, education, and infrastructure have expanded, but their revenue-raising abilities have not kept pace.
- **Low Revenue Collection Capacity:** States are heavily reliant on indirect taxes, which are often regressive and less productive compared to the broad-based taxes collected by the Union government.
- **Dependency on Central Grants:** While States receive grants and financial aid from the Union, this dependency limits their fiscal autonomy and makes them reliant on discretionary grants, which may not always be timely or sufficient.
- **Bureaucratic Delays in Fund Allocation:** The process of allocating funds and grants from the Union to States can be bureaucratic, causing delays and inefficiencies in utilizing funds effectively for development projects.

Steps to Combat VFI

Several measures are needed to address the vertical fiscal imbalance and create a more balanced financial structure:

1. **Increase in Tax Devolution:** Many States have proposed that their share of tax devolution should be increased to **50%** in the upcoming **16th Finance Commission** to better align revenue and expenditure responsibilities.
2. **Strengthening State Revenue Capacities:** States need to focus on improving their internal revenue generation by expanding their tax base and improving the efficiency of tax collection.
3. **Greater Fiscal Autonomy:** States should be granted more fiscal autonomy to manage their own finances without excessive reliance on central grants.
4. **Streamlining Central Assistance:** The central government should simplify the process of grant disbursement to ensure States receive financial aid in a timely manner.

Conclusion

- Addressing the **Vertical Fiscal Imbalance (VFI)** is crucial for the effective functioning of India's federal structure. The central government must work closely with States to ensure that revenue is shared equitably, and States are empowered to meet their expenditure responsibilities.
- The **16th Finance Commission** will play a key role in shaping these financial relationships, and States are pushing for a greater share of tax revenues to ensure that they have the resources necessary to meet the growing demands of public services.

Mains Practice Question

[Q] The Vertical Fiscal Imbalance (VFI) in India's fiscal federalism structure poses a significant challenge to equitable development and efficient governance. Critically Analyze.