An Empirical Analysis of Fiscal Federal System of India with Special Reference to Current Scenario

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Abstract- India is the largest and probably the most diverse democratic country with a federal form of government where functions of union and state governments are well defined in the constitution of India. Such division of responsibilities aimed at achieving social, political, economic and administrative efficiency. Government of India act, 1919 could be said to be the beginning of modern federalism as it provided the clear cut separation of revenue heads between Centre and the state government, but with the revision and development of 73rd and 74th amendments to the constitution in 1993 and the recent developments in the field of fiscal system that is GST, Demonization and Covid-19 makes impact on the fiscal federal system of the country. By this paper it is pertinent that we try to understand what fiscal federalism is and how it affects the functioning of a country. How did Fiscal Federalism evolve in India and what are its essential facets? What are the changes that have impacted Fiscal Federalism in the recent past? we try to understand the persistent challenges faced by Fiscal Federalism in India and what can be done to overcome these challenges and further strengthen the Fiscal Federalism in India. Now the study concluded that the essence of changing dynamics of fiscal federalism in India lies majorly in two questions- who controls the fiscal resources? and what is the availability of the overall fiscal space? The competition among the Centre and the States over control of resources is central to the issues related to fiscal federalism. This competition needs to be nudged towards coordination with mechanisms like GST Council, Finance Commission and NITI Aayog. Along with coordination in collective fiscal sharing and management, there will always be the need for increasing the available resources. This can be ensured by ensuring structural reforms like reviewing of GST on continuous basis and increasing tax compliance.


1. INTRODUCTION

A tussle has ensued between the Centre and States as there was an estimated shortfall of Rs. 30,000 crores in the GST compensation cess. The GST compensation cess was a mechanism provided by the Centre to compensate for any revenue loss of the states on account of implementation of GST. The cess served as marker of trust between the Centre and the states. Erosion of this trust has made the states wary of all recent changes made by the Centre from abolition of the Planning Commission to terms of reference of the 15th Finance Commission, fearing that all these steps collectively are weakening the structure of Fiscal Federalism in India. On the other hand, Centre negates these apprehensions citing the increased devolution in 14th Finance Commission and reasoning that GST compensation cess is an independent matter of contention and not a part of any larger plan (economic survey 2018-2019).

India is federal country with a constitutional division of functions between the Union and States. The legislative functions of the two levels are assigned in terms of the Union, State and Concurrent lists. The conditions prevailing at the time of independence necessitated adoption of the constitution with centripetal bias. The centralizing trend was reinforced in the evolution of intergovernmental policies and institutions within the framework of planned development strategy in a mixed economy framework (Govind, 1996). It broadly applies the comparative advantage principle in assigning tax powers and expenditure functions. It also recognises the imbalances that arise consequently and provides for a mechanism to resolve the vertical (between union and state) and horizontal (among the states) mismatch between revenue and expenditure assignments. The institutional arrangement is the Finance Commission (FC) But transfers can take place and do take place outside of FC. These once had the benefit of advice of the Planning Commission and more recently of the NITI Aayog (Reddy & Reddy, 2019).
In the recent event the fiscal federalism in India has been impacted considerably by the implementation of the award of the 14th FC, the implementation of Goods and Services Tax (GST), the replacement of the Planning Commission with the NITI Aayog and the terms of reference (ToR) of the 15th FC (Reddy, 2019).

The issues triggered by recent events may be summarised as follows: (a) the manner in which the recommendations of the 14th FC on vertical and horizontal balances have been dilated, resulting in a widening gap between perception and reality, (b) the effect of changes in the fiscal responsibility framework suggested by the fiscal responsibility and budget management (FRBM) Review Committee on the vertical and horizontal balances envisaged by the 14th FC, (c) the impact of the implementation of GST on the overall fiscal space available to the states and the Centre, relative to the past, (d) the controversies surrounding ToR of the 15th FC and (e) the loss of revenue to states due to tax exemptions granted in the union interim budget of 2019–2020, in addition to the existing infirmities (Reddy, 2019).

These developments have led eminent economists and policymakers to float new approaches to address the perceived problems relating to fiscal federalism (Das, 2019; Isaac, Mohan, & Chakraborty, 2019; Kelkar, 2019; Rao, 2019; Subramanian, 2018). In the following section, I review the recent developments. Subsequently, I analyse the new approaches to fiscal federalism in India. In the concluding part, I propose a way forward by attempting a synthesis of the approaches while taking account of the lessons of experience (Reddy, 2019).

2. LITERATURE REVIEW

(Kletzer & Singh, 1995), In his paper try to understand how the fiscal federal structure works in India and the constraints given by its political economy are important inputs for analyzing the likely effects of reform. He begins the development of a model of fiscal federalism in the Indian case that allows for self-interested government decisions, political pressure, and imperfect instruments of control. He shows that how costly influence activities may depend on the federal fiscal structure in place in India.

(Govind, 1996), By his paper analysed and identified the major problem areas in federal fiscal arrangements in India. The paper begins with an analysis of tax and expenditure assignments and identifies anomalies. The paper also analyses the vertical and horizontal imbalances in the Indian federation and brings out the shortcomings of intergovernmental transfers as a mechanism of satisfactorily resolving these imbalances. In the light of the analysis, the paper makes recommendations for the reform of federal fiscal arrangements in India.

(Rao, 2005), The paper attempts to bring out the major shortcomings of intergovernmental policies and institutions in India which has had planning as been a cornerstone of development strategy and addresses the issues of reform in fiscal arrangements in the context of economic liberalization.

(Biswas et al, 2010), In his paper attempts at constructing certain political proxy variables to quantify the extent of such lobbying in India. He quantifies lobbying through the ministerial representation in the council of ministers. he also uses several time and state dummies to account for the constituent states’ political alignment with the center as well as the coalition and the reform period breaks in the Indian system. Taking panel data that cover 29 years and 14 major states he shows that his constructed variables do explain disparity in central fiscal disbursements under the non-formulaic “discretionary” head in a robust way. His findings remain true even after we take into account the impact of endogeneity of net state income on the transfer flow. Additionally, his exercise brings to the fore the fact that the coalition governments and economic reform measures impact upon state lobbying at the center in a significant manner.

(Endicott, 2015), In his study introduces how the type of government predicts whether core versus swing supporters receive relatively more transfers. Electoral incentives—the underlying causes of political bias in distributive politics—are different for majority governments versus coalition governments. As a result, within parliamentary systems, majority governments tend to target their core supporters relatively more and coalition governments tend to target their swing supporters relatively more. Furthermore, this study adds hypotheses to account for the context of federalism. Subnational governments aligned with the prime minister’s party tend to receive more fully funded grants whereas coalition partners and unaligned states tend to receive more partially funded grants. Using India as a case study from 1972 to 2008, initial evidence provides support for the argument.

(Joshi & Jain, 2016), Lighted that Madhya Pradesh state finances experiencing alarming deterioration in during the last decade resulting fiscal and primary deficits, increases in the indebtedness and contingent liabilities, and decline in capital and maintenance expenditures. The state’s fiscal performance is adversely affected by low buoyancy of central transfers and spillover of central pay revisions which is a matter of serious concern. This paper presents the various issues and challenges with reference to fiscal federalism in state of Madhya Pradesh of India.

(Sethia, 2017), Recent literature highlights role of political forces in determining interstate allocation of discretionary central transfers. However, available literature in Indian context suffers from serious data gaps due to omission of central transfers & spending bypassing the state budgets. Present paper addresses this specific data gap by using panel dataset of interstate allocation of all central transfers & spending relevant for regional welfare. Analysis suggests that while discretionary central transfers are driven by concerns for income inequality and poverty alleviation, bargaining power of the states through representation in ruling coalition at central level also influence disbursement of central funds. The paper also finds some evidence on role of median voter theorem in influencing interstate distribution of central transfers.
(Bhavnani & Lacina, 2017), in his study he extends this literature empirically by examining the degree to which exogenous, long-term migration prompts the redirection of central fiscal resources in India. Following the literature on distributive politics, he argues that transfers in decentralized systems addressing the costs of population movements are influenced by partisan politics.

(Reddy, 2019), point out that fiscal federalism in India has been impacted considerably by recent events, in particular, the implementation of the award of the 14th Finance Commission (FC), the implementation of Goods and Services Tax, the replacement of the Planning Commission with the NITI Aayog and the terms of reference of the 15th FC. He examines the issues unfolding from the developments, analyses the new approaches suggested by economists and policymakers and proposes a way forward that synthesises the approaches, he argue that FC being the bedrock of fiscal federalism in India, it is necessary to strengthen the hands of FC to give an award that is fair and acceptable to the union and states.

3. OBJECTIVES OF THE STUDY
- To understand what Fiscal Federalism is and how it affects the functioning of a country.
- To Know the Evolution of Fiscal Federalism in India and its essential facets.
- To Study the changes that have impacted Fiscal Federalism in the recent past.
- To understand the persistent challenges faced by Fiscal Federalism in India.
- To understand the step taken by to overcome these challenges and further strengthen the Fiscal Federalism in India.

4. RESULTS AND DISCUSSION
4.1: Concept of Fiscal Federalism and how does it affect the functioning of a country: Fiscal federalism can be simply defined as financial relations between units of governments in a federal government system. In case of India, these units are the Centre and the States. The financial relations encompass fiscal resource management of both Centre and States, collective fiscal stability and consolidation and most importantly intergovernmental transfers. Intergovernmental fiscal relations usually reflect fundamental societal choices and history and affect the behavior of firms, households and governments and thereby economic activity. This can be illustrated by analyzing the role played by fiscal federalism in following areas:

a. Political decentralization: The nature of Fiscal Federalism in a country plays a key role in determining the extent of potential political decentralization. Not only the extent of intergovernmental transfers but nature of these transfers affixes the level of autonomy, financial and otherwise, provided to lower tiers of government. For example, on an average, close to 90% of the transfers to a third tier of government in India are conditional, thus effectively limiting the decentralization at that level.

b. Nature of economic growth: The structure of Fiscal Federalism in a country dictates the expenditure priorities based on the tier of government that spends the money. This in turn affects the nature and direction of national economic growth. For example, the centralized nature of fiscal dynamics in Russia has tilted its economy more towards central priorities like defense industries.

c. Governance structures: The nature of financial relationship between the tiers of government considerably affects the administrative functioning of the Government. For instance, the fiscal autonomy of a governmental unit is co-existent with certain level of accountability towards people. Thus, the structure of fiscal federalism indirectly influences the accountability arrangements in the overall governance.

Figure 1: Organization of Multilevel Fiscal System in India
Several studies have indicated that fiscal decentralization is positively correlated with GDP per capita levels, educational outcomes and investment in physical and human capital. In the light of this, it becomes important for every country to find its optimal fiscal balance among all the tiers of government.

### 4.2. Evolution of Fiscal federalism in India and its essential facets.

**Figure 2: Pre-independence evolution of fiscal federalism**

- **India's first budget in 1860**
  - The idea of federal division of finances in India took root.

- **The Government of India (Gol) Act, 1919**
  - The Act brought about the division of subjects into central and provincial lists.

- **The Government of India (Gol) Act, 1935**
  - The Act divided powers between the centre and units in terms of 3 lists: Federal, Provincial and concurrent.
  - It consolidated the idea of fiscal federalism in the form of sharing of Centre's revenues and for the provision of grants-in-aid to provinces.

**Source:** Author’s Compilation

The post-independence evolution of fiscal federalism happened in the background of under development, large disparity among states, a clear objective in the government to make a more egalitarian society and a perennial fear of disintegration of the Indian Union. Keeping this in mind, the essential facets of India's structure of fiscal federalism revolves around three key ideas:

1. **7th Schedule acting as constitutional base for division of resources:** The 7th schedule of the constitution clearly lays down the subjects for the union list (functions assigned to the federal government), the concurrent list (shared functions between federal and state governments), and the state list (functions exclusively assigned to the state governments).
2.) **India is a 'Union of States' rather than a 'Federation of States':** Since independence, India has faced several issues with regard to a possible disintegration to secessionist tendencies in several parts of the country. This accompanied with a preference for planned economy immediately post-independence has tilted the control of fiscal relations more towards the Centre. The manifestation of this can be seen in following observations:

- **2/3rd-1/3rd distribution:** On an average, States spent about 2/3rd of the overall public expenditure done by both Centre and States, but States control only about 1/3rd of the total tax levying sources.
- The erstwhile planning commission (an executive body created by the Union Government and not a constitutional body) played an integral role in intergovernmental transfer of resources from Union to the States.
- The transfers under Central Sector Schemes and Centrally sponsored schemes constitute a significant share of transfers from Centre to States. The State just plays the role of an implementing agency in relation to these transfers.

3.) **Finance Commission as a primary channel of fiscal devolution (FFC):** The Finance Commission, set up under Article 280 of the constitution, has been bestowed with the exclusive power to make recommendations to the President as to the distribution between the Union and the states of the net proceeds of taxes which are to be, or may be, divided between them and the allocation between the states of respective shares of such proceeds. The nature of these recommendations is guided by following features:

- Increasing financial autonomy of states and balancing the fiscal space between the Centre and the States acts as core principle of vertical devolution of resources.
- Difference in the fiscal capacities among States and the objective of equitable development acts as the core principle of horizontal devolution of taxes.
- The sharing shall be of net proceeds of all union taxes (except a few mentioned in Articles 268, 269 and 271 of the Constitution).

### Channels of Intergovernmental Transfers in India

These transfers constitute about 1/3rd of total fiscal space available to States (including borrowing and own resources). The distribution of intergovernmental finance primarily happens through three channels.

1) Tax devolution as a share of divisible pool of taxes, which I nature of entitlement of the Union and States based on assessment or their resources and needs by the Finance Commission.
2) Grants-in-aid in the recommendations of Finance Commission, which are in the nature of transfer of funds from Union to States, unlike devolution which is sharing of funds.
3) The third channel is transfer of resources by Union to States outside the award of Finance Commission, essentially by the Union Government which in the past was, on the advice of Planning Commission.

**Transfer from Centre to States:** transfer of funds to the States comprises the share of States in Union taxes devolved to the States, Finance Commission Grants, Centrally Sponsored Schemes (CSS), and other transfers. Total transfers to States have risen between FY19 and FY23 (refer to Table 1).

**Table 1: Details of transfers from Centre to States (other than devolution to States)**

<table>
<thead>
<tr>
<th>Types of Transfer</th>
<th>FY 19</th>
<th>FY20</th>
<th>FY21</th>
<th>FY22</th>
<th>FY23</th>
</tr>
</thead>
<tbody>
<tr>
<td>Centrally Sponsored Schemes</td>
<td>3.0</td>
<td>3.1</td>
<td>3.8</td>
<td>4.2</td>
<td>4.4</td>
</tr>
<tr>
<td>Finance Commission Grants</td>
<td>0.9</td>
<td>1.2</td>
<td>1.8</td>
<td>2.1</td>
<td>1.9</td>
</tr>
<tr>
<td>Other Grants/Loans/Transfers</td>
<td>0.9</td>
<td>2.0</td>
<td>1.9</td>
<td>2.3</td>
<td>3.0</td>
</tr>
</tbody>
</table>

**Source:** Economic Survey 2022-23

**Figure 3:** Shows Details of Transfers from Centre to States
By the above figure no 3, it is clear that in Centrally sponsored schemes the transfer amount is increasing continuously but in finance commission grants head and other grants head it is increasing as well as decreasing.

4.3. Changes have impacted Fiscal Federalism in the recent past.
Over the course of time, there have been several developments which have altered the nature of Fiscal Federalism in India. These include the market reforms initiated during 1991 and enactment of 73rd and 74th Constitutional Amendment Act among others. In the recent past, following can be cited as paradigm shifting changes:

1.) **Recommendations of the 14th altered Finance Commission (FFC):** The FFC altered the fiscal dynamics in the following ways.
   - **Higher vertical devolution:** Increased vertical devolution may not have increased the overall fiscal space of the States, but it has increased the fiscal autonomy available to States by increasing the share of General purpose transfers vis a vis the Specific purpose transfers.
   - **Doing away with concept of Plan and Non-Plan expenditure:** The removal of a distinction could enable reversal of the neglect of non-Plan activities like maintenance. Also, removing this artificial distinction could help create classification of Government expenditure solely on capital and revenue basis.
   - **Moving away from the idea of Special category States:** This could help remove the political discretion exercised by granting some States the Special Category status and thus higher devolution.

**Figure 4: Formula of State’s Share Division**
2. Issues arising from the Terms of Reference of 15th Finance Commission

The Terms of Reference (TOR) of the 15th FC has generated friction between Centre-State relations due to its following provisions:

- **The Commission may examine whether revenue deficit grants be provided at all:** Even though financing of revenue deficit is not considered progressive but completely doing away with revenue deficit grant may put considerable financial pressure on the states, especially the poor states.
- **The Commission shall use the population data of 2011 while making its recommendations:** The 15th Finance Commission has been mandated to use data from the 2011 Census, instead of 1971 Census, as the base for determining revenue share across states. This, southern states have argued, may penalize them for their successful efforts in controlling population growth, by decreasing their share in the overall resource pool. Although the argument has political salience, it overlooks the core redistributive principle of the revenue transfers.
- **The Commission may consider proposing measurable performance-based incentives for States** like achievement of 'Flagship schemes', 'creation of disaster resilient infrastructure' and 'controlling expenditure on populist measures' among others. Although these incentives could lead to healthy competition among states but tying State's fiscal space to a mandate decided by the Centre may indirectly increase centralization and micro-management of States by the Centre.
- **Separate mechanism for funding of defense and internal security needs:** In an amendment to the ToR of the 15th FC the Commission shall also examine whether a mechanism for funding of defense and internal security ought to be set up. This was done in the light of declining defense expenditure (from 2% of GDP in 2014-15 to 1.43% in 2019-20). The States have been opposing this citing that special measures like this will lead to reduction in the overall vertical devolution of taxes to the States.

Table 2: Allocation of grants to the State Governments as recommended by the 15th FC.

<table>
<thead>
<tr>
<th>Amount in crore</th>
<th>11th FC</th>
<th>12th FC</th>
<th>13th FC</th>
<th>14th FC</th>
<th>15th FC</th>
</tr>
</thead>
<tbody>
<tr>
<td>29.5</td>
<td>30.5</td>
<td>32</td>
<td>42</td>
<td>41*</td>
<td></td>
</tr>
</tbody>
</table>

*Effective share does not change due to change in J&K status
Sr. No. | Components                              | Allocation FY23 | Amount Released (As on 22 November 2022)
---     | ---------------------------------------|----------------|--------------------------------------
1       | Post Devolution Revenue Deficit Grant  | 86,201         | 57,467                               
2       | Disaster Management Grant (Union Share) | 23,294         | 10,976                               
3       | Local Bodies Grants                    | 69,421         | 28,609                               
4       | Health Sector Grants                   | 13,192         | 275                                  
**Grand Total** |                                   | **1,92,108** | **1,61,230**                         

**Source:** Department of Expenditure (Ministry of Finance): Economic Survey 2022-23

The Finance Commission had recommended allocation of an amounting to ₹1.92 lakh crore for FY23 in respect of post-devolution revenue deficit grants, grants to local bodies, health sector grants, and disaster management grants under Article 275 of the Constitution. The details of the grants released during the current year can be seen in Table 2.

**Figure 5:** Shows the Amount Allocated and Released for Various Components to State Governments

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3.) **Moving from Planning Commission to NITI Aayog:** Planning Commission was one of the primary channels to enable intergovernmental transfers outside the Finance Commission. Thus, its rekindling into NITI Aayog has affected Fiscal Federalism in following ways:

- **Tilt towards the idea of Cooperative Federalism and Competitive Federalism:** The mandate of NITI Aayog as a policy research entity strives to provide both Centre and States adequate institutional space with a decentralized and shared national agenda.

- **Shift of some functions from Finance Commission to NITI Aayog:**
  - The indicative ceiling on transfers outside the Finance Commission has been removed due to abolition of plan and non-plan differentiation which will indirectly shift the burden of increased transfers outside Finance Commission on NITI Aayog.
  - Some of the overlap between the Finance Commission and the Planning Commission has been addressed by the Finance Commission by relinquishing most of the State specific or project specific grants-in-aid and associated conditionalities, in its recommendations. For example, incentives or disincentives or rewards to States for appropriate policies have been left out of the Finance Commission's considerations and thus, they legitimately fall under NITI Aayog.

4.) **Implementation of GST:** GST was implemented through the GST (101st Amendment Act), 2016 as a long pending indirect tax reform. It is a single tax that replaces multiple other indirect taxes. The Centre lost out on its power to levy taxes such as excise duty, while the States could no longer levy entry tax, VAT etc. The advent of GST has altered the dynamics of Fiscal Federalism in the following ways:

- **Pooled sovereignty via GST Council:** As the GST is implemented through a process of collective decision-making, both the Centre and the States have lost out on their autonomy to unilaterally determine their indirect tax
policies. This is reflected in clause (9) of Article 279A, which lays down the voting pattern that shall be adhered to before any recommendation of the GST Council is ratified.

➢ **Mutual Trust on ensuring justified sharing of revenues:** One of the primary reasons for the country wide consensus on enactment of GST was assurance from the Centre that any shortfall in the tax revenue of the States shall be compensated. To ensure this, a GST Compensation Cess was created through GST (Compensation to States) Act, 2017. The act states that:

1. Under the Act, the percentage of annual revenue growth of a State has been projected to be 14%. If the annual revenue growth of a State is less than 14%, the State is entitled to receive compensation under the statute.
2. The compensation payable to a State shall be provisionally calculated and released at the end of every two months period.

**GST and flow of resources to states:**

**Table 3 - Pre-GST period - Total fiscal resources to States from taxes subsumed in GST (Including devolution)**

<table>
<thead>
<tr>
<th></th>
<th>Rs Lakh Crore</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>State taxes subsumed in GST</strong></td>
<td></td>
</tr>
<tr>
<td>States taxes subsumed in GST</td>
<td>3.22 3.48 3.73 4.41 4.41</td>
</tr>
<tr>
<td>Central taxes subsumed in GST</td>
<td>1.66 1.90 2.02 2.48 3.14</td>
</tr>
<tr>
<td>Devolution factor</td>
<td>0.32 0.32 0.32 0.42 0.42</td>
</tr>
<tr>
<td>Total fiscal resources to States from taxes subsumed in</td>
<td>3.75 4.08 4.38 5.46 5.73</td>
</tr>
<tr>
<td>Nominal GDP</td>
<td>99.44 112.34 124.68 137.72 153.92</td>
</tr>
<tr>
<td>Pre-GST buoyancy of revenue from taxes subsumed in GST accruing to states</td>
<td>0.97</td>
</tr>
</tbody>
</table>

**Source:** Department of Expenditure (Ministry of Finance), Economic Survey 2022-2023

The last five years of experience with GST have seen several rounds of policy debates around rate rationalisation, simplification of return filing, compensation cess levies on products, compensation payments to states etc. One pertinent question that has not been carefully studied is the impact of GST on the flow of resources to the states. While comparing the total fiscal resources accruing to States in the pre and post-GST regimes, it is essential to measure the relative performance of taxes vis-à-vis the performance of the economy. In the pre-GST regime, when the economy grew at 11.5 per cent nominally, the total fiscal resources accruing to States from the Central and state taxes subsumed in GST (including devolution) grew at 11.1 per cent. It implied a buoyancy of 0.97 (See table 3)
By the above figure it is clear that states and central taxes subsumed in GST and devolution factor shows the Increasing trend in the allocation of resources.

Table 4- Post-GST period - Total fiscal resources to states from the GST system (including devolution)

<table>
<thead>
<tr>
<th>Rs Lakh Crore</th>
<th>FY19</th>
<th>FY20</th>
<th>FY21</th>
<th>FY22</th>
<th>FY23</th>
<th>CAGR (FY23 over FY19)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CGST Collections</td>
<td>2.02</td>
<td>2.27</td>
<td>2.10</td>
<td>2.69</td>
<td>3.14</td>
<td>10.9%</td>
</tr>
<tr>
<td>SGST Collections</td>
<td>2.79</td>
<td>3.09</td>
<td>2.73</td>
<td>3.44</td>
<td>3.98</td>
<td>8.9%</td>
</tr>
<tr>
<td>IGST Collections</td>
<td>5.99</td>
<td>5.87</td>
<td>5.66</td>
<td>7.62</td>
<td>9.40</td>
<td>8.9%</td>
</tr>
<tr>
<td>GST Compensation paid for the year</td>
<td>0.85</td>
<td>1.66</td>
<td>1.68</td>
<td>0.69</td>
<td>0.35</td>
<td></td>
</tr>
<tr>
<td>Back-to-Back Loan</td>
<td>1.10</td>
<td>1.59</td>
<td>1.59</td>
<td>1.59</td>
<td>1.59</td>
<td>8.9%</td>
</tr>
</tbody>
</table>

Total fiscal resources to states from the GST system.

- (1) SGST + IGST for states + Devolution from Centre’s GST: 7.89 to 8.74 Lakh Crore (10.9%)
- (2) SGST + IGST for states + Devolution from Centre’s GST + Compensation: 8.74 to 10.65 Lakh Crore (8.9%)
- (3) SGST + IGST for states + Devolution from Centre’s GST + Compensation + loans: 8.74 to 12.24 Lakh Crore (8.9%)

India Nominal GDP: 189.0 to 273.0 Lakh Crore (9.6%)

Post-GST buoyancy of GST revenues accruing to states (excluding compensation/loans): 1.13

Source: Department of Expenditure (Ministry of Finance), Economic Survey 2022-23

In the post-GST period, total fiscal resources accruing to the states from the GST (including devolution from the Centre's GST) exhibited a buoyancy greater than that in the pre-GST period (Table 4). This performance is especially noteworthy, considering the reduction of the effective weighted average GST rate from 14.4 per cent at the time of inception to 11.6 per cent in 2019 (RBI).

Note: (a) The devolution factor is taken as 0.32 from FY13 to FY15; 0.42 from FY16 to FY20; and 0.41 from FY21 onwards, as per the recommendation of the respective Finance Commission.

(b) IGST for States is taken as 50% of total IGST collection. State's share in Centre's GST is arrived by multiplying the devolution factor with CGST and Centre's IGST share.

(c) The collection for FY23 have been extrapolated based on the average collections from May to Dec 2022.

(d) The GST collections used are gross collections, including domestic supplies and import. However, with only the GST collections through domestic supplies, the post GST buoyancy is still greater than 1 (~1.05).
In addition to the regular stream of revenues from GST, a compensation was also provided to the states in the post-GST period. Since GST was a new tax regime, the compensation scheme was designed to safeguard the states for any difference in the new versus the old tax regime by ensuring steady revenue growth of 14 per cent per annum for five years. The compensation arrangement was also meant to help states ride out the differences in the inter-state distribution of GST. It is pertinent to note here that the compensation system was not envisaged as a buffer to the state's revenues in the eventuality of a fall in tax revenues resulting from a collapse in economic growth.

Nevertheless, the incidence of the pandemic has highlighted the relevance of GST Compensation as a buffer to the States' revenues. During FY21, revenues for Centre and states were adversely affected due to the economic contraction. The compensation requirement by the states increased substantially amidst a decline in the CGST and the compensation cess collections. Despite having limited fiscal resources in the middle of a crisis, the Centre borrowed funds and passed them on to States on a back-to-back loan basis, in addition to the release of regular GST compensation. These loans will be repaid from future inflows into the GST Compensation Cess Fund and hence are not a burden on the states.

Figure 6: Total fiscal resources to states from the GST system.

By the above figure it shows that collection of different types of GST maintain increasing as well as decreasing trend.

5.) GST Compensation Cess and COVID-19: Are State's apprehensions regarding changing fiscal dynamics real? The pandemic has given an economic shock to the Indian Economy which has dented the tax collection expectations (including the collections from GST Compensation Cess) of both Centre and States. Resultantly, the Centre has refused to immediately compensate the states citing this revenue shortfall. Since the GST Compensation acts as a harbinger of State's trust on Centre, non-compliance on this agreement has the potential to erode the trust between the Centre-State relationship. Also, the estimated Rs 30,000 crore shortfall has come at a time when waning fiscal federalism is a burning issue. For instance, Centre's latest decision to suspend the Members of Parliament Local Area Development (MPLAD) Scheme and divert that money to the Consolidated Fund of India is being cited as a step towards the centralization of country's financial resources. In this context, several States have expressed following apprehensions:

- **Centre not honoring its moral and legal obligation:** Finance Ministers of both Kerala and Punjab have argued that the Government has a legal, and a moral obligation to compensate the State Governments for the revenue shortfall. A deadlock so early in the implementation of GST has made States skeptical about the future of Fiscal Federalism.

- **Ineffectiveness of the GST Council:** Any dispute regarding GST is to be handled by the GST Council but in the recently concluded 39th GST Council meeting, no steps were taken to create such a dispute resolution mechanism. With a 1/3rd voting power, the Centre has a virtual veto over the decision making in the council (since 3/4th majority is needed to pass a decision). This has made the States question the functioning structure of the Council itself.

- **Resort to legal proceedings:** In the absence of an alternate remedy, the only option left for states like Kerala and Punjab is to approach the Supreme Court under Article 131 of the Constitution. Such a judicial remedy to establish fiscal federalism of the states would erode even the limited institutional capital present between Centre and States. The stand of the Centre on these issues should not be viewed solely as a response to the States but in the background of abysmal economic growth and negative tax buoyancy rates (percentage change in tax revenue to percentage change in GDP) which is in addition to almost 25% reduction in collection of corporate taxes. In this background, the Centre has taken following stands:
The Centre has refused to compensate the States immediately but has provided the States with an option to borrow (to make good either the shortfall in compensation arising from GST implementation or the overall shortfall).

The Centre has also contended that the revenue shortfall is on account of the COVID-19 pandemic, which is an 'Act of God', stating that it has no legal obligation to compensate the States. It has also argued that the inflows to the GST Compensation Fund are to be made from the GST Compensation Cess and if that is inadequate, the Centre is not obligated to supplement it by diverting flows from other sources.

The stalemate has been finally broken with all 28 States and 3 UTs with legislatures going with the borrowing option provided by the Centre. Under this option, the Centre has operationalized a special borrowing window of 1.1 lakh crore of which 30,000 Crore has been already borrowed by Centre on behalf of the States.

The primary advantage states have here is that the interest on the borrowing under the special window will be paid from the cess as and when it arises until the end of the transition period. After the transition period, principal and interest will also be paid from proceeds of the cess, by extending the cess beyond the transition period for such period as may be required. The states will not be required to service the debt or to repay it from any other source. As this being the debt of the State, it will not reflect in the fiscal balance sheet of the Centre thus creating a win-win in the short term for both sides.

Although the immediate issue has been resolved but the helplessness experienced by the States and Centre's response on its apprehensions has made the threat of changing fiscal dynamics seemingly real for the future. Not much can be said about the intention of the Central dispensation vis-à-vis changing Fiscal Federalism, but looking at the aforementioned developments solely through the lens of their impacts and not intentions provide merit to the apprehensions of the States.

4.4: The persisting challenges faced by Fiscal Federalism in India

1. Implementation of the 14th Finance Commission: The promise of 42% vertical devolution of taxes has not been realized. States' share reached a peak of 36.6% in 2018-19 and has fallen sharply since. Also, it has been observed that much confusion has been generated by the FFC regarding the 'continuation' and 20 'discontinuation of the provisions and privileges associated with Special Category States.

2. Principles of Grant-in-aid: Since its inception, states have aired conflicting views on the principles that govern the grants-in-aid to the revenues of the states. The relatively better off states like Karnataka, Tamil Nadu, Goa, Maharashtra and Gujarat have suggested an incentive-based grant-in-aid for better fiscal management. The less developed states like Madhya Pradesh and Orissa have suggested that the grants-in-aid should be given to meet the deficits in revenue expenditure.

3. The future of the 7th Schedule: The division of fiscal powers derived from the 7th schedule has its socio-economic realities in the pre-independence era. Since then, there have been changes in the economy, society and governance structures in the country, indicating towards a revision of the 7th Schedule. Also, some economic experts argue that "entitlement-based central legislations" (for instance, the Mahatma Gandhi National Rural Employment Guarantee Act of 2005, the Right of Children to Free and Compulsory Education Act of 2009, and the National Food Security Act of 2013) are in conflict with the 7th schedule of the constitution. The States share a substantial financial burden in fulfillment of these entitlements, without the accompanied fiscal and decision-making powers.

4. Misuse of Article 282: Article 282 of the Constitution says, "The Union or a State may make any grants for any public purpose, notwithstanding that the purpose is not one with respect to which Parliament or the Legislature of the State, as the case may be, may make laws. "Constitutional debates highlight that the objective of the article was to enable the Union to deal with unforeseen contingencies. This provision seems to be misused as it is used as a basis for transgressions of the central government into state subjects through Centrally Sponsored Schemes (CSS) and the Central Sector Schemes on the grounds that such spending will better serve national priorities. Also, according to analysis by the Fifteenth Finance Commission there are approx. 211 schemes/ sub-schemes under the 29-umbrella core and core of the core schemes. The total outlay of the Central Government on these Centrally Sponsored Schemes has been approx. 3.3 lakh crores in 2019-20.

5. Overuse of Cesses and Surcharges: They are outside the divisible pool of taxes and the Centre need not share their proceeds with State Governments. In recent times they have increasingly become important instruments of revenue mobilization. Just to illustrate, while the total transfer to states and UTs was Rs 4.1 lakh crore in 2017-18, revenue mobilization by the central government through cess and surcharge alone stood at 3 lakh crore or 15.7% of Centre's gross tax revenue.

6. Issue of finances of third tier of government: The primary issues of the third tier of the Government (especially Rural Local Bodies) are negligible own revenue and complete dependence on State Governments. As a result, there is an increasing concern about the arbitrariness and ad-hocism of fiscal transfers at the third tier of the Government.

7. Fiscal stability and discipline: Fiscal discipline of both Centre and the States is necessary to maintain a healthy fiscal balance in federal structures. The Central Government debt is estimated at 48.4% as a percentage of GDP for 2018-19 and is expected to come down to 48% of GDP in 2019-20. This is way beyond 40% debt level suggested by the
Fiscal Responsibility and Budget Management (FRBM) Act by the end of 2024-25. The outstanding liabilities of the State Governments stood at 25.1% of GSDP in 2017 (compared to 20% suggested by the FRBM Act), with a wide range of 42.8% in Punjab and 17% in Chhattisgarh.

8. Regionalism: It is considered one of the significant challenges to federalism in India. Federalism best thrives as a democratic system when it mitigates the centralization of power sharing between the centre and the states. The pluralistic character of India gives rise to many factors including regionalism. People from far northeast sometimes feel themselves at a formidable distance from New Delhi and people in southern part of the country with bigger states feel neglected having been within larger states.

9. Division of Powers: in India distribution of power is made under Three Lists found in the Seventh Schedule of the Constitution. The powers of both the Central and State Governments are specifically enumerated in the Union list and State list respectively while powers mentioned in the Concurrent list are enjoyed by the two sets of governments. The residuary powers are vested in the Central government. However, in the case of conflict over the legislation on any of the subjects mentioned in the Concurrent List, the Centre supersedes the States and become threat to Indian federalism.

10. Not Following Fiscal Federal Principle: The Indian Constitution, while expressly vesting the Centre with greater powers of taxation, also provides for an institutional mechanism — the Finance Commission — to determine the share of the States in the Central tax revenues by way of correcting this imbalance. While deciding the devolution of taxes and the provisions of grants the Finance Commission is required to address both the vertical imbalance between the Centre and the States and the horizontal imbalance between states. At present, about 40 percent of Central revenues (tax and non-tax) is transferred to the States, and this includes the grants they get from the Planning Commission which is now NITI Aayog and the Central Ministries. Despite the enlargement of the shareable pool under the 80th Amendment which includes all central taxes, the revenue accruals of the Centre and the States have not seen any major changes. Asymmetrical sharing of revenue and resource crunch at the periphery results in uneven development across the country. The current Goods and Services Tax measure is feared by many states to be against fiscal federalism in India.

11. Centralized Planning: Although economic and social planning is found in the Concurrent List of the Seventh Schedule to the Constitution, the Union Government enjoys unbridled authority over national and regional planning in India. Centralised planning, through the Planning Commission, now NITI Aayog appointed by the Centre, considerable preponderance in legislative power for the Union, the financial dependence of the states on the Centre’s mercy, the administrative inferiority of the states make the states meek and weak that impacted the India’s fiscal federal system.

12. Economic Incompatibilities of the units: Differences in economic standards and relative economic and fiscal incompatibilities among the constituent states also pose a threat to a federation. The forces of imbalances in the field are demands for economic planning and development and for regional economic equality and financial autonomy of states. Demand for financial equality of a region creates problems in a federation. In India, some states are declared as poor and on the principle of equalization, are getting grants-in-aid. But the dilemma in a federation emerges that if the principle of equalization is adhered to, the national income and the total income growth will suffer. Again, if much attention is paid to economic development, equalization of all units cannot be attained.
Source: Author’s Compilation

4.5: Measures to overcome these challenges and further strengthen Fiscal Federalism in India: In this light we highlighted the following recommendations to strengthen fiscal federalism:

➢ **Symmetry in the working of the GST Council and the Finance Commission:** The Finance commissions whilst giving their recommendations look at projections of the expenditure and revenue, but issue of GST rates exemptions, changes, and implementation of the indirect taxes are entirely within the domain of the GST Council. This leads to unsettled questions on the ways to monitor, scrutinise and optimise revenue outcomes. Since both the Finance Commission and the GST Council are constitutional bodies, the coordination mechanism between the two is now an inescapable necessity. To further improve this coordination and to address the issues arising out of implementation of the Finance Commission, the option of giving Permanent status of the Finance Commission can be explored.

➢ **Relook at the 7th Schedule:** The nature of polity, technology, increasingly aspirational society, the demographic profile and the power of technology has dramatically altered the contours of the Constitution. As a result, the entries of List I and List III in the 7th Schedule of the Constitution can be examined and a more suitable redistribution of entries can be adopted.

➢ **Need for a more credible policy for Rationalisation of CSS and Central outlays:** Since the role of NITI Aayog is primarily of a Think Tank institution and not a financial body, there is no present central entity to provide an over-view of the CSS and how these could be amalgamated with central sector outlays. A mechanism needs to be created for detailed financial rationalization of these schemes preferably in consultation with State Governments.

➢ **Rebuilding institutional capital:** Several economists and policy makers have argued that abolition of Planning Commission has created an institutional vacuum. Efforts could be made to rejuvenate and rekindle the Inter-State Council as the body not only has constitutional backing but its mandate and nature of participation is ideally suited for a larger federal role. Alongside the Inter-State Council, efforts could be made to increase political capital through institutions like Chief Minister's Conference. For instance, if the Terms of Reference of 15th Finance Commission were actively discussed in the forum, the political misunderstandings could have been avoided.

➢ **More effective devolution of funds to local bodies:** It is important that a steady financial flow is guaranteed in order to provide effective fiscal autonomy. To ensure this, local bodies could be provided with more taxation powers for independent revenue streams and efforts could be made to improve tax collection efficiency of local bodies. (E.g.- Collection of property tax by Urban Local Bodies). In addition to this, it is important that State Finance Commissions are constituted as stipulated in the Article 243 (1) of the Constitution of India and arrangements are made for their robust functioning.

➢ **Adopting a fiscal consolidation roadmap for sound fiscal management:** Adhering to the roadmap charted by the amended FRBM Act and alongside creating a differentiated debt path of States which recognises the present constraints and issues of legacy debt and ensures judicious use of the available resources.

➢ **Widening the ambit of GST for revenue augmentation:** The primary reason for the tussle between Centre and States over GST Compensation Cess was shortage of revenue. The current coverage of GST excludes electricity,
petrol, diesel and real estate, as also agriculture. Widening the ambit of GST could provide a larger base for taxation in the long run.

Figure 8: Measures to overcome challenges and strengthen Fiscal Federalism

Source: Author’s Compilation

5. Findings and Recommendations of the study

5.1: Findings

From the above discussion it is found that the autonomy of the states has been curved and the states merely turning into implementing agencies. The division of a states own fund to centrally sponsored scheme, thereby depleting resources for its own scheme violates a constitutional provisions. It creates constraints to the state from charting their own autonomous path of development. It is observed that the state share in divisible pool increases continuously from 11th finance commission to 14th finance commission recommendations, but the 15th finance commission reduces 1 percent share of disable goal and keep it at 41 percent from 42 percent, it is because of covid 19 impact and GST reform.

From the above study it is seen that the issue of term of reference makes higher impact on fiscal federal system where the data of population being collected from 2011 census instead of 1971 census. From the study a positive outcome can be seen that the replacement of planning commission at the place of NITI aayog create an environment of cooperative federalism and it ensure the proper engagement of all states in the decision making of financial resources. It is found that the horizontal imbalances arise because of differing levels of attainment by the states due to differential growth rates and their developmental status in terms of the state of social or infrastructure capital. Vertical imbalance arises due to the fiscal asymmetry in powers of taxation vested with the different levels of government in relation to their expenditure responsibilities prescribed by the constitution.

5.2: Recommendations

1. Generating symmetry in the working of the GST Council and the Finance Commission to better monetize, scrutinize and optimize revenue targets. 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 focusing to the determination of vertical Share which is the proportion of the center’s tax revenue that should be given to the states and ensuring a fair allocation of resource.

2. 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. 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. Relook at the 7th Schedule accounting for changed nature of polity, technology, increasingly aspirational society, the demographic profile.

4. A more credible policy for rationalization of CSS and Central outlays can be created in consultation with the state government.
5. The transfers from the Union to the States (outside the recommendations of the Finance Commission), should be ideally under the aegis of the Inter-State Council.
6. More effective devolution of funds to local bodies through measures like more taxation powers, reforming the functioning of State Finance Commissions etc. and strictly follow the recommendation of Punchhi commission, 2007 for better Centre-state fiscal relations.
7. Adopting a fiscal consolidation roadmap for sound fiscal management with FRBM targets as guiding light.
8. Widening the ambit of GST for revenue augmentation.
9. 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.
10. 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.

6. Conclusion
Indian fiscal federal system is a unitary in nature, where both Centre and state work together on the basis of three list which is prescribed in the constitution of India. The history of federal transfer in India demonstrate that the states have succeeded in getting larger share where they work politically more assertive and the recent developments in the fiscal system in India impacted the fiscal relation between center and states. This paper tries to find out the problem associated with the fiscal distribution among the level of the Government and how the problem can be solved. So it is found that there is requirement of continuous reviewing of available resources and need to be restructured the available pillars like finance commission, NITI Aayog, GST and decentralization which strengthen India’s unique cooperative federalism.

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