Redesigning India’s Fiscal Federalism

This editorial is based on the article *“Reimagining the NITI Aayog”* which appeared in The Hindu on 24th June 2019. The article talks about the need and ways of redesigning India’s fiscal federalism.

In India, the Finance Commission and the Planning Commission promote **fiscal federalism** by carrying out systemic fiscal transfers in the nature of devolution or conditional ones but with the replacement of Planning Commission by NITI Aayog there is an urgent need for **revisiting and redefining** the **fiscal architecture** of India.

India’s Fiscal Federalism

- **The Government of India Act 1919 and 1935** formalized the tenets of fiscal federalism and revenue sharing between the Centre and the states.
- **The 14th Finance Commission** chaired by Dr. Y V Reddy, recommended **42% devolution** of revenue to the states.
- **Goods and Services Tax** was introduced in 2017 to streamline India’s indirect tax structure as a measure to promote cooperative federalism in India**,** giving the states an enhanced role in formulating and implementing the overhauled taxation system.
- **The** NITI Aayog established in 2015 was expected to address new realities of macroeconomic management that were missed by the Planning Commission.

Need for Redefining India’s Fiscal Federalism

- **Horizontal imbalances and rising regional inequalities:** Replacing the Planning Commission (which was mandated to give grants to the states as conditional transfers using the Gadgil-Mukherjee formula) with **NITI Aayog** (Government think tank with no resources to dispense) has reduced the policy outreach of government by relying only on single instrument of fiscal federalism i.e Finance commission. This approach if not reviewed can lead to a serious problem of increasing **regional and sub-regional inequities.**

Horizontal Imbalances

- 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.
- Horizontal imbalances involve two types of imbalances:
    - **Type I** is to do with the adequate provision of basic public goods and services.
    - **Type II** is due to growth accelerating infrastructure or the transformational capital deficits.

Vertical imbalance

- **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.

- **Vertical imbalance:** In India's fiscal federalism (three levels of Governments: Central Government, State Governments and the elected Local Bodies) central government has a far **greater domain of taxation** (e.g., income taxes personal or corporate, taxing consumption of goods and services (CGST), taxing foreign transactions, etc).
    - **Central Government collects around 60%** of the total taxes, while its expenditure responsibility (for carrying out its constitutionally mandated responsibility such as defense, etc.) is only 40% of the total public expenditure.
    - Such vertical imbalances are even sharper in **the case of the third tier** consisting of elected **local bodies and panchayats.**
    - Vertical imbalances can adversely affect India's **urbanization, the quality of local public goods** and thus further aggravating the negative externalities for the **environment and climate change.**

Restructuring the Fiscal Federalism

India's Fiscal Federalism needs to be restructured around the four pillars namely Finance Commission, NITI Aayog, GST and decentralization in order to eliminate the inadequacies of vertical and horizontal imbalances.

- **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 focussing on removal of basic **public goods imbalance (Type I).**
- **NITI Aayog** can serve as the second pillar for dealing in the realm of **infrastructure and capital deficits (Type II).**
    - It should be engaged with the allocation of capital in a way different than that used by the Finance Commission with different parameters for allocation.
    - **Regional Imbalances:** NITI Aayog should receive significant resources (1% to 2% of the GDP) to remove regional and subregional disparities among states by reducing **development imbalances** in the areas of infrastructure deficit.
        - **Independent Evaluation Office:** 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.
        - **Decision-Making Body:** 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.
- **Decentralization** can serve as the **third pillar** of the new fiscal federalism by strengthening local finances and state finance commission.
    - **Local public finance:** the creation of an urban local body/**Panchayati Raj institutions consolidated fund.**
        - 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.
        - **One-sixth** sharing of the CGST and SGST with the third tier can generate more than **1%** of the GDP every year for the financing of public goods by urban-level bodies.
    - **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.
- **Goods and Services Tax** should be simplified in its structure and can serve as the **fourth pillar** of our fiscal federalism, by ensuring:
    - **Single Rate GST:** with suitable surcharges on “sin goods,” (goods that are harmful to society and individuals, for example, alcohol and tobacco, drugs, etc), zero ratings of exports and reforming the Integrated Goods and Services Tax (IGST) and the e-way bill.
    - **Transparency:** The GST Council should undertake reforms in an **informed and transparent manner**, by creating its own secretariat and independent experts (as its staff).

Goods and Services Tax

- GST is a comprehensive, multi-stage, destination-based tax that is levied on every value addition.
- GST is one **indirect tax** for the entire country.
- The **GST council** is the key decision-making body that will take all important decisions regarding the GST.

Conclusion

Creating the new fiscal federal architecture based on the effective decentralization, transparent GST regime, independent Finance commission and effective NITI Aayog can strengthen India’s unique cooperative federalism**.**

Drishti Input

Discuss the need and ways for redefining the fiscal architecture of India to strengthen the fiscal federalism.