



Fiscal Federalism amidst Coalition Politics

This editorial is based on “ [Union Budget 2024: Fiscal balance amid coalition compromises](#)” which was published in Business Standard on 25/07/2024. The article reviews the first Budget of 18th Lok Sabha, noting its alignment with expectations. It emphasizes long-term goals like achieving "developed-country" status by India's centenary, while accommodating coalition demands.

For Prelims: [Finance Commissions](#), [Planning Commission](#), [NITI Aayog](#), [GST](#), [tax devolution](#), [Union Budget for 2024-25](#), [Goods and Services Tax Council](#), [Seventh Schedule](#), [Andhra Pradesh Reorganisation Act, 2014](#), [Fiscal Responsibility and Budget Management \(FRBM\) Act](#), [Cooperative Federalism](#), [Competitive Federalism](#).

For Mains: Major Challenges of Fiscal Federalism in India and Way Forward to Overcome These Challenges by Cooperative Federalism.

Fiscal federalism in India is crucial for maintaining a balance between the center and states' financial autonomy, ensuring equitable resource distribution. It strengthens democratic governance by promoting local decision-making and accountability, while addressing regional disparities and fostering cooperative federalism.

Envisaging sound **fiscal federalism**, the Indian Constitution has established mechanisms such as shared taxes and grants-in-aid to address regional imbalances, complemented by institutional frameworks like [Finance Commissions](#) with specific mandates.

Significant reforms including the abolition of the [Planning Commission](#), establishment of [NITI Aayog](#), constitutional amendments for [GST](#), and increased [tax devolution](#) based on the **Fourteenth Finance Commission** have fundamentally altered fiscal relations between the Union and states.

The [Union Budget for 2024-25](#), aims to prioritize achieving "**developed-country**" status by India's centenary. In this path it is necessary to foster **cooperative federalism** which faces challenges in a coalition democratic system. Thus, recognizing **coalition dynamics**, the budget accommodates demands from key allies crucial for political support.

What are Constitutional Provisions Related to Centre-State Financial Relations?

▪ Constitutional Framework (Part XII):

- The **Indian Constitution** delineates comprehensive provisions governing the distribution of **taxes, non-tax revenues, borrowing powers, and grants-in-aid** between the Centre and the States.
- **Articles 268 to 293** specifically address financial relations, outlining the mechanisms for fiscal transactions and allocations.

- **Article 269A (Goods and Services Tax - GST):**
 - **GST** was introduced by **The Constitution (101st Amendment) Act, 2016**.
 - **Article 269A** says that **GST** on supplies in the course of inter-State trade or commerce shall be levied and collected by the Government of India and such tax shall be divided between the Union and the States in the manner as may be provided by Parliament by law on the recommendations of the [Goods and Services Tax Council](#).
- **Article 275 (Post Devolution Revenue Deficit Grants):**
 - Under **Article 275**, the central government exercises discretionary authority to transfer funds to state governments for specific purposes or schemes, ensuring financial support where necessary.
- **Article 280 (The Finance Commission):**
 - Constitutionally mandated under **Article 280**, the **Finance Commission** plays a pivotal role in recommending the distribution of tax revenues between the **Centre and States**.
 - Beyond **tax devolution**, it advises on enhancing state finances, promoting fiscal discipline, and ensuring overall fiscal stability.
- **The Seventh Schedule:**
 - The [Seventh Schedule](#) of the Constitution delineates the taxation powers between the Centre and the States:
 - **Parliament** has exclusive authority over taxes listed in the **Union List**.
 - **State legislatures** hold exclusive power over taxes listed in the **State List**.
 - Both can levy taxes on subjects enumerated in the **Concurrent List**, with residual tax powers vested solely in Parliament.

What are the Challenges Faced by Fiscal Federalism in India?

- **Declining Share in Gross Tax Revenue:**
 - Despite recommendations from the **14th and 15th Finance Commissions (FCs)** suggesting **42% and 41%** of net tax revenue for States, their actual share of gross tax revenue dwindled to **35%** in 2015-16 and further to **30%** by 2023-24 (Budget Estimates).
 - As per budget estimates, for 2024-25, Gross Tax Revenue (GTR) is projected to grow at 11.7% over 2023-24 at **Rs 38.40 lakh crore** (11.8% of GDP). Thus with increasing GTR states share should vary to meet their fiscal needs.
- **Erosion of State Tax Autonomy:**
 - States have witnessed a decline in their ability to independently set tax rates on revenue sources, particularly evident post the adoption of **value-added tax (VAT) for intra-state trade**.
 - This shift along with introduction of GST has curtailed states' capacity to tailor tax policies to local economic conditions. Further, timely **disbursement of GST compensation dues** has been flagged by states at several occasions.
- **Reduction in Grants-in-Aid to States:**
 - Financial aid provided to States saw a decrease from **Rs 1.95 lakh crore in 2015-16 to Rs 1.65 lakh crore in 2023-24**.
 - Consequently, the combined proportion of statutory financial transfers to the Union government's gross tax revenue declined from **48.2% to 35.32%**.
- **Increasing Tax Collection Under Cess and Surcharge Categories:**
 - A significant factor contributing to the decline in States' share of gross revenue is the inclusion of revenue collected through **cess and surcharge** in the deduction process for net tax revenue.
 - This collection, excluding GST cess until June 2022, has notably increased over time.
- **Financial Centralisation Concerns:**
 - The Union government utilizes **Centrally Sponsored Schemes (CSS) and Central Sector Schemes (CS)** as direct financial transfers to States, influencing their fiscal priorities.
 - The allocation for CSS rose from **Rs 2.04 lakh crore to Rs 4.76 lakh crore** between **2015-16 and 2023-24**, spanning 59 CSS.
 - This approach compels **States** to commit equivalent financial resources alongside **Union funds**.
- **Issues Surrounding Wealthy vs Less Wealthy States:**
 - **CSS implementation** reveals disparities among States, as wealthier ones can

independently fund matching grants, whereas less affluent States must rely on borrowing, increasing their fiscal liabilities.

- This disparity accentuates **inter-State inequality** in public finances.

▪ **Larger Financial Powers of Union Govt with Limited Expenditure Responsibilities:**

- Despite transferring **less than 50% of gross tax revenue to States**, the **Union government** retains a significant fiscal deficit of **5.9% of GDP**.
- This setup confers substantial financial authority to the Union while limiting its expenditure obligations leaving less room for state allocative .

What is the Impact of Coalition Politics on Fiscal Federalism?

▪ **Positive Impacts:**

- **Impact on Central Transfers:** States represented in the coalition may negotiate for more favorable terms in terms of **revenue-sharing and grants**, impacting the overall **fiscal federalism framework**.
 - **For instance**, along with other announcements an outlay of **Rs 26,000 crore** for various road projects in **Bihar** in **Budget 2024-25** similarly, in addition to other provisions, **Andhra Pradesh** will receive **Rs 15,000 crore** for building new capital.
- **Enhanced Bargaining Power For States:** Coalition governments often require the support of **regional parties**, which gives states increased bargaining power to negotiate for **larger shares of central transfers** and more autonomy in fiscal management.
- **Focus on Regional Development:** The **coalition governments** may adopt policies that cater to regional needs and priorities, which may lead to increased focus on more **fine-tuned fiscal policies** that address **local developmental challenges**, thereby promoting balanced regional development.
 - For instance, [Andhra Pradesh Reorganisation Act, 2014](#), aiming for development of 2 states thus formed, was passed by parliament due to cooperation of coalition parties at center .
- **Increased Transparency and Accountability:** The need to maintain coalition partners can sometimes lead to greater transparency in **fiscal decisions and accountability** in the use of public funds.
- **Stability and Long-term Planning:** While coalitions can sometimes be unstable, they can also **foster consensus-building** and **long-term planning** in fiscal matters which can ensure **stability in governance**, allowing for sustained economic growth and development.

▪ **Negative Impacts**

- **Fiscal Indiscipline:** The desire to **appease coalition partners** can lead to excessive spending and populist measures, impacting fiscal discipline and macroeconomic stability.
- **Delayed Decision-Making:** Coalition governments often face challenges in reaching consensus on fiscal matters, leading to **delays in decision-making and implementation of important reforms**.
- **Uncertainty and instability:** The **fragile nature** of coalition governments can create uncertainty in the fiscal environment, discouraging long-term investments and planning.
- **Potential for misuse of funds:** The pressure to distribute resources to satisfy coalition partners can sometimes lead to the misuse of funds and corruption.

What Should be the Way Forward?

▪ **Promoting Competitive Federalism:**

- Along with [cooperative federalism](#), [competitive federalism](#) should be promoted.
- **Benchmarking and performance indicators, incentive-based resource allocation, and investment attraction** should be parameter to promote competitive federalism and fund allocation.

▪ **Reform the Finance Commission and Tax Sharing Mechanisms:**

- **The Finance Commission** should be directed to **review tax-sharing principles** in the context of India's evolving fiscal federalism.
- The divisible pool should be redefined, incorporating IGST fully, and criteria for horizontal devolution should be revised to suit the consumption-based tax system.

▪ **Enhance the Institutional Framework for Fiscal Federalism:**

- A formal relationship should be established between the **GST Council and the Finance Commission** to ensure coordinated decision-making on the divisible pool and its distribution.
 - The **Inter-State Council** should be empowered to serve as a platform for dialogue and consensus-building between **the Centre and states** on fiscal matters.
 - Furthermore, the provisions of the [Fiscal Responsibility and Budget Management \(FRBM\) Act](#) should be aligned for both central and state governments to maintain fiscal discipline while accommodating their unique situations that allows flexibility on a state to state basis
- **Improve Fiscal Transfers and Grants:**
 - The grant mechanism under **Article 275** should be redesigned in light of the **GST** compensation law.
 - **Intergovernmental transfers** should be restructured to promote equity, addressing both **horizontal and vertical fiscal imbalances**.
 - Clear guidelines should be established for the **distribution of central funds, grants, and subsidies** to ensure transparent **fiscal transfers and reduce discretionary powers**.
 - **Implement Robust Anti-defection Laws:**
 - Strengthen and strictly enforce [anti-defection laws](#) to discourage political horse-trading and maintain stability in governments, which is crucial for consistent fiscal policies.
 - In absence of such measures there may be skewed fiscal allocation to the state.
 - **Strengthen State and Local Government Autonomy:**
 - More fiscal powers should be devolved to **states and local bodies**, providing them with **greater flexibility in revenue generation**, expenditure planning, and borrowing limits.
 - States should be given more control over taxation to enable them to generate revenue according to their local economic conditions and priorities.
 - **Promote Cooperative Federalism:**
 - Incentives should be introduced to encourage states to **collaborate and share resources** for regional development initiatives by promoting the spirit of **cooperative federalism**.
 - Regular mechanisms for **dialogue between the central and state governments** should be established to discuss fiscal issues, policy challenges, and potential improvements to the fiscal federalism framework.
 - **Address Structural Issues in Fiscal Federalism:**
 - Constitutional reforms should be considered to revisit **Articles 246** and the **Seventh Schedule**, redefining the division of powers and responsibilities between central and state governments.
 - The issue of **off-budget borrowings** should be addressed to prevent hidden liabilities and increase transparency in fiscal management.
 - **Enhance Capacity Building and Long-term Planning:**
 - The capacity of states in fiscal management should be enhanced through training programs, knowledge-sharing platforms, and technical assistance.
 - **Long-term fiscal policy** stability should be promoted by avoiding frequent changes and ensuring continuity across political transitions.

Drishti Mains Question:

Examine the role of coalition politics in influencing fiscal federalism in India. Discuss how coalition dynamics shape fiscal policies and resource allocation between the Centre and states.

UPSC Civil Services Examination, Previous Year Question (PYQ)

Prelims:

Q. Which one of the following in Indian polity is an essential feature that indicates that it is federal in character?

(a) The independence of judiciary is safeguarded.

(b) The Union Legislature has elected representatives from constituent units.

(c) The Union Cabinet can have elected representatives from regional parties.

(d) The Fundamental Rights are enforceable by Courts of Law.

Ans: (a)

Mains:

Q. The concept of cooperative federalism has been increasingly emphasized in recent years. Highlight the drawbacks in the existing structure and the extent to which cooperative federalism would answer the shortcomings.

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