Mains Practice Question

Q. To what extent has India's federal fiscal architecture been able to address regional economic disparities? Analyze with reference to recent reforms in center-state financial relations. **(250 words)**

29 Jan, 2025 GS Paper 3 Economy

Approach

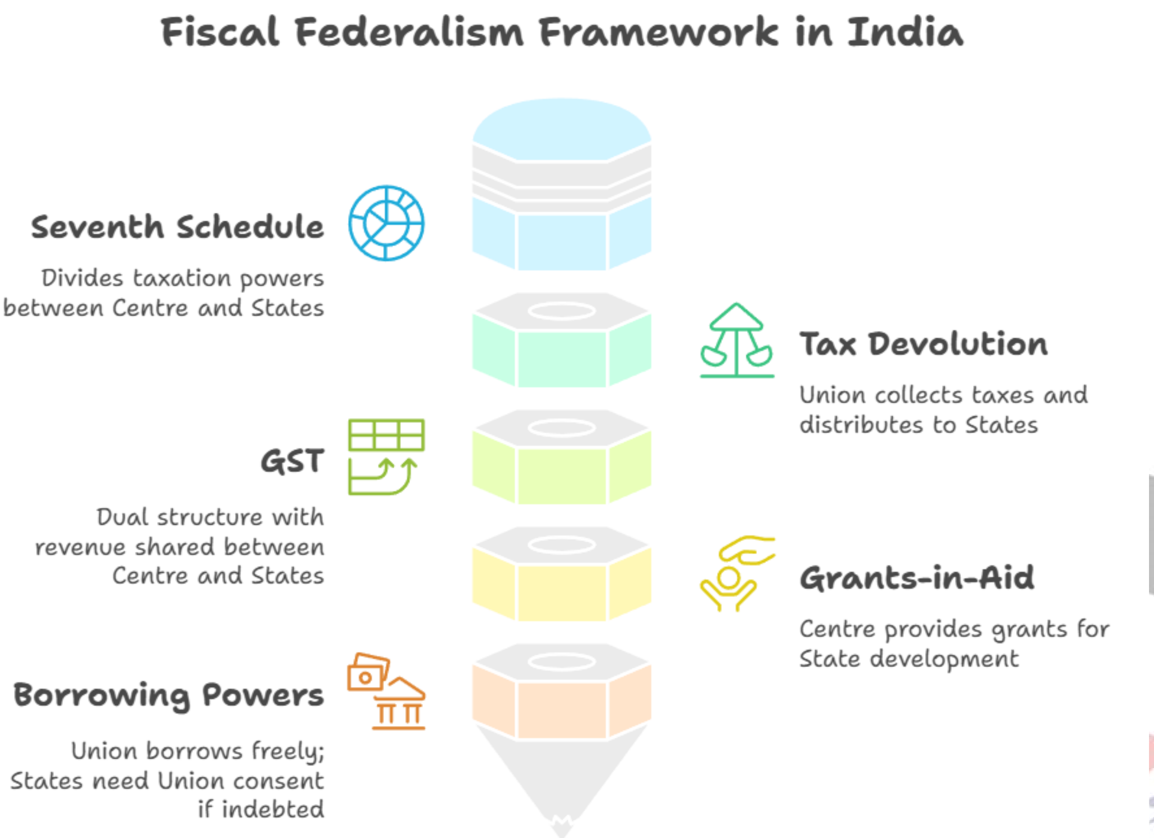
- Introduce the answer by briefing India's federal fiscal structure
- Delve into how Fiscal Federalism has addressed Regional Economic Disparities
- Highlight the gaps that still remain
- Suggest a Way Forward
- Conclude by stressing upon to what extent it has been addressed regional economic disparities and way ahead.

Introduction

India's federal fiscal structure, as outlined in the **Constitution,** aims to balance financial **resources between the Centre and States** to promote equitable economic growth.

- However, despite mechanisms such as **tax devolution (Article 270), grants-in-aid (Article 275), and Finance Commission recommendations (Article 280),** regional economic disparities persist.

//



Body

Fiscal Federalism Addressing Regional Economic Disparities :

- **Increased Tax Devolution**: Post **14^{th} FC (2015-20),** states' share in central taxes rose from **32% to 42%** (later revised to **41%)**.
  - Greater fiscal autonomy for states in prioritizing expenditures.
- **Goods and Services Tax (GST) Implementation (2017): Unified tax structure**, reducing cascading effects.
  - **GST Council** (Article 279A) ensures cooperative federalism in taxation.
- **Grants & Centrally Sponsored Schemes (CSS)**: Specific grants for **disaster relief, health, and rural development.**
  - Shift from **Plan and Non-Plan Expenditure** to sectoral funding.
- **Borrowing & Fiscal Responsibility: Fiscal Responsibility and Budget Management (FRBM) Act** limits deficits but allows flexibility in crises (e.g., COVID-19).
  - States allowed additional borrowing **(up to 5% of GSDP)** under Atmanirbhar Bharat Package.

However, significant gaps still exist including:

- **Vertical Fiscal Imbalance and Erosion of State Tax Autonomy:** The Centre retains taxation power over high-revenue sources **(income tax, CGST, foreign transactions), while States primarily rely on SGST and minor local taxes.**
  - Post-GST, States have limited autonomy in setting tax rates, making them dependent on **Union transfers,** which are often delayed (e.g., **pending GST compensation dues flagged by States).**
- **Changing Trends in Finance Commission Transfers:** The **15^{th} Finance Commission's**

formula allocates tax transfers based on population (15%), area (15%), income distance (45%), demographic transition (12.5%), forest cover (10%), and tax effort (2.5%).
    - The **income distance criterion** disadvantages **economically progressing States like Tamil Nadu and Maharashtra**, while favoring historically poorer States.
    - This method definitely helps **less developed States** but creates resentment among high-growth States regarding their fiscal share.
- **Decline in Grants-in-Aid and Rise in Cess & Surcharges**
    - **Grants-in-aid have fallen** from ₹1.95 lakh crore (2015-16) to ₹1.65 lakh crore (2023-24), reducing discretionary funding for States.
    - **Cess and surcharge collections increased by 133% (2017-18 to 2022-23), but are not shared with States.**
    - This has disproportionately impacted poorer States, which rely more on central grants for development projects.

Way Forward

- **Greater Fiscal Autonomy for States:** Allow States **greater flexibility in taxation under GST** to cater to regional economic needs. Ensure **timely release of GST compensation dues.**
- **Reforms in Finance Commission Allocations** Balance **income distance criteria** with incentives for high-growth States to maintain inter-State equity.
    - Increase **untied grants** to allow greater State-level fiscal planning.
- **Rationalization of Centrally Sponsored Schemes:** Rationalise the number of Central Sponsored Schemes **(NK Singh Committee)** or reduce **State co-financing obligations** to support financially weaker States.
    - Allow **State governments greater say in scheme design** to ensure region-specific development.
- **Revisiting Cess and Surcharge Sharing Mechanism:** Institutionalize a framework to **share a portion of cess and surcharge revenue with States** to reduce fiscal imbalance.
- **Enhancing Borrowing Flexibility for Developmental Expenditure**: Allow higher borrowing limits for **States with responsible fiscal management** to finance infrastructure and welfare schemes.

Conclusion

While decent progress has been made in ensuring fiscal transfers, significant gaps remain like increased **centralization of revenues, decline in State grants, and borrowing restrictions** disproportionately impact less developed States, exacerbating existing inequalities. To achieve equitable growth, reforms should focus on empowering States with **greater financial autonomy, fairer revenue-sharing mechanisms, and flexibility in expenditure planning.**