Fiscal Federalism

Why in News?

Recently, the Chief Minister of Bihar and Andhra Pradesh have demanded special financial packages for their respective States.

How States receive finance from centre?

> ***Fiscal federalism*** *deals with the division of governmental functions and financial relations among levels of government.*

- **Distribution of revenues** – ***Articles 268 to 272*** of the Indian Constitution define the distribution of revenues between the Union and the states.
- As per ***Article 268,*** certain duties are levied by the Centre but collected and retained by the States.
- ***Article 269*** mentions about those taxes and duties that are levied and collected by the Centre but assigned in whole to the States.
- ***Article 270*** deals with sharing of the proceeds of all Union taxes between the Centre and the States.
- **Grants-in-Aid –** The Constitution provides for grants-in-aid to the states from the Central resources.
- **Statutory grants** – ***Article 275*** provides for compulsory statutory grants-in-aid to the revenues of States.
- **Discretionary grants –** ***Article 282*** empowers both the Centre and the states to make any grants for any public purpose, even if it is not within their respective legislative competence.
- Under this provision, the Centre makes grants to the states.
- **Other grants** - These grants were to be given for a period of ten years from the commencement of the Constitution.
- These sums were charged on the Consolidated Fund of India.
- **Finance through schemes** – A significant proportion of fiscal transfers to states from the Centre is taken up by *centrally sponsored schemes (CSS)*.

> ***Centrally Sponsored schemes (CSS)*** *are designed and partially funded by the central government, are implemented by state governments in accordance with the terms fixed by the Centre.*

- CSSs have been ***implemented via Article 282*** of the Indian Constitution.

What is the role of finance commission in fiscal federalism?

- **Finance Commission** – It is a constitutional body set up under Article 280.
- It is constituted *by the President every fifth year or even earlier*.
- **Role in fiscal federalism** – It is constituted, mainly to give its recommendations regarding revenue sharing between centre and states and also regarding allocation of grants to the states.
- **Distribution of net proceeds of taxes**- Finance commission recommends the distribution of the net proceeds of taxes to be shared between the Centre and the States.
- **Principles governing grants-in-aid**- Finance commission determines the principles which should govern the grants-in-aid to the states by the Centre out of the Consolidated Fund of India.
- The statutory grants under Article 275 (both general and specific) are given to the states on the recommendation of the Finance Commission.
- Other temporary grants-in-aid were also made to the states on the re commendation of the Finance Commission.

15th Finance Commission on fiscal devolution
• **Vertical devolution (between centre and states)** – States should be given 41% of the divisible tax pool. • **Horizontal devolution (between states)** – Uttar Pradesh and Bihar in 2020-21 got the largest amount of funds and Karnataka and Kerala saw the largest decrease in the share of funds. • There is a formula applied by the commission which is based on - Income - Population - Area - Forests and ecology - Demographic performance, etc. • So, in other words, the criteria that the Finance Commission use can change the amount of funds going to different States.

Critically analyse on special financial packages?

- **Special financial packages** – They are financial support to the states which are in need rather than to all the states.
- They are granted under Article 282 ('Miscellaneous Financial Provisions')

70% of the funds that the Centre spends is non- discretionary. But the remaining 30% are discretionary.

- **Need** – It is demanded by a specific state for a specific purpose concerned to that state.
- **Recent demands** – *Bihar's demand* for a special financial package often revolves around the need to address backwardness, improve infrastructure, boost agricultural productivity, and enhance educational and healthcare facilities.

- Bihar, being one of the less developed states in India, seeks additional funds to bridge the development gap with more prosperous states.
- *Andhra Pradesh* demand for a special financial package is primarily linked to the state's bifurcation in 2014, which resulted in significant economic and infrastructural challenges.

Pros of Special Financial Packages
• **Address specific needs** – Certain states might face unique challenges like natural disasters, insurgencies, or economic disadvantages. • This targeted approach helps in delivering quicker and accurate relief measures. • **Promote regional equity**- It can help in bridging the development gap between richer and poorer states, promoting regional development and ensuring that no state is left behind. • **Promotes development** – It can incentivise states to undertake significant reforms or projects that align with national priorities (like green energy, digital infrastructure, or health initiatives).
Cons of Special Financial Packages
• **Undermine the fiscal discipline** – It can lead to *misuse of funds* with the already growing concern of corruption. • **Creates inequity and favouritism**- Special packages could be allocated *based on political considerations* rather than genuine needs, leading to favouritism and inequity among states. • **Lead to duplication**- It can overlap with existing schemes and can *reduce the overall effectiveness* of government spending. • **Macroeconomic instability** – Unplanned and Outside budget expenditures can *strain the centre's finances* and contribute to fiscal deficits. • This can have a cascading effect on the entire economy.

What lies ahead?

- Channelise more resources for higher capital investment in the poorer regions of the country for balanced regional development.
- Reduce leakages and collect a lot more from direct taxes and reduce collections from indirect taxes, which are having a negative effect on the backward States as compared to the advanced ones.
- Deliberate at the national level involving all the stakeholders to understand which schemes the Centre should intervene in, and which it should leave to the States.
- Follow the recommendations of the 14th Finance Commission, the Centre should intervene in schemes where there are large externalities or national priorities involved.
- Improve governance of states and the quality of expenditures on various development activities.

Reference

The Hindu| Special Financial Packages