

## **Reassessing Fiscal Federalism in India**

### **What is the issue?**

With new developments in tax sharing, it is high time that the Constitution is amended to fix the proportion of shareable taxes for the States.

### **Why is federalism significant?**

- The efficiency of a government depends on, among other factors, its structure.
- In large countries, it has been felt that only a federal structure can efficiently meet the requirements of people from different regions.
- Underlying this proposition is the premise that preferences vary across regions.
- This is why even provincial autonomy was regarded as an integral part of the freedom movement.

### **How is federalism at present?**

- After Independence, the Centre assumed greater importance due to compulsions of defence and internal security.
- Also in the years soon after Independence, the Centre and all States were ruled by the same party and many of the powerful provincial leaders migrated to the Centre.
- Moreover, economic planning at a nation-wide level helped this centralising process.

### **What are the challenges in fiscal federalism?**

- Fiscal federalism is the economic counterpart to political federalism.
- It assigns functions to different levels of government and also offers appropriate fiscal instruments for carrying out these functions.
- Determination of these specific fiscal instruments is a challenging task. E.g. the 'tax-assignment problem'
- Building the principles into an actual scheme of assignment of taxes to different levels of government in a Constitution is difficult.
- In India, income tax is levied only by the Central government though shared with the States.
- Given the possibility of imbalance between resources and responsibilities,

many countries have a system of inter-governmental transfers.

### **What is the concern in India?**

- The Indian Constitution lays down the functions as well as taxing powers of the Centre and States.
- It is against this background that the issues relating to vertical and horizontal imbalances are addressed by every Finance Commission.
- However, Central transfers to States are not confined to the recommendations of the Finance Commissions.
- There are other channels such as those through the Planning Commission until recently and the discretionary grants of the Central government.
- Resultantly, in 2010-11, in the combined revenue receipts of the Centre and States, the share of the Centre was around 64%.
- But after transfer, the share came down to nearly 40%. Thus the shares of Centre and states got reversed after the transfers.
- In 2016-17, the share of the Centre after transfers was around 33% and that of the States was 66%.
- In comparison, in the case of total expenditures, the share of the Centre in 2014-15 was nearly 41% and that of the States was 58%.
- Moreover, Fourteenth Finance Commission recommendation to raise tax devolution to 42% of the divisible pool has introduced new challenges to fiscal federalism.

### **What is to be done?**

- The Constitution can be amended and the proportion of shareable taxes that should go to the States should be fixed at the desired level.
- The shareable tax pool must also include cesses and surcharges (now with Centre), as these have sharply increased in the recent years.
- Fixing the ratio at 42% of shareable taxes, including cesses and surcharges, seems appropriate.
- Otherwise, as in the U.S. and Canada, States could be allowed to levy tax on personal income, with some limitations.
- Given the concern that resources do not match functions, this may be a way out.
- But, as in the U.S., it should be simple and ride on federal income tax i.e. just a levy on the income assessed by federal authorities.
- Also, on giving this power to the States, the transfers from the Centre need to be adjusted.
- As far as India is concerned, there has to be a study to assess the feasibility and benefits of the two alternatives to adopt one.
- This will go a long way in avoiding friction between the Centre and the

States.

- However, the ability of bringing about equalisation across States in India has limitations, and the concerns with horizontal distribution continue.
- Even the relatively richer States have their own problems and they feel being deprived of their due share due to the overuse of the equity criterion.

**Source: The Hindu**

