KERALA ECONOMY
2024, VOL. 5, NO.2. pp 32-48.

ISSN : 2583-4436

GIFT GULATI INSTITUTE OF FINANCE AND TAXATION

Is India's fiscal federalism under threat? Issues in resource transfers

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Abstract

The Indian structure of fiscal federalism is marked by the complex system of sharing fiscal resources and powers between the centre and the states and among the states. This report looks into the issues revolving vertical and horizontal devolution. The horizontal imbalances are also analyzed, particularly the aspect of the North-South divide. The states compete among themselves to obtain a higher share of the overall fund corpus from the centre leading to evident regional disparities. The analysis concludes by emphasizing the relevance of revisiting the allocation formula to uphold the principles of equity and efficiency in resource distribution. The centre should revisit the vertical devolution by enlarging the divisible pool. Secondly, the weightage for efficiency criteria in horizontal devolution should be increased. GST being a consumption-based destination tax that is equally divided between the Union and the State means that State GST accrual (inclusive of Integrated GST settlement on inter-state sales) should be changed to 60:40 share (60% for states and 40% for Centre). States' own revenue generation should be supported by adding more flexibility.

Keywords: *Fiscal federalism, divisible pool, Horizontal imbalance, Cess & Surcharge, Transfers.*

Introduction

Fiscal federalism, a cornerstone of modern governance, involves a careful balancing act between national and subnational governments as they formulate and allocate financial powers and obligations. In this framework, the ideals of economic theory meet the realities of

political life. The Indian Constitution has mandated fiscal federalism since its inception. However, its trajectory in the Indian context is set to change in the evolving political and socio-economic landscape.

Imbalances in fiscal arrangement, both vertical and horizontal, are inevitable in a federation, with India being no exception. These imbalances are tackled within the Indian context through various mechanisms outlined in the Indian Constitution, such as shared taxes, grants-in-aid, and the establishment of Finance Commissions tasked with specific terms of reference.

Kletzer and Singh (1995) proposed a systematic framework for analysing the interactions between the institutions of fiscal federalism and political decision-making. They suggest that strategic behaviour by self-interested government decision-makers can be explored within this framework, setting the stage for understanding the broader implications of fiscal federalism. This foundational perspective provides a lens through which to examine the subsequent case studies and empirical findings.

Extending this theoretical framework to practical applications, countries like Australia, Canada, Germany, and Switzerland have established their individual equalization frameworks, each carrying specific implications for equity, incentives, and distribution *(Bahl, Martinez, and Sjoquist, 1992; Blair, 1992; Boadway, 2004; Ladd and Yinger, 1994; Ma, 1997; and Ridge, 1992).* These comparative perspectives highlight how different nations approach the challenges of fiscal equalization, providing diverse strategies and outcomes. For instance, *Buettner and Krause (2020)* suggest that Germany's fiscal equalization mechanisms motivate states to raise tax rates. This leads to notable tax policy changes following the transfer of taxing authority, thereby influencing subnational fiscal decisions and redistribution patterns. This demonstrates the dynamic relationship between fiscal transfers and state tax policies, illustrating the practical impacts of theoretical principles in a real-world context. Similarly, in the UK, the approach to devolution has been reactive, iterative, and largely ad hoc, reflecting the asymmetric nature of fiscal arrangements. This underscores the necessity for a coordinated and oversight mechanism to enhance fiscal frameworks and ensure effective budget scrutiny *(McIntyre, Mitchell, and Roy, 2022).* The UK's experience highlights the importance of structured and consistent policy frameworks to manage fiscal federalism effectively.

Moving to the Indian context, *Rangarajan and Srivastava (2008)* emphasize that the stability of states' shares from the divisible pool is essential for maintaining fiscal balance and equity in India's fiscal transfer system. They argue that long-term stability in the share of states after transfers in the combined revenues of the centre and states is crucial for ensuring fairness and equity in the distribution of resources. This perspective is critical for understanding the fiscal dynamics within India.

Furthermore, the impact of tax devolution to the states appears to have a more equalizing effect compared to the distribution of grants *(Mohan & Shyjan, 2009)*. This is attributed to the discretionary nature of grants allocation, which contrasts with the criteria-based approach of tax devolution. The authors argue that tax devolution can effectively address differing fiscal capacities among states. However, concerns are raised regarding the declining state share in the divisible pool, suggesting a need for higher state participation in tax devolution to prevent states from being disadvantaged by grant restructuring.

Rao and Singh (2001) provide empirical evidence supporting the bargaining view of federalism. Their study indicates that states demonstrating greater bargaining power tend to receive larger per capita transfers. This finding highlights the complex interplay of political and economic factors in shaping fiscal transfers between the central and state governments, emphasizing the role of negotiation and power dynamics.

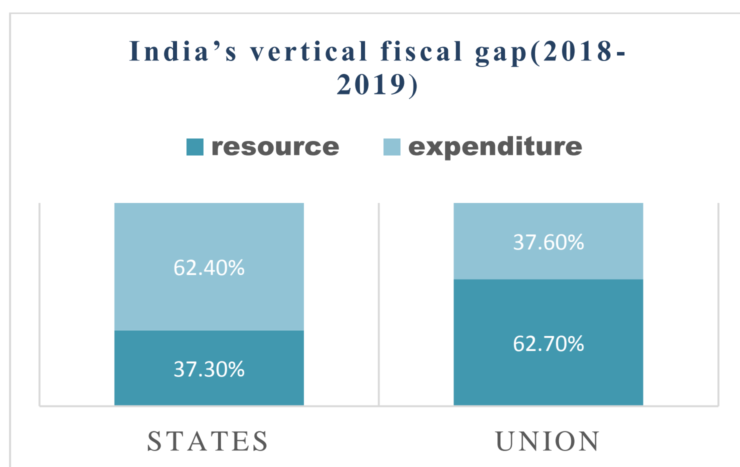
The distribution of fiscal transfers from the central government to the state governments has evolved over the years. States have increasingly preferred tax devolution over grants due to its responsiveness to economic changes. This shift underscores the practical implications of the theoretical and empirical findings discussed, reflecting a trend towards more adaptive and responsive fiscal policies. In an analytical study, *Sindhu, Khatkar, and Panghal (2016)* highlight the importance of balancing autonomy and hard budget constraints for states to achieve economic growth within a fiscal federalism framework. The study emphasizes that while greater autonomy allows states to provide better services tailored to local needs, softer budget constraints may lead to states unduly benefiting from tax-sharing mechanisms. This highlights the need for states to enhance their tax collection and utilization mechanisms while the central government maintains oversight to ensure efficient resource allocation.

Finally, *Tannenwald (1998)* analyses the impact of federal policies on state finances, focusing on changes in funding levels and terms. The study discusses how shifts in federal funding can

significantly affect state budgets and their capacity to respond to devolution, highlighting the critical influence of federal policy decisions on state fiscal health.

This analysis tries to demonstrate how policy decisions at the federal level have profound implications for fiscal federalism. This study aims to bring forth the issue revolving around vertical and devolution. Finally, the issue of north north-south divide will also be looked into of the inter se share by the finance commission.

Figure 1



Source: Report of 15th Finance Commission

Figure I shows extend of variation in the resources collected and expenditure incurred by both state and centre.

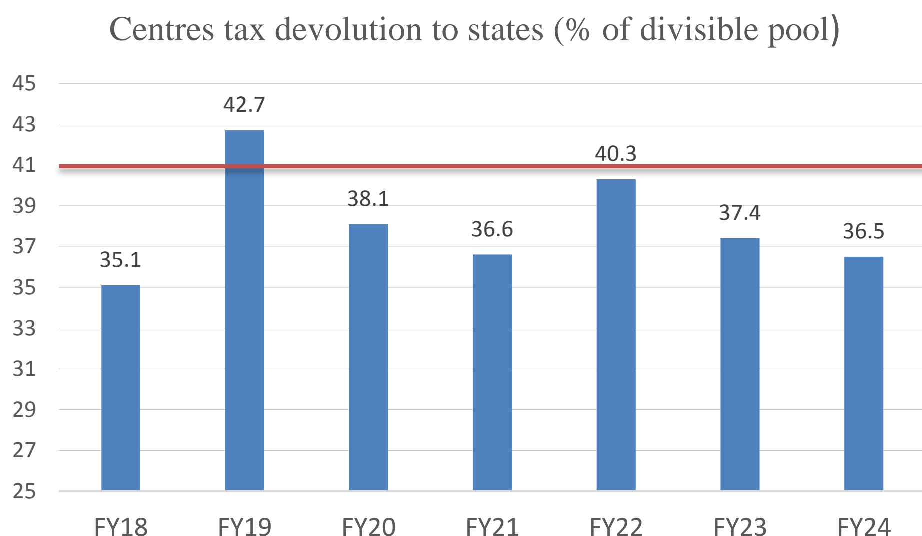
Income tax, corporate tax central GST, union excise duties, customs duties which are more buoyant and has nationwide base can only be collected by the centre. state governments have to bear higher expenditures to focus on local service provision due to their proximity to the people.

With this framework in place, the center raises the bulk of the resources. A conflicting situation arises when we look at who have to spend more, the centre or the states. Here the equation changes. State needs to finance several economic services like agriculture, transport, social services like education healthcare and housing in addition to their administrative expenses. Although the states have to spend 62%, they could collect only 37% whereas the centre collects the remaining 67%, to spend a lesser amount than the states

Issues in vertical devolution

According to the 15th FC's recommendation, the share of States in the divisible pool (vertical devolution) is 41%. With changes over the years, culminating in a constitutional amendment in 2000, all taxes of the Union were added to the net proceeds. there is an issue - cesses and surcharges under Article 270 and Article 271 were excluded from the net proceeds. Past cess and surcharge exceptions were based on specific FC recommendations. However, the amendment in 2000 provided a constitutional basis for it. Currently, the net proceeds contain the gross tax revenue after deducing the cesses, surcharges, and the cost of collecting taxes.

Figure 2



Source: The Hindu Business Line, February 16, 2023

According to an analysis of Budget 2023-24 by Emkay Global Financial Services, the Center's tax devolution to the states, which continues to fall short of the Finance Commission's suggestion, will drop to a five-year low in FY24. The study, 'The Centre-States Nexus of Fiscal Imbalances' by Madhavi Arora and Harshal Patel, estimates that 36.5% of the divisible pool of taxes is allocated to tax devolution- the lowest in 6 years, as against the 15th Finance Commission's recommendation of 41 percent. Taxes that are devolved to States are untied funds, thus states can exercise their discretion in spending. But, the divisible pool does not include cess and surcharge that are levied by the Centre. Out of all the taxes collected by the Centre, the majority is shareable. But the non-shareable portion goes straight

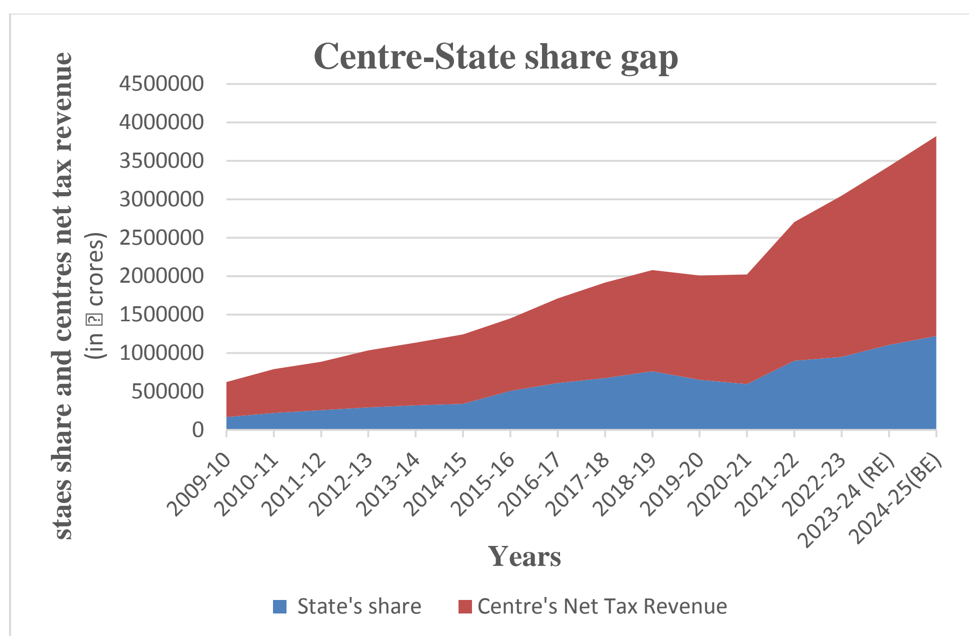
into the center's piggy bank. Non-shareable taxes are mostly made up of cesses and surcharges. The Centre can increase the amount of cess and surcharges it collects.

Centres -State revenue share gap

India's economy was in not the best health before the pandemic and the situation was worsened during the outbreak. Consequently, tax revenue was hit with the Centre collecting less tax than before. Centre's gross tax revenue registered a negative growth rate of -3.4% in FY20.

While the tax collected by the Centre declined, its share in the collection continued to grow. On the other hand, the state share in the Centre's taxes saw a fall.

Figure 3



Source: Authors calculation using data from various union budget documents

In the past three years, the gap between the centre and the states in the divisible portion of the tax has widened significantly. The point to note is that if the centres tax collection declines both the centre and states share should decline. How did the center escape this fall? The above graph visually represents the widening gap from 2009-10 to 2024-25. This indicates that the centres retention of tax revenue is growing faster than the share distributed to the states. Notable jumps can be seen around 2016-17,2020-21 and 2023-24. In the earlier years (2009-10 to around 2013-14), the gap was relatively smaller, indicating a more balanced

distribution between the Centre and the states. Post-2014, there is a visible acceleration in the Centre's net tax revenue compared to the state's share. A similar trend is observed in the case of total revenue receipts. The total revenue receipts have sharply increased, especially in recent years, while the state's share has seen relatively modest growth.

The proportion of state share of tax in gross tax revenue (as a percentage) dropped to 32.37% in 2019-20 and further to 29.35% in 2020-21. Although there was a recovery to 33.16% in 2021-22, it again declined slightly in the subsequent years. The projection of 31.84% indicates a continuing trend of state share around 32%. The states are entitled to get 41% of the tax share from the Union Government as per the 15th FC devolution. Due to the exclusion of cess and surcharges from gross tax revenue, there seems a decline in the share of taxes to states.

North-South divide

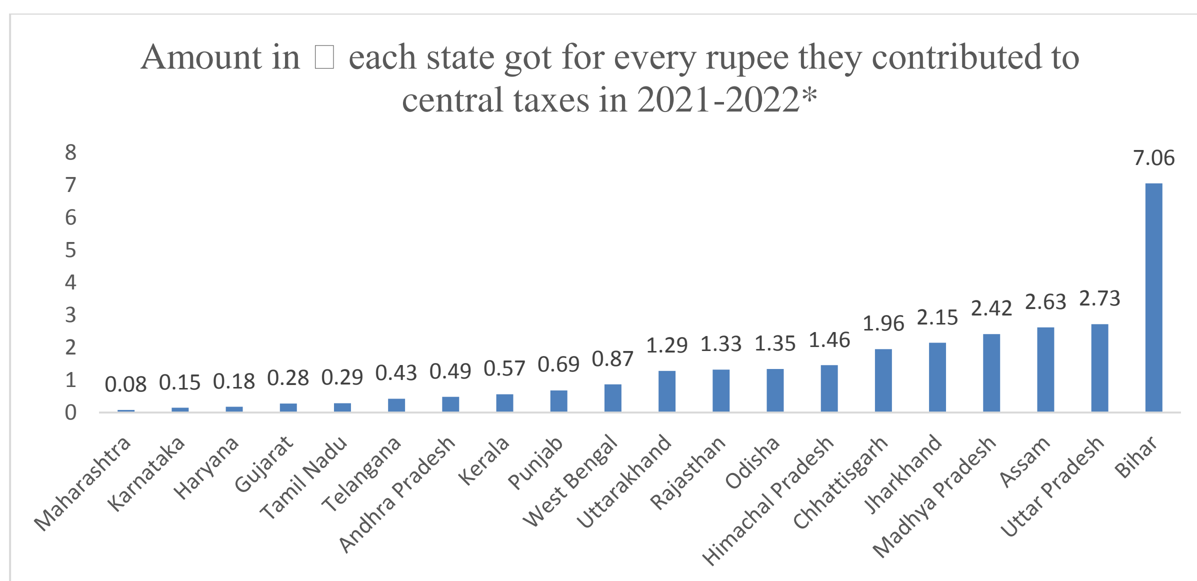
There exists huge inter-regional differences in growth and economic development among states. Per capita transfers are higher to states with lower per capita incomes. However, transfers do not fully offset the revenue disabilities of poorer states. More affluent states may incur significantly higher per capita expenditure than their poorer counterparts but feel that they should be enabled to perform better. The states compete among themselves to obtain a higher share of the overall fund corpus from the center. Thus, we have a game of competing states confronting the centre together, a phenomenon that can be described as union vs competing states. the vertical and horizontal imbalances and the manner of managing them have varied over the years, partly because of the developments in the economy and partly from political considerations.

The southern states have reignited the southern tax movement which puts the blame on the central govt for distributing the central taxes unfairly.

Allocation for one northern state Uttar Pradesh alone is significantly higher than to all the five southern states combined. Uttar Pradesh alone is getting 2.29 thousand crores, and Andhra Pradesh, Karnataka, Kerala, Tamil Nadu, and Telangana combined are getting around 1.93 thousand crores. Even before this budget, the southern states were at a huge disadvantage.

According to the data quoted in The Hindu (21 February 2024) , for every 1-rupee tax, Karnataka gets back 15 paise. The state contributes around 4 lakh crores to the union govt in tax and gets back around 52000 crores. The story is by and large similar to other southern states as well. TN gets back around 29 paise for every 1 rupee, Telangana gets 43 paise, Andhra Pradesh gets 49 paise, and Kerala gets 57 paise. Bihar gets back 7.06 rupees for every 1-rupee tax. UP gets back 2.73 rupees. Assam gets back 2.63, M.P gets back 2.42.

Figure 4



**Customs and union excise duties have not been considered in the calculation as state wise data is not maintained*
Source: The Hindu, February 21, 2024.

Issues with the finance commission's allocation formula:

The President of India appoints a Finance Commission every five years to address vertical and fiscal imbalances. The Commission's recommendations on tax devolution and grants-in-aid are crucial, though the government often transfers funds beyond its recommendations. Contentions arise over the relative shares of Finance Commission and non-Finance Commission transfers. Additionally, there are implicit transfers through central government investments in public enterprises, priority sector lending, and interest subventions.

Till the 13th finance commission, the formula was based on population in numbers as per the 1971 census. But the 14th finance commission recommendation that came into force from

2015 marks a break from the past. They started taking the formula based on 1971 and 2011 census. The 15th finance commission looks at only the 2011 census. This translates into the case where the states which have not implemented population control methods well like Bihar, Jharkhand, U.P get the larger share of the taxes and this happens at the expense of the states that have performed much better.

FC allocation for all the southern states has gone down while it has increased for Maharashtra. It went from 4.99% under the 12th FC to 6.31 under the 15th FC for Maharashtra.

As far as Telangana and Andhra Pradesh are concerned, when it was one state Andhra Pradesh got 7.35%. 15th FC gave Telangana 2.1% and A.P got 4.04%. Meanwhile, U. P's allocation swung between 17%-19%.

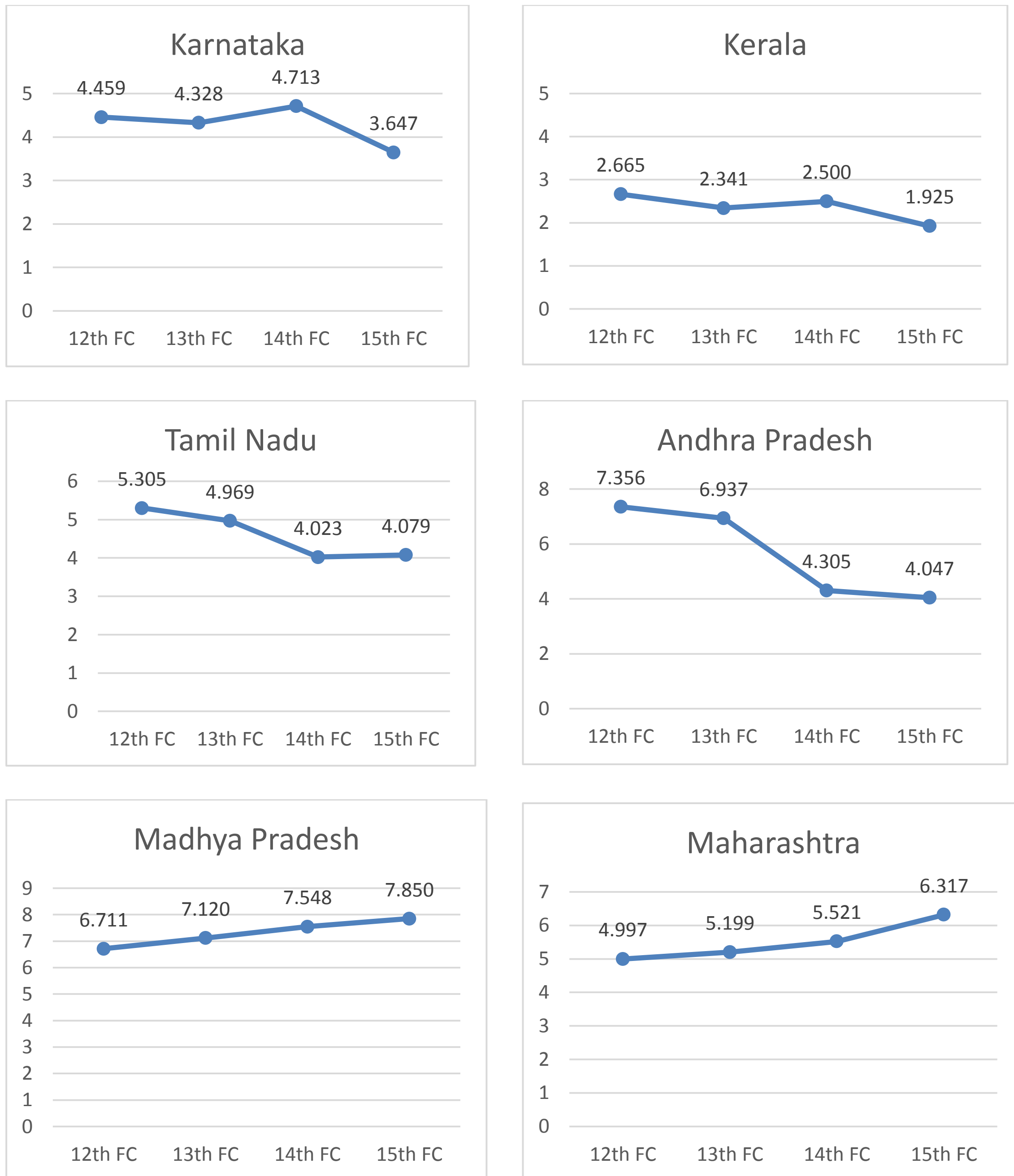
Allocation to each state changed based on the parameters used by FC and assigned weights. The 15th FC says that its formula looks at the fiscal needs and equity of states, allocating more funds to poorer states with lower per capita income. But the commission also had performance-based criteria thereby rewarding states with a lower total fertility rate or rewarding states with forest cover.

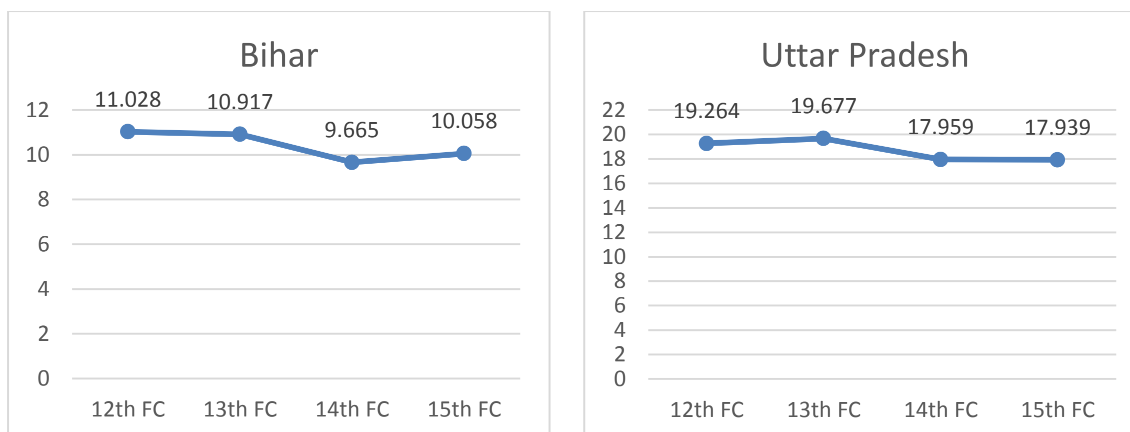
The allocation rises and falls every 5 years based on the state's needs and its performance. The base of reference is decided by the central govt which gives it an undue advantage and even categorizes certain income as exclusive to them, leaving less for the state or they can shift the balance between the states by readjusting the formula.

States's Share of tax in selected states from each finance commission is given in figure 5

Figure 5

Share of tax share of selected states from each finance commission





Source: Authors calculation using data from reports of the 12th-15th Finance Commissions

Rise in tied transfers

The Union government may argue that a part of the revenue collected through cesses and surcharges is used to finance centrally sponsored schemes (CSS) and central sector schemes, while another part is used to provide non-plan grants or capital transfers to states. However, these transfers are insufficient and not untied, unlike the devolution of the state's share in central taxes.

In centrally sponsored schemes, around 40% of the cost should be contributed by the state governments. Even in central sector schemes, the contribution of the Union government is often meagre, forcing state governments to contribute significantly larger amounts to run the schemes meaningfully. A considerable portion of the funds given by the Union government to the states comes in the form of CSS. Around 20% to 25% of the total funds come through these schemes, and these funds come with instructions on how to spend them. This means that the states have less freedom to decide how to spend the money they receive, even if it pertains to subjects in the state or concurrent list, like health.

The Union government attempts to take credit for central initiative even when state governments undertake it with the majority of the effort by insisting on displaying the Prime Minister's portrait or other forms of labeling. Recent disputes over labeling in the Ayushman Bharat wellness centers are one such example. Similarly, several grants given to the states are contingent on the fulfilment of conditionalities, and some of these conditionalities include the insistence on labeling. Additionally, most capital transfers given to the states are loans, which must be repaid to the Union government.

In conclusion, the transfers that the state govt gets outside the recommendations of the finance commission are neither unconditional nor suitable to meet their context-specific needs. Instead, they tend to reaffirm a centralizing tendency in the fiscal realm, effectively pushing the Union-State relationship into a patron-client relationship. Any deviation from the guidelines or a failure to meet the imposed conditionalities can lead to the denial of such resources.

Cess and surcharges

Since 2017, with the implementation of the GST, the Union government has significantly increased the percentage of cess by 153%, which it alone has the power to levy. These funds are not shared with states, although the Union claims they are eventually distributed through discretionary grants, which often favor politically important states. Despite expectations that GST would eliminate many cesses and surcharges, new ones continue to be introduced, and old ones remain outside the GST system. For example, the Agriculture Infrastructure and Development Cess was introduced in 2021-22, and the Health and Education Cess replaced earlier education cesses in 2017-18.

The expansion of cesses and surcharges has led to a larger portion of gross tax revenue being excluded from the net proceeds shared with states. Conflicting government reports indicate that the share of cesses and surcharges in gross tax revenue was 18.2% in 2019-20, 25.1% in 2020-21, and 28.1% in 2021-22. However, another statement in March 2023 reported lower shares for the same periods.

Analysis of budget documents from 2009-10 to 2024-25 shows that the collection of cesses and surcharges rose from ?70,559 crore in 2009-10 to ?6.6 lakh crore in 2023-24 (RE) and ?7 lakh crore in 2024-25 (BE). Excluding the GST compensation cess, collections increased from ?70,559 crore in 2009-10 to ?5.1 lakh crore in 2023-24 (RE) and ?5.5 lakh crore in 2024-25 (BE). As a share of gross tax revenue, cesses and surcharges fell from 11.3% in 2009-10 to 9.5% in 2014-15, but rose to 15.3% in 2018-19, peaked at 20.2% in 2020-21, and were 16.3% in 2022-23. Tentative figures for 2023-24 estimate them at 14.8%.

The share of cesses and surcharges in gross tax revenue has outpaced overall tax revenue growth, nearly doubling from 11.4% in FY18 to 19.8% in FY21, though it is expected to moderate to 16.4% in FY24. The 15th Finance Commission noted that the growing share of

these non-shareable revenues reduces the divisible pool percentage. A CAG audit found that funds collected through specific cesses were often not allocated to their intended purposes. For example, in 2019, nearly ?9,000 crore collected as Social Welfare Surcharge on customs were not transferred to a dedicated fund, and in FY20, 40% of cesses, valued at ?78,376 crore, were not transferred to reserved funds.

Between 2009-10 and 2023-24, the Union government collected ?36.6 lakh crore through cesses and surcharges, with an additional ?5.5 lakh crore projected for 2024-25. These funds were not shared with states, effectively reducing the states' share of gross tax revenues from the expected 42% to 32%.

Financial challenges for states: Discontinuation of GST compensation and tapering revenue deficit grants

The discontinuation of GST compensation for states, which ended in June 2022, is a significant factor for the Centre's devolution coming down in FY24, according to a report by Emkay Global. This compensation was initially paid to states to meet the shortfall in indirect tax revenue below a specified threshold due to the introduction of GST. Going forward, the compensation cess will be used for servicing debt that the Centre took on behalf of the States during the Covid-19 pandemic. For FY24, market loans worth ?78,100 crore are due for redemption.

Additionally, the 15th Finance Commission recommended revenue deficit grants for certain states between 2021-22 and 2025-26. These grants were provided in a manner that they taper off in successive years. However, several states have continued to budget revenue deficits. In the backdrop of reducing grants, states may have to augment their revenue or reduce expenditure to maintain revenue balance. All recent Finance Commissions have recommended grants to states to eliminate revenue deficits. These grants are awarded to address any revenue needs of the states which may remain after accounting for the devolution of central taxes. Post-devolution revenue deficit for a state signifies the presence of an imbalance that remains to be corrected.

The 15th Finance Commission recommended revenue deficit grants worth Rs 2.95 lakh crore to 17 states for the period between 2021-22 and 2025-26. Around 87% of the total grants were awarded for the first three years. As the grants will be substantially lower in the next

two years, states will have to augment their own sources of revenue or cut expenditure to maintain revenue balance. For instance, Kerala, which received Rs 4,749 crore as revenue deficit grants in 2023-24, will not receive any grants in 2024-25.

Way forward

It must be noted that States generate around 40% of the revenue and bear around 60% of the expenditure. The Finance Commission (FC) and its recommendations are meant to assess this imbalance and propose a fair sharing mechanism. However, there are important reforms that may be considered for maintaining the balance between equity and federalism while sharing revenue.

Firstly, the divisible pool can be enlarged by including some portion of cess and surcharge in it. This could be possible with necessary constitutional amendment. The Centre should also gradually discontinue various cesses and surcharges it imposes by suitably rationalising the tax slabs. Secondly, the weightage for efficiency criteria in horizontal devolution should be increased. GST being a consumption-based destination tax that is equally divided between the Union and the State means that State GST accrual (inclusive of Integrated GST settlement on inter-state sales) should be changed to 60:40 share (60% for states and 40% for Centre) .

Additionally, it is imperative that the States uphold principles of fiscal federalism by devolving adequate resources to local bodies for vibrant and accountable development. States that create more jobs and better income should be incentivized, and there should be a built-in mechanism to address inequities in weightages used for allocation.

Furthermore, there is a need to revisit the allocation formulas to ensure a balance between equity and efficiency. Factors like contribution to GSDP, fiscal effort, and specific state needs should be given more weight. Performance-based grants should be introduced to reward states for good governance, economic management, and innovation. This can incentivize states to improve their fiscal health while ensuring they get necessary funds.

Supporting states in enhancing their own revenue generation through better tax administration, broadening the tax base, and promoting investments that increase state revenues are crucial. Allowing states more flexibility in how they utilize central funds can enable them to address their specific developmental needs more effectively.

India needs a relook at fiscal distribution and federalism. It's beyond doubt that the states that have poorly performed on parameters like human development indices and employment need financial assistance both from the union government and from fellow states. However, this cannot continue to be at the cost of the states that are performing better. The union government cannot continue to consolidate its power to unilaterally decide the distribution of funds. If these issues are not resolved quickly, the situation could get even more complicated with the upcoming delimitation exercise, which is expected to increase friction among states and between the states and the union government.

In conclusion, it is crucial to implement reforms that ensure a fair and efficient fiscal federalism system in India. This includes enlarging the divisible pool, increasing the weightage for efficiency criteria, enhancing state revenue capacity, allowing flexible fund utilization, and introducing performance-based grants. Such measures will not only address current imbalances but also promote a more equitable and accountable development across all states.

(This article is part of their internship report submitted at GIFT under the guidance of Smt Anith Kumary, Visiting Faculty, GIFT).

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