FISCAL FEDERALISM IN INDIA - GS II MAINS

Q. The reliance of states on central government revenue has grown. In this context, discuss the erosion of fiscal federalism in India at the present context. (10 marks, 150 words)

News: *The severe erosion of fiscal federalism*

What's in the news?

- On February 8, Kerala Chief Minister Pinarayi Vijayan will lead a protest in New Delhi against the Centre for "placing Kerala on a financial embargo".

Key takeaways:

- The Kerala government has accused the Centre of pushing the State into a severe financial crisis by imposing a limit on its borrowings.
- Kerala has moved the Supreme Court contending that the Centre's imposition of a **Net Borrowing Ceiling (NBC) on the State,** which limits borrowings from all sources, **violates Article 293 of the Constitution**.

Key Highlights:

- The wide array of constitutional issues that are now thrown open point at the severe erosion of fiscal federalism in the country.
- The NBC limits the borrowings of States from all sources including open market borrowings.
- The Centre has decided to deduct liabilities arising from the public account of the States to arrive at the NBC.
- In addition, borrowings by state-owned enterprises, where the principal or interest are serviced out of the Budget, or through assignment of taxes or cess or any other State revenue, are also deducted from the NBC.

Issues in Fiscal Federalism:

1. Centre's Ceiling Rule:

- Kerala has moved the Supreme Court contending that the Centre's imposition of a Net Borrowing Ceiling (NBC) on the State, which limits borrowings from all sources, violates Article 293 of the Constitution.
- According to Article 293(3) of the Constitution, the State has to obtain the consent of the Centre to raise 'any loan', if 'any part of the previous loan' extended by the Centre is outstanding.
- Parliament does not have the power to legislate upon the 'Public Debt of the State' as this finds place in Entry 43 of the State List of the Constitution.

2. Increasing dependency on Centre:

- The reliance of states on central government revenue has grown, witnessing a decrease in the share of revenue from independent sources from 55% in 2014-15 to 50.5% in 2020-21.
- This trend is partly inherent in India's fiscal structure, where states are significant spenders while the central government controls financial allocations.
- The introduction of the GST has further compounded this situation, as most indirect taxes, except for a few like petroleum products, property tax and alcohol excise, have been absorbed into the GST framework. This has diminished the states' capacity to generate their own revenue.

3. Post GST:

- States no longer possess the authority to independently determine tax rates for subjects listed under the State List.
- In the past, state governments had the flexibility to set tax rates based on factors such as their expenditure needs and revenue base.
- The current situation, where states cannot adjust tax rates according to their developmental needs, results in increased reliance on central government funds.

4. Cess and Surcharges:

- Another emerging challenge is that cesses and surcharges are becoming a disproportionate proportion of the overall divisible revenue, with non-tax revenues being kept outside the divisible pool.

5. Reduction in Corporate tax:

- Instead of strengthening direct taxation, the Union government slashed corporate tax from 35% to 25% in 2019 and went on to monetise its public sector assets to finance infrastructure.

WAY FORWARD:

- Disputes between the Centre and States regarding economic policies have a long history in India.
- However, in recent years the frequency and intensity of such disputes have increased and assumed the character of 'persistent frictions' in the federal system.
- These issues **needed urgent consideration to reinforce trust in fiscal federalism.**
- Therefore, there is a need to give serious consideration for a consultative forum for credible policy dialogue between the Centre and the States.
- It is equally important to ensure **all round efficiency in the deployment of public funds, in particular, investments in productive enterprises in the public sector.**
- There is a need for augmenting the resources both of the Centre and the States and the cake has to grow before the slices can become bigger. This requires faster growth of the economy and restructuring the expenditure of the Centre and the States.
- The **15th Finance Commission has thus recommended a slew of fiscal reforms to increase the tax-to-GDP ratio, especially through an overhaul of the goods and services tax.**
- It is time that the major political parties develop a broad consensus at the centre and the states and blend good economics with politics.