THE SIGNIFICANCE OF INDIAN FISCAL FEDERALISM

Abstract

Federalism is a fundamental feature of our constitution. The federal fiscal system consists of two components: revenue sharing, which is overseen by the Finance Commission, and expenditure financing through other measures. Despite the fact that state governments' tax-to-GDP ratios are currently lower than those of the federal government, the ratio has consistently increased over time. As exemplified by a revenue expenditure-to-GDP ratio that has consistently exceeded the tax-to-GDP ratio, all states have relied on intergovernmental transfers, borrowing, or other income sources to support their expenditures. The division of responsibilities and powers between the centre and states is intended to ensure the resources are allocated efficiently, and development is not concentrated in one region. This helps to promote balanced economic growth across the country.

Keywords: Fiscal Federalism, Fiscal Imbalances, Division of powers, Government expenditure, Resource Mobilisation.

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I. INTRODUCTION

India gained independence from British rule in 1947 and became a democratic republic in 1950 with a federal structure that assigns political and fiscal powers to the states. The princely states were quickly absorbed into the new political structure and their special status was greatly reduced, eventually being fully removed by 1970. The boundaries of the states can also be redrawn by the central government. The constitution was designed to give the central government significant authority over the states, resulting in a centralised federation and a quasi-federal structure, with a strong national government and decentralisation and devolution. The country's colonial past and economic policies resulted in economic stagnation and poverty. The national movement criticised colonial rule for its unfettered imports that hurt domestic industries and laissez-faire attitude that hindered economic development. As a result, the adoption of import substitution and public sector-led five-year development plans were central to independent India's economic policy leading to the adoption of Soviet-style 5-year plans and import substitution-based development strategies. The federal system in India is influenced by historical factors, such as partition, and tends to have a strong central government. There is a constitutional division of revenue and expenditure powers among different levels of government.

The Constitution of India outlines a three-fold distribution of legislative powers, as described in the Seventh Schedule of the Constitution. In this schedule, 97 items are designated as Centre Subjects, 66 items as State Subjects, and 47 items under the Concurrent List, on which both the Centre and States have the power to legislate, with the Centre being accorded a dominant position. Although the Constitution does not explicitly mention expenditure assignment, it gives executive authority to the Government of India and State Governments on subjects under the Union List and State List, respectively. This distribution of legislative power forms the basis for expenditure assignment between the Union and State Governments. Generally, the States are responsible for providing basic public services, such as maintaining public order, health, sanitation, water supply, primary education, and roads, while the Union Government is assigned exclusive power over subjects of national importance. The assignment of legislative power between the Union and States largely follows the provisions of the Government of India Act 1935, with the exception of certain centralising features incorporated in the Constitution, such as the increase in items under the Concurrent List and the allocation of the residuary power to the Centre.

According to the 2017 report by the Comptroller and Auditor General (CAG), the vertical distribution, centre accounts for 69.3 per cent of resources, while the states only have 30.7 per cent, resulting in a vertical fiscal imbalance due to the larger expenditure responsibilities assigned to the states. While the resource disparity persists at both the federal and state levels, it is significantly larger and more severe at the state level. Uninterrupted public service delivery is necessary for a responsible government, and the government is required to reconcile these resource deficits through deficit financing in accordance with statutory constraints. Inadequate resource generation results in external or internal borrowing, which has become an increasingly important source of financing in many countries with a federal structure, resulting in a massive accumulation of debt in subnational budgets (Renjith& Shanmugam, 2019). There are numerous ongoing debates about the sustainability of public debt.

II. TRENDS IN EXPENDITURE, REVENUE AND INTERGOVERMENTAL TRANSFERS

Indian public finance has seen a significant increase in government expenditure both at the central and state levels compared to the colonial period, which is the most important feature. During the colonial era, the government followed a laissez-faire policy, and all government expenditure was kept at less than 10 percent. However, independent India chose a path of planned development of a market economy with a substantial public sector presence, which was only possible with a substantial increase in government spending. As a result, the ratio of government expenditure to Gross Domestic Product (GDP) surpassed 25 percent in the mid-1980s and has since fluctuated within a 3-4 percentage point band around this figure. The Indian government's increased expenditure creates a resource gap that is typically filled by deficit financing, leading to inflationary consequences due to supply constraints. However, the main issue is the government's failure to mobilise revenue resources that keep pace with expenditure. The revenue-GDP ratio of 18 percent is significantly lower than that of developed and middle-income countries, which average above 25 percent and sometimes exceed 40 percent. This lack of revenue mobilisation is due to class limitations in the development regime, which have hindered the mobilisation of sufficient resources from the classes that have benefited the most from the development process.

Table 1: Expenditure Trend (Rs Crore)

Year	Combined - Developmental expenditure	Combined - Non-developmental expenditure	Combined - Other expenditure	Combined - Total Expenditure	Combined - Total Expenditure (Per cent of GDP)	Gross Fiscal Deficit (Per cent of GDP)
2004-05	445354	416340	8063	869757	27.3	7.2
2005-06	509525	440377	9953	959855	26.43	6.5
2006-07	588028	507635	13511	1109174	26.07	5.1
2007-08	710271	588779	16233	1315283	26.85	4
2008-09	943708	637453	18516	1599677	29.01	8.3
2009-10	1062808	768734	20577	1852119	29.09	9.3
2010-11	1267697	852046	25402	2145145	28.1	6.9
2011-12	1420938	969588	31242	2421768	27.72	7.8
2012-13	1574162	1085047	35724	2694933	27.1	6.9
2013-14	1714221	1242783	43295	3000299	26.71	6.7
2014-15	1872062	1366769	46379	3285210	26.35	6.7
2015-16	2201287	1510810	48513.9	3760611	27.31	6.9
2016-17	2537905	1672646	55417	4265969	27.72	6.9
2017-18	2635110	1812455	68381	4515946	26.42	5.8
2018-19	2882758	2078276	79712.8	5040747	26.67	5.8
2019-20	3074492	2253027	83368.4	5410887	26.95	7.2
2020-21	3906147	2526514	91255.2	6523916	32.95	13.3
2021-22	*4254004*	*2810847*	*95843.3*	*7160694*	*30.26*	*10.2*

Source: RBI Handbook of Statistics on the Indian Economy, 2021-22

During the 1990s, the fiscal and current account deficits resulting from this crisis pushed the Indian economy towards neoliberal reforms. The trend in the government expenditure to GDP ratio ended, and it fluctuated around 25-26 percent of GDP until the global financial crisis of 2008. India, like most countries worldwide, adopted an expansionary stimulus policy in response to the crisis, leading to an increase in the expenditure to GDP ratio to 28-29 percent in subsequent years. Consequently, the resource gap, which had declined to below 5 percent primarily due to a significant increase in the revenue to GDP ratio and a slight downward trend in expenditure, increased again to 9.80 percent in 2009-10 and has been around 7 percent since. The compression of expenditure during the 1990s resulted mainly from the implementation of the Fiscal Responsibility and Budget Management (FRBM) Acts. However, the spike in deficits in the post-global financial crisis period reflects the de facto pause in the pursuit of its FRBM targets by the central government. As a result of the gap between revenues and expenditure, the government must borrow, which runs counter to the constraints set by the FRBM targets. This places an asymmetric burden on the states, which must function within this framework through conditionalities imposed by the Finance Commissions.

Table 2: Tax- GDP ratio as well as Revenue Expenditure

Year	Tax-GDP ratio of all States	Tax-GDP ratio of centre	Revenue Expenditure- GDP ratio of all States	Revenue Expenditure- GDP ratio of centre
2004-05	5.71	9.52	12.64	12.06
2005-06	5.85	10.03	12.06	12.10
2006-07	5.94	11.08	11.89	12.10
2007-08	5.85	12.06	11.86	12.13
2008-09	5.84	10.96	12.37	14.40
2009-10	5.70	9.76	12.55	14.32
2010-11	6.03	10.34	12.21	13.63
2011-12	6.38	10.13	12.30	13.12
2012-13	6.58	10.39	12.39	12.51
2013-14	6.34	10.10	12.28	12.21
2014-15	6.25	9.96	13.13	11.77
2015-16	6.15	10.53	13.35	11.17
2016-17	5.93	11.10	13.56	10.98
2017-18	6.61	10.81	13.69	10.99
2018-19	6.43	10.92	13.96	10.62
2019-20	6.10	10.00	13.91	11.71
2020-21	6.27	10.18	16.09	15.57
2021-22	6.74	10.37	15.10	13.38

Source: Author's calculation based on the RBI Handbook of Statistics on the Indian Economy, 2021-22.
Note: GDP is at current market price from 2004-05 and 2011-12 series.

The table indicates a gradual reduction in the resource gap since 2011-12, albeit at a modest pace. However, the COVID-19 pandemic had a severe impact on the economy, leading to a substantial increase in the fiscal deficit of the country. In 2019, the gross fiscal deficit reached an all-time high of 13.3 percent, prompting the relaxation of restrictions imposed by the FRBM Act to counteract the significant economic downturn through increased government expenditure at both the central and state levels. To gain a clearer picture of the issues, it is necessary to examine trends in receipts, expenditure, and their components.

Tax revenue accounts for a significant portion of the revenue receipts of both the Centre and the States, making it a crucial factor in their resource mobilization efforts. The central government relies heavily on personal income tax, corporation tax on profits, central excise duty on manufacturing, customs duty on imports, and service tax to generate revenue. However, the introduction of GST in July 2017 led to the subsuming of central excise (excluding petroleum products) and service tax. While the share of indirect taxes in the Centre's gross tax revenue gradually decreased from 80% in the 1980s to 49% in 2016-17, the combined tax revenues of the Centre and States still have a high proportion of indirect taxes. Despite the economy's significant growth since the 1980s, the tax-GDP ratio of the Centre has only seen a slight improvement over the past four and a half decades. This highlights the need for continued efforts to improve tax collection and mobilization, especially given the substantial role that tax revenue plays in the overall revenue receipts of the Centre and States (Issac, 2019).

The table 1.2 shows the tax-GDP ratios of both the state governments and the central government of India for the years 2004-05 to 2021-22. The tax-GDP ratio is a measure of the proportion of a country's Gross Domestic Product (GDP) that is collected as taxes by the government. Looking at the data, we can see that the tax-GDP ratio for state governments has generally remained between 5.7% to 6.74% over the years, with some minor fluctuations. On the other hand, the tax-GDP ratio for the central government has been more volatile, ranging from 9.52% in 2004-05 to 12.06% in 2007-08, with a slight dip in 2009-10 before recovering to around 10.5% in recent years. The trend of state governments having a lower tax-GDP ratio compared to the central government is not surprising, as the central government has greater fiscal powers and a larger tax base. Another interesting trend is the gradual increase in the tax-GDP ratio of state governments over the years, which can be attributed to various factors such as economic growth, and greater efficiency. Which can only be analysed by looking into the trends in tax buoyancy. However, despite this increase, the tax-GDP ratio for state governments still remains relatively low, which suggests that there is still room for further tax reforms and revenue mobilization at the state level. The fluctuations in the tax-GDP ratio of the central government can be attributed to various factors such as changes in tax policies, economic growth, and fiscal deficits. For instance, the tax-GDP ratio spiked in 2007-08, which was a year of high economic growth, but then dipped in 2009-10, which was a year of economic slowdown due to the global financial crisis. The revenue expenditure-GDP ratio of all states has generally been higher than that of the centre, indicating that the states spend a higher proportion of their income on government expenditure. However, the revenue expenditure-GDP ratio for both the centre and the states has been on an increasing trend, which indicates a rise in government expenditure. It is also observed that the revenue expenditure-GDP ratio for all states has been consistently higher than the tax-GDP ratio, indicating that the states have been relying on inter-governmental transfers, borrowing or other sources of revenue to finance their expenses. On the other hand, the revenue expenditure-GDP ratio for the centre has been lower than the tax-GDP ratio, indicating that the central government has been able to finance its expenses with its taxation powers. The data indicates that there is a need for the central government to devolve a larger share of taxes to the states in order to address the issue of vertical fiscal imbalances.

In Table 1.3 Central Grant share -GDP ratio as well as the central tax share- GDP ratio over the years has been shown. Central Grant share -GDP ratio means the amount of grants given to states as intergovernmental transfers and it has varied over the years, ranging from 1.77 in 2004-05 to 3.78 in 2020-21. The Central Tax share -GDP ratio, which is the ratio of the central government's tax devolutions to the states to the GDP, has also varied over the years, ranging from 2.47 in 2004-05 to 3.95 in 2016-17 and 2018-19.The latter has been fluctuating over the years, with a relatively high ratio in 2016-17 and 2018-19.The relationship between the Central Grand share -GDP ratio and the Central Tax share -GDP ratio is not consistent. Because factors such as the finance commission’s recommendations are important. There have been years when both ratios have increased together and there have been years when one ratio has increased while the other has decreased.

Table 3: The Central Grant share-to-GDP ratio and The Central Tax share-to-GDP ratio

Year	Central Grand Share -GDP ratio	Central Tax Share -GDP ratio
2004-05	1.77	2.47
2005-06	2.11	2.59
2006-07	2.22	2.83
2007-08	2.22	3.09
2008-09	2.36	2.92
2009-10	2.37	2.59
2010-11	2.14	2.87
2011-12	2.13	2.93
2012-13	1.90	2.93
2013-14	1.83	2.83
2014-15	2.65	2.71
2015-16	2.37	3.68
2016-17	2.31	3.95
2017-18	2.38	3.54
2018-19	2.33	3.95
2019-20	2.66	3.24
2020-21	3.78	2.98
2021-22	3.73	2.92

Source: Author’s calculation based on the RBI Handbook of Statistics on the Indian Economy, 2021-22.

During the 1990s, there was a decline in the ratio of central taxes transferred to and grants made to the states as a share of GDP. However, there was a slight increase during the first decade of the 21st century (Issac, 2019). From 2010-11 to 2016-17, there was a rise in the share of central taxes devolved to states relative to GDP compared to previous decade due to enhanced tax devolution in the initial two years of the 14th Finance Commission award that is 2015-16 and 2016-17. According to the 14^{th} finance commission recommendation, the share of states in the net proceeds of shareable Central taxes should be 42%, which represents a 10-percentage point increase from the recommendation of the 13th Finance Commission. Comparing the period of 2010-11 to 2014-15 with the previous five-year period of 2005-06 to 2009-10, there was a marginal increase in tax devolution to states, merely 0.05 percentage change. But Central tax share to GDP ratio increased to 3.68 and 3.95 percent in 2015-16 and 2016-17, respectively. The ratio of central grants to GDP also increased from 2010-11 to 2016-17, but there was a change in the method of grants transfer to states in 2014-15, where the entire central share in Central Sponsored Scheme was routed through state budgets instead of being given directly to implementation agencies as was done previously. This explains the rise in the share of grants relative to GDP in 2014-15 to 2.65 percent compared to 1.90 and 1.83 percent in 2012-13 and 2013-14, respectively. However, figures prior to and in 2014-15 are not strictly comparable to the figures after implementing the recommendation of 14^{th} finance commission. There was a decline in the grant-GDP ratio in 2015-16 and 2016-17 to 2.37 and 2.31 percent, respectively, due to a fall in the central share in many of the CSS. The Central Grand share -GDP ratio has been increasing in recent years, with a sharp increase in 2020-21 at the same time The Central Tax shar-GDP ratio decreasing. This is because of the decrease in divisible pool of tax revenue.

III. CONCLUTION

Indian fiscal federalism is unique in a number of ways, both legally and constitutionally. There is an organised distribution of power within the government at the outset. The Seventh Schedule of the Indian Constitution divides some authorities between the central government and the individual states. The separation of duties guarantees that every tier of government has the power it needs to carry out its functions. According to the Indian Constitution, the central government is responsible for generating revenue through taxes like customs, excise, and income tax, while the state governments are in charge of generating money through taxes like sales tax and stamp duty (initially, but now it has changed). As a result of this disparity, the federal government has a greater fiscal advantage over the states. The Constitution also allows for federal grants and other forms of financial help to be distributed to state governments.

Government spending in India has skyrocketed since colonial times, with deficit financing being the norm at both the federal and state levels. In contrast to developed and middle-income nations, however, the government has not been able to collect enough money to offset the money it spends. Class restrictions in the development regime have prevented the mobilisation of sufficient resources from the classes that have benefited most from the development process and hence contributed to the lack of revenue mobilisation. While state governments' tax-to-GDP ratios now remain lower than the federal government's, they have been steadily rising over time. All states have relied on intergovernmental transfers, borrowing, or other income sources to support their expenditures, as evidenced by a revenue expenditure-to-GDP ratio that is continuously larger than the tax-to-GDP ratio. The federal government should transfer more of its tax revenue to the states in order to correct vertical fiscal imbalances. Recent years have shown an upward trend in the Central Grant share-GDP ratio, with a considerable rise expected in 2020-21, while the Central Tax share-GDP ratio in state revenue has been decreasing as the divisible pool of tax income has shrunk.

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