Importance Of Fiscal Federalism in India and Impact of GST And Demonitization on Fiscal Policies: A Legal Study

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Abstract*— *The theory of fiscal federalism is an integral part of our Indian Constitution. It helps the government in solving problem in more efficient and effective manner. The term 'fiscal' means money and the term 'federalism' means the system of division of powers between the center and the state. In a country like India, having huge amount of population, the distribution of income and economic stability plays an important role. As there is a difference between urban and rural areas in terms of their annual income, it becomes extremely important for the federal government to distribute the income in such a manner that helps in equal development of the country both at urban and rural areas. One of the major responsibilities of a federal government is the proper allocation of resources at each level. The role of federal government is to regulate income, proper division of taxes, subsidy, providing at each level all the possible goods and services and income redistribution. Therefore, the importance of fiscal federalism in India is huge as both the urban and rural part of the country plays an important role in the development of the country and economic growth. The government needs to be vigilant in determining the amount of income distribution and allocation of resources and in creation of fiscal policy.

Indexed Terms*- *Federalism, GST, Demonetization, Finance commission, Constitutional Provisions

I. INTRODUCTION

Federalism is the system of government where the power is divided between a Central authority and various constituent units of a country. In a federal system, there are three levels of government, governing the same citizens, but each level has its own jurisdiction- legislative and judiciary. The top level is the Central/Union Government, Union Territories controlled by the Centre. Below Union, lays the State Government and below State, lays the local governments which are further sub-divided in rural and urban local governments.

Rangarajan in 2004 mentioned that, as a paramount objective, fiscal federalism is expected to enable the national and sub-national governments to operate in such a way that leads to efficiency in the use of resources - not only in terms of the quality of services provided by the various levels of government but also in terms of creating the environment in which all economic agents use resources efficiently[1].

Within the context of Indian Federalism, what remains important is to take into account the social diversity in a general sense and the diverse ways in which each member state is able to relate to the federal system as a whole and to other member states (Thornton, 1995). The existing cultural, economic, social, environmental and political factors combining to produce asymmetrical variations in the country, if not handled properly, have the potential to affect harmony within the federal structure of the country[2].

India has a largest democratic federal system with 29 States governed by their own elected government and 7 Union Territories which are centrally administered.

II. HISTORICAL BACKGROUND AND EVOLUTION

The constitutional design of federal fiscal arrangements has pre-independence roots, especially in the Government of India Act, 1919 and 1935. The post-constitutional arrangements have run a course of more than sixty years and it constitutes a dynamic and pulsating experimentation with fiscal federalism.

The Montague Chelmsford Report on Constitutional Reforms was submitted in 1918, which led to the passing of Government of India Act, 1919. The Montague Chelmsford Reform of 1920 accepted the federal goal and marked the first major step towards

provincial autonomy and federalism. The provincial and central budgets were completely separated. The background principle for this division had been that the subjects and interests of the provinces should be predominantly provincial.

Fiscal relations in India had evolved over time through political, institutional and functional changes within the ambit of the provisions of Indian Constitution. The Finance Commission had played an important role in this evolving structure because resource sharing, based on constitutional division of functions and finances between the Centre and states, is a critical element in the Indian federal system (Rangarajan, 2004)[3].

III. CONSTITUTIONAL PROVISIONS

Division of functions and resource asymmetry: The Indian Constitution has, under Article 246 and Seventh Schedule, distributed powers and allotted subjects to the Union and the states with a threefold classification of subjects:

(i) List I invests the Union with all functions of national importance such as defense, external affairs, communications, constitution, organization of the supreme court and the High courts, elections etc.

(ii) List II invests the states with a number of important functions touching on the life and `welfare of the people such as public order, police, local government, public health, agriculture, water land etc.

(iii) List III is the Concurrent list, which includes administration of justice (excluding Supreme Court and High Courts), economic and social planning, trade and commerce, etc. It is of interest to note that higher education; forests and population control were all added to this list in 1977 during the emergency when it was felt that the states were not doing justice to these subjects of national importance.

Accordingly, the Parliament has exclusive powers to make laws regarding matters enumerated in List I. On the other hand, the Legislature of any state has exclusive power to make laws for that state regarding any of the matters enumerated in List II, subject to other clauses of Article 246. With regard to List III, both the Parliament and State Legislature can make laws but in case of any conflict, the law made by Parliament will prevail (Article 254). The residuary functions, that is, those not included in either lists I or II, vest with the Union.

The Union and State lists include the powers of taxation as well. The enumeration of taxation powers placed in the Union List includes: tax on income other than agricultural income, excise duties, customs and corporate tax. Recently service tax had been included in view of diminishing importance of customs. The State List contains land revenue, excise on alcoholic liquor, tax on agricultural income, estate duty, tax on sale or purchase of goods, tax on vehicles, tax on professions, luxuries, entertainment, stamp duties etc. However, due to political reasons, none of the states had imposed tax on agriculture income. The Concurrent List does not include any tax power.

IV. CONSTITUTIONAL PROVISIONS FOR DISTRIBUTION OF REVENUES BETWEEN THE UNION AND THE STATES IN INDIA

Article 268: Duties levied by the Union but collected and appropriated by the States.
Article 268(A): Taxes on services shall be levied by the Government of India and such tax can be collected and appropriated by Government of India and the States. (88th Amendment)
Article 269: Taxes levied and collected by the Union but assigned to the States.
Article 270: Taxes levied and collected by the Union and distributed between the Union and the States.
Article 271: Surcharge on certain duties and taxes for purposes of the Union.
Article 272: Taxes levied and collected by the Union and may be distributed between the Union and the States.
Article 275: Grants from the Union to certain States.
Article 276: Taxes on professions, trades, callings and employments.
Article 280(3)(b): Finance Commission to make recommendations as to the “principles” which should govern such grants in aid.
Article 275(1): Specific “sums” to be paid to States which are assessed to be in need of assistance.[4]

Any amendment to the List from which the Union and(i) the States derive their power of taxation is covered by the proviso to Article 368. This requires ratification by the Legislatures of not less than one-half of the states. On the other hand, if any of provisions of part XII are to be amended, this can be done under Article 268(2) which requires the approval of only half of the members of each house of Parliament. This means that the share of the Union resources that the states are entitled to, can be altered by Parliament by its powers of amendment.

Mechanism of Transfers: Over the last six decades, an overarching institutional framework had emerged to deal with Centre-state financial relations in India. Initially the main pillars of this frame work were:

a) Finance Commission appointed periodically as per Article 280 of the Constitution of India, intended to address the vertical imbalance in financial resources between the centre and states and to address the horizontal distribution of resources among the states.
b) Planning Commission set up by a Resolution of the Government of India dated 15th March 1950 to make an assessment of the material, capital and human resources of the country, and to formulate a plan for effective and balanced utilization of the country's resources.
c) National Development Council set up in August 1952 to strengthen and mobilize the effort and resources of the nation in support of the Five year plans.

V. FEATURES OF FISCAL FEDERALISM IN INDIA

Fiscal federalism in India unlike in many rich countries has to satisfy the competing demands to deliver a number of essential and basic socio-economic services.

Distribution of resources between the Centre and the states together with the perceived mismatch between the functional responsibilities and revenue raising powers assigned by the Constitution to the two layers of Governments i.e., Centre and states, has been the subject of considerable discussion and debate in the relevant literature. Two points have been made in this regard:

That there is mismatch between the functions allocated to the centre and to the states and their powers of taxation; and That the more buoyant tax areas have been assigned to the Centre.

But, it has also been pointed out that "the Constitution recognizes that the division of resources and functions between the Union and the states was such that there would be imbalance between them" and that "the Finance Commission periodically corrects the imbalance bringing about an alignment between them" (Vithal and Sastry, 2001).

A notable feature of transfer system in India is the existence of multiple channels. They are:

1) Finance Commission:

The Constitution provides for the appointment of the Finance Commission by the President of India every five years to make an assessment of the fiscal resources and the needs of the Centre and the individual States. Based on these, the Commission is required to recommend the shares of personal income tax and union excise duty and grant-in-aids to the States. However, with development planning gaining emphasis, the scope of the finance commissions was restricted to cover the States' non-plan requirements in the current account.

2) NITI Aayog (The then Planning Commission):

It became a major dispenser of funds to the States by way of both grants and loans.

3) Central Ministries:

In addition to these two channels, various Central Ministries give specific purpose transfers with or without matching requirements. Grants for the Central sector schemes are given to the States to execute Central projects and are entirely funded by it. Centrally sponsored schemes, on the other hand, are shared cost programs falling within the States' ambit with uniform matching ratios across the States, but, varying with the projects.

Vertical and horizontal imbalances:

Vertical imbalances: Non-correspondence between revenue and expenditure commitments of the central governments vis-a-vis the non-correspondence between revenue and expenditure commitments of the federating units put together is known as Vertical Fiscal Imbalance. It is natural that the federal governments of any country have vertical fiscal

imbalance irrespective of their development status.[5] Adequacy and elasticity are the essential elements of federal finance. Adequacy implies sufficient resources for discharging constitutional responsibilities and elasticity implies an expansion of resources in response to the growing needs of Government. The practical effect of the division of tax powers has been to deny both these characteristics in the case of states in India (Vithal and Sastry, 2001). A vertical imbalance between the Centre and states is built into the Constitution by the provisions relating to powers of taxation. This arises, not out of any consideration of making the centre stronger, but out of the desire to build a common economic space in the country and out of an apprehension that with more powers the states may put up 'barriers' within this space. The vertical imbalance is further accentuated by the assignment of several responsibilities involving the public expenditure to the states on the grounds that tiers of government nearer to the people would be more sensitive to their needs and thus be better able to discharge such responsibilities.[6]

Horizontal imbalances: Non-correspondence between revenue and expenditure commitments across state governments in a federation is known as Horizontal Fiscal Imbalance. This type of fiscal imbalances arises due to the differences in the endowment of natural resources, given the uniform revenue powers and expenditure responsibilities. Thus, horizontal fiscal imbalance also exists in federations across the countries irrespective of their state of development.[7] Since states differ in their resource endowments, levels of development and standards of delivery of public services, there are sharp horizontal imbalances among the states in India.

Boadway and Flatters define horizontal equity in two different ways. According to the broad view, the fiscal system should be equitable nation-wide vis-ś-vis the actions of all governments. Two persons equally well off before Centre and State actions must also be so afterwards. To conform to this concept of horizontal equity, it is necessary to give transfers so that each province is enabled to provide the same level of public services at a given tax rate (like in a Unitary State). In contrast, the narrow view of horizontal equity takes the real level of incomes attained by the individuals after a State's budgetary operation as the starting point and the Central fiscal action will be directed to ensure horizontal equity after the State's fiscal system has been established. The Central budget need not offset the inequalities introduced by the operation of the State budgets *per se*, but takes the income distribution effects of the States' fiscal operations as a given datum.[8]

Federal transfers to the states in India, are made in three streams, as

1. Devolution of states share in Central Taxes;
2. Grants from Central to the states, which are classified as:

i. Statutory; or Non statutory;

ii. Non Statutory grants, comprising of:

(a) Plan grants;
(b) State plan schemes;
(c) Central plan schemes;
(d) Centrally sponsored schemes;
(e) Special schemes for North Eastern council etc.

iii. Plan as well as non-plan, covering

a. Non-Plan grants, comprising of:

i) Statutory grants recommended by the Finance Commission to cover gap in revenue;

ii) Assistance for relief measures after natural calamities

iii)

iv. Loans from Centre:

a) Plan loans
b) Non Plan loans including Ways and Means Advance.

Economic Rationale or Transfers:

Inter-governmental transfers have been employed to fulfill a variety of objects and the design of the transfer scheme depends on the purpose for which it is given. In the literature, federal transfers are recommended for

(i) Closing the fiscal gap;

(ii) Equalization;

(iii) Spillovers and merit good reasons.[9]

(iv)

Impact of Goods and Services Act and Demonetization on Fiscal Federalism

Economists like Rangarajan said that GST and demonetization had a negative impact on economy. But it is evident that in whichever country GST is implemented, although the countries faced immediate negative impacts but the same posed positive effects in the long term. For illustration, let us take

Bangladesh, where GST has been implemented. In the Pre-GST era, import of garments from Bangladesh was attracting Rs 77 per piece (where MRP is Rs 999 per piece) in duties and Rs 116/pc (where MRP is Rs 1,500/pc) in the shape of CVD (counterveiling duty) plus education cess and thereon. However, in the post-GST scenario, there was no cost for import of garments from Bangladesh. "Leading retail stores in the country have also started importing garments from Bangladesh and other countries as it is cheaper compared to garments produced here," said the President, Tirupur Exporters' Association (TEA).[10] Hence, if we discard the immediate negative impacts, the GST and demonetization are future betterment.

One of the reasons as to why GST and demonetization pose immediate negative impacts on the economy is that, the cash based businesses got affected. The like business reduced the contribution in GDP. Hence, the same is represented as the degradation in economy.

Demonetization and the GST regime are aimed at ensuring transparent transactions. GST will neutralize the ill-effects of demonetization like fall in demand, market shrinkage and unemployment by extending market frontiers.[11]

In the following manner, GST, in a long-term will prove to be a boon for Indian Economy:

1) As GST ensures that tax credit is given to producers/ sellers for the taxes already paid, specialization and efficiency in production will be promoted. Producers and traders will get tax credit even on inter- state movement of goods and services.
2) India will emerge as one common national market, with a seamless flow of goods and services across the country. There will be no tax on tax, so production and distribution of goods would become less costly, thereby boosting consumption and investment.
3) Producers will be induced to invest in logistics and building warehouses and inventories, giving a fillip to ease of doing business. Implementing GST should not be viewed as a matter of prestige by the states or the Centre and both should adopt a pragmatic approach.
4) The most significant impact of GST will be on extending the volume of trade.
5) A National Council of Applied Economic Research (NCAER) study has evaluated the possible impact of GST on India's international trade. It has been observed that, "The differential multiple tax regimes across sectors of production are leading to distortions in the allocation of resources as well as production inefficiencies. Complete offsets of taxes are not being provided to exports, thus affecting their competitiveness".
6) The study has estimated that "implementation of a comprehensive GST across goods and services will enhance the nation's Gross Domestic Product (GDP) by between 0.9 and 1.7 per cent". Boosting trade, both internal and external, with forward and backward linkages may lift the GDP by 1-2 per cent. Of course, the organized sector may gain at the cost of the unorganized sector, yet the conversion of the informal sector into the formal is the prerequisite for reducing poverty and inequalities.
7) Demonetization too has induced the informal sector to convert into the formal sector.
8) Earlier, the GST Council broadly approved the four-tier rate structure of five per cent, 12 per cent, 18 per cent and 28 per cent, but spared the essential items, including food grains, out of the purview of taxation. The Centre has been allowed to impose a cess on luxury items like high-end cars, tobacco, pan masala, aerated drinks and other demerit goods. This cess amounting to Rs 50,000 crore will continue for five years and the proceeds wherefrom will be used to compensate States for any loss of revenue on account of the switch over to the GST regime. The Centre has promised to abolish this cess after five years. Experience shows that once the cess is levied, it continues on one pretext are another. However, the Centre must assure the States that the proceeds from this cess will form part of the divisible pool if it continues thereafter.
9) Now onwards, GST would be states' main source of revenue.[12]

In the post-GST regime, local self-governments would be losers as they would have to forego revenue from local taxes like octroi, entertainment tax, entry tax, etc. That is why an institutional mechanism to safeguard their financial interests must be put in place.[13]

Now, if we look into the constitution of the GST Council, GST Council decides the revenue distribution and GST rates. The Council consists of many State Governments and Finance Ministers. It will strengthen the financial structure. It will also ensure the accountability.

Also, the compliance will be ensured as the Finance ministers of all the State Governments, as they form the part of the GST Council, will act as the mutual checks and balances. State government will get more revenue as the VAT collected will be more.

Problems in the existing Fiscal Federalist Structure in India

The financial provisions of the Constitution are in accordance with what experts would consider acceptable principles for a federal constitution and a desirable attribute of inter-governmental tax power assignment (Bagchi, 2001). However, it is the actual working of the scheme that has revealed deficiencies that seriously detract from much of its supposed merits. Bagchi (2001) cites the under utilization of Article 269 by the Union Government, the abridgement of the scope of Article 275, and, consequently, the extensive use of Article 282 by the Union to make extensive grants to the states as examples of the original constitutional scheme being distorted in actual practice over the years[14].

Following are the shortcoming faced by the Intergovernmental transfers in India:

1) Multiple agencies with overlapping jurisdictions have blurred the overall objectives of transfers.
2) Accommodating different interest has unduly complicated the transfer formula.
3) The design of the transfer system is not well targeted to achieve equalization and to ensure minimum service levels in the States.
4) They have disincentive effects on the fiscal management in the States.

Factors affecting Fiscal Federalism[15]

- As per Raghuram Rajan- "India can't work from the Centre. India works when you have many people taking up the burden. And today the Central government is excessively centralized".[16] He further mentioned the hurdles of the GST, which supposedly had a negative impact on the economy as only the initial hurdles. He also said that the part of the problem in India is that there is an excessive centralization of power in the political decision making.
- Political environment is important in determining contours of fiscal federalism. After Independence, there was a single and same party rule at the Centre and in almost all states for many decades. There are now telltale signs that India is moving away from an era of cooperative federalism towards competitive federalism, due to multi-party polity, and predominance of regional parties at the state level, and coalition governments at the centre. The existence of competition brings-in the importance of transaction cost of coordinating policies and their implementation- vertically between different levels of government and horizontally between different units within each of the levels. Many challenges, therefore, lie ahead for fiscal federalism in the country.
- Further, in case there arises the situation of financial emergency, that if President is satisfied that there is an economic situation in which the financial stability or credit of India is threatened, the President has the right to declare financial emergency u/A 360 which has to be approved by the Parliament within two months. In such a state, he can direct State to observe certain principles as regards economic measures relating to financial matters.
- Centre vs. State Autonomy: Recently, there has been a huge tussle between southern States demanding more financial autonomy from the Centre on the basis that they are helping in country's developmental problems like population control and also contribute more to the Gross Domestic Product of the country as compared to other States as well as they have high literacy level against the other States. The Centre has rejected such proposal by the States as the same demand came up only due to regional party politics without keeping the system of distribution setup by the constitution in mind. If such demand for financial autonomy is extended, the aim of the Constitution of establishing a welfare state, equal distribution of resources, establishing an egalitarian society and developing the undeveloped will go undeveloped and already existing inequalities will increase with

declining level of chances of reduction of poverty and other societal and economic menaces. Already, the 14th Finance Commission, headed by Y.V. Reddy has stepped up increasing the financial autonomy to the States from 32% to 42%.

SUGGESTIVE MEASURES

1) Inter-governmental transfers In order to correct built-in vertical and horizontal imbalances for an even and equitable development of the entire country, the main instrument for achieving this is fiscal transfers from the Centre to states through different channels and the mechanisms as provided in the Constitution. Fiscal transfers to the third tier of government through subsequent Constitutional Amendments (73rd and 74th) had also been envisaged in India. Accordingly, there are both mandatory and enabling provisions facilitating a wide ranging transfer of resources from Union to states, arranged in a systematic manner.[17]
2) The rationale for specific purpose transfer is rooted in offsetting spillovers. In the absence of perfect 'mapping', the public services by sub-Central governments may spill over the jurisdictions and such externalities result in the non-optimal provision of public services. A Pigovian subsidy is required to 'set the prices right'. To be cost-effective, specific purpose transfers made to the States to ensure optimal provision of public services require matching contributions from them.
3) In an ideal system, there should be an optimal combination of general and specific purpose transfers. General purpose transfers would enable all the States to provide a given normative standard of public services at a given tax effort. The specific purpose transfers would ensure a given standard of outlay on the aided services.[18]
4) For poorer States and those located close to international borders, they could even provide loans at concessional rate of interest.
5) The Finance Commission can be set up on State level for every State so that working goes systematic as per the budgetary requirements of every State, which would also eliminate the problem of baseless and unjust demanding of autonomy by the States.

CONCLUSION

While there is certainly a role for specific purpose transfers in Indian federation, the design and implementation of the centrally sponsored schemes has not served the purpose. It has intended to multiply State level bureaucracy and distort States' own allocation in unintended ways. There are various shortcomings, which are due not merely to Constitutional arrangements, but also to conventions, methods and working of institutions. The system of assignments, have resulted in a significant degree of vertical fiscal imbalance. The wide differences in per capita incomes among the States have also caused severe horizontal fiscal imbalances. The same can be prevented and cured by following the above-mentioned suggestive measures and if there exists a co-ordination and checks by all the organs and levels of governance on each other, following constitutionally formulated scheme and provisions in its essence and intention rather than merely colourably.

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