

FISCAL FEDERALISM*

INTRODUCTION

The classical definition of federalism attempts to explain it in juristic sense. The test that is commonly formulated, is to see whether a system of Government embodies predominantly a division of power between general and regional authorities, each of which, in its own sphere, is coordinate with the other 's and independent of them. If so, that government is federal.

Federalism is considered efficient from the political angle, because of the facility it provides for a heterogeneous population to come together under the banner of one nation and acquire strength from unity while allowing the constituents to retain their identity and autonomy over a wide area of public life.¹ Federalism also fosters democratic values and the civic virtues of people's participation in political processes. A well designed, and more important, well functioning system of federal governance, by virtue of its manifold benefits, plays a key role in promoting the stability and prosperity of nations as the heights attained in development by the leading federations of the world – USA, Canada, Australia and Switzerland – demonstrate.² Some of these nations extend this concept into systems of taxation and revenue collection.

Fiscal federalism refers to the idea that decentralisation in governance leads to welfare gains.³ This system of government has made some of the federal countries quite prosperous with high standards of government services. This concept has a broad scope and is relevant in all kinds of governments.⁴

In its traditional form, fiscal federalism talks about welfare gains from decentralisation, assignment of resources and responsibilities between different tiers of government, fiscal instruments for the resolution of vertical and horizontal imbalances. Its modern extensions deal with areas such as fiscal competition among jurisdictions, political economy aspects of

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¹ Oates, Wallace E., An essay on fiscal federalism, Journal of Economic Literature, Sep99, Vol. 37 Issue 3, p1120, 30p

² Amresh Bagchi, Fifty Years of Fiscal Federalism in India: An Appraisal, p. 3.

³ C. Rangarajan & D.K. Srivastava, Federalism and Fiscal Transfers in India, Oxford University Press, New Delhi, p. 1.

⁴ Ibid.

fiscal federalism, market preserving fiscal federalism, environmental federalism, and decentralization and growth.⁵

In recent years, fiscal decentralization has received enthusiastic attention from academic analysts and policy makers alike. Most analysts find inherent merit in decentralization; often it is considered to be a component of human wellbeing and therefore, an end in itself.⁶ The experiences in developing countries in particular, underline the fact that there is much to be done to create appropriate conditions for fiscal decentralization to be successful in achieving its objectives. In India, the adoption of market oriented reforms since 1991 has redefined the role of the State and this has necessitated a re-examination of fiscal arrangements between different levels of government.⁷

Through this paper, the author wishes to analyse whether the fiscal structure in India, would satisfy the set standards of federalism which are set by the US Constitution and theorists.

⁵ *Ibid.* p. 2.

⁶ M. Govinda Rao, *Fiscal Decentralization in Indian Federalism*, Institute of Social and Economic Change, Bangalore, p. 3.

⁷ *Ibid.*

FISCAL STRUCTURE IN INDIA

India is a federation with constitutional demarcation of functions and sources of finance between Union, State and local governments. However, statutory introduction of the third tier is a recent phenomenon – after the 73rd and 74th amendments of the Constitution in 1992 gave the rural and urban local governments the constitutional status. The statutory recognition to local governments was accorded with the 73rd Constitutional amendment in 1992. With this, each of the State governments was required to pass legislation appointing Panchayat Raj institutions. It was stipulated that election to these Panchayats was to be held within the stipulated period.⁸

The Seventh Schedule to the Constitution specifies the legislative, executive, judicial and fiscal domains of Union and State governments in terms of Union, State and Concurrent Lists. The Constitution also requires the President to appoint a Finance Commission every five years or earlier to review the finances of the Union and States and recommend devolution of taxes and grants-in aid of revenues to them for the ensuing five years. In addition to these transfers, the Planning Commission also gives assistance to the States based on a formula determined by the National Development Council and specific purpose transfers for various central schemes implemented by different ministries of the Union government. The Constitution has formed the basis of governance in India since independence.⁹

Notably, the tax powers are assigned on the basis of the principle of separation and are assigned exclusively either to the Centre or the States. However, the separation is only in legal and not in economic sense.¹⁰ Thus, the centre can levy taxes on production (excise duty) whereas, the tax on sale or purchase of goods has to be levied by the States. Similarly, only the States can levy the taxes on agricultural incomes and wealth and only the Central government can levy taxes on non-agricultural incomes and wealth. The States have found taxing agricultural incomes politically infeasible besides being administratively difficult. At

⁸ M. Govinda Rao, *Fiscal Decentralization in Indian Federalism*, Institute of Social and Economic Change, Bangalore, p. 3.

⁹ Amresh Bagchi, *Fifty Years of Fiscal Federalism in India: An Appraisal*, p. 5.

¹⁰ C. Rangarajan & D.K. Srivastava, *Federalism and Fiscal Transfers in India*, Oxford University Press, New Delhi, p. 7.

the same time, the separation of the tax base has opened up a floodgate for avoidance and evasion of personal income tax.¹¹

In terms of their relative size as measured by their share in the total expenditure of the government, states in India do not compare unfavourably with their counterparts in other federations. Of the total expenditure of the government, the states account for over 50 percent as compared to 40 percent in USA (states and local governments combined), and 47 percent in Australia. Revenue receipts of the states from their own sources form around 38 percent of the total government revenues as compared to 34 percent in USA, and 30 percent in Australia.¹²

FINANCE COMMISSION

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. 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.

The Constitution itself has provisions for transfer of funds from the Union to the States since the revenues of the States would not be enough to meet the expenditures of the States. To effect the transfers on an objective basis, the constitution provides for the appointment of the Finance Commission every five years. The functions of the Commission include (i) distribution of the proceeds from sharable taxes (ii) provision of grants in aid to the States in need of assistance and (iii) measures to augment resource of the State government to supplement the resources of the Panchayats and Municipalities in the States and (iv) address any other matter referred to the Commission in the interest of sound finance. Since the adoption of

¹¹ C. Rangarajan & D.K. Srivastava, *Federalism and Fiscal Transfers in India*, Oxford University Press, New Delhi, p. 6.

¹² Amresh Bagchi, *Fifty Years of Fiscal Federalism in India: An Appraisal*, p. 4.

Indian Constitution, Thirteen Finance Commissions have submitted their reports.¹³

Overriding powers of the centre in exceptional situations are not unusual even in polities universally recognised as 'federal'. Residuary powers are not always vested in the states either, eg., in Canada. Yet, Canada is regarded as a most vibrant federation of the world. Under the US constitution residuary powers belong to the states but the US Supreme Court has left the task of deciding the allocation of state and federal policy responsibilities to the congress arguing that the states' representation in the senate would serve to protect their policy interest.¹⁴

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.¹⁵

A moot point is whether relative responsibilities of the Centre and states could be defined and worked out in financial terms. The Indian Constitution had given a workable solution that has been able to sustain the federal spirit and provide the framework for many years to come.

IMBALANCES

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.¹⁶

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

¹³ M. Govinda Rao, Fiscal Decentralization in Indian Federalism, Institute of Social and Economic Change, Bangalore, p. 3.

¹⁴ shodhganga.inflibnet.ac.in/jspui/bitstream/10603/.../12_chapter%203.pdf

¹⁵ Ibid.

¹⁶ Ibid.

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. 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.¹⁷

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.¹⁸

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. However, it is the actual working of the scheme that has revealed deficiencies that seriously detract from much of its supposed merits. There has been 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.¹⁹

FINANCE COMMISSION REPORTS

Clause (1) of Article 175 requires the Union to make grants-in-aid to such States as are in need of such assistance. The Proviso to Clause (2) of that Article entrusts to the Finance Commission the task of finding out those States who are in need of assistance and the extent of their respective needs, and to make recommendations to the President accordingly.²⁰

¹⁷ shodhganga.inflibnet.ac.in/jspui/bitstream/10603/.../12_chapter%203.pdf

¹⁸ *Ibid.*

¹⁹ *Ibid.*

²⁰ D.D. Basu, *Commentary on the Constitution of India*, Lexis Nexis Buttersworth Wadhwa, Nagpur, 8th Ed., Vol. 8, p. 9298.

In order to properly perform this function, it is first important to know the principles that should be applied in this matter. This power has been given to the Finance Commission. The Finance Commission has to examine the fiscal condition of each State in order to determine its need, according to the principles determined by it. Each Commission lays down its own principles and there is no standard that must be followed.²¹

Apart from the matters specified in Sub. Clause (a) – (b) of Clause (3) of Article 280, the President may refer any other matter to the Finance Commission. The Second, Third and Fourth Finance Commission were assigned some additional tasks in this regard.²²

The most important recommendations that are made by the Finance Commission are with regard to grants-in-aid and have certain scope of discussion.

GRANTS-IN-AID AND FEDERALISM

Article 275 makes provision for grants-in-aid to be given to States for augmenting their revenue. These grants are given not to each State, but only to such States as may be in need of assistance. The amount of money payable to the State by way of fiscal need grants is also unconditional and the recipient State can use the money as they like. These grants are made on the recommendation of the Finance Commission.²³

Parliament is given power to make such grants as it may deem necessary to give financial assistance to any State which is in need of such assistance. Discrimination in the matter of making grants would not be unconstitutional, for grants to financially weak States cannot be discriminatory in nature. By means of these grants, mentioned in Article 175 the Union will be able to correct inter-State disparities in financial resources which are not conducive to an all-round development of the country and also to exercise control and co-ordination over the welfare schemes of the State on a national scale.²⁴ Grants are also provided for under Article 282, but they are of a discretionary nature.

Federal grants are necessary in all Federal economies for the simple reason that no system of distribution of financial resources between the federation and the Units can possibly meet the need for natural development and social services which is usually the responsibility of the

²¹ *Ibid.*

²² *Ibid* p. 9277.

²³ *Ibid.*

²⁴ D.D. Basu, *Commentary on the Constitution of India*, Lexis Nexis Buttersworth Wadhwa, Nagpur, 8th Ed., Vol. 8, p. 9278.

Units. While the more productive sources have to be kept in the hand of the Federation to provide for the prime contingency of defence and national development, the resources of the Units are augmented by grants made by the Federation according to the varying needs of the States.²⁵ The First Finance Commission recommended that transfers should be made from the Centre to the States without much strain and taking into account its own responsibilities.²⁶

With regard to grants in aid, most of the Finance Commissions have made recommendations. The First Finance Commission lay down the reasons for which grants-in-aid are usually needed by local units of administration. These are the deficiency of State resources, augmenting welfare services and development projects and developing activities in order to deal with employment. The Sixth Finance Commission also made recommendations on governing the distribution of grants to be made to the States on account of the imposition of wealth tax on agricultural property.²⁷

The recommendations of the Finance Commission are not binding. As per Article 281, they are tabled before the Parliament and on the basis of these recommendations, decisions are taken. Although it is often said that deviations are not made from these recommendations, the largest amount of deviations were made from them at the time of the Eighth Finance Commission.

GRANTS-IN-AID IN THE UNITED STATES

Article 1, s. 8(1) of the American Constitution, says that

“The Congress shall have power to levy taxes.....and provide for the common defence and general welfare”

It has been held that this spending power is not restricted to the purposes with respect to which Congress has legislative power delegated to it by the Constitution. The Constitution enables the Congress to make grants and subsidies to State Governments for agriculture,²⁸ irrigation or reclamation of land etc. During the ratification debates, this broad grant of power worried critics of the Constitution, who asserted that it would transform the national Government into a Government of infinite, rather than enumerated powers. James Madison rejected the interpretation, maintaining in “The Federalist No. 41” that the enumeration of

²⁵ *Ibid.*

²⁶ *Ibid.*

²⁷ *Ibid* p. 9310.

²⁸ *Steward Machine Co. v. Davis*, (1937) 301 US 548.

Congressional powers that followed the general authorisation served to “explain and qualify” it. In a Constitution that is the epitome of federalism, it has been held that, the power to make grants has been held to include the power to impose terms and conditions as to the expenditure of the moneys granted.²⁹ It has earlier been stated that the Indian Constitution merely provides that Finance Commission shall recommend amount of grants and States may spend it as they please. However, the amount of grants may vary. Therefore, greater independence is given to States in the Indian scenario, while in the United States, it is more unitary in this regard.³⁰

The 10th Amendment would stand in the way of the Union intruding into State or local affairs, but this difficulty has been avoided by resorting to the device of making ‘conditional grants’ which has been judicially upheld. The Court held that the Federal Government³¹

“does have power to fix the terms upon which its money allotments to States shall be disbursed...”

According to learned author M.P. Jain,

“the conditional grants have made much good in the USA, as they have helped in stimulating the States to launch and expand many welfare activities and have also greatly improved the State administration. The system has proved useful and it is expanding all the time as more and more activities are brought within its purview. There is no reason why conditional grants should not play a similar role in India”³²

CONCLUSION

After more than six decades of functioning, Finance Commissions of the past, have in their approach to transfer of Central resources to the states have appraised the ‘*quantitative*’ and assessed the ‘*qualitative*’ aspects of public expenditure.³³

²⁹ *Oklahoma v. U.S. Civil Service Commn.*, (1947) 330 US 127 (143-44).

³⁰ D.D. Basu, *Commentary on the Constitution of India*, Lexis Nexis Buttersworth Wadhwa, Nagpur, 8th Ed., Vol. 8, p. 9320.

³¹ *Oklahoma v. U.S. Civil Service Commn.*, (1947) 330 US 127 (143-44).

³² See M.P. Jain on *Indian Constitutional Law*, 5th Ed., Vol. I at p. 759.

³³ shodhganga.inflibnet.ac.in/jspui/bitstream/10603/.../12_chapter%203.pdf

Having experienced thirteen Finance Commissions in India, it could be concluded that the mechanisms envisaged in the Constitution have proved adequate for dealing with the consequences of the asymmetry of resources between the Centre and the states. The Commissions did not feel constrained by the terms of reference given by the Centre, and derived authority from the constitutional provisions to go beyond these terms whenever they felt that an equal treatment between the Centre and the states required this. They excluded the plan expenditure from their purview, not because they accepted this as a constraint imposed by the Constitution or the terms of reference, but because they recognized the complementary role of the Planning Commission in the plan process.³⁴

It would also be proper to mention that each Commission left its own stamp on its specific recommendations, based partly on the circumstances at that time and partly on its own emphasis on priorities within their general approach. Nevertheless, it could be observed that there were three consistent strands that run through the recommendations of all the Commissions namely (1) satisfaction with the provisions of the Constitution; (2) a desire to do justice to both the Centre and the states; and (3) a concern to ensure equitable treatment among the states taking into account the special circumstances of each state.

However, nothing is all good. The expansion of the grants-in-aid by the federal government is usually accomplished at the expense of state and local government action. This often has the consequence of destroying state and local initiative and leads to a growing dependence on the federal government to solve their problems. Also, the grant can lure the states into providing matching funds for federal programs to the disadvantage of programs that the state feels should have first priority. All of the dangers involve the increased concentration of authority in the federal government and a corresponding decrease in authority and responsibility in state and local government.³⁵

Since, this system is followed by the most federal of countries, it has been accepted by India as well. Even if the Article 280, did not provide for grants-in aid, Entry 20 of the Concurrent List could have been employed to pass any such legislation by the Union. At least, with the presence of Article 280, the power of Union to make laws in this regard will be restricted. It is therefore safe for us to call India fiscally federal.

³⁴ Ibid.

³⁵ Sam J. Ervin Junior, *Federalism and Federal Grants-in-Aid*, 43 N.C. L. Rev. 487 1964-1965