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Essay · Essay

Impact of the new economic measures on fiscal ties between the union and states in India.

भारत में संघ और राज्यों के बीच राजकोषीय संबंधों पर नए आर्थिक

उपायों का प्रभाव।

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Answer Hint

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Model Answer

Introduction

India's federal system distributes legislative, administrative and financial responsibilities between the Union and the states. Fiscal relations are particularly important because governments require adequate financial resources to fulfil their constitutional responsibilities, provide public services and promote economic development. The Constitution establishes mechanisms for distributing taxation powers, sharing revenues and providing grants to address differences in the financial capacities of different states.

Since the economic reforms initiated in 1991, India has introduced several measures that have transformed its fiscal landscape. Economic liberalisation, changes in tax administration, the introduction of the Goods and Services

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Tax (GST), the expansion of centrally sponsored schemes and changes in fiscal management have influenced the relationship between the Union and state governments.

These measures have created opportunities for greater economic integration, improved tax collection and coordinated policymaking. At the same time, they have raised concerns about state fiscal autonomy, revenue uncertainty and the equitable distribution of resources. The central challenge is to ensure that economic reforms strengthen India's fiscal federalism rather than concentrate financial power disproportionately at the Union level.

Body

1. Constitutional Framework of Fiscal Relations

India's fiscal federalism operates within a constitutional framework that allocates taxation powers and expenditure responsibilities between the Union and the states.

The Union has access to important sources of revenue, including customs duties, corporation tax and certain other taxes, while states rely on sources such as state excise duties, stamp duties, electricity duties and taxes on specified activities. The Constitution also provides for the sharing of certain Union tax revenues with the states.

Article 280 provides for the establishment of the Finance Commission, which recommends the distribution of the divisible pool of Union taxes between the Union and the states, the allocation among states and principles governing grants-in-aid.

Article 270 deals with the distribution of specified Union taxes, while Article 275 provides for grants-in-aid to eligible states. Article 282 permits the Union or a state to make grants for public purposes, including areas beyond its ordinary legislative competence.

This framework reflects the need to reconcile two realities: the Union possesses greater revenue-raising capacity, while states undertake major responsibilities in areas such as public health, agriculture, local infrastructure and law and order.

2. Economic Liberalisation and Changing Fiscal Priorities

The economic reforms initiated in 1991 sought to improve efficiency, encourage private investment, reduce unnecessary controls and integrate India more closely with the global economy.

Liberalisation altered the relationship between governments and the economy. Greater private-sector participation, changes in industrial policy and the expansion of market-based economic activity influenced the tax base and public expenditure priorities.

The Union introduced changes to customs duties, corporate taxation and indirect taxation, while states increasingly sought investment through infrastructure development, industrial incentives and improvements in the business environment.

These changes created new opportunities for state-level economic growth. States with better infrastructure, skilled labour and administrative capacity were often better positioned to attract investment.

However, differences in starting conditions meant that the benefits of liberalisation were not distributed uniformly. Economically advanced states could often mobilise greater resources, while less-developed states continued to depend heavily on transfers from the Union.

Consequently, economic reforms made the equitable distribution of public resources even more important.

3. Tax Reforms and Their Impact on Revenue-Sharing

Tax reforms have been a major component of India's economic transformation. Before the introduction of GST, India's indirect tax system consisted of multiple central and state-level taxes, including excise duties, service tax, value-added tax and entry taxes.

The coexistence of multiple taxes created compliance burdens, cascading taxation and barriers to the movement of goods across state borders.

The movement towards a more integrated tax system sought to simplify taxation, reduce distortions and improve economic efficiency. However, tax harmonisation also affected the autonomy of states to determine their own indirect tax policies.

The GST framework represents the most significant example of this change. It has created a common national market while requiring coordination between the Union and state governments on tax rates, exemptions and administrative arrangements.

Thus, tax reform has strengthened the need for institutional cooperation while changing the nature of fiscal bargaining between the two levels of government.

4. Goods and Services Tax: Integration and Federal Negotiation

The Constitution (One Hundred and First Amendment) Act, 2016, established the constitutional framework for GST, which was implemented on 1 July 2017.

GST replaced several central and state indirect taxes with a more integrated system. It includes Central GST, State GST and Integrated GST, depending on the nature of the transaction.

The GST Council, established under Article 279A, provides a forum for the Union and states to deliberate on important tax-related matters. Its institutional design reflects the principle that both levels of government must participate in decisions affecting a shared tax system.

Positive impacts of GST

- It reduced several tax-related barriers to interstate trade.
- It sought to minimise cascading taxation through input tax credits.
- It created a common framework for indirect taxation.
- It encouraged greater coordination between tax administrations.
- It provided opportunities to improve compliance through digital reporting and data integration.

Concerns regarding state autonomy

- States have limited independent discretion over GST rates and exemptions.
- Revenue performance may differ across states because of variations in consumption and economic activity.
- States can face uncertainty when collections grow more slowly than their expenditure requirements.
- Disputes over compensation, rates and revenue projections can generate tensions.

The GST compensation mechanism was particularly important during the initial transition. Under the GST (Compensation to States) Act, 2017, eligible states were provided compensation for specified revenue shortfalls during the prescribed transition period, subject to the statutory framework.

GST therefore illustrates both the possibilities and limitations of cooperative fiscal federalism. Its success depends on transparent decision-making, reliable revenue administration and meaningful participation by all governments.

5. Changes in Tax Devolution and the Role of the Finance Commission

Tax devolution is a central mechanism for addressing the imbalance between the Union's revenue-raising capacity and the expenditure responsibilities of states.

The Finance Commission recommends the share of the divisible pool of Union taxes to be distributed to states, along with the criteria for inter-state allocation. These criteria may consider factors such as income distance, population, demographic performance, area and forest or ecological considerations, depending on the commission's recommendations.

The Fourteenth Finance Commission recommended increasing the states' share in the divisible pool of Union taxes to 42% for its award period, 2015–20. This was intended to provide states with greater untied resources and flexibility in expenditure decisions.

Greater tax devolution can strengthen state autonomy by allowing governments to allocate funds according to local priorities. It can also reduce excessive dependence on scheme-specific grants.

However, the effective fiscal space available to states depends on more than the devolution percentage. It is also influenced by the size of the divisible pool, the treatment of cesses and surcharges, grant arrangements and the expenditure responsibilities assigned to states.

Therefore, a balanced fiscal framework requires predictable transfers and transparent accounting of the resources available to each level of government.

6. Centrally Sponsored Schemes and State Fiscal Space

Centrally sponsored schemes are used to pursue national development objectives in sectors such as health, education, rural development, sanitation and social protection.

These schemes can help states finance important public services and promote minimum standards across the country. They are particularly valuable for states with limited revenue-raising capacity.

However, many schemes require states to contribute a specified share of expenditure. This can constrain state budgets, especially when matching contributions must be provided alongside salaries, pensions, debt servicing and other committed expenditures.

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States may also have limited flexibility to adapt centrally designed schemes to local needs. Differences in geography, administrative capacity and development priorities can make uniform programme designs less effective.

The challenge is not to eliminate centrally sponsored schemes but to improve their design. Greater consultation, flexibility in implementation, realistic matching requirements and outcome-based monitoring can improve their effectiveness while respecting state priorities.

7. Cesses, Surcharges and Concerns over Revenue Distribution

The Constitution permits the Union to levy certain cesses and surcharges for specified purposes or under applicable constitutional provisions. These revenues are generally not part of the divisible pool distributed to states under the ordinary tax-devolution mechanism.

Consequently, an increasing reliance on such levies can create concerns among states about the effective resources available for sharing.

Even when the Union uses these revenues to finance national priorities, states may argue that the growth of non-divisible revenue reduces the practical benefit of a higher tax-devolution percentage.

This issue illustrates the importance of looking beyond headline percentages when evaluating fiscal federalism. The actual balance of resources depends on the composition of Union revenues and the extent to which they are shareable.

Greater transparency, predictable revenue-sharing arrangements and constructive consultation can help reduce such tensions.

8. Competitive Federalism and Regional Economic Inequalities

Economic reforms have encouraged states to compete for domestic and foreign investment by improving infrastructure, simplifying regulations and offering a conducive business environment.

Healthy competition can encourage innovation, administrative efficiency and better public service delivery. States may learn from successful policies adopted elsewhere and improve their own economic performance.

However, excessive competition can also produce uneven outcomes. States with stronger infrastructure, better educational outcomes and greater administrative capacity may attract more investment, while poorer states may struggle to catch up.

Competition through excessive tax concessions or poorly designed subsidies can also reduce public revenue without guaranteeing sustainable employment or long-term investment.

Fiscal federalism must therefore combine competition with cooperation. Equalisation transfers, investment in human capital, infrastructure support and capacity-building initiatives can help less-developed states participate more effectively in economic growth.

9. Fiscal Responsibility and State-Level Development

Economic reforms have increased the importance of fiscal discipline, expenditure efficiency and public debt management.

The Fiscal Responsibility and Budget Management framework, along with corresponding state-level legislation, seeks to promote fiscal prudence and improve budgetary transparency.

Sound public finances can strengthen investor confidence and ensure that governments retain resources for essential services. However, rigid fiscal targets may create difficulties when states face economic downturns, natural disasters or urgent social expenditure requirements.

Fiscal rules must therefore balance discipline with flexibility. Expenditure quality matters as much as the overall deficit. Investment in irrigation, education, healthcare, transport and climate resilience can generate long-term economic and social benefits.

A cooperative approach to fiscal management should enable states to maintain responsible budgets without compromising essential development expenditure.

10. Strengthening Cooperative Fiscal Federalism

The changing fiscal environment requires stronger institutional cooperation between the Union and the states.

The following measures can improve fiscal relations:

- **Predictable transfers:** Ensure timely and transparent distribution of tax devolution and grants.
- **Meaningful consultation:** Involve states in decisions affecting their revenue base and expenditure obligations.
- **GST Council effectiveness:** Strengthen evidence-based deliberation and consensus-building on tax policy.
- **Greater fiscal flexibility:** Allow states appropriate discretion to address region-specific development priorities.

- **Transparent accounting:** Provide clear information on divisible taxes, cesses, surcharges and grants.
- **Capacity-building:** Improve tax administration, digital infrastructure and public financial management in states.
- **Balanced development:** Support states facing structural disadvantages through appropriate equalisation mechanisms.
- **Outcome-based spending:** Evaluate public expenditure by its contribution to welfare, productivity and sustainable growth.

Such measures can make fiscal relations more predictable and reduce unnecessary conflict.

Conclusion

New economic measures have significantly reshaped fiscal ties between the Union and the states in India. Liberalisation altered economic priorities, tax reforms changed revenue structures, GST created a common indirect tax framework, and changes in tax devolution and expenditure arrangements influenced the fiscal autonomy of states.

These reforms have generated benefits through economic integration, improved tax coordination and new opportunities for cooperative governance. At the same time, concerns about revenue uncertainty, the use of non-divisible levies, conditional grants and regional inequalities remain important.

India's federal system requires a careful balance between national economic coordination and state-level fiscal autonomy. The Union must retain the capacity to pursue national priorities, while states need adequate, predictable and flexible resources to fulfil their constitutional responsibilities.

Ultimately, effective fiscal federalism is not a contest between the Union and the states. It is a partnership in which transparent revenue-sharing, mutual trust and equitable development enable every state to contribute to India's collective prosperity.

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