EVOLUTION OF FISCAL FEDERALISM IN INDIA WITH SPECIAL EMPHASIS ON THE DEVELOPMENTS POST 14TH FINANCE COMMISSION AND THE 101TH CONSTITUTION AMENDMENT ACT

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ABSTRACT

The fiscal federalism lays down independent sources of revenue that are assigned to the federal government and the units which are autonomous within their defined spheres. The constitutional provisions have assigned the powers to the respective governments to exercise their power of taxation. Fiscal federalism in India has ensured that the Union and state governments are efficient, adequate, suitable, and independent to provide public service. Fiscal federalism in India has evolved through the implementation of various policies and plans of the government. Implementation of GST vis-à-vis the constitutional amendment has brought both advantages and disadvantages in fiscal arrangements between the centre and the state. Having said this, the current research tends to analyse the evolution of fiscal federalism through the lens of various policies and initiatives taken by the state in order to maintain the fiscal relationship between the centre and the state government.

Keywords: GST, Fiscal federalism, administration, NITI Ayog, Finance Commission.

Introduction:

The Constitution of India defines India as a federation by stating that India is a "Union of States"[1] whereby the functions with respect to the administration of the Union is divided between the Union and the State governments. Through this division, the economic, political, and administrative stability is ensured between the levels of the government. This type of federation is a mixture of both federal and unitary principles that have been responsible for the growth of the country and its constituent units. Since Independence, the concept of federalism in India has undergone several modifications. As rightly quoted by Chief Justice Beg in the Assembly dissolution case [2], "….. the extent of federalism in the Indian Union is largely watered down by the needs of progress and development of a country which has to be nationally integrated, politically and economically coordinated, socially, intellectually and spiritually uplifted." So federalism in true sense is the outcome of the dynamic changes in the country's administration. The fiscal federalism lays down independent sources of revenue that are assigned to the federal government and the units which are autonomous within their defined spheres. Based on the constitutional provisions, each layer of the government exercises its power of taxation and public expenditure which is compulsorily directed by the principle of public finance. The role of fiscal adjustment between governments in federalism becomes more important in the context of allocation of resources among themselves and transference of tax-proceeds between them in accordance with the functions and responsibilities assigned to them.[3]

The evolution of fiscal federalism in India can be broadly divided into five phases: (1) Conceptualizing decentralized finance: 1858 to 1871 (2) Informal decentralization of finances: 1871 to 1919 (3) Formal decentralization of finances: 1919 to 1935 (4) Decentralization to federal finances: 1935 to 1947; and (5) Starting of Constitutional fiscal federalism: 1947 to 1950. [4] Although the Constitutional fiscal federalism stands on much importance as its evolution took place after the Government of India Act of 1919 was enacted. Through this act, the fiscal arrangements in India i.e the distribution, collection, and sharing of revenues and taxes came into the picture. Soon after independence, the focus of the constituent makers diverted towards the economic development of the nation by adopting various measures that will further strengthen the economic growth of the country. The Constitution itself contains the provisions with respect to finance, distribution of revenues between the Union and the states, etc. The seventh schedule set outs the division of powers between the Centre and the State in

terms of the three lists Union, state and concurrent list. To review the finances of the Centre and the state, the constitution of Finance commission by the President of India has been enumerated under Article 280 of the Constitution of India. Further to strengthen the fiscal arrangement between the Union and the state, the One hundred and first Amendment Act, 2016 introduced a new policy of taxation known as National Goods and service tax. The fiscal arrangement in India is the result of Parliamentary enactments and executive directions. The regulation of the fiscal federation in India has undergone improvisation through the recommendations of the Finance Commission, committees, and parliamentary enactments.

Fiscal federalism in India has ensured that the Union and state governments are efficient, adequate, suitable, and independent to provide public service. It avoids double taxation and duplication of tax machinery so common in other federations. It also precludes the possibility of multiple taxations. The developments in finance policies are the result of the flexibility provided by the founding fathers of the Constitution especially after the introduction of the Finance commissions, their recommendations, and reports. The centre-state fiscal system is based on the devolution of financial resources from the centre to the constituent states and Union territories based on the recommendations of the finance commission, which is a statutory ad hoc body and the Planning commission which is a non-statutory permanent body which eventually in 2014 got replaced by a new institution known as the NITI Aayog. The finance commission recommends before each Five Year Plan period, the devolution of grants and loans for the capital budgets or plan budgets of the states.

Phases of the evolution of Fiscal Federalism.

1. PHASE I- 1858 to1871

In 1858, the crown took control over the administration of British India, the finances were not subjected to the concern of the crown. A finance minister was to be appointed for accounting and managing funds. Some significant changes were observed when William Massey got appointed as the Finance Minister in 1866. The policies introduced by him largely supported the decentralization of finance. Col. Strachey's scheme of decentralization of finance transferred some domain of power to legislate to the provinces on matters such as road, jail, education, and medical services. It was further suggested that one-sixteenth of the land revenue and one-fourth of the proceeds of license tax should be allotted to the provinces. The scheme recommended that the Provinces should be empowered to augment their revenue by imposing

additional taxes and cesses on the existing taxes.[5] This phase ended with the steps taken by Lord Mayo and no significant changes were observed apart from the implementation of the principles suggested by Massey and Strachey.

1. PHASE II- 1871-1919

This period observed an accelerating transfer of financial authority from the Central to the State government with respect to certain matters. The provinces were in a state of deficit since the economic development was subjected to policies framed by the British councils. Irrespective of the establishment of cotton mills and growing industrialization in British India, no significant changes took place in the growth of the finances of the provinces. Irrespective of the productivity, the cotton mills of India did not get direct encouragement from the colonial government during the period. Indeed the colonial economic policy discouraged the mills in India.[6] The Indian Economy was stagnant as a result of the decline of the per-capita income, decline in the secondary sector, and slow progress in Urbanization. Lord Mayo, who was the then Governor-General of India (1870) included decentralization of finances to uplift the economic instability of the provinces. This phase too did not grant any Independent powers of taxation to the state. There was no state autonomy in borrowing any funds or loans on their credit. The provincial budgets too needed the approval of the Government of India and the provinces had to depend upon the centre to meet even their ordinary set of expenses. During this period, the fiscal federalism in India just evolved by the transfer of certain subjects to the provinces. But no real fiscal autonomy was given to the provinces.

1. PHASE III- 1919-1935

This period has observed remarkable changes in the approaches of the government in setting up the fiscal federalism in Modern India. Various committees and commissions have contributed to align the system of decentralized financial administration in India. The passing of the Government of India Act of 1919 on the recommendations of the Montague-Chelmsford Report was a major step in developing the formal setup of fiscal federalism in India. This act relaxed the central control over the provinces by demarcating and separating central and provincial subjects. For the first time, the provincial budgets were separated from the central budget, and complete autonomy was given to the provinces to enact their budgets. The power to confer the right of taxation and borrowing was another step towards fiscal federalism. The fundamental issue was that the fiscal powers of the provinces were not derived from a sovereign

constitution but were delegated by the supreme central government. Such a system could not be considered as a federal system.[7] Recommendations of the Indian Statutory Commission (1930) suggested the imposition of new taxes. The tax revenue was to be divided into the following four categories which included taxes collected and spent by the Centre, taxes collected and spent by the provinces, taxes collected by the Centre, and distributed to the provinces on the basis of origin and on the basis of the population. The first Peel Committee (1931) and Percy Committee (1932) laid down recommendations on the income tax and the distribution of the same with respect to the centre and the provinces. Apart from these, significant contributions were made by the White Paper on Indian Constitutional Reforms (1931), Second Peel Committee (1932), and Parliamentary Committee (1934) focusing on the allocation and devolution of resources.

1. PHASE IV- 1935-1947

The Act of 1935 was a turning point in the evolution of fiscal federalism in India. The act divided the powers between the centre and the units in terms of three lists. There was clarity with respect to the matters on revenue and expenditure between the centre and the provinces. Moreover, now the provinces could borrow in the open market on the security of their revenues.[8] Thus resulting in granting complete autonomy to the provinces in matters of financial administration. The act also introduced a policy of Grants-in-aid. But later it was observed that since there were huge differences in the finances of the provinces, the grants-in-aid could be of no help.

1. PHASE V- 1947-1950 and aftermath

The provision of the Act of 1935 were adopted by the Constituent Assembly in framing the financial relations between the Centre and the State. Recommendations of the expert committee were taken into consideration in the framing of the draft constitution. More or less, the draft constitution was a framework of the provisions under the Act of 1935. The creation of a constitutional body, Finance Commission (Art.280) is one such major step in developing the financial relations between the centre and the state. Through the reports submitted by the finance commission every five years, the system of transfer, collection and expenditure of taxes is improvised. Moreover, through these reports, various fiscal policies related to taxes are introduced.

Recent developments:

Recent development in the taxation system of India marked with the introduction of the Goods and service tax in 2016. The One hundred and first Amendment Act, 2016 introduced the provision of GST by substitution of Articles 246A, 269A, 279A, and amendments in the Seventh Schedule of the Constitution of India. Significant changes were observed by the introduction of this new tax regime in the fiscal federalism of the Nation. The GST subsumes majority of the Indirect taxes such as excise, service, sales, etc. focusing to create one nation - one market. Through the implementation of GST, complete autonomy is provided to the states to decide on the matters related to the National economy resulting in a collective decision-making process. The introduction of GST has created new institutions of national importance to the federal structure of the Nation. Exclusive spheres of taxation are reserved for both the state (SGST) and the centre (CGST) under the Constitutional scheme by including the taxation as a subject of legislation in both Union and State list under Schedule VII. The creation of a constitutional body known as the GST council which decides the tax rates has affected the autonomy of the state within its sphere. The state's inability to fix the tax rates to match their requirements has resulted in the growing dependence of the state towards the Centre. The creation of the GST Council under Article 279A as the only mechanism to solve disputes related to tax matters imposes a threat to the autonomy of the states. Although the implementation of GST promises equality between the centre and the state, the inclusion of the GST council in deciding the disputes over tax matters shall or may act arbitrarily in the favor of the states. The fact that there is a dispute resolution mechanism provided for in Article 279A(11) suggests that the recommendations are supposed to be binding –if they were merely recommendatory and non-binding, no legal obligations would arise out of them, and there would be no dispute to address as the State or the Union would be free to disregard the recommendations. If the intent was to make the recommendations non-binding there would be no need to have a dispute settlement body to enforce compliance of recommendations [9]. The recommendations being binding, the states are the ones that will suffer, harming the federal structure of the country. Moreover, the majority of the members in the council are a part of the Union [10] therefore there are more chances of the Council acting in an arbitrary manner. On the other hand, the council has the power to make recommendations on the kind of subjects that imply that the Union has a say on the same directly hampering the federal set-up under the constitution.

Such a mechanism which allows the Union to determine and direct the tax policies of a State through a binding "recommendation" of the Council is unlikely to pass the "basic structure" test in that it could amount to a violation of the Constitution's basic feature of federalism. It

directly infringes and violates one of the fundamental tenets of the Constitution's federal structure – the political sovereignty of the States.[11]

The Finance Commission is a constitutional body formed once in five years, which provides recommendations on the fiscal relations between the Centre and States. The recommendation of the 14th Finance Commission has stated that the primary source of transfer of funds shall be from the Centre to the states. The share of taxes of the Centre to the states is recommended to be increased from 32% to 42% [12]. In case of additional budgetary needs will be addressed by providing grants-in-aid. The report also addressed the issue of implementation of GST in the initial years and the losses incurred by the states. To recover the losses 100% compensation was recommended by this report to be paid to the states in the first three years. The recommendation of the Fourteenth Finance Commission has both a positive and negative impact on the federal nature of the country. One being equality between the centre and the states in the matters of national development. Another being that the distribution of funds within the divisible pool of tax revenues of the centre. Although the negative impact appears to be on states that are not financially strong since there is differential access to the resources.

Conclusion:

The evolution of fiscal federalism is the outcome of various factors that have taken place since Independence. The conflicts between the Union-states on finances which are also aggravated by the political and ideological differences have impacted the autonomy of the states in federalism. Since the Centre comes to rescue the states in times of difficulty have often resulted in the complete domination and control of the states by the centre. Sometimes it has been also observed that the states are financially irresponsible and indiscipline because of which the responsibility of the centre increases. Such actions have impacted not only the financial relationship of the state with the union but also upon the political status. To restore this economic and political autonomy of the states in fiscal federalism, various committee reports were referred such as the Rajamannar Committee on Centre-State Relations set up by DMK government (1969), the J.K. Thavaraj Committee by the Kerela government, the West Bengal Memorandum which emphasized on the allocation of 75% of the centre's revenue to the states and the Sakaria Commission (1987) [13].

The implementation of the recommendations of the Fourteenth Finance Commission and GST has led to structuring the federal system of India as cooperative federalism. Since both the

centre and the states have an equal say upon the matters related to the National economy. But since the tax rates are fixed by the GST council, the autonomy of the state in federal set up is threatened. This can be understood by a very simple example that if there are any special requirements or implementation of any schemes within the domain of the state, the state is bound to act only after the agreement of the centre on the same. Moreover, GST has taken away the individual freedom of the states to levy taxes as per their requirement. Overall the implementation of the recommendations of the fourteenth finance Commission had positive as well as negative impacts on the federal structure.

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