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India's Fiscal Policy and Fiscal Federalism

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Abstract

Purpose: The study aims at critically examining fiscal policy and fiscal federalism in India in the decade from 2011 to 2021. It tries to trace out the fiscal policy trajectory followed by the Government of India along with the evolution of fiscal federalism in the last decade.

Theoretical framework: The theory of fiscal policy is a product of Keynesian economics, in which it is defined as changes introduced by the government in the levels of taxation and expenditure influencing aggregate demand and levels of economic activity. The theory of fiscal federalism lays out a normative framework for the assignment of expenditure responsibilities to ensure the efficient and effective allocation of resources between the states.

Design/methodology/approach: Qualitative research design has been used to evaluate the fiscal policies and state of fiscal federalism in India. Descriptive and analytical approach with Analytical tools such as Tax to GDP ratio, Debt to GDP ratio, and Tax devolution has been used to evaluate the fiscal policies and fiscal federalism in the past decade.

Findings: The results show that while the objectives of fiscal consolidation, economic growth, increased tax revenues and capital spending, and reduced debt to GDP ratio have stood out in the fiscal policy of the Government of India in the past decade. However, the performance of the fiscal policy in achieving all these targets is still questionable. The fiscal policy of the country has failed to address and change its orientation to focus on the reduction of revenue expenditure and develop capital infrastructure in the priority sectors, which could have added to the growth of the economy.

Research, Practical & Social implications: The study mentions the fiscal policy outlook of the government in the selected decade and tries to analyse and assess their effectiveness in the context of how successful they have been in attaining the objectives of growth and in qualifying for a sound fiscal policy. The study focuses on discussing the evaluation of fiscal federalism in India in the past decade with the help of factual figures related to tax devolution, share in total revenue of the centre, grants, etc. Lastly, from the perspective of critical analysis, some of the major problems are discussed, along with some suggestions.

Originality/value: The value of the study lies in the innate significance of fiscal policy and fiscal federalism in achieving the goals of effective and efficient allocation of resources. This is the collective study of two most important segments of the economy to achieve the financial objectives.

Keywords: Fiscal policy, Fiscal federalism, Tax, Revenue, Capital Expenditure, Revenue Deficit
JEL Classification: E6, H3, H6, O2

I. Introduction

In the context of a developing country like India, fiscal policy takes the front seat in the run-up

to growth and development. Through taxation, it generates revenue that is utilized in the mobilization and allocation of resources for the creation of socio-economic infrastructure and other public amenities. When used efficiently, it can play an important role in minimizing imbalances in the distribution of resources in the country. Fiscal policy guides the government's spending activities and revenue generation strategy. Matters which are under the direct control of the government are covered under the ambit of fiscal policy. The key objectives of any fiscal policy are the attainment of high growth and economic stability; price stability; and full employment; ensuring optimum allocation of resources; encouraging investment and capital formation; and reducing inequality. These objectives are met through the fiscal tools, which include: consumption control (whereby the ratio of savings to income is raised); increasing overall investment by increasing government investment; taxation (progressive taxation and more taxes on luxury goods); infrastructural development; and undertaking measures to prevent tax evasion. The two important components of fiscal policy are taxation and expenditure.

Taxes, both direct and indirect, are the main components of the government’s revenue receipts. Through taxes, the government not only raises a sufficient amount of revenue but also controls the level of aggregate consumption in the economy and thereby inflation. Progressive taxation is used to ensure an equitable distribution of income and wealth in the economy. An increase in taxes will reduce consumption expenditure, stimulating investment, and a reduction of the same would increase consumption expenditure, resulting in increased economic activity. Government expenditure is of two types, viz., and capital and revenue expenditure. The former relates to the acquisition of long-term assets, which lead to the addition of infrastructure in the economy or the reduction in liabilities of the government, which reduces the debt burden, e.g., purchase of machinery, capital formation etc. The latter type refers to expenses which do not result in the creation of any assets or reduction of liabilities of the government, e.g. salaries paid to government employees, interest payments etc. Increased government expenditure increases the overall aggregate demand and promotes employment, while a reduction in the same has contractionary effects on the economy. Apart from these, policies of investment and disinvestment and debt management are also part of the elements of fiscal policy. It is through the use of these instruments that the fiscal policy determines whether the government spends more than its revenue or less than it; and also influences the cyclical fluctuations and trends in the economy.

II. Review of Literature

Fiscal policy is the guiding force that helps the government decide how much money it should spend to support economic activity and how much revenue it must earn from the system to keep the wheels of the economy running smoothly. The fiscal policy encompasses two separate but related decisions: public expenditures and the level and structure of taxes. It occupies the central place in maintaining full employment without inflationary forces in the economy. With its various instruments, it influences the economic stability of an economy (Thakurta, 2021). The Government of India has been using the tools of the taxation system and expenditure under the heads of developmental expenditure, social service expenditure, and expenditure on subsidies to improve the income distribution of the economy (Singh & Srinivasan, 2004). Guajardo et al. (2014) have studied the aggregate impacts of fiscal policy changes, but their appraisal in the past 10 years has to be evaluated in depth.

Various aspects of Indian fiscal policy have been extensively studied through the literature (Shome, 1988; Roy, 1998; Rao, 2000; and Bagchi, 2006). Shome (1988) explored the taxation leg of the fiscal policy and presented a framework for estimating the buoyancy and elasticity of taxes and then provided some estimates of these measures from selected Asian economies. Rao (2000) analysed the relationship between budget deficits, money creation and inflationary pressures and presented an analytical framework which suggests that for any budget deficit, there exists an optimum level of monetisation and market borrowings of the government. Bagchi (2006) studied the fiscal management of the Indian central government in the post-liberation period and analysed its effects on federal relations and the social sector. Herd et al. (2008) analysed various areas of Indian fiscal policy and described how the reforms in the past two decades have helped the Indian economy move on a high growth rate path. But they also note that there is a scope for improving the quality of public spending to target poverty reduction better. Kumar & Soumya (2010) make an attempt to understand India’s fiscal situation in the aftermath of the global financial crisis of 2007. With the analysis of previous trends and policy measures, they prescribe a new set of policy measures to achieve long-term and inclusive economic growth. De (2012) presented a review of trends and trajectories seen in Indian fiscal policy since independence. Hussein,

(2022) has done a similar kind of analysis for the years 1990 to 2018 in the context of Iraq. Lulaj & Dragusha, (2022) has studied the effect of tax policies on income growth and welfare of Kosovo.

Fiscal federalism in India can be viewed in practice as a game in politics, economics, and public finance played between the union and the states. In fiscal federalism, tax sharing powers and expenditure responsibilities are shared between the union and the states. While the centre has a large share of revenues, the states have greater responsibilities, which are the source of vertical imbalance in fiscal management (Reddy & Reddy, 2018). The performance of the economy of a country is influenced by many factors, among which government policies and institutions play a crucial role. Whether or to what extent federalism promoted efficiency in the allocation of resources in the Indian economy does not admit of a straightforward answer. The Centre's intrusion into areas earmarked for the States in the constitution harmed the economy in another way, viz., by thwarting the operation of market forces and the growth of a common market within the country (Bagchi, 2001).

Various issues related to fiscal federalism have been discussed. Inter-state disparities in India, even among the general category of states, are high and increasing. It is also seen that per capita income levels have tended to diverge sharply after market-based reforms were initiated (Rao et al., 1999). Further, the argument for equalization on horizontal equity grounds was advanced by Buchanan (1950) and later reformulated by Boadway & Flatters (1982). Even when the states' revenues grew at a faster rate than that of the centre, their fiscal dependence on the states has increased, which caused imbalances. Another important feature of Indian fiscal federalism is the wide inter-state differences in revenue capacity and, consequently, per capita expenditures (Rao, 2005). To address these issues, there is a need to relook at the existing fiscal federalism architecture in India. (Kelkar, 2019) has proposed four pillars for India’s new fiscal federalism, which currently has only one pillar in the form of the Union Finance Commission. As a second pillar, it has argued that there is a need for an institution, say New NITI Aayog, that has financial powers for allocating for developmental schemes to address the issue of increasing regional and sub-regional imbalances in India. Further, it has argued for having constitutional arrangements for sharing the GST proceeds with the third tier, which forms the third pillar, i.e., local bodies (municipality or village panchayat). And lastly, it points towards the implementation of a "flawless GST’ as the fourth pillar of new fiscal federalism. India's federal structure has led to a well-developed system of tax-sharing and transfers, both through constitutionally empowered bodies and delivered through the annual budget. While overall, India’s fiscal federalism has worked well in moving resources towards the poorest states, it has become very complex and there are still some features which weaken the fiscal discipline of the states (Herd, 2008). 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 needs of the Centre and individual states. Based on these, the Commission is required to recommend the shares of personal income tax and union excise duty and grants-in-aid to the States (Rao, 2005). An important feature of tax devolution recommended by the Finance Commissions is that, while the criteria adopted for distribution are different from the principles of grants-in-aid, nowhere it is made clear that the economic objectives of the two instruments are different (Rao & Sen, 1996).

III. Material and Methodology

The study primarily focuses on the evaluation of fiscal policy and fiscal federalism in India in the past decade. The databases used for the purpose of the research include Scopus, Web of Science, and Google Scholar to collect relevant information in the context of fiscal policy and fiscal federalism in India. To evaluate the fiscal policy and fiscal federalism, the relevant secondary data has been collected from the websites of the Reserve Bank of India, the Annual Budget of India, the International Monetary Fund, the World Bank and other authentic sources. Based on the relevant resources, a descriptive and analytical approach has been used to evaluate the fiscal policy and fiscal federalism in India.

Analytical Methods/Tools

Tax-to-GDP ratio

A tax-to-GDP ratio is a measure of a nation's tax revenue relative to the size of its economy as measured by Gross Domestic Product (GDP). Due to the ratio's ability to indicate future taxes in relation to the GDP, it offers a good look at a nation's tax revenue. Additionally, it makes it possible to compare the tax receipts of various nations internationally as well as see the general trajectory of a country's tax policy.

Debt-to-GDP ratio

The measure used to compare a nation's public debt to its gross domestic product is called the debt-to-GDP ratio (GDP). The debt-to-GDP ratio accurately

predicts a nation's capacity to repay its debts by contrasting what it owes with what it generates. This ratio, which is sometimes represented as a percentage, can alternatively be understood as the number of years required to retire debt if GDP were totally devoted to debt repayment.

GDP growth rate

The GDP growth rate of an economy, often known as the growth rate of an economy, is the percentage increase in real GDP during a given period.

Gini coefficient

A statistical indicator of economic inequality in a population is the Gini coefficient, often known as the Gini index or Gini ratio. The coefficient gauges how wealth or income is distributed among a population's constituents. One of the most often used indicators of economic inequality is the Gini coefficient. The coefficient can have any value in the range of 0% and 100%, or 0 to 1. A population with a coefficient of 0 has an entirely equal distribution of wealth or income. When one person in a population receives all the income and everyone else receives nothing, the inequality is complete and has a coefficient of one.

Tax devolution

The method by which states obtain funding from the federal government is through tax devolution. It essentially represents the state's portion of the gross tax revenue.

IV. Results

The fiscal policy of the government of India in the decade 2011–2021

The global economic situation has deteriorated significantly during the 2008-09 and 2009-10 periods owing to the repercussions of the global financial crisis. It impacted the performance of emerging market economies, and India was not immune to it either. Growth rates had slumped, and debts and deficits were on the rise. It was against this backdrop that subsequent fiscal policies in India were formulated. The following objectives have underlain successive fiscal policies that have been adopted by the Central government of India in the past decade. The fiscal policies of a few years ago introduced certain landmark changes which are also mentioned. The details of the fiscal policy of the Government of India in the past decade, as outlined below, are derived from the Fiscal Policy Strategy Statements which were released u/s 3(4) of the Fiscal Responsibility and Budget Management Act, 2003.

The objectives common to fiscal policy over the years are:

Reduction in the growth of non-plan expenditure and reorientation of expenditure towards priority sectors

This was the objective outlined in fiscal policy statements starting from the year 2011-12 till 2015-16. However, in 2016, the government decided to do away with the distinct categorization of expenditure into plan and non-plan expenditure. Resultantly, the subsequent policies focused on increasing capital spending or capital expenditure, which would lead to the creation of assets and to subsequent economic growth.

Increasing the tax-to-GDP ratio

This was to be done by means of rationalization of tax structures—maintaining moderate levels of taxes and keeping the number of tax rates at a minimum—and by widening the tax base. It was keeping these aspects in mind that the Direct Tax Code was implemented in 2011 and Goods and Services Tax in 2017. These measures were aimed at increasing both the tax and non-tax revenues.

Curtailment of overall public debt and reducing the debt to GDP ratio

The fiscal policies over the years have been targeted at reducing the debt burden of the government. Especially in light of the global financial crisis and the fiscal burden that comes with external debt, the fiscal policy is aimed at placing greater reliance on domestic borrowings over external ones. However, the policy also aimed to keep the domestic debt in check.

Reduction in the fiscal deficit

This became a primary objective of the fiscal policy of Government of India starting from 2012-13 as the deficit levels soared high. It was considered imperative to bring the deficit under control to keep in line with the Fiscal Responsibility and Budget Management Act, 2003 derived regulations and also to improve the fiscal consolidation in the economy. Another point under consideration was that a reduced fiscal deficit would allow the growth of private sector players in the investment arena.

Economic growth and revival

The Global Financial Crisis had shaken the economy and though the growth rates had recovered slightly in 2010-11 and 2011-12, the Gross Domestic Product (GDP) growth slumped yet again in 2012–13 (4.5%) and recovered only by a bit in 2013–14 (4.7%). The economy has experienced several such slumps in the last decade, and so economic growth was a necessary objective of fiscal policy throughout. Then, the Direct Benefit Transfer (DBT) scheme was introduced in 2013 to increase effectiveness and efficiency in the disbursement of funds to beneficiaries.

Apart from the introduction of the Direct Tax Code in 2011 and the Goods and Services Tax (GST) in 2017, certain other changes have been made in the past decade to the fiscal policy of the government.

The 14th Finance Commission's recommendations and the changes that followed were the first in a series of many more. The recommendations of the Finance Commission were implemented starting from the fiscal year of 2015-16 and, in line with them, institutionalization of the cooperative federal structure became a goal. The focus on Centre-State financial relations increased, and so did the share of states in tax revenue from the divisible pool. Consequently, non-tax revenue has become an important source of revenue for the Centre. From 2016-17 onwards, fiscal policy put greater stress on agriculture and the rural sector, and on social sector infrastructure, and made them the priority sectors. In 2017–18, there was a redirection of focus of expenditure allocations towards investments to promote growth and employment. Social development in the country became yet another goal of the fiscal policy around this time. Earlier, the correction of structural imbalances in expenditure and revenue was targeted through expenditure control, but the fiscal policy of 2017–18 shifted to increase revenues instead of curtailing expenses. This was to be achieved through the effective implementation of GST, which was rolled out in the same year. This remained a significant goal even in 2018-19. Another major fiscal measure was to make permanent account numbers (PANs) mandatory for various activities like opening a bank account or dematerialization of accounts and for other financial activities. This was done with the aim of increasing tax compliance and, thereby, increasing the inflows of tax revenues. As a part of the fiscal policy of 2020–21, the government reduced the rates of corporate taxes from the erstwhile 30% to 25%, and this necessitated an upward revision of the estimated fiscal deficit for the corresponding year. Increased stress on capital asset creation was also an aspect of the fiscal policy throughout the decade.

V. Discussion

The fiscal policy of the Government of India in the past decade is assessed based on its performance and shortcomings as follows:

Performance of priority sectors

The fiscal policy has focused on certain key areas and tried to improve the growth prospects therein. Among these, the two primary areas were the agriculture and rural sector and various heads under the social sector. The targets to improve the agricultural sector, however, remained futile. Problems like low agricultural infrastructure, less use of technology, low fertility resulting in low yields, the MSP issue, etc. still plague the agricultural sector. Several schemes to uplift rural households were initiated in the past decade, like the Deendayal Upadhyaya Grameen Kaushalya Yojana, Pradhan Mantri Jan Dhan Yojna, Deendayal Antyodaya Yojna, Prime Minister Ujjwala Yojana, Aushmaan Bhaarat Yojana, etc., but these too are ridden with some loopholes which need to be addressed. In terms of social overheads, the fiscal policy in the past decade has failed to generate sufficient employment in the country, which represents a failure in fulfilling the objective of optimal utilization of all the resources. The unemployment rates throughout the last decade have fluctuated. Starting from a rate of 5.65% in 2011, unemployment increased to 5.67% in 2013 and then took a declining trend. It increased in 2002 to a record high of 7.11%, as estimated by the World Bank. The performance of fiscal policy to target another major objective of fiscal policy, that was to reduce inequality in the economy, is also disappointing. The Gini coefficient value, which was 0.36 in 2011, declined initially to 0.34 in 2014 but again increased to 0.35 and 0.47 in 2016 and 2018 respectively. Thus, it can be observed that the performance of fiscal policy in the past decade in fulfilling its goals of developing certain priority sectors was barely passable.

Tax and Non-Tax Revenues

The revenues accruing to the government can be classified as tax and non-tax revenues. While the former comprises revenues from direct and indirect taxes, the latter includes interest payments by the state governments and Union Territories (UTs) to the center on the loans given out to the former by the latter, profit earnings of public sector undertakings (PSUs), transfers of surpluses from the Reserve Bank of India (RBI), revenue generated from services provided by the Central Government (which include fees, stamp duties etc.) and external grants from the IMF, World Bank and other institutions and/or nations. Through the course of the past decade's fiscal policy, the government has tried to increase its tax revenues by improving its tax administration, undertaking measures to prevent tax evasion, broadening the tax deductible at source system, and increasing the tax base. The major trends in the past decade, as presented in Table-1, show that the revenue accruing from corporate tax and income tax has increased. The tax base has widened significantly due to the increased number of people filing for GST, thereby increasing indirect tax buoyancy. These increases in tax revenue also resulted in an improvement in the tax-GDP ratio from 10.17% in 2011 to 12.98% in 2018. There was a decrease of the same to 9.8% in 2020 due to a reduced inflow of revenue from customs and reduced rates of corporate tax. Receipts from excise duty registered only a

marginal growth. The non-tax revenue of the government increased from Rs. 1.98 lakh crores in 2014-15 to Rs. 3.13 lakh crores in 2019-20. Whether or not this increased indirect revenue collection will be sustained depends upon the buoyancy of indirect taxes under the GST regime. So far, although GST has improved revenue receipts, it is laden with several loopholes which make it easy for taxpayers to evade it. Some do so unintentionally due to the complexity of the structure, and others intentionally exploit the aforesaid loopholes, e.g. by underreporting sales, generating fake invoices, trading branded goods as non-branded ones, etc. These issues need to be addressed to effectively fulfil the objectives of the one nation, one tax system and to increase tax revenues.

Table-1: Tax and Non-Tax Revenues

	Values in Crores of INR	
Year	**Direct Tax Revenue**	**Indirect Tax Revenue**
2011-12	493947	391232
2012-13	558658	474767
2013-14	638542	495541
2014-15	675744	545680
2015-16	741945	708013
2016-17	849713	866109
2017-18	1002037	913456
2018-19	1136615	942050
2019-20	1170000	990633
2020-21	1319000	1101090

Source: Author's calculation from Fiscal Policy Strategy Statement Document

Expenditure front

The composition of expenditure by the government becomes important in the context of developing countries where the tax to GDP ratio is not as high as required to support various investment and infrastructural projects. It is in this context that the government's fiscal policy is aimed at improving the quality of its expenditure by increasing capital spending. In the trends of the last decade, it has been observed that the revenue expenditure of the government is more than 60% of the total expenditure of the government. Under revenue expenditure, the major heads amassing maximum expenditure are defence services, salaries, pensions, subsidies, and most importantly, interest payments. In 2020–21, this figure stood at 87.2% of the total expenditure. As shown in Table-2, capital expenditure, on the other hand, has crawled quite slowly in the past decade.

Table-2: Capital Expenditure

Year	Capital Expenditure (as % of Total Expenditure)
2011-12	12.1
2012-13	11.8
2013-14	12.3
2014-15	11.8
2015-16	14.1
2016-17	14.4
2017-18	12.2
2018-19	13.2
2019-20	12.4
2020-21	12.7

Source: Author's calculation from Fiscal Policy Strategy Statement Document

Although revenue expenditure on subsidies has declined due to improved targeting after the realignment of focus of the fiscal policy, there is still scope for reduction in the subsidies that add burden on the exchequer and instead replace these with capital infrastructural investments which would aid the beneficiaries in the long run. There is still headroom available for further rationalization of subsidies, especially food subsidies. Subsidies have grown at a rate of around 3.1% in 2018-19. The share

of major subsidies was 16.7% of total expenditure in 2011-12 and has gone up to 18.8% in 2020-21. Capital expenditure needs to be increased even further to give the required boost to private investment and to facilitate infrastructural growth, which is more important for growth and economic revival.

Fiscal indicators of debt and deficit and growth

The debt to GDP ratio has decreased. Both external and domestic debt had been reduced till 2017-18.8 after which it again picked up pace. The COVID-19-induced lockdowns have taken up both the debts significantly. The fiscal deficit was reduced more in 2015-16 due to the 14th Finance Commission but increased again in 2017-18 as GST was rolled out and revenues decreased. However, the last two years of the decade have seen a significant rise in the fiscal deficit of the government. The growth in the value for last year is, however, due to the COVID-19 induced shock. The trends, shown in Table-3, of the last decade also reveal a decline in the primary deficit of the country, which is suggestive of the fact that the government is nearing its objective of fiscal consolidation.

Table-3: Values of Fiscal Indicators as % of GDP

Year	Net Fiscal Deficit	Domestic Debt	External Debt
2011-12	5.88	49.76	3.70
2012-13	4.87	49.21	3.34
2013-14	4.42	48.83	3.33
2014-15	3.97	48.48	2.94
2015-16	3.83	48.59	2.95
2016-17	3.36	46.89	2.05
2017-18	3.44	46.87	2.83
2018-19	3.38	47.14	2.71
2019-20	4.56	48.50	2.88
2020-21	8.89	48.24	2.62

Source: Author's calculation from Fiscal Policy Strategy Statement Document

From Table-4 it is shown that the objective of economic revival of the fiscal policy in the first half of the decade worked efficiently, as is evident by the increase in GDP growth rates till 2016. Thereafter, the GDP growth declined owing to factors like contraction of the global economy, implementation and effects of demonetization, a dip in the sales of automobiles, fallacies in the GST regime and faulty implementation, and reduced growth of investment in the core sector industries and construction industry. The growth rates plummeted yet again and turned negative, owing to the nationwide lockdown due to the pandemic in 2020.

Table-4: Annual GDP Growth Rate

Year	GDP Growth Rate (Annual, in %)
2011	5.241
2012	5.456
2013	6.386
2014	7.410
2015	7.996
2016	8.256
2017	6.795
2018	6.533
2019	4.042
2020	-7.965

Source: Author's calculation from Fiscal Policy Strategy Statement Document

Fiscal federalism

Fiscal federalism refers to the financial relationship between different tiers of the government in any federal country. Some of the examples of federal countries are Canada, Australia, the United States, Brazil, and India. In a federal structure, the center and other tiers are assigned specific powers and duties, which sometimes

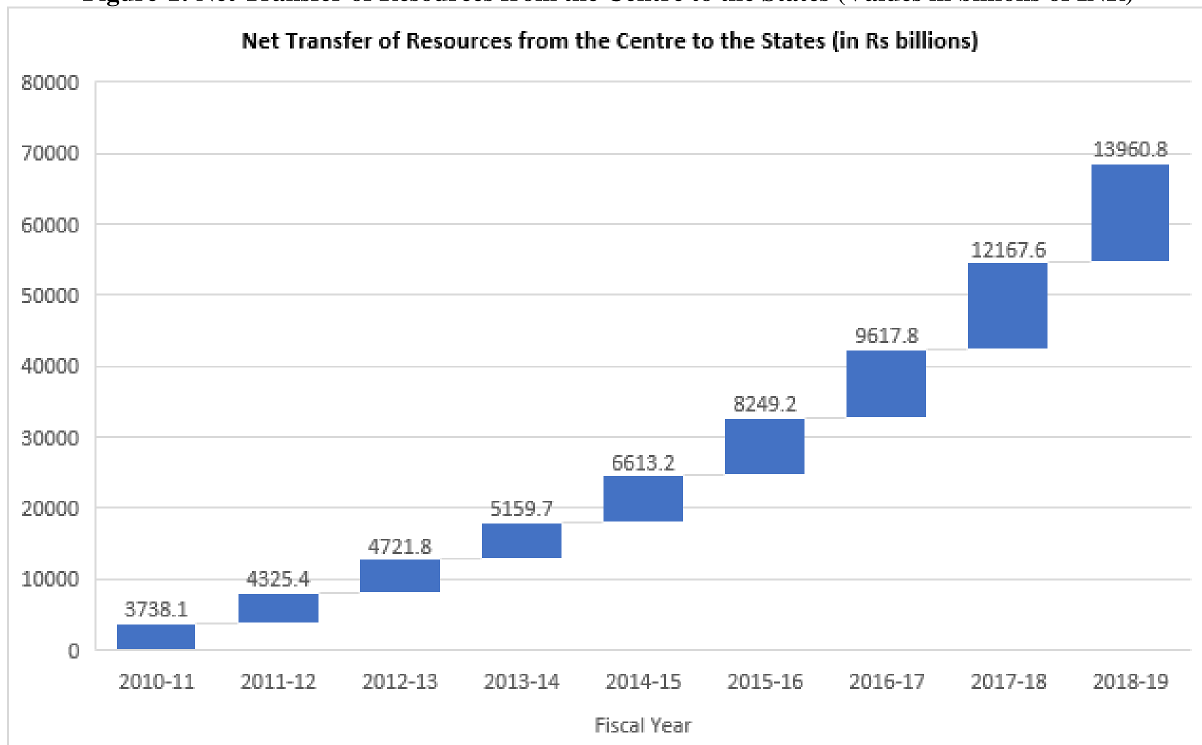
become points of conflict or disputes. In India, it is a case of a three-tier government, namely, the Centre, state and local bodies (urban and rural). Each tier is responsible for its own legislation, taxation, and administration. The powers and duties of each sphere of government are constitutionally guaranteed. The fiscal federalism deals with the distribution of revenues, allocation of resources and economic stability among governing bodies at different levels. The taxation power of states is less than that of the center, so if the union doesn't share its revenue with states in an equitable manner, the regional disparities will increase. In order to advise how the revenue collected at the Centre should be distributed among states and local bodies, every five year Finance Commission is constituted under article 280 of the Constitution of India, 1950. It decides the criteria of distribution. Under article 246 and the seventh schedule of the Constitution of India, 1950, the powers and allotted subjects to the Union and the states are classified into three lists, i.e., it specifies on which subjects the legislative and executive powers are vested under which sphere.

The Finance Commission and the distribution criteria

The Finance Commission is constituted every five years and it decides the criteria of tax devolution (vertical and horizontal). The 13th Finance Commission had recommended 32% for vertical tax devolution, i.e., say, for example, out of Rs 100 collected by the Centre, Rs 32 will be distributed to states and local bodies. Although from the remaining Rs 68, grants-in-aid will be provided in the time of need. However, with regard to vertical distribution, the 14th Finance Commission (2015-2020) had recommended that the States' share in the net proceeds of the Union tax revenues (vertical devolution) be increased to 42%.

From the Figure-1, we can observe that there was a consistent increase in the net transfers from the side of the centre to the states. The share of tax for the states was increased to 42% after the 14th Finance Commission's recommendations. In deciding which state will get how much, several other parameters are taken into consideration (horizontal devolution).

Figure-1: Net Transfer of Resources from the Centre to the States (Values in billions of INR)

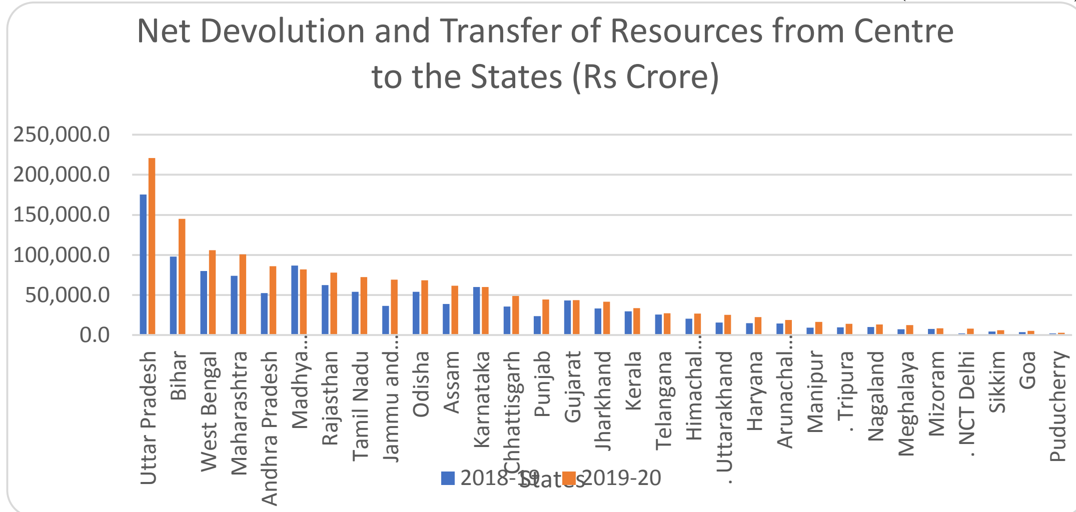


Source: Author's calculation

For example, population and area were given more weightage for the computation of the share of the states in net proceeds. Accordingly, Uttar Pradesh received the highest share of taxes, duties, and grants-in-aid. Figure-2 depicts the net devolution and transfers of resources from the centre to the states after the 14th Finance Commission's recommendations. However, according to a data

story by Roshan Kishore published in Hindustan Times (2021), the actual share of states in the gross revenues of the Union government has been less than 35% in the past five years. The main reason for the lower share is that cesses and surcharges are not shared with the states, which ultimately leads to union dependency on these. From Table-5, we can observe that the share of cesses and surcharges has been increasing since financial year 2012–13, but these are not included in the divisible pool of revenue share. According to RBI Annual Press Release (September, 2019), the decision to keep the union's levy of cesses and surcharges outside the divisible pool outweighs the effect of the increase in tax devolution recommended by successive Finance Commissions.

Figure-2: Net Devolution and Transfer of Resources from the Centre to the States (values in crore, INR)



Source: Author's calculations

Table-5: Trends in Special Levies (Cesses and Surcharges) by the Central Government (values in Crores of INR)

Year	Cess	Surcharge	Total Cess & Surcharge	Centre's Gross tax revenue	Divisible pool	Share of Cess & Surcharge in Centre Gross Tax Revenue (%)	Devolution on to States	States' Share (Percent) in Centre GTR
	1	2	3 = 1+2	4	5	6	7	8
2012-13	72,200	19,500	91,700	1,036,200	944,500	8.8	291,500	28.1
2013-14	76,300	28,000	104,300	1,138,700	1,034,400	9.2	318,200	27.9
2014-15	83,900	31,900	115,800	1,244,900	1,129,100	9.3	337,800	27.1
2015-16	132,658	39,053	171,711	1,455,648	1,283,937	11.8	506,193	34.8
2016-17	173,308	44,537	217,844	1,715,822	1,497,978	12.7	608,000	35.4
2017-18	149,164	54,151	203,315	1,919,009	1,715,694	10.6	673,006	35.1
2018-19	183,348	142,672	326,020	2,248,175	1,922,155	14.5	761,454	33.9
2019-20	204,463	164,648	369,111	2,461,195	2,092,084	15.0	809,133	32.9

Source: Author's calculation from RBI database

As per the 15th Finance Commission (2020-26), the states will be provided net proceeds of 41% under specified criteria, which is as follows:

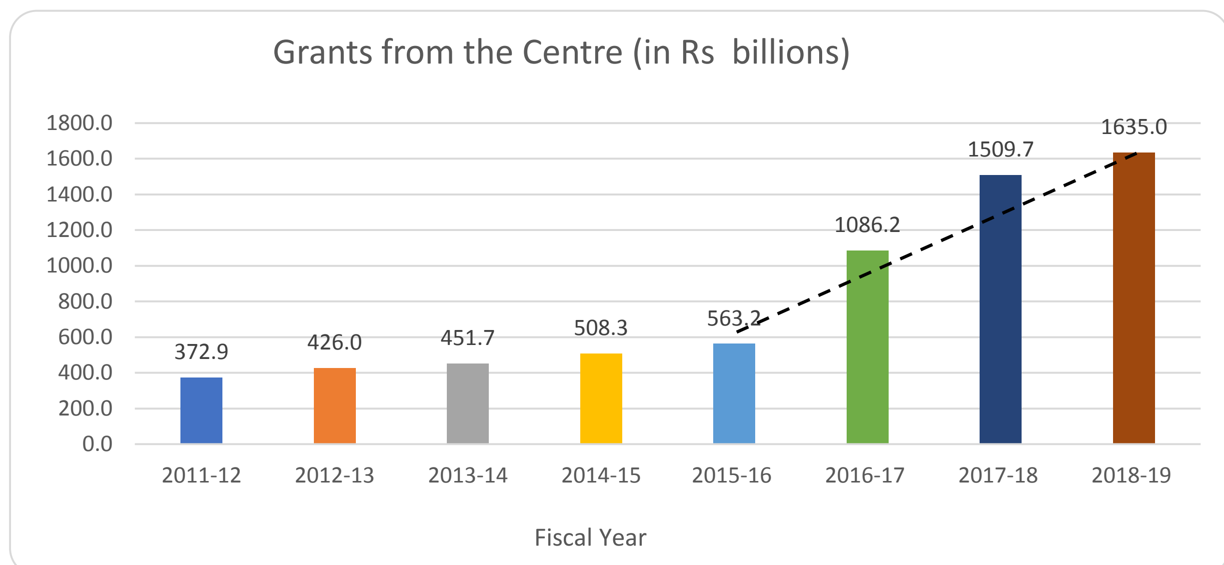
- Income distance (45%): To compute this formula, the per capita income of the state (i.e., Gross Domestic Product/Population of the State) will be taken into account and then the state with the highest per capita income, having a similar economic structure to most of the states, will be set as the benchmark. After this, income difference will be calculated,
- Population as per 2011 Census (15%):

States with larger population will receive more share in net proceeds,

- Area (15%): The states having larger area will get more under this category,
- Demographic performance (12.5%); States that have reduced their Total Fertility Rate like Kerala, Tamil Nadu will receive more under this category,
- Forest & ecology (10%): In order to preserve the forest covered states and to incentivize those states to do so, instead of robust industrialization, they will receive more in the net proceeds,
- Tax efforts (2.5%): This is to reward those states which have increased their per capita tax collection in the last three years, specifically state levied tax, like professional tax, property tax, SGST, etc.

Apparently, states like Uttar Pradesh, Bihar, and Madhya Pradesh topped in receiving the highest share of net revenue. However, from the remaining amount, the Finance Commission will decide the portion of grants provided. Along with this, the Ministry of Finance, Govt. of India will decide the share of states for Centrally Sponsored Schemes like Jan Arogya Yojana, Prime Minister Fasal Bima Yojana, etc.

Figure-3: Grants from the Centre (values in billions of INR)



Source: Author's Calculations

Grants are provided to local bodies (urban local and rural bodies) for tied (bound to spend on mentioned sectors) and untied purposes and states for post-devolution revenue deficit, disaster management, sector-specific like health, agriculture, education, rural roads, judiciary (to set up more courts/judges), fast dispute settlements, state-specific grants with performance-based incentives (for tourism, historical monuments, infrastructure). The 15th Finance Commission has also recommended a special defense fund and an internal security fund for the Centre of about Rs. 2.38 lakh crores. The other recommendations of the 15th Finance Commission are as follows:

- Reforming the tax system so that overall collections would increase.
- Review the progress of all the government schemes and abolish non-essential ones, if any.
- Separate law for Public Management Financial System which will prescribe the effective ways of budgeting, accounting, audit standards to be followed.
- Governments at all levels should sincerely abide by the Fiscal Responsibility and Budget Management Act, 2003.

Nevertheless, only some of the recommendations of the 15th Finance Commission were taken into consideration. Also, some of the states were unsatisfied with the terms of reference. For example, Kerala and other southern states used the population census of 2011 for the computation of the formula of tax shares. Likewise, as per the report, states have to spend on schemes conforming to the union's vision (tied amount on Swachh Bharat Mission, Smart City etc.).

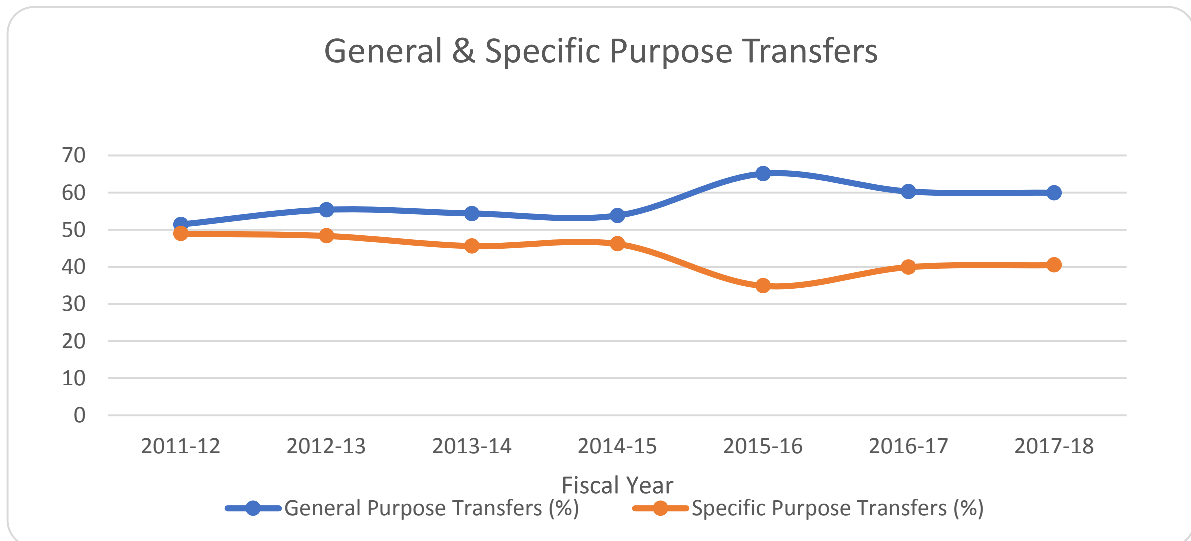
Critical Analysis

The financial resources devolved from the centre to the states can be broadly classified as follows:

- General purpose transfers (the states can utilize this type of grant according to their priorities).
- Specific purpose transfers (only on the schemes which are drawn up by the Centre).

As we can observe from Figure-4, the share of specific-purpose grants (conditional) is around 40% in 2011-12 and every subsequent year. Such transfers are mostly channelized to centrally sponsored schemes (CSS). This becomes a cause of concern for the states as they cannot freely utilize such large shares according to their developmental needs.

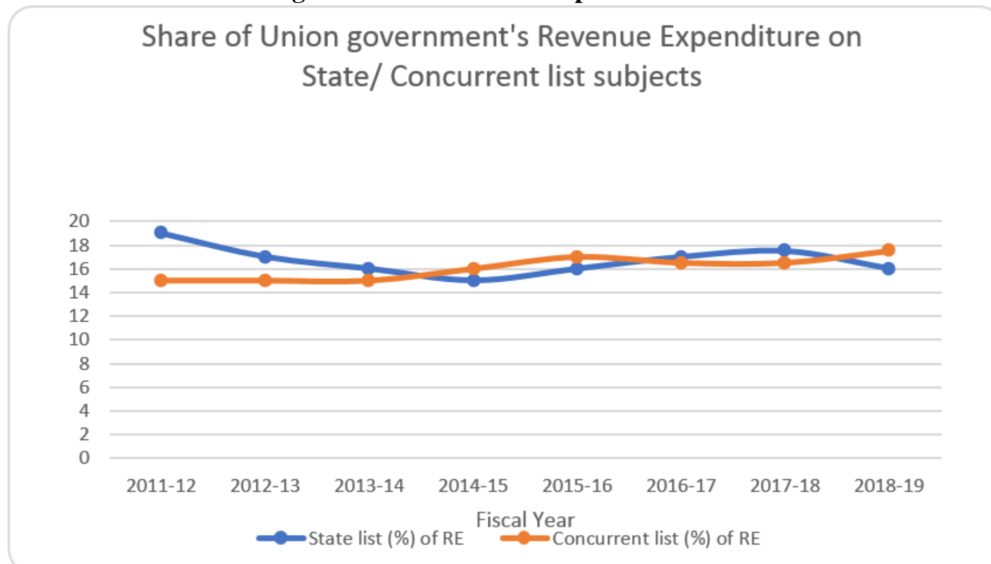
Figure-4: General and Specific Purpose Transfers



Source: Author's calculation

Figure- 5 reveals that a large part of the revenue expenditure of the central government is spent on states and concurrent subjects, while at the same time there is a decline in expenditure on Union List subjects. Hence, union intervention in state subjects has been increasing in the overall union budget in recent years.

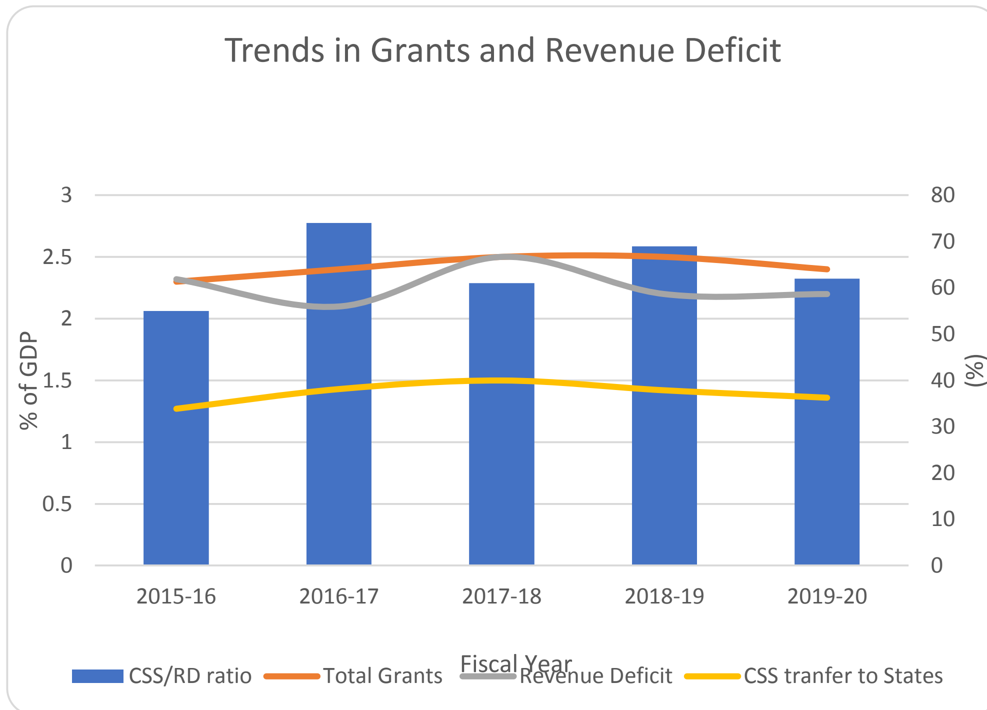
Figure- 5: Share of the Union government's revenue expenditure on State/Concurrent list subjects



Source: Author's calculation

From Figure-6, we can infer that the Centre's providing total grants as a percentage of GDP has been exceeding the revenue deficit in the past subsequent years after 2015-16. This is a kind of irony, as on one hand, the Centre is incurring expenditure on state and concurrent list subjects and, on the other hand, it has to borrow for transferring resources to the states for other state subject purposes.

Figure-6: Trends in Grants and Revenue Deficit



Source: Author's calculation from RBI Database

The collection of cess and surcharges has increased over time, and constitutionally it doesn't fall under the divisible pool category. Evidently, from Table-2, we can infer that the increase in cess and surcharges is both in absolute and percentage terms. Apparently, the Union government has increased its cess and surcharge collections to meet its expenditure needs. This has led to the overall share of states in the divisible pool being less than what had been recommended by the Finance Commissions.

VI. Conclusion

The above assessment reveals significant details about the fiscal policy of the country. The main objectives of fiscal consolidation, economic growth, increased tax revenues and capital spending, and reduced debt to GDP ratio have stood out in the fiscal policy of the Government of India in the past decade. The performance of the fiscal policy in achieving all these targets is, however, questionable. The fiscal policy of the country has failed to address and change its orientation to focus on the reduction of revenue expenditure and develop capital infrastructure in the priority sectors, which could've added to the growth of the economy. Another failure is in terms of debt reduction and employment generation. The unemployment is at a 10-year high and the fiscal policy has failed to undertake its expansionary activities and keep in touch with the current macroeconomic situation.

On the other hand, the Finance Commission plays a major role in the equalization of fiscal resources among the states. In order to achieve the goal of fiscal equalization, states should be provided more share in unconditional grants, allowing transfers through untied tax devolution, and cesses and surcharges should be subsumed under the divisible pool. There is a need to restructure fiscal federalism when it comes to removing inefficacy in horizontal and vertical imbalances. The restructuring of fiscal federalism can be done around three pillars, namely, GST, the Finance Commission, and decentralization. The Finance Commission should be given only the task of eliminating basic public goods

imbalances. By creating separate urban local and Panchayati raj consolidated funds, the Indian federal system can be strengthened. Also, some share of the State and Centre GST should be sent to the consolidated fund of local bodies. A one-sixth share of GSTs with local governments can add more than 1% to GDP each year.
The study is limited to the evaluation of 2011 to 2021 years only, earlier years are not included in this study, so there is a future study scope to extend it to other previous years as well as to include the coming years to conduct a comparison study.

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