FEDERALISM

Fiscal Federalism

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Fiscal Federalism refers to the **constitutional and institutional framework governing the allocation of financial powers, taxation, expenditure responsibilities, and intergovernmental fiscal transfers among different levels of government** in a federal system.

It seeks to ensure that each level of government has **adequate financial resources** to perform its constitutional functions while promoting **efficiency, equity, accountability, and balanced regional development**.

Fiscal federalism is one of the **pillars of federal governance**, as political and administrative autonomy cannot be effectively exercised without **financial autonomy**.

According to economist **Richard A. Musgrave**, fiscal federalism is concerned with **“the assignment of functions and financial relations among different levels of government.”**

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Definitions

Scholar/Institution	Definition
Richard A. Musgrave	Fiscal Federalism deals with the allocation of taxation, expenditure, and intergovernmental transfers among different levels of government.
Wallace E. Oates	It is the study of the allocation of public-sector functions and finances in a multi-level government system.
OECD	Fiscal federalism concerns the assignment of expenditure responsibilities, revenue powers, and fiscal transfers among different levels of government.
Government of India	Fiscal federalism ensures an equitable distribution of financial resources between the Union and the States to enable effective governance and balanced development.

Objectives of Fiscal Federalism

- Ensure **financial autonomy** of different levels of government.
- Promote **efficient allocation of public resources**.
- Reduce **regional economic disparities**.
- Maintain **macroeconomic stability**.
- Promote **equity and inclusive development**.
- Improve **accountability in public expenditure**.
- Encourage **fiscal discipline**.
- Facilitate **cooperative federalism** through financial collaboration.

Principles of Fiscal Federalism

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Principle	Explanation
Subsidiarity	Public services should be provided by the lowest level of government capable of delivering them efficiently.
Financial Autonomy	Each level of government should have adequate revenue sources to discharge its constitutional responsibilities.
Equity	Fiscal arrangements should reduce inter-regional inequalities.
Efficiency	Resources should be allocated to maximize social welfare.
Accountability	Governments must be responsible for raising and spending public funds.
Transparency	Fiscal transfers and revenue-sharing should follow clear and objective criteria.
Fiscal Responsibility	Governments should maintain sustainable public finances and avoid excessive borrowing.

Components of Fiscal Federalism

Component	Explanation	Example
1. Assignment of Functions	Distribution of expenditure responsibilities among different levels of government.	Defence (Union); Public Health (States); Sanitation (Local Bodies).
2. Assignment of Revenue	Allocation of taxation powers between governments.	Income Tax (Union), State GST, Property Tax (Local Bodies).
3. Intergovernmental Transfers	Financial transfers from higher to lower governments to address fiscal imbalances.	Tax devolution and grants-in-aid.
4. Borrowing Powers	Constitutional regulation of public borrowing by different governments.	State borrowing subject to constitutional and statutory provisions.
5. Fiscal Equalization	Transfers designed to reduce disparities in fiscal capacity across regions.	Finance Commission recommendations.

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Types of Fiscal Imbalances

Type	Meaning	Example
Vertical Fiscal Imbalance (VFI)	Revenue-raising powers and expenditure responsibilities are unevenly distributed between different levels of government.	The Union collects a larger share of taxes, while States bear substantial expenditure responsibilities in sectors such as health and education.
Horizontal Fiscal Imbalance (HFI)	Differences in fiscal capacity and development among States.	Wealthier states generate more own-tax revenue than economically weaker states.

Instruments of Fiscal Federalism

Instrument	Purpose
Tax Devolution	Sharing of Union tax revenues with States.
Grants-in-Aid	Financial assistance to States for specific or general purposes.
Finance Commission	Recommends tax devolution and grants under the Constitution.
GST Council	Coordinates indirect taxation and harmonizes GST policy.
Centrally Sponsored Schemes (CSS)	Jointly funded programmes implemented by the Union and States.
Equalization Transfers	Reduce regional disparities in fiscal capacity.

Fiscal Federalism in India

Constitutional Provisions

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Provision	Subject
Article 268–281	Distribution of revenues between the Union and States.
Article 270	Taxes to be shared between the Union and States.
Article 275	Grants-in-aid to States.
Article 280	Establishment of the Finance Commission.
Article 279A	Establishment of the GST Council.
Article 282	Discretionary grants by the Union and States.
Seventh Schedule	Distribution of taxation powers between the Union and the States.

Constitutional Institutions

Institution	Role
Finance Commission	Recommends tax devolution, grants, and measures to augment State finances.
GST Council	Makes recommendations on GST rates, exemptions, and administrative coordination.
Comptroller and Auditor General (CAG)	Audits public expenditure and promotes financial accountability.
NITI Aayog	Facilitates cooperative fiscal planning and policy coordination.

Evolution of Fiscal Federalism in India

Phase	Characteristics
1950–1991	Centralized planning, Planning Commission, greater dependence of States on Union transfers.
Post-1991 Economic Reforms	Fiscal decentralization, economic liberalization, increased State autonomy.

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Phase	Characteristics
Post-2015	Replacement of the Planning Commission by **NITI Aayog**, greater emphasis on cooperative and competitive federalism.
GST Era (2017 onwards)	Unified indirect tax system with shared decision-making through the GST Council.

Role of the Finance Commission

The **Finance Commission** is a constitutional body established under **Article 280**.

Functions

- Recommend distribution of net proceeds of central taxes.
- Determine principles governing grants-in-aid.
- Recommend measures to augment State finances.
- Strengthen local government finances.
- Promote fiscal stability and balanced development.

Role of the GST Council

The **GST Council** (Article 279A) is a unique institution of cooperative fiscal federalism.

Functions

- Recommend GST rates.
- Determine exemptions.
- Resolve GST-related issues.
- Promote harmonization of indirect taxation.
- Strengthen Centre–State fiscal cooperation.

Advantages of Fiscal Federalism

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Advantage	Explanation
Financial Autonomy	Enables governments to perform constitutional responsibilities effectively.
Balanced Regional Development	Fiscal transfers reduce inter-state inequalities.
Efficient Resource Allocation	Public expenditure is aligned with local needs.
Greater Accountability	Governments are accountable for raising and spending public funds.
Improved Public Service Delivery	States can better address regional priorities.
Promotes Cooperative Federalism	Financial coordination strengthens Centre–State relations.
Encourages Fiscal Discipline	Fiscal rules and institutions promote sustainable public finances.
Economic Stability	Supports macroeconomic management while allowing regional flexibility.
Strengthens Local Governments	Devolution of finances improves grassroots governance.
Inclusive Development	Equalization transfers help less-developed regions catch up.

Challenges of Fiscal Federalism

Challenge	Explanation
Vertical Fiscal Imbalance	States have greater expenditure responsibilities than revenue powers.
Horizontal Fiscal Imbalance	Wide differences in fiscal capacity among States.
Dependence on Union Transfers	Many States rely heavily on tax devolution and grants.

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Challenge	Explanation
GST Compensation Issues	Disagreements over compensation and revenue-sharing can strain Centre–State relations.
Borrowing Constraints	Fiscal responsibility laws limit borrowing, sometimes restricting development expenditure.
Conditional Grants	Excessive conditionality may reduce State autonomy.
Regional Inequalities	Fiscal transfers alone cannot eliminate development disparities.
Political Economy Issues	Fiscal decisions may be influenced by political considerations.
Weak Local Finances	Local governments often lack adequate revenue sources despite constitutional status.
Off-Budget Liabilities	Borrowing through public agencies can reduce fiscal transparency.

Fiscal Federalism in Contemporary India

Recent Development	Significance
GST Regime (2017)	Unified indirect taxation and strengthened cooperative fiscal governance.
15th Finance Commission	Enhanced local government grants and emphasized fiscal sustainability.
Digital Public Finance	Expansion of Public Financial Management Systems (PFMS), Direct Benefit Transfer (DBT), and digital tax administration.
Performance-Based Grants	Linking fiscal transfers with reforms and outcomes.
Aspirational Districts Programme	Targeted fiscal support for lagging regions.

Comparative Perspective

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Country	Distinctive Feature
India	Finance Commission, GST Council, constitutional tax devolution.
Canada	Strong equalization programme to reduce regional disparities.
Australia	Commonwealth Grants Commission ensures horizontal fiscal equalization.
Germany	Extensive revenue sharing between the Federation and Länder.
United States	Greater fiscal autonomy of states with limited federal equalization.

Way Forward

Recommendation	Expected Outcome
Strengthen fiscal autonomy of States	Enhance self-reliance and accountability.
Improve tax administration through digitalization	Increase revenue efficiency and transparency.
Rationalize Centrally Sponsored Schemes	Reduce overlap and provide greater flexibility to States.
Strengthen local government finances	Deepen democratic decentralization.
Promote transparent and objective transfer mechanisms	Build trust in intergovernmental fiscal relations.
Enhance fiscal discipline	Ensure long-term macroeconomic stability.
Improve coordination through the GST Council	Reduce Centre–State fiscal disputes.
Expand outcome-based fiscal transfers	Encourage better governance and service delivery.
Address regional disparities through targeted equalization	Promote inclusive and balanced development.
Strengthen public financial management	Improve efficiency, accountability, and transparency.

Category: Federalism, Political Institutions in India

Tag: Contemporary Federalism, Federalism, Fiscal Federalism, Political Institutions in India

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