5. State Fiscal Autonomy - Polity

Restoring fiscal space for the States**.** After eight years, India's GST system has improved tax efficiency and market integration but raised concerns over declining State revenues, reduced fiscal autonomy, and the weakening of cooperative federalism in the post-compensation era.

GST at a Turning Point - Balancing Efficiency with Federal Equity

After eight years of implementation, India's Goods and Services Tax (GST) is at a crucial crossroads. While it has streamlined taxation, improved compliance, and unified the national market, it has also deepened concerns over fiscal autonomy and vertical imbalances between the Union and the States. The expiry of the compensation mechanism and the Centre's growing fiscal dominance have reignited debates on India's cooperative federalism.

1. Fiscal Federalism - Concept and Constitutional Basis

Meaning - Fiscal federalism refers to the division of taxation, expenditure, and financial responsibilities among different levels of government—Union, State, and Local.

Objective - To ensure fiscal efficiency, accountability, and equity in resource distribution.

Key Constitutional Provision -

Article 280 - Provides for the Finance Commission (FC) as the "balancing wheel" of fiscal federalism.

Functions of the FC -

1. Recommend the vertical share of Union taxes to States.
2. Recommend grants-in-aid to cover State revenue deficits.
3. Suggest measures to strengthen local governments and fiscal equalization.

Underlying Principles

1. **Fiscal Equivalency -** The jurisdiction that provides a public good should correspond to the group that benefits from it.
2. **Decentralization Theorem -** Public goods should be provided by the lowest competent level of government.
3. **Subsidiarity Principle -** Functions should be performed at the lowest effective level to enhance efficiency and citizen participation.

2. Evolution of India's Tax Federalism

Pre-GST Regime

Centre - Levied excise, customs, and service tax.

States - Levied VAT, sales tax, octroi, and entry tax.

This arrangement offered significant fiscal autonomy to States, allowing them to design taxes suited to regional needs.

Post-GST Constitutional Shift - 101st Amendment (2016) - Introduced *Article 246A* empowering both Centre and States to levy GST. GST replaced an origin-based taxation system with a destination-based regime—enhancing efficiency but reducing fiscal freedom for States. Rate decisions now lie with the GST Council (Article 279A), where the Centre holds dominant voting power (1/3rd share), altering India's fiscal balance.

3. Goods and Services Tax (GST) - Structure and Governance

Introduced - 1st July 2017

Type - Destination-based indirect tax.

Objectives

1. Create a unified market
2. Eliminate cascading of taxes
3. Simplify compliance
4. Enhance revenue efficiency

Dual Structure

Type	Collected by	Applicability
Central GST (CGST)	Centre	Within State

Type	Collected by	Applicability
State GST (SGST) / UTGST	State/UT	Within State/UT
Integrated GST (IGST)	Centre	On inter-State supplies

4. Post-Compensation Challenges and Revenue Strains

End of Compensation Act (2017–2022) - States were guaranteed 14% annual revenue growth for five years. Post-2022, with the end of compensation, States face severe revenue uncertainty.

Key State Concerns -

1. **Revenue Losses -** States like Maharashtra, Tamil Nadu, and Punjab reported lower collections post-compensation.
2. **Erosion of Fiscal Autonomy -** States cannot alter GST rates independently.
3. **Rise of Cesses and Surcharges -** Excluded from divisible pool—States' share in gross tax revenue fell from 88.6% (2011–12) to 78.9% (2021–22).
4. **Falling Devolution -** Despite 41% devolution (15th FC), effective transfers remain <33% due to rising cesses and discretionary grants.

5. Constitutional and Institutional Framework

Provision	Subject	Impact on Fiscal Federalism
Article 280	Finance Commission	Defines Centre-State tax devolution
Article 282	Discretionary grants	Enables Centrally Sponsored Schemes (CSS)
Article 293	State borrowing	Central approval needed in case of pending dues
42nd Amendment (1976)	Shifted key subjects like Education, Forests to Concurrent List	Reduced State fiscal space

6. Key Issues in India's Fiscal Federalism

(a) Shrinking Divisible Pool - Cesses and surcharges (₹4.23 lakh crore, 18% of receipts) not shared with States. Reduces transparency and undermines cooperative fiscal trust.

(b) Horizontal Inequity - Dependence on central transfers varies widely -

1. Bihar – 72%, UP – 61%, MP – 58%
2. Tamil Nadu – 31%, Maharashtra – 28%

Creates regional inequity and limits autonomy.

(c) Politicisation of Grants - CSS dominate transfers in State List areas. Central discretion and political bias in project approvals weaken cooperative spirit.

(d) GST and Fiscal Centralisation - States have little say in rate-setting. Centre-dominated GST Council and delayed ₹78,000 crore compensation worsen trust deficit.

(e) Borrowing Constraints - Centre collects 67% of taxes but States handle 52% of expenditure. Debt-to-GSDP ratio at 31.2% (RBI 2025) limits fiscal flexibility.

(f) Weak Local Governments - Despite 73rd & 74th Amendments, local bodies receive <5% of public expenditure. Undermines subsidiarity and local accountability.

7. The Fiscal Imbalance and GST Paradox

Period	Centre's Share (Tax)	States' Share (Tax)	Centre's Share (Expenditure)	States' Share (Expenditure)
Pre-GST (2012–17)	67%	33%	47%	53%
Post-GST (2018–23)	67%	33%	48%	52%

Despite centralised tax powers, expenditure responsibilities of States continue to rise—especially in health, education, and welfare. This mismatch has intensified vertical fiscal imbalance and limited States' fiscal innovation.

8. Strengthening Fiscal Federalism - The Way Forward

1. Reinforce the Finance Commission's Role

The 16th FC (2025–30) must address GST-era imbalances. Recommended reforms -

1. Increase vertical devolution share.
2. Integrate IGST and input credit flows.
3. Introduce performance-linked transfers.
4. Include demographic and ecological indicators in formula.

2. Expand the Tax Base - Bring petroleum, electricity, and real estate under GST to boost buoyancy. Allow State-level Personal Income Tax (PIT) top-ups or a 50 - 50 sharing model like Canada.

3. Merge Cesses into Divisible Pool - Merging ₹4.23 lakh crore cesses could yield States ₹1.5 lakh crore annually. Enhance transparency through real-time fiscal data dashboards.

4. Rationalise CSS - Merge 200+ CSS into fewer, outcome-based programmes. Create a Federal Fiscal Council (FFC) to manage shared accountability.

5. Empower Subnational Governments

1. Link FC allocations to State Finance Commission (SFC) performance.
2. Ensure predictable untied funds for Panchayats and Municipalities.
3. Create a new Local List to clarify financial jurisdiction.

6. Institutional Reforms - Amend Article 246 and rationalise Concurrent List entries. Establish a Permanent Intergovernmental Fiscal Council for dispute resolution and coordination.

7. Lessons from Global Models

Country	Model	Relevance to India
Australia	Horizontal Fiscal Equalisation	Ensures equitable service delivery
Germany	Cooperative Tax Administration	Promotes shared responsibility
Canada	PIT Top-Ups by Provinces	Encourages fiscal flexibility

9. Conclusion

GST is both an economic unifier and a fiscal stress test for India's federal design. As India enters the post-compensation era, GST 2.0 must evolve—balancing efficiency with equity, central coordination with State autonomy. A reformed fiscal architecture—anchored in transparency, decentralisation, and cooperative federalism—can ensure that India's growth story remains both fiscally sustainable and democratically inclusive.

Source - https - //www.thehindu.com/business/Economy/restoring-fiscal-space-for-the-states/article70171047.ece

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