Restoring Fiscal Space for the States in India – Explained

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Fiscal Space Latest News

- The growing fiscal imbalance between the Centre and States has reignited debates on restoring fiscal autonomy and equitable tax devolution to States.

Changing Fiscal Dynamics in India

- India's fiscal architecture is built upon a **multi-tiered system of governance**, where the **Centre and States share both taxation powers and expenditure responsibilities**.
- However, this balance has been steadily shifting toward centralisation, particularly after the introduction of the **Goods and Services Tax (GST)** in 2017.
- While GST simplified indirect taxation and improved tax efficiency, it also **altered the resource autonomy of States**.

- The **abolition of the GST compensation cess**, a five-year mechanism that ensured States were reimbursed for potential revenue losses, has intensified debates on the erosion of fiscal space available to States.
- The restructuring of GST slabs in 2025, expected to pass on over Rs. 2 lakh crore in tax benefits to consumers, has further strained State finances.
- Although it may boost consumption and tax revenue indirectly, **States argue that no proper estimation of revenue loss has been made**, and the abolition of the compensation system leaves them fiscally vulnerable.

Fiscal Federalism and Constitutional Framework

- Fiscal relations between the Centre and the States are governed by **Articles 268 to 293** of the Constitution. These provisions delineate taxation powers through the **Union and State Lists**, with the **residuary power** resting with Parliament.
- The **Finance Commission**, established under **Article 280**, determines the principles of tax devolution and grants-in-aid.
- Historically, India's fiscal system has evolved from **tax-by-tax sharing** to a **global sharing principle**, which allocates a fixed percentage of the Centre's gross tax revenue to the States.
- The **80th Constitutional Amendment** (2000) initiated this system, with the **11th Finance Commission** recommending a 29.5% devolution to States.
  - The share was successively raised, **30.5% (12th FC)**, **32% (13th FC)**, and **42% (14th FC)**, before being revised to **41%** after the reorganisation of Jammu and Kashmir.
- However, **the actual devolution has often fallen short** due to the Centre's increasing reliance on **cesses and surcharges**, which are excluded from the divisible pool of revenue.
- In FY 2025-26, cesses and surcharges are projected at **Rs. 4.23 lakh crore**, giving the Union government additional fiscal leverage while limiting the States' shareable resources.

The Impact of GST on States' Fiscal Autonomy

- Before GST, States had independent authority to levy taxes such as **Value Added Tax (VAT), octroi, and entry taxes**, which provided them significant control over their own revenues.
- With GST, **taxation powers have been pooled into a common system**, jointly managed by the **GST Council**, where the Centre holds greater voting weight.
- GST also introduced a **destination-based tax model**, replacing the earlier origin-based system, meaning revenues accrue to the State where goods are consumed rather than where they are produced.
- This shift adversely affects **industrialised States** such as Maharashtra, Tamil Nadu, and Gujarat, which were traditionally net producers and major revenue contributors.
- While studies show that the compensation mechanism initially benefited all States, the **post-compensation regime** has reignited concerns about revenue adequacy and fiscal dependence.
- The **cess and surcharge system**, which allows the Centre to mobilise non-divisible revenue, further accentuates asymmetry in fiscal power.

Declining Fiscal Independence and Central Transfers

- Central transfers constitute around **44% of total State revenue receipts**, varying from **72% for Bihar** to **20% for Haryana**.
- Wealthier and industrialised States, including **Maharashtra, Tamil Nadu, Karnataka, and Gujarat**, receive substantially less, underscoring **unequal fiscal dependence**.
- Comparing the pre- and post-GST periods also reveals a stagnation in fiscal balance:
    - The Centre collected **67% of total tax revenue**, while the States collected **33%**, both before and after GST.
    - Expenditure responsibilities, however, remained skewed, with **States accounting for over 52%** of total public spending, primarily in areas like **health, education, agriculture, and local governance**.
- This imbalance, coupled with **increasing Centrally Sponsored Schemes (CSS)** that often overlap with State subjects, reduces fiscal flexibility.
- States have expressed frustration over **delayed fund transfers, conditional grants**, and **political bias in allocations**, particularly in opposition-ruled regions.

Rethinking Fiscal Devolution and Autonomy

- Many States and economists advocate revisiting the principles of fiscal federalism. One proposal suggests **sharing the personal income tax base** with States, akin to GST revenue sharing.
- If States were allowed a **50:50 share** of the personal income tax base (estimated at Rs. 13.57 lakh crore for FY 2025-26), their fiscal dependence on central transfers could be significantly reduced.
- Alternatively, States could be empowered to **'top-up' income tax rates**, allowing them to mobilise additional revenue without altering the central tax structure. Such measures would:
    - Strengthen States' fiscal capacity and liquidity.
    - Reward progressive and high-performing States for their revenue generation.
    - Enhance accountability by aligning tax collection with expenditure responsibilities.
- Another suggested model, inspired by **Canada's federal structure**, envisions the **Centre collecting 46% of total revenue and spending 40%**, while **sub-national governments collect 54% and spend 60%**.

Way Ahead

- The erosion of fiscal space for States is not merely a financial issue; it strikes at the core of **India's cooperative federalism**.
- With **rising developmental aspirations** and expanding welfare responsibilities, States require greater financial autonomy to deliver efficient public services.
- Going forward, reforms should focus on:
    - **Incorporating cesses and surcharges** into the divisible pool.
    - **Revising Finance Commission criteria** to balance equity with efficiency.
    - **Strengthening GST Council deliberations** to ensure parity in decision-making.
    - **Encouraging fiscal innovations**, such as State bonds and public-private partnerships.

Source: TH
