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FISCAL FEDERALISM AND REGIONAL INEQUALITY IN INDIA

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ABSTRACT:

India's federal fiscal system must reconcile two objectives that do not automatically coincide: preserving incentives for state-level economic initiative and ensuring that citizens can access comparable public services regardless of where they live. Wide differences in income, tax capacity, infrastructure, human development, administrative capability, and exposure to climate or demographic pressures make this task difficult. This paper examines how tax devolution, grants, centrally sponsored schemes, borrowing rules, and intergovernmental institutions influence regional inequality. It argues that equalization is essential for national cohesion and inclusive growth, but transfers are effective only when their design is transparent, predictable, sensitive to expenditure needs, and supported by stronger state and local capacity. Excessive conditionality can weaken accountability, while poorly designed unconditional transfers may fail to improve services. A balanced framework should combine rule-based general transfers with carefully targeted grants, credible fiscal responsibility, stronger municipal and panchayat finance, and public reporting of outcomes. Fiscal federalism should therefore be evaluated not merely by the volume of resources transferred, but by its ability to equalize opportunity, protect macroeconomic stability, and strengthen democratic accountability.

***KEYWORDS:* fiscal federalism, regional inequality, tax devolution, grants, state finance, local government, India**

INTRODUCTION

Economic development in India has always had a strong regional dimension. States differ in geography, historical institutions, natural resources, urbanization, industrial structure, literacy, health, infrastructure, and administrative capacity. These differences shape private investment and employment, but they also determine the cost and quality of public services. A poorer or geographically difficult state may need to spend more to provide schooling, health care, roads, water, and social protection, even though its own tax base is smaller. Without intergovernmental transfers, regional inequality can reproduce itself through unequal public investment and human development.

The Constitution distributes legislative, administrative, and fiscal responsibilities between the Union and the states. In practice, revenue-raising powers and expenditure obligations are not perfectly matched. The Union controls several broad and productive tax bases, while states carry major responsibilities for health, education, agriculture, policing, local infrastructure, and welfare delivery. This vertical imbalance is addressed through tax devolution and grants. Differences among states create a horizontal imbalance, requiring transfers that account for fiscal capacity and expenditure needs. The central question is how to achieve equalization without weakening incentives, autonomy, and accountability.

OBJECTIVES AND METHODOLOGY

1. To explain the economic logic of fiscal federalism in a diverse federation.
2. To examine the relationship between intergovernmental transfers and regional inequality.
3. To assess the roles of the Finance Commission, Goods and Services Tax system, grants, and centrally sponsored schemes.
4. To propose reforms that combine equity, efficiency, autonomy, and fiscal discipline.

The paper follows a descriptive and analytical method based on constitutional arrangements, Finance Commission reports, government budget documents, Reserve Bank of India studies on state finances, and established literature on public economics and federalism. It does not estimate a new econometric model. Instead, it evaluates the incentive and distributional effects of major fiscal instruments. Regional inequality is interpreted broadly to include income, tax capacity, infrastructure, human development, and access to essential public services.

ECONOMIC FOUNDATIONS OF FISCAL FEDERALISM

Assignment of Functions and Revenues

The classical economic case for federalism begins with the assignment problem. Functions with national spillovers, redistributional objectives, macroeconomic consequences, or strong economies of scale are generally suited to the central government. Services whose benefits and preferences are local can be decentralized. Decentralization may improve information, responsiveness, experimentation, and accountability. Yet subnational governments cannot always finance assigned services from their own revenues. Mobile tax bases may migrate, tax competition may erode collections, and poorer regions may have limited taxable activity. Transfers are therefore an integral part of federal design rather than evidence of failure.

Vertical and Horizontal Imbalances

Vertical imbalance arises when the revenue powers of one level of government exceed its expenditure responsibilities, while another level faces the opposite condition. Horizontal imbalance refers to differences in fiscal capacity and expenditure needs across governments at the same level. India displays both. States vary widely in per capita income, consumption, urbanization, population structure, forest cover, terrain, and service-delivery costs. Equal per capita transfers would ignore these differences; complete compensation for every disadvantage could weaken incentives for revenue effort and prudent spending. Equalization formulas must consequently balance need, capacity, cost, and performance.

Efficiency Equity and Accountability

Fiscal federalism involves unavoidable trade-offs. Greater state autonomy permits policy innovation and allows spending to reflect local preferences. National standards can protect basic rights and prevent severe territorial inequality. Conditional grants may direct resources to priority sectors, but they can fragment budgets and encourage compliance with centrally designed procedures rather than local results. Unconditional transfers support autonomy, yet voters may find it difficult to distinguish whether outcomes reflect local choices or central funding. Good design makes revenue sources, responsibilities, and results visible to citizens.

THE ARCHITECTURE OF FISCAL TRANSFERS IN INDIA

Finance Commission and Tax Devolution

The constitutionally mandated Finance Commission recommends the distribution of divisible central taxes between the Union and the states and among the states. Its formula is the principal rule-based equalization mechanism. Criteria such as income distance, population, area, forest and ecology, demographic performance, and tax effort seek to reflect both need and incentive. Formula-based devolution offers transparency and predictability compared with discretionary bargaining. Its effectiveness, however, depends on the size and composition of the divisible pool, the treatment of cesses and surcharges, and the reliability of revenue projections.

Grants in Aid

Grants supplement tax devolution where formulas cannot adequately address specific needs. Revenue-deficit grants, sector-specific grants, disaster-management support, and grants for local bodies serve different purposes. A grant should have a clearly defined rationale. Equalization grants address inadequate fiscal capacity; matching grants encourage spending with spillover benefits; performance grants reward measurable institutional improvements; and disaster grants respond to shocks. Mixing these objectives in a single instrument makes evaluation difficult and can create contradictory incentives.

Centrally Sponsored Schemes

Centrally sponsored schemes finance shared priorities in health, education, rural development, housing, nutrition, agriculture, and infrastructure. They can establish national minimum standards and pool technical expertise. At the same time, numerous schemes with separate guidelines, reporting systems, and matching requirements can reduce state flexibility. Uniform scheme design may fit neither advanced urban states nor poorer rural states. States with weaker administrative capacity may also struggle to provide matching funds or satisfy documentation requirements, causing assistance to flow toward governments already better equipped to use it.

Goods and Services Tax Federalism

The Goods and Services Tax created a common indirect-tax framework and a council in which the Union and states jointly make decisions. It reduced several internal tax barriers and strengthened the idea of cooperative fiscal rule-making. It also constrained independent state control over a major tax field and increased the importance of timely settlement, compensation arrangements, rate design, and council consensus. The system demonstrates that harmonization can generate national efficiency while simultaneously raising questions about autonomy, revenue certainty, and the distribution of adjustment costs.

REGIONAL INEQUALITY AND FISCAL CAPACITY

Unequal Revenue Bases

High-income and urbanized states generally possess broader consumption, property, vehicle, professional, and business tax bases. They may also collect more user charges and attract investment that expands future revenue. Poorer states face a smaller formal economy, weaker compliance, and higher collection costs. This divergence creates a cumulative process: stronger revenues finance better infrastructure and services, which attract further investment and skilled workers. Equalization transfers seek to interrupt this cycle, but they cannot fully substitute for structural transformation and improved administration.

Unequal Expenditure Needs

Expenditure needs are shaped by more than population. Sparsely populated, mountainous, forested, drought-prone, border, or disaster-exposed regions may face high unit costs. Rapidly urbanizing states require mass transport, water, sanitation, housing, and pollution control. States with young populations need education and job creation, while ageing populations require health and social care. A fair transfer system must recognize these differences without becoming so complicated that calculations are opaque or vulnerable to negotiation.

Human Development and Spatial Traps

Regional inequality persists when poor health, weak schooling, limited connectivity, low female participation, and inadequate institutions reinforce one another. Private capital often favours regions with reliable infrastructure, skilled labour, and large markets. Public finance has a corrective role because investments in nutrition, education, health, roads, electricity, and digital connectivity raise productivity over long horizons. The benefits may cross state boundaries through migration and trade, giving the Union a legitimate interest in minimum standards. Yet local knowledge remains essential for effective delivery.

INSTITUTIONAL AND POLICY CHALLENGES

Predictability and Fiscal Space

States plan multi-year investments, hire personnel, and maintain public assets. Uncertain transfers or frequent changes in scheme conditions make these commitments difficult. Predictable, formula-based resources improve budgeting and reduce incentives for ad hoc negotiation. Fiscal space is also affected by borrowing limits, debt-service obligations, guarantees, power-sector liabilities, pensions, and disaster expenditure. Discipline is necessary because subnational distress can threaten national stability, but rigid controls may prevent productive investment or pro-cyclical support during downturns.

Cesses Surcharges and the Divisible Pool

When a larger share of Union revenue is raised through instruments outside the divisible pool, the effective base for tax sharing narrows. Even when such revenues finance national priorities, their expansion can weaken the spirit of predictable sharing and increase vertical imbalance. Greater transparency regarding collections, purposes, duration, and expenditure would improve trust. Sunset clauses and periodic review can prevent temporary levies from becoming permanent substitutes for shareable taxation.

Capacity and the Absorption Problem

Low utilization of grants is often described as a shortage of absorptive capacity. This phrase can conceal distinct problems: inadequate project preparation, staff vacancies, weak procurement, delayed approvals, unreliable data, or burdensome reporting. Penalizing non-use without diagnosing the cause may worsen inequality. Capacity-building grants, shared technical facilities, stable staffing, interoperable financial systems, and simplified procedures can help weaker states and local bodies convert allocations into services.

Local Government Finance

Panchayats and municipalities deliver many services that directly affect welfare and productivity, yet they often lack adequate own revenue, predictable transfers, professional staff, and borrowing capacity. Rapid urbanization makes municipal finance particularly important. Property-tax reform, transparent user charges with protection for low-income households, land-value instruments, pooled finance, and timely state transfers can strengthen cities. Rural local bodies need reliable grants, accounting support, and meaningful authority over local planning. Decentralization without funds, functions, and functionaries remains incomplete.

A Reform Framework for Balanced Development

First, the core of fiscal equalization should remain rule-based and transparent. General-purpose tax devolution allows states to allocate resources according to local priorities. The formula should incorporate fiscal capacity and expenditure needs while retaining moderate incentives for tax effort, demographic performance, and environmental stewardship. Major methodological choices should be publicly explained, and comparable state-level data should be improved.

Second, specific-purpose grants should be limited to clearly justified spillovers, national minimum standards, institutional reform, or temporary shocks. Their conditions should focus on outcomes and fiduciary safeguards rather than excessive procedural uniformity. Matching requirements should reflect fiscal capacity so that poorer states are not excluded. Successful pilots should be scalable, while schemes with overlapping objectives should be consolidated.

Third, fiscal responsibility should distinguish recurrent imbalance from productive capital expenditure. Transparent debt statements, disclosure of guarantees and off-budget liabilities, independent fiscal analysis, and credible medium-term frameworks can support discipline. During exceptional downturns or disasters, temporary flexibility should operate through predefined escape clauses. Incentives for maintenance are also necessary because new infrastructure loses value when operating expenditure is neglected.

Fourth, equalization must extend below the state level. Finance Commission grants to local bodies should be complemented by stronger State Finance Commissions, predictable state transfers, professional municipal cadres, modern property records, and public accounts that citizens can understand. Digital systems can improve reporting and payments, but institutional authority and local revenue effort remain indispensable.

Finally, evaluation should connect fiscal flows to equal opportunity. Indicators of school learning, primary health access, nutrition, water, sanitation, connectivity, and service reliability can reveal whether transfers narrow capability gaps. Outcome measurement must account for initial disadvantage and should not reward data manipulation. Public dashboards, independent audits, and accessible state and district accounts can strengthen accountability across all levels of government.

CONCLUSION

Fiscal federalism is one of India’s principal instruments for managing diversity and promoting balanced development. Tax devolution and grants enable states with unequal revenue bases to discharge constitutionally important responsibilities. Centrally sponsored schemes and the Goods and Services Tax add mechanisms of coordination, but they also generate tensions over flexibility, predictability, and autonomy. Regional inequality cannot be eliminated by transfers alone, yet without credible equalization, differences in fiscal capacity can become differences in citizenship and opportunity.

The appropriate objective is neither complete fiscal uniformity nor unrestricted competition among unequal states. India requires a cooperative system that protects macroeconomic stability, preserves incentives for revenue effort, and ensures minimum standards of public services. Transparent formulas, a broad divisible pool, rationalized conditional grants, capacity support, responsible borrowing, and empowered local governments can move the federation toward that balance. The success of fiscal federalism should ultimately be judged by whether place of residence becomes less decisive in determining a citizen’s access to health, education, infrastructure, and economic opportunity.

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