ISSN: 2583-6129
DOI: 10.55041/ISJEM01454

Fiscal Federalism in India: Learning from best practices in Canada

Abstract:

This research paper aims to provide a comparative study on the fiscal federalism of India and Canada. Both India and Canada have a federal form of government, but their fiscal federalism systems differ in many aspects. This paper analyzes the historical development, constitutional provisions, tax systems, revenue-sharing mechanisms, and challenges of fiscal federalism in India and Canada. The paper concludes that while both countries face challenges in fiscal federalism, Canada has a more established and effective system due to its focus on revenue sharing and cooperative federalism. This paper will examine the key features of Canada's fiscal federalism model and explore the lessons that can be drawn for India.

1.0 Introduction:

The design and Implementation of inter-governmental transfer schemes suffer from a number of weaknesses in India. Transferring central resources with overlapping roles result in wasteful duplication in functioning. The absence of a clear and co-ordinated approach is a major weakness in the Indian federation. Fiscal federalism is a crucial aspect of federal systems of government. It refers to the distribution of powers and responsibilities between the central and subnational governments in a federal system. In a federal system, the central government shares power with the state/provincial governments, and both levels of government collect and spend their own revenues. Fiscal federalism provides autonomy and flexibility to subnational governments to address the unique needs of their respective regions.

India and Canada are two of the largest federal countries in the world. They both have diverse populations, economies, and political systems. Fiscal federalism has been a key feature of both

ISSN: 2583-6129
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countries since their inception. However, the systems of fiscal federalism in India and Canada differ in many aspects.

Indian and Canadian Fiscal Federalism: A Comparison

The major areas of expenditure in Canada are social services, debt charges, and national defence at the federal level, and health, education, social services, and debt charges at the provincial and local levels. The federal government is responsible for goods and services with national scope, such as defence, international affairs, industrial policy, and research. The provincial and local governments have major responsibility for spending on goods and services that are local in nature, such as public education, health care, and municipal services. The two share responsibilities in areas where both have legitimate interests, such as agriculture, forestry, fishing, and public health. While in India, Central government collects around 60 percent while its expenditure responsibility for carrying out its constitutionally mandated responsibility such as defence etc., is only to the tune of 40 percent of the total public expenditure, and thus arises the vertical imbalance (Kelkar, 2019). Although increased vertical devolution may not have increased overall fiscal space to states, it has increased fiscal autonomy available to states, as the share of general-purpose transfer in total transfers has increased considerably. Further, collective decision-making process under GST has put an end to autonomy of union as well as state governments in determining their indirect tax policies. However, central government has assured the states with less than 14 percent annual revenue growth rate to compensate for the shortfall in tax revenue, if any.

2.0 Literature Review

Harisha (2018) made attempt to bring out the comparison of both India and Canada's federal fiscal structure and the lessons to learn each other. He found that Indian states are very much imbalanced regarding their revenue capacities and expenditure needs in comparison to Canada. Compared to India, the provinces in Canada are better placed in terms of revenue position, owing to the huge federal

International Scientific Journal of Engineering and Management
Volume: 03 Issue: 04 | April – 2024
An International Scholarly || Multidisciplinary || Open Access || Indexing in all major Database & Metadata
ISSN: 2583-6129
DOI: 10.55041/ISJEM01454

transfers. In respect of fiscal indicators Canada's position is far better. All provinces in Canada were sufficient to reach their expenditure needs.

Rao and Singh (2001) examined the nature of India's federal system, the reforms that have occurred over the last ten years, and what remains to be done. They suggested that privatization motivated by efficiency concerns can be an effective complement to a more streamlined system of explicit transfers that deals with interstate disparities or the needs of poorer states.

Seidel and Vesper (1999) examined through international comparison of fiscal federalism of US, Canada, Germany, Switzerland that in federal systems it is necessary to find the best way to combine the advantages and disadvantages of centralization and decentralization. They found that in all countries, the regional capacity to tax varies greatly. Most federal systems therefore use some form of revenue sharing in order to facilitate fair competition between locations.

Forman et al. (2020) identified a range of good practices on the design of country policies and institutions related to strengthening fiscal capacity, delineating responsibilities across levels of government and improving intergovernmental co-ordination.

Kelkar (2019) discussed the need to revisit the fiscal federal architecture in contemporary India. He had attempted to point out the changing political- economic parametric environment calling for commensurate change in the way our fiscal federal setup ought to be conceptualised, here and now.

Rangarajan and Srivastava (2004) examined the relevance and applicability of the Canadian system of inter-governmental transfers in the Indian case. They found that in the Canadian system there is no autonomous body like the Finance Commission. In their case, most decisions are arrived at through consultations and discussions, although in India the system of transfers is fragmented, with several bodies being responsible for the transfers.

Singh et al. (2021) argued that India needs to benchmark its fiscal architecture to 21st century international standards and learn from global best practices. They suggested that India needs to

ISSN: 2583-6129
DOI: 10.55041/ISJEM01454

improve the quality and efficiency of public spending and financial management across all levels of government.

Bird (2008) argued that two concepts (fiscal federalism and federal finance) differ in some important key aspects and illustrated his argument in terms of post-war developments in intergovernmental finance in Canada. He found that Canadians and their institutions have shown considerable capacity to evolve and change in response to differing pressures and circumstances.

Kletzer and Singh (1995) developed a model of fiscal federalism in the Indian case that allows for self-interested government decisions, political pressure and imperfect instruments of control. They showed how costly influence activities may depend on the federal fiscal structure in place in India.

Singh (2007) analysed to what extent, and through what mechanisms, lower-level governments are held accountable to higher-level governments, the extent to which policies of subnational governments are affected by the competition for mobile firms, taxpayers, and investment capital, the functioning of credit markets, including the responsiveness of subnational governments to credit ratings and bond yields, and the role of democratic electoral channels at national and subnational levels in providing accountability in the provision of subnational public goods.

3.0 Historical development of Indian fiscal federalism:

India is a federal country that gained independence from British colonial rule in 1947. The Indian Constitution, which was adopted in 1950, provides for a federal system of government that divides powers and responsibilities between the central and state governments. The Constitution also establishes a revenue-sharing mechanism between the central and state governments.

In the early years of Indian independence, there was a centralizing trend in the fiscal system, with the central government retaining a larger share of the revenues compared to the state governments. However, with the establishment of the Finance Commission in 1951, there was a shift towards a more

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decentralized fiscal system. The Finance Commission is responsible for making recommendations on the distribution of revenues between the central and state governments.

Over the years, there have been several reforms in the Indian fiscal federalism system. In the 1990s, India embarked on economic liberalization and introduced reforms to increase fiscal decentralization. The Constitution was amended to establish the Panchayati Raj system, which gives local governments more powers and responsibilities. The introduction of the Goods and Services Tax (GST) in 2017 was a major reform in the Indian fiscal federalism system, with the central and state governments sharing the revenues from the GST.

4.0 Historical development of Canadian fiscal federalism:

Canada is a federal country that gained independence from British colonial rule in 1867. The Canadian Constitution divides powers and responsibilities between the federal and provincial/territorial governments. The Canadian Constitution also establishes a revenue-sharing mechanism between the federal and provincial/territorial governments.

The early years of Canadian independence saw a centralized fiscal system, with the federal government retaining a larger share of the revenues compared to the provincial governments. However, with the establishment of the Royal Commission on Dominion-Provincial Relations in 1937, there was a shift towards a more decentralized fiscal system. The Commission recommended that the provinces be given more powers and responsibilities in the fiscal system.

Over the years, there have been several reforms in the Canadian fiscal federalism system. In the 1960s, Canada introduced the equalization program, which provides fiscal transfers to provinces with lower fiscal capacity. The 1982 Canadian Constitution Act also included provisions that strengthened the fiscal autonomy of the provinces. In recent years, Canada has introduced several fiscal reforms, including the introduction of the Canada Health Transfer and the Canada Social Transfer, which provide fiscal transfers to the provinces for healthcare and social programs.

5.0 Constitutional Provisions in India

The Constitution of India provides for the following provisions of fiscal federalism:

Distribution of taxes: The Constitution divides the power to levy taxes between the central and state governments. The central government has the power to levy taxes on income, customs and excise duties, service tax, and other taxes. The state governments have the power to levy taxes on sales, value-added tax, and entertainment tax.

Grants-in-Aid: The Constitution provides for grants-in-aid from the central government to the state governments. These grants are given to the state governments for specific purposes such as education, health, and infrastructure development. The grants are given in the form of statutory grants and discretionary grants.

Finance Commission: The Constitution provides for the establishment of a Finance Commission every five years to make recommendations to the President of India on the distribution of tax revenues between the central and state governments. The Finance Commission also recommends the principles that govern the distribution of grants-in-aid to the states.

Consolidated Fund of India: The Constitution provides for the creation of a Consolidated Fund of India and a Consolidated Fund of each state. All revenues received by the central and state governments are credited to these funds. The funds can be used only for the purposes specified in the Constitution.

Borrowing powers: The Constitution provides for borrowing powers for the central and state governments. The central government has the power to borrow on behalf of the state governments with the consent of the states. The state governments also have the power to borrow from the market.

Tax sharing: The Constitution provides for the sharing of taxes between the central and state governments. The taxes that are shared include the proceeds of income tax, corporation tax, and other taxes that are levied and collected by the central government.

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Overall, the Constitution of India provides for a system of fiscal federalism that seeks to balance the powers and responsibilities of the central and state governments while ensuring that the needs of the citizens are met.

Original, Modified, and Revised Gadgil Formula for Central plan Assistance to States

XI FC	XII FC	XIII FC	XIV FC	XV FC
Population-10%	Population-25%	Population-25%	Population (1971)-17.5% Demographic change population (2011)-10%	Population (2011)-15% Demographic Performance-12.5%
Income Distance-62.5%	Income Distance-50%	Fiscal Capacity Distance-47.5%	Income Distance-50%	Income Distance-45%
Fiscal Discipline-7.5%	Fiscal Discipline-7.5%	Fiscal Discipline-17.5%	Fiscal Discipline-0	Forest and Ecology-10%
Tax effort-5%	Tax effort-7.5%	Tax effort -0	Tax effort-0	Tax effort-2.5%
Area-7.5%	Area-10%	Area-10%	Area-15%	Area-15%
Index of Infrastructure-7.5%	Index of Infrastructure-0	Index of Infrastructure-0	Index of Infrastructure-0	
			Forest Cover-7.5%	

Source: Reports of XI, XII, XIII, XIV and XV Finance Commissions

The states always complain that resources allocated to them are inadequate to enable them to discharge their responsibilities. They complain against widening gap between their own resources and needs. Similarly, the centre also feels constrained at the widening gap between its resources and needs, as reflected in the budgetary deficits.

6.0 Constitutional Provisions in Canada

Canada also has a federal system of government, where powers are divided between the federal government and the provincial governments. The Constitution Act, 1867 and the Constitution Act, 1982 provide for the following provisions of fiscal federalism:

ISSN: 2583-6129
DOI: 10.55041/ISJEM01454

Distribution of Taxes: The Constitution divides the power to levy taxes between the federal government and the provincial governments. The federal government has the power to levy taxes on income, customs and excise duties, and other taxes. The provincial governments have the power to levy taxes on sales, property, and other taxes.

Transfer Payments: The federal government provides transfer payments to the provincial governments for specific purposes, such as health care, education, and social services. The transfers are made through various programs, such as the Canada Health Transfer, the Canada Social Transfer, and the Equalization program.

Fiscal Equalization: The Equalization program is designed to ensure that all provinces have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. The program transfers funds from the federal government to the provincial governments with lower fiscal capacity.

Canada Pension Plan: The Canada Pension Plan is a national pension plan that provides retirement, disability, and survivor benefits to eligible Canadians. It is a jointly funded program between the federal government and the provinces, with contributions from both employers and employees.

Borrowing Powers: The federal government and the provincial governments have the power to borrow, subject to certain restrictions. The federal government also has the power to raise funds by issuing bonds and other securities.

Fiscal Stabilization: The Fiscal Stabilization program is designed to provide support to provinces experiencing a sudden and severe decline in revenues, such as during an economic downturn or natural disaster. The program provides funding to offset the costs of such events.

Overall, the Constitution of Canada provides for a system of fiscal federalism that balances the powers and responsibilities of the federal and provincial governments, while ensuring that Canadians have access to essential public services and supports.

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7.0 Revenue sharing mechanism in Indian Context

India has a federal system of government where power is divided between the central government and state governments. In this system, revenue sharing is a crucial aspect of fiscal federalism. The revenue sharing mechanism in India can be understood in the following ways:

Tax-sharing: The central government collects taxes such as income tax, customs duty, and excise duty. These taxes are shared with the state governments through the Finance Commission. The Finance Commission is a constitutional body that is set up every five years to recommend the sharing of taxes between the central and state governments.

Grants-in-aid: The central government provides grants-in-aid to the state governments for specific purposes such as rural development, education, health, and infrastructure. These grants-in-aid are given based on the recommendations of the Finance Commission.

State share in central taxes: The state governments also receive a share in the central taxes collected by the central government. This share is determined by the Finance Commission.

Sharing of resources: The central government also shares its resources with the state governments such as minerals, forests, and water.

8.0 Revenue sharing mechanism in Canadian Context

Canada also has a federal system of government where power is divided between the federal government and provincial/territorial governments. The revenue sharing mechanism in Canada can be understood in the following ways:

Tax-sharing: The federal government collects taxes such as personal income tax, corporate income tax, and goods and services tax (GST). These taxes are shared with the provincial and territorial governments through various transfer programs, including the Canada Health Transfer, the Canada Social Transfer, and the Equalization program.

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Equalization program: The Equalization program is designed to ensure that provincial governments have sufficient revenue to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. The federal government provides funding to provincial governments that have a lower capacity to raise revenue through their own sources.

Territorial formula financing: The territorial governments also receive funding from the federal government through the Territorial Formula Financing program. This program provides funding to the territorial governments to help them provide public services and meet the unique needs of their populations.

Gas Tax Fund: The federal government provides funding to municipalities through the Gas Tax Fund. This fund provides predictable and long-term funding to municipalities for local infrastructure projects such as roads, public transit, and water systems.

9.0 Challenges in Indian Fiscal Federalism

Some of the challenges faced by fiscal federalism in India are:

Vertical Fiscal Imbalance: There is a vertical fiscal imbalance between the central government and state governments. The central government has more resources at its disposal than the state governments. This creates an unequal distribution of resources and makes it difficult for state governments to meet their financial obligations.

Horizontal Fiscal Imbalance: There is also a horizontal fiscal imbalance between the richer and poorer states. The richer states have higher revenue-generating capacity and are able to provide better public services to their citizens. The poorer states, on the other hand, have limited resources and struggle to provide basic public services.

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Dependence on central grants: State governments are heavily dependent on central grants for their revenue. This makes them vulnerable to the central government's decisions and reduces their autonomy.

Unequal distribution of tax revenues: The distribution of tax revenues between the central government and state governments is not always equitable. The central government collects a majority of taxes, but the state governments are responsible for providing public services. This leads to a mismatch between revenue collection and expenditure responsibilities.

Inadequate revenue mobilization: State governments are often unable to mobilize adequate revenue from their own sources. This limits their ability to provide public services and meet the needs of their citizens.

Lack of transparency and accountability: There is a lack of transparency and accountability in the allocation and utilization of funds. This leads to corruption and inefficiencies in the system.

10.0 Best practices in Canadian fiscal federalism that can be adopted in India

Canadian fiscal federalism is known for its emphasis on fiscal responsibility, transparency, and accountability. Here are some best practices from Canada that could be adapted by India:

Fiscal transfers: In Canada, the federal government transfers funds to the provincial governments to support their programs and services. The transfers are based on a formula that takes into account the needs of each province. India could adopt a similar system to ensure that states with weaker economies and greater needs receive adequate funding from the central government.

Clear division of responsibilities: Canada has a clear division of responsibilities between the federal and provincial governments. The federal government is responsible for national issues, such as defense and foreign affairs, while the provincial governments are responsible for areas like healthcare and

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education. India could benefit from a clearer division of responsibilities between the central and state governments.

Fiscal rules: Canada has adopted strict fiscal rules that require governments to balance their budgets over the economic cycle. This helps ensure that governments do not run up unsustainable levels of debt. India could benefit from adopting similar fiscal rules to ensure fiscal sustainability.

Independent fiscal institutions: Canada has independent fiscal institutions that provide non-partisan analysis of government finances. These institutions help ensure transparency and accountability in fiscal decision-making. India could establish similar institutions to provide independent analysis of government finances.

Cooperative federalism: Canada has a tradition of cooperative federalism, where the federal and provincial governments work together to address national issues. India could benefit from adopting a similar approach to foster greater collaboration between the central and state governments.

Conclusion

India could benefit from learning best practices from Canada on fiscal federalism. The Canadian model emphasizes fiscal responsibility, transparency, and accountability through fiscal transfers, a clear division of responsibilities, fiscal rules, independent fiscal institutions, and cooperative federalism. By adopting these practices, India could improve its fiscal federalism system and ensure adequate funding for states with weaker economies and greater needs, foster collaboration between the central and state governments, and promote fiscal sustainability. Overall, the adoption of best practices from Canada could help India address its fiscal challenges and achieve greater economic growth and development.

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