

MAINS MATRIX

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Restoring Fiscal Space for the States

1. Introduction

Fiscal federalism is a cornerstone of Indian democracy. However, recent trends indicate growing **vertical fiscal imbalance**, as the Centre's control over taxation has expanded while States' expenditure responsibilities have risen sharply. The debate over **restoring fiscal space to States** has thus gained renewed relevance.

2. Core Issue & Context

Problem:

States face increasing fiscal stress due to expanding welfare expectations, infrastructure needs, and service delivery gaps.

Primary Cause:

The **Goods and Services Tax (GST)** has centralized taxation authority, reducing states' fiscal autonomy and flexibility.

3. Key Developments & State Grievances

Abolition of GST Compensation:

- The end of the **GST compensation cess** has

removed a guaranteed revenue buffer for states.

- Many states argue that **actual revenue losses exceed projections**, and their demand for continued compensation has been ignored.

Centralization of Tax Power:

- GST's **destination-based structure** replaced origin-based taxes, shifting revenue from producing to consuming states.
- Decision-making under the **GST Council**, dominated by the Centre, has further diluted fiscal federalism.

4. Analysis of Fiscal Imbalance

Revenue–Expenditure Mismatch:

- **Centre's share of total tax revenue:** ~67%
- **States' share:** ~33%
- **Expenditure pattern:** States account for 52% of total spending, primarily on health, education, agriculture, and law & order.

Dependence on Central Transfers:

- Around **44% of states' revenue receipts** come from central transfers (tax devolution + grants).
- This creates **dependency** and the potential for **political discrimination** against opposition-ruled states.

Shortfall in Tax Devolution:

- Actual transfers often fall short of **Finance Commission recommendations**, aggravating liquidity and planning constraints.

5. Institutional Mechanisms & Criticisms

Finance Commission (FC):

- Constitutionally mandated to define Centre–State fiscal relations.
- States allege **inconsistency, penalization of better-performing states, and lack of transparency** in criteria and weightages.

Centrally Sponsored Schemes (CSS):

- CSS expansion into State List subjects (health, education, rural development) is viewed as **fiscal encroachment**.
- Reduces states' flexibility to design schemes suited to local contexts.

6. The Way Forward

Learning from Other Federations:

- In **Canada**, sub-national governments collect **54% of revenue** and spend **46%**, allowing greater fiscal autonomy and accountability.

Empowering States Financially:

- **Progressive States:** Allow retention of a higher share of locally generated taxes (e.g., partial sharing of personal income tax).
- **All States:** Permit limited “**top-up taxes**” over central levies to meet local needs.
- **Reform Finance Commission Process:** Make it more transparent, formula-based, and consultative.
- **Rationalize CSS:** Shift toward block grants and outcome-linked funding instead of scheme-based conditional transfers.

Dynamic Fiscal Framework:

- The fiscal architecture should evolve with changing economic realities, ensuring **resources match responsibilities** as per the Seventh Schedule.

7. Conclusion

India's cooperative federalism must rest on **fiscal trust and flexibility**. Restoring fiscal space for states is essential to

strengthen public service delivery, deepen democratic accountability, and realize the constitutional spirit of **“Union of States”** envisioned in Article 1. True economic progress demands that states not merely spend what they receive, but earn, innovate, and invest with autonomy.

HOW TO USE IT

The debate over fiscal space is a conflict between **constitutional idealism** (India as a "Union of States") and **fiscal centralization**. It highlights the tension between the **Centre's control over revenue** and the **States' responsibility for expenditure**, which undermines cooperative federalism, stifles regional development, and weakens democratic accountability.

Primary Relevance: GS Paper II (Governance, Constitution, Federalism)

1. Indian Constitution—historical underpinnings, evolution, features, amendments, significant provisions and basic structure:

- **How to use:** This is the core of the issue. The debate is about realizing the federal spirit of the constitution.
- **Key Points:**
 - **Article 1:** Use the phrase "Union of States" to argue that the constitution envisages a federal

structure where states are not mere administrative units but partners in governance.

- **Seventh Schedule:** The mismatch is clear: States are responsible for most items on the **State List (like health, education, agriculture)** which are expenditure-heavy, but they lack corresponding revenue-raising powers.
- **Finance Commission (Article 280):** Critique its functioning. While constitutionally mandated, states allege a lack of transparency and that its recommendations are sometimes not fully honored, affecting predictability.

2. Functions and Responsibilities of the Union and the States, Issues and Challenges Pertaining to the Federal Structure:

- **How to use:** The data on revenue vs. expenditure is a direct indicator of a dysfunctional federal structure.
- **Key Points:**
 - **Vertical Fiscal Imbalance:** The stark data—Centre collects **~67% of taxes** but States undertake **~52% of**

expenditure—creates a fundamental dependency.

- **GST as a Centralizing Force:** While GST subsumed multiple taxes, it also took away states' autonomy to tweak tax rates for their needs. The **GST Council**, where the Centre has a de facto veto, is cited as a site where states' voices are diluted.
- **Political Discrimination:** The dependence on central transfers (44% of state revenue) creates a tool for the Centre to potentially discriminate against opposition-ruled states, violating the spirit of non-partisan federalism.

Secondary Relevance: GS Paper III (Economy)

1. Government Budgeting, Mobilization of Resources:

- **How to use:** This is a classic public finance and resource mobilization issue.
- **Key Points:**
 - **Fiscal Stress of States:** The abolition of the **GST compensation** has removed a safety net,

exacerbating the fiscal stress of states already struggling with high welfare and infrastructure spending.

- **Centrally Sponsored Schemes (CSS):** Frame the proliferation of CSS as an infringement on the fiscal autonomy of states. It forces them to spend on schemes designed by the Centre, often with a one-size-fits-all approach, rather than on locally relevant priorities.

Is Landlockedness the Reason for Bihar's Underdevelopment?

1. The Landlockedness Debate

Argument:

Bihar's landlocked geography is often cited as a natural disadvantage limiting access to ports and raising transportation costs for exports like makhana, litchi, maize, and vegetables.

Counter-Argument:

Landlockedness alone does not determine development outcomes.

- **Telangana** (Hyderabad) and **Punjab** show that efficient infrastructure, a diversified economy, and skilled human capital can overcome geographic constraints.
- **Manindra Nath Thakur (MT)** acknowledges the logistical

challenge for perishable exports but stresses it is **not the major cause** of Bihar's backwardness.

- **R. Nagaraj (RN)** concurs that other landlocked states have offset similar disadvantages through **policy and institutional reforms**.

Inference:

Landlockedness is a **secondary constraint**—it amplifies Bihar's weaknesses but does not cause them.

2. The Agricultural Conundrum

Current Situation:

Nearly **80% of Bihar's workforce** is engaged in agriculture, yet productivity and incomes remain below the national average.

Divergent Perspectives:

- **MT (Pro-Industry):**
Argues that "no society can survive on agriculture alone." Bihar must transition toward **industrialization and agro-processing** for long-term growth.
- **RN (Pro-Agriculture Reform):**
Questions why agriculture has stagnated despite fertile soil and abundant water. Calls for **state-led investment in irrigation, infrastructure**, and a shift to **value-added crops**.

Cautionary Note:

MT warns against replicating Punjab's Green Revolution model, which caused

water depletion and health issues from chemical overuse.

Inference:

The core issue lies in Bihar's **failure of structural transformation** from low-productivity agriculture to a diversified economy.

3. Root Causes of Underdevelopment

(a) Historical and Structural Factors (MT)

- **Frozen Transition:** Bihar remains stuck between feudalism and capitalism.
- **Internal Colonization:** The state supplied raw materials but lost value-added benefits as industries developed elsewhere.
- **Labor Supplier:** Out-migration of cheap labor benefits other regions, reducing incentives for local industrialization.

(b) Policy and Infrastructure Deficits (RN)

- **Freight Corridor Bias:** The Eastern Dedicated Freight Corridor bypassed Bihar, keeping logistics costs high.
- **Lack of Incentive:** Large-scale migration reduces pressure on the state to create local jobs. When local agricultural investments rise, migration declines—showing the link between infrastructure and retention.

(c) Ideological and Political Factors

- **RN on “Socialist Hangover”:** Bihar’s politics prioritizes **redistribution over production**, focusing on welfare rather than productive capital formation.
- **MT on Ideology:** Bihar neither practiced socialism effectively nor adapted to India’s capitalist transformation.
- **Identity Deficit:** The absence of a strong, mobilizing “Bihari” identity has limited collective developmental push.

4. The Question of Special Category Status**RN (Skeptical):**

- **Capacity Issue:** Bihar lacks the administrative efficiency to absorb and utilize special funds effectively.
- **Utilization Problem:** Funds from Finance Commissions often lapse due to weak institutional capacity and inability to meet performance-based criteria.

MT (Conditionally Supportive):

- **Potential Benefit:** Special category status could ease fiscal pressure by removing the need for a matching share.
- **Governance Precondition:** Real benefits will accrue only if **elite capture** by bureaucrats,

contractors, and politicians is curtailed.

Inference:

Fiscal incentives can help only when **governance and capacity bottlenecks** are simultaneously addressed.

5. Summary of Key Constraints

Category	Key Constraints
Geographic	Landlockedness raises transport costs for perishables.
Economic	Over-dependence on agriculture; failure of industrial transition; “internal colonization.”
Infrastructure	Poor connectivity; freight corridor bypass; limited logistics and energy networks.
Governance & Politics	Elite capture; weak capacity; redistribution-focused politics.
Social	Mass out-migration; lack of cohesive “Bihari” identity; low developmental pressure.

6. Conclusion

Bihar’s underdevelopment cannot be attributed primarily to its **landlocked geography**. The deeper causes lie in

historical neglect, structural stagnation, poor governance, and political economy constraints.

Geography may pose hurdles, but **visionary governance, human capital investment, and institutional reform** are the decisive levers of Bihar's economic transformation.

HOW TO USE IT

Bihar's predicament is not a result of a single factor but a **complex interplay of historical legacy, political economy, governance failures, and geographical constraints**. It serves as a critical case study for understanding the challenges of **regional development, federalism, and the limits of geography as a deterministic factor**.

Primary Relevance: GS Paper I (Indian Society & Geography)

1. Salient features of Indian Society, Diversity of India:

- **How to use:** The "lack of a **cohesive Bihari identity**" and the politics of "**redistribution over production**" are key sociological factors explaining the lack of a collective push for development.
- **Key Points:**
 - Discuss how social structures and political mobilization around caste and community, rather than a unified

developmental agenda, have impacted the state's economic trajectory.

2. Role of Women and Women's Organization:

- **How to use:** While not explicitly mentioned, the high out-migration of male labor has profound implications for women, leading to **feminization of agriculture** and increased burdens, which can be linked to broader social issues.

3. Distribution of Key Natural Resources:

- **How to use:** Counter the geography argument by highlighting Bihar's **fertile soil and abundant water resources**. The problem is not a lack of natural resources but their underutilization due to other constraints.

Primary Relevance: GS Paper II (Governance, Constitution, Social Justice)

1. Indian Constitution—Historical Underpinnings, Federalism:

- **How to use:** The demand for **Special Category Status (SCS)** is a live issue in Indian federalism.
- **Key Points:**
 - Use the debate between MT and RN to present a

balanced view. SCS can provide fiscal relief (as MT argues), but without addressing **governance bottlenecks and "elite capture"** (as RN highlights), it may not lead to transformative outcomes.

- This shows a mature understanding that constitutional tools alone are insufficient without good governance.

2. Development Processes and the Development Industry:

- **How to use:** Bihar is a prime example of a "**frozen transition**" from a feudal to a modern economy.
- **Key Points:**
 - **Internal Colonization:** Use this concept to explain how Bihar became a supplier of raw materials (migrant labor, agricultural produce) without capturing the value-added benefits, leading to a cycle of underdevelopment.
 - **Welfare vs. Production:** The critique of a "**socialist hangover**"—where politics focuses on redistribution (welfare

schemes) at the cost of productive capital formation (industries, infrastructure)—is a sharp analytical point.

Primary Relevance: GS Paper III (Economy, Agriculture, Infrastructure)

1. Indian Economy and issues relating to Planning, Mobilization of Resources, Growth, Development and Employment:

- **How to use:** This is the core application. The entire analysis is about the failure of economic development.
- **Key Points:**
 - **Structural Transformation Failure:** The key issue is that **~80% of the workforce is in low-productivity agriculture**. The state has failed to shift to industry or high-value services.
 - **Migration as a Symptom and Cause:** Large-scale out-migration acts as a safety valve, reducing pressure on the state to create jobs (as RN notes), thus creating a vicious cycle.

2. Agriculture:

- **How to use:** The "**Agricultural Conundrum**" is central.

- **Key Points:**

- Argue for a shift from staple crops to **value-added agricultural products (like makhana, litchi)** with robust **agro-processing industries** (as MT suggests), rather than a chemical-intensive Green Revolution model.
- Highlight the need for state investment in

irrigation and supply chains (as RN suggests).

3. Infrastructure: Energy, Ports, Roads, Airports, Railways etc.:

- **How to use:** The **bypassing of Bihar by the Eastern Dedicated Freight Corridor (EDFC)** is a critical infrastructural deficit that perpetuates its landlocked disadvantage.

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