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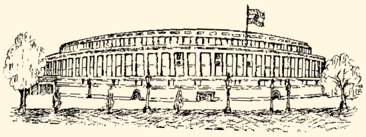

Parliamentarians' Forum on Economic Policy Issues (PAR-FORE)

Fiscal Federalism in India

Call to Revisit the Debate

In a large and diversified country like India fiscal federalism should be practiced in its letter and spirit. However, in India the fundamentals of fiscal federalism have been eroded over time. Given this era of coalition governments at the Centre and also in many states, fiscal federalism assumes a greater significance. This Issue Note for our parliamentarians, legislatures and the polity at large including non-state actors deals with the concept and importance of fiscal federalism, summarises its current state of affairs in India, and offers some important points for discussion.

INTRODUCTION

Fiscal federalism is a specialised subject and comes under the study of public economics and administration. It is concerned with understanding which functions and instruments are best centralised and are best placed in the sphere of decentralised levels of government. It deals with allocation of competencies (expenditure side) and fiscal instruments (revenue side) across different layers of the administration.

The concept applies to all forms of government: unitary, federal and confederal. It is associated with fiscal decentralisation as fiscal federalism is in general a normative framework for assignment of functions to different levels of government and appropriate fiscal instruments to carry out those functions. In other words, it is a dynamic concept and talks about "what it is" as well as "what it ought to be".

Intrinsically, the concept is related to the performance of the public sector (and its improvement), and the provision of their services by ensuring a proper alignment of their (different layers of the administration) responsibilities and fiscal instruments. Economic efficiency in the delivery of public services and welfare maximisation should be the guiding principle of an optimal division of jurisdictional authority. In short, fiscal federalism is linked with fiscal decentralisation.

Other than the impact of globalisation and deepening of democracy, the reasons for greater fiscal federalism are as follows:

- central governments are finding that it is impossible for them to meet all of the competing needs of various constituencies, and are attempting to build local capacity by delegating responsibilities to their sub-national governments;
- central governments are dependent on sub-national governments to assist them on national economic development strategies; and
- sub-national political leaders are demanding more autonomy and want the taxation powers that go along with their expenditure responsibility.

The theoretical framework of fiscal federalism is based on the identified roles for the government/public sector. They are as follows:

- correcting various forms of market failure,
- ensuring an equitable distribution of income between different jurisdictions, and
- seeking to maintain macroeconomic stability at full employment and stable prices.

Fiscal Federalism: An unequal balance

The schemes that the Central government *babus* and politicians pride themselves on, the "favour" of development that they bestow upon the states, is actually the states' own money! When Rahul Gandhi loftily announced in public meetings how much money the Central government has sent to Bihar, it is this money he is mostly talking about.

Source: Fiscal Federalism, An unequal balance, Vasundhara Raje, Financial Express, June 10, 2011

In other words, the concept of fiscal federalism emanates from an activist role of the state – provision of public goods whenever there is market failure. Since many of these public goods are localised in nature, local outputs targeted at local needs by respective local jurisdictions are expected to generate higher social welfare than centralised provisions.

Keeping the above in mind, correcting various forms of market failure clearly falls under the jurisdiction of local authorities whereas the other two functions of fiscal federalism (income distribution and macroeconomic stability) falls under the central jurisdiction. However, there are public goods whose social welfare impact may go beyond a particular local jurisdiction and they are best dealt in coordination between and among sub-national and central jurisdictions.

FISCAL FEDERALISM IN INDIA

India is a federal country. Article 1 of the Indian Constitution states that India is a Union of States. Part XI of the Indian Constitution (Articles 245 to 263) deals with the relations between the Union and the States. Article 246 divides the distribution of law making power into three lists:

- List I or the Union List – the Union Parliament has exclusive powers of legislation with respect to 97 subjects or items in List I
- List II or the States List – the State Legislatures have exclusive powers with respect to 66 items enumerated in List II
- List III or the Concurrent List – both the Union and the State Legislatures can make laws in respect of the subjects enumerated in the Concurrent List but any Union Act can override a State Act in the event of a conflict between the two on a matter in the Concurrent List.

Article 267 to 281 of Part XII of the Indian Constitution deal with the Centre-state fiscal/financial relations and constitute the heart of the debate on fiscal federalism in India.

As against legislative and/or executive supremacy of the centre, much of the criticism on centre-state fiscal/financial relations and fiscal federalism in India stems from the process of economic policy making

Though, according to the Indian Constitution, India is a federal country, there are criticisms that it is a unitary or quasi-federal state and much of this criticism stems from the functioning of Centre-state fiscal/financial relations.

As against legislative and/or executive supremacy of the Centre, much of the criticism on Centre-state fiscal/financial relations and fiscal federalism in India stems from the process of economic policy making. Some of it is due to the emergence of the Planning Commission of India playing a dominant role in economic policy making and disbursing a large sum of central funds to state governments as Non-Plan expenditures. Unlike the Finance Commission of India, the backbone of Centre-state fiscal/financial relations, the Planning Commission is a body not envisaged in the Indian Constitution.

Over the years, there is considerable erosion of states' power to utilise available (as originally envisaged in the Indian Constitution) fiscal instruments (revenue side) while their expenditure policies are getting heavily influenced by central plan and transfer of central funds to the states. Not only that the states are to get their plans approved by the Planning Commission but also they are to implement many so-called centrally-sponsored schemes.

Speaking in simple terms, there is frequent mention of "centre's money" by a large section of ill-informed political class but actually there is nothing like that concept. In India, as per its Constitution, the centre is bound to collect certain taxes on behalf of the states and must share a substantial portion with the state governments.

And while deciding taxation the 'Centre' does not discuss the relevant issues with the 'states'. For instance, in the 2011-12 Union Budget, the centre decided to forego approximately ₹6,00,000 crores as possible tax revenue by providing various sops such as tax holidays. As per the formula of devolution of centrally-collected tax revenues between the centre and the states by the 13th Finance Commission, the states were to get 32 percent of this amount. Not only that the Centre did not discuss this matter with the states, there is no mechanism to compensate such loss to the state governments.

Furthermore, in the name of a plethora of centrally sponsored schemes the Centre has systematically eroded fiscal autonomy of states. Besides the fact that many of these schemes are not discussed among the Centre and states (Inter-State Council was made effective as late as during the first United Front government of 1996 – a blessing of coalition government at the Centre), some are either irrelevant to public goods requirements of many local jurisdictions and state governments are forced to bear some significant portion of their costs.

There are demands to abolish some of these centrally-sponsored schemes as they are adding to confusion in their implementation. And there are overlaps too including on subjects which come under the exclusive jurisdiction of states. For example, the Ministry of Agriculture, Government of India is implementing 51 centrally-sponsored schemes with a total outlay of more than ₹15,000 crore – besides the fact that agriculture is a state subject, many of these schemes have overlapping objectives.

Centrally-sponsored schemes should be restricted to those subjects, which are under the exclusive jurisdiction of the centre but having significant implications in the delivery of public goods at sub-national levels, and on those subjects having implications on the delivery of public goods in contiguous sub-national jurisdictions.

Moreover, as state governments are getting more burdened with their fiscal responsibilities (along with the erosion of their ability to generate enough revenue from local sources), centrally-sponsored schemes should be entirely funded by the Central government. While that will act as an incentive for the state governments to undertake better implementation of such schemes, there should be disincentives too as an outcome of independently organised performance evaluation.

There are merits in the states' demand to have greater flexibility in implementing centrally-sponsored schemes and to abolish such schemes on those subjects which come under their exclusive jurisdiction. The Centre should restrict itself to policy making on such subjects and leave implementation to states because they are in a better position to understand local needs for public goods and thus, it will lead to the maximisation of social welfare at local levels.

Our Constitution has mandated that part of the taxes that the Centre collects should go back to states. At least 80 percent of central assistance to state plans should be in the form of Plan assistance as was the practice in 1950s and 60s. Over time this proportion has reduced hugely and now just about 10 percent of total outlays to states to support the Central plan go as untied normal plan assistance.

Much of central assistance is in the form of non-plan assistance – grants to states determined by the Planning Commission of India to run those so-called centrally-sponsored schemes. Such grants are not only based on political factors determining Centre-state relations but even their nomenclature and disbursements are politicised.

Furthermore, over time the autonomy of the institution of Finance Commission has been considerably eroded largely due to political economy of Centre-state fiscal/financial relations. The centre determines the terms of reference of finance commissions and interprets their recommendations to suit its own needs, and the Finance Commission is compelled to first determine the requirements of the Central government including budgetary support to the central plan.

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In this manner, finance commissions are forced to leave only about 32 percent of total revenues collected by the Centre (but to be shared with states) which are divided among states. Moreover, discriminations are there in allocation of such revenues. There are instances when state governments were denied their legitimate share (as recommended by finance commissions) on account of political differences with the Centre.

Successive Central governments have eroded the letter and spirit of fiscal federalism in India. Now, there is a new threat to this basic structure of our Constitution. It is in the form of a new regime of indirect taxation in India. Though necessary from the point of view of better integration of our national economy, many provisions of the proposed goods and services tax (which will replace the existing system of value added tax in India) will further erode the fiscal autonomy of the states.

While the ability of the states to generate enough revenue on their own to meet their expenditure needs is under attack mainly as a result of expansionary use and interpretation of the Concurrent List and political discrimination on the part of the Centre, they are forced by the centre to undertake a large number of new expenditures as their contributions to so-called centrally-sponsored schemes and some of them are totally wasteful (means not necessary to spend in particular local jurisdictions to maximise social welfare).

It is to be underlined that state governments are much more competent than the Centre to undertake provisioning of most public goods whose needs are local in nature. They should have commensurate power to raise revenue and get a larger share of tax and non-tax revenues from the Centre as untied plan expenditure.

CONCLUSION

Fiscal federalism is not about administrative nature of governance of a country. It is about why and how best public goods can be made available to maximise social welfare of citizens.

Most countries (whether unitary, federal or confederal) are practising fiscal federalism as they have realised that one size does not fit all and local needs are best served by local authorities. And such needs are changing due to globalisation and deepening of democracy.

An analysis of the impact of fiscal federalism in Canada (*Fiscal Federalism in Canada*, Robin Boadway and Ronal Watts, Institute of Intergovernmental Relations, Queen's University, Ontario, July 2000) has shown how effective it was in "reconciling the desire to achieve national standards with the desire to decentralise provision to provinces" in terms of achieving economic efficiency, fiscal efficiency as well as its positive impact on equity in public services.

In Australia – another federal country – it was found that vertical fiscal imbalances between states became more pronounced because of the monopolisation of income tax base by the Central government (the Commonwealth of Australia) and with the introduction of a broad-based expenditure tax (similar to the proposed goods and services tax regime in India) – *Fiscal Federalism in Australia*, Iain McLean, Social and Political Theory Programme, Research School of Social Sciences, Australian National University, Canberra, 2002. The author argued that an economically efficient system based on the minimisation of vertical fiscal imbalances between the Centre and states and on the principles of horizontal fiscal equalisation among states would minimise perverse incentives especially incentives to seek rent, encourage states to grow, discourage sub-optimal location decisions and minimise transaction costs of doing business.

However, all such positive implications of a well-thought-out and broad-based fiscal federalism regime has been reversed in India. Despite the fact that India is a federal country and the essentials of fiscal federalism is a part and parcel of the Indian Constitution, successive governments at the Centre have made a mockery of allocation of competencies (expenditure side) and fiscal instruments (revenue side) between different jurisdictions.

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Based on the theories of public economics and administration, there is a strong case that the Centre should focus on maintaining an equitable distribution of income between various jurisdictions and macroeconomic stability and leaves the delivery of public goods to local jurisdictions (state and other sub-national jurisdictions).

In India the exact opposite is happening. The Centre is failing in its duty to maintain macroeconomic stability and creating an unequal system of income distribution. This has created a system of provisioning public goods with a built-in agenda for inefficiency and sub-optimal welfare maximisation.

With the advent of coalition governments at the Centre and as a result of the impact of globalisation, it was expected that fiscal federalism would get strengthened in India. Ironically, it is going the other way – from bad to worse.

There should be a Ministry of States under the Prime Minister's Office to discuss all relevant issues of federalism in India including fiscal. Inter-State Council which comes under the Ministry of Home Affairs should be brought under the purview of the Prime Minister's Office and its mandate should be expanded to include fiscal federalism and related issues. In consultation with the Ministry of Finance, the Ministry of Home Affairs and other relevant ministries of the Government of India this new Ministry (of states) should, among others, coordinate Centre-state fiscal relations and relevant issues should be debated at the Inter-State Council.

The issues of fiscal federalism in India should be debated afresh among the larger polity including non-state actors so that social welfare is better maximised through better provisioning of public goods. After all it is we the people of India, through our Constitution has entrusted this responsibility to our parliamentarians and legislatures.

ISSUES FOR DISCUSSION

- Essentials of the concept and the political and economic rationale behind fiscal federalism in India.
- How to ensure political autonomy of the institution of the Finance Commission of India, particularly its recommendations on the strengthening of Centre-state fiscal/financial relations?
- Should the role of the Planning Commission of India be confined to broad policy making in consultation with the states and not in disbursing Non-Plan grants to states?
- Should there be a Ministry of States at the Centre for performing coordinating role on state subjects such as agriculture, health and dealing with larger issues of fiscal federalism and policy (including global policies) ramifications in consultation with state governments?

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