# Opinion | The best way to reform India's architecture of fiscal federalism

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A revival of the Inter-States Council could ensure revenues are shared in a way that preserves the fiscal autonomy of states

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On 29 July 2019, the government amended and added to the terms of reference (TOR) of the 15th Finance Commission (15th FC), asking it to "... examine whether a separate mechanism for funding of defence and internal security ought to be set up..." The amendment has been interpreted as an attempt by the Centre to encroach on the fiscal autonomy of states and pre-empt a part of states' resources to fund defence and internal security. There is a wider political and economic context that accounts for this interpretation.

The political context is the conversion of the Jammu and Kashmir state into three Union territories by the stroke of a pen, along with the abrogation of Article 370. Opposition parties and others claim that amendment of the 15th FC TOR is part of a larger campaign to undermine the federal character of the Constitution. The economic context is the sharp deceleration of growth and large shortfall in revenue, which are driving each other. Central revenue is projected to grow 25.6% in 2019-20, compared to the 8.9% rise in 2018-19. The expenditure projections are equally unrealistic. The Central government is well aware that another major expenditure shortfall in 2019-20 will further reduce growth, which had decelerated to 5% by the first quarter of 2019-20. The Central government is therefore scrambling for resources. It is against this background that the 15th FC TOR amendment is being seen as an attempt to preempt some resources of the states for funding defence and internal security.

Will the TOR amendment indeed encroach the fiscal space of the states and, if so, what should be done to preserve their fiscal autonomy? To address these questions, it has to be noted that nearly two-thirds of the shareable pool of tax revenue is usually transferred to the states. In the 14th FC award period, this was set at 63%, with the balance 37% being the Centre's share. But in addition, the Centre also receives cesses and surcharges and the dividends and profits of central public enterprises and public sector financial institutions like banks and the Reserve Bank of India. In setting the Centre's share at 37% of the shareable pool, the 14th FC had also factored in the Centre's access to these non-shareable revenues as well as its expenditure needs, including the provision for defence and internal security. This is standard practice for all finance commissions.

If the 15th FC recommends that a certain portion of the shareable pool should be separately carved out for defence and internal security, then the requirements of the Centre, net of defence and internal security, will have to be adjusted downwards. The 15th FC cannot obviously double-count the provision for defence and internal security both before and after devolution. Hence, the carve-out need not necessarily erode the fiscal space of states. However, while defence is a Central subject, internal security is the joint responsibility of the Centre and states. This would imply that the provision for internal security would be carved out in advance from what would otherwise have been states' resources, but without their approval. So what would be eroded is not so much the fiscal space of states but their fiscal autonomy.

There is a similar erosion of fiscal autonomy with Centrally Sponsored Schemes (CSS), the largest component of non-FC transfers to the states. CSS schemes are funded on a cost sharing basis, hence they pre-empt a large share of the states' expenditure. Moreover, unlike FC transfers, which explicitly balance considerations of equity and efficiency, CSS allocations are entirely ad hoc decisions of Central ministries, favouring some states at the cost of others.

These issues call for reform of the overall architecture of fiscal federalism. Three possible options can be considered, each requiring a constitutional amendment.

One option is to only allow transfers through untied tax devolution. This option is unrealistic for several reasons. First there may be externalities, effects that spillover beyond state boundaries, or issues of national importance such as food security, which cannot be left entirely to states. Further, strong states may have the resources and capacity to design, finance and manage schemes on their own, but the weaker ones may not. Finally, given the long legacy of CSS, it is difficult to imagine that any central government would completely walk away from CSS, especially those that are popular and have considerable political mileage.

A second option is to make the FC a permanent body and expand its mandate to undertake the resource allocator role of the erstwhile Planning Commission. However, this option would not preserve the fiscal autonomy of states since the FC would decide what programs or projects should be allocated to which states.

A third option, my preferred option, is to revive the Inter-States Council as an effective federal decision making body. It already exists as a constitutional body, but has been left dormant. It can be restructured as a federal institution outside the home ministry, a Council with state chief ministers as members and chaired by the prime minister. The Council should be supported by a secretariat of experts to design programmes and lay put the principles for their allocation among the states.

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