The case for a radical transformation

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THIS article argues the case for a radical transformation of the architecture of fiscal federalism in India. The debate on reform of fiscal federalism has gained considerable traction in recent months, particularly following publication of the book *Indian Fiscal Federalism* by Y.V. Reddy, Chairman of the 14th Finance Commission, and his co-author G.R. Reddy (henceforth the Reddy volume).[1] As the volume points out, the debate has been triggered by a number of important developments during the past few years.

The most significant perhaps is the establishment of the Goods and Services Tax Council (GSTC), a unique federal body consisting of all the state finance ministers and chaired by the Union finance minister. The council is empowered by law to make all decisions regarding the nationwide GST, which has replaced most major indirect taxes, thereby establishing a national common market with a uniform indirect tax regime. The central government has *de facto* veto power in decisions of the GSTC, but a majority of the states also collectively have similar veto powers. With this careful balancing of powers over indirect taxation, and despite the various limitations of the GST design and its implementation, the GSTC has established an impressive track record as an institution of cooperative federalism.

The second major development is the abolition of the Planning Commission. Though not a constitutional body like the Finance Commission (henceforth FC), ever since its inception in 1950 the Planning Commission came to play a key role in the flow of financial resources to the states that were additional to FC transfers. It was wound up on 15 August 2014 and replaced by the Niti Aayog, but the latter does not have any role in the transfer of resources to the states. A related development was the abolition of the distinction between plan and non-plan expenditure. Whatever limited leverage the states had in determining the flow of plan funds through the erstwhile National Development Council, a body of state chief ministers headed by the prime minister, has now been completely appropriated by central ministries, especially the Ministry of Finance.

The third major development is the award of the 14th FC on tax devolution, which vastly increased the fiscal autonomy of states without any significant increase in their total share of the divisible pool of taxes.[2]

There is a vertical imbalance between the powers of taxation and expenditure responsibilities of the central government and the states. The central government collects about 60% of total tax revenue while it accounts for only about 40% of public expenditure. The states collectively account for 60% of total expenditure, but raise only about 40% of tax revenue.

To address this vertical imbalance and a further horizontal imbalance between the revenue raising capacity and expenditure responsibilities of individual states, which are at different levels of development, the Constitution mandated the appointment of a FC every five years or earlier.[3] It was to recommend how the net proceeds of tax, the shareable pool, should be distributed between the central government and the states over a five year period and the allocation of the states' share between the individual states (Article 280[3a]). It also mandated the Finance Commissions to recommend the principles that should govern grants in aid of the revenues of the states out of the Consolidated Fund of India (Article 280[3b]).

These articles did not explicitly invoke the concept of equity. However, the principal of equity is implicit in Article 275 relating to grants, which states that Parliament may provide 'grants-in-aid of the revenue of *such* states as Parliament may determine to be in need of such assistance.' The equity principal was also made explicit by the chairman of the very first FC in indicating that the fundamental role of a FC is to eliminate, as far as possible, the vertical and horizontal imbalances to enable the provision of a comparable level of basic public services to all citizens of the country regardless of their place of residence.

All subsequent FCs have attempted to pursue this goal in one way or another, though with limited success. This is partly because FC transfers are only one of several channels through which resources are transferred to the states and also partly because there are other factors, including a legacy of unequal development across states, that have an impact on service delivery.

A major component of FC transfers is through devolution of the shareable pool of taxes. The states share had been gradually raised by successive FCs up to about 32% in the award of the 13th FC. The 14th FC sharply raised this to 42 per cent. However, it was quite restrained in providing grants under Article 280(3b). Hence, the increase in total transfer to the states through FC plus non-FC sources was marginal, rising from about 62 per cent in the 13th FC period to just over 63 per cent in the 14th FC period. Thus, the fiscal space available for the Centre to meet its own requirements for Union list subjects was preserved. But in raising the share of *untied* transfers and tax devolution by almost one-third, at the cost of tied transfers, the 14th FC vastly increased the fiscal autonomy of the states.

This was done in response to a legitimate complaint of the states about the increasing encroachment of the central government in the constitutional and fiscal space of the states, especially through Centrally Sponsored Schemes (CSS). In this big push for decentralization, the 14th FC was aided by its terms of reference, which required it to assess federal finances as a whole, and did not limit it to only considering non-plan revenue expenditure, as was the case for most of the earlier FCs. The Planning Commission had in fact been abolished and the distinction between plan and non-plan expenditure eliminated by the time the 14th FC submitted its report.

The fourth major development was the terms of reference of the 15th FC and the controversy it generated. Several items in its terms of reference appear to privilege the central government at the cost of the states. It would appear that the central government is seeking to use the FC, a neutral federal institution, to exercise greater financial control over the state governments in line with its own priorities.

This move, which could reverse the enhanced fiscal autonomy of the states following the recommendations of the 14th FC, has been widely discussed and criticized by many experts and state governments. Several states have jointly appealed to the President of India to revise the terms of reference of the 15th FC. This politicization of the terms of reference of the FC is an unprecedented challenge to India's fiscal federalism.

After a detailed analysis of these and other related developments, the Reddy volume has outlined its views on the way forward. While strongly arguing the case for greater empowerment of the states vis-a-vis the central government, it also argues that Niti Aayog should be given constitutional legitimacy and suitably empowered to allocate non-FC transfers to the states. While launching the Reddy volume in Chennai and in an article published in *The Hindu* at the same time (25 March 2019), C. Rangarajan, Chairman of the 12th Finance Commission, argued that there are compelling needs for both decentralization and centralization which need to be suitably balanced.[4]

With that in view, and recognizing that a future government might even revive the Planning Commission, Rangarajan suggested that the share of the states in the sharable pool of taxes, including cesses and surcharges, should be permanently fixed at 42 per cent through a constitutional amendment. While launching the Reddy volume in Mumbai, Shaktikanta Das, Governor of the Reserve Bank and a former member of the 15th FC, is reported to have suggested that the FC should be made a permanent body. While launching the same volume in New Delhi, N.K. Singh, Chairman of the 15th FC, pointed out that with the abolition of the Planning Commission the misuse of Article 282 of the Constitution had ended. He also mentioned that with the elimination of the distinction between plan and non-plan funds, FCs can now take a holistic view of total government finances and transfers to the states.

Earlier, in his Sukhamoy Chakravarty Memorial Lecture at the Annual Conference of the Indian Econometric Society, Vijay Kelkar, Chairman of the 13th FC, called for a new fiscal federalism to address three imbalances: the vertical imbalance between the central, state and local governments; the horizontal imbalance among the states and the long-term development imbalance among the states.[5] Institutionally, the FC is mandated to deal with the first and second imbalance as far as the central and state governments are concerned.

To ensure adequate finances for the third tier of local governments, Kelkar recommended a constitutional amendment to create a consolidated fund for panchayats and municipal governments, to be funded by allocations from the FC and state FCs and the mandatory share of GST revenues. To deal with the long-term development imbalance, Kelkar recommended that Niti Aayog should be suitably empowered and reinvented as a Niti Aayog 2, which could assume the investment allocation role of the erstwhile Planning Commission, but without the bureaucratized micro-management of that body.

Differences in opinions and nuances notwithstanding, there is a shared core in the views of these recognized authorities on the subject of fiscal federalism. All of them agree that following the abolition of the Planning Commission there is now a missing institution to deal with the allocation of pubic investment for regionally balanced long-term development. They agree on the need for a constitutional amendment to create such a federal public institution in some form, whether a revived and legally mandated Planning Commission, or a suitably empowered Niti Aayog or an institution that combines the functions of the FC and the Planning Commission.

On the other hand, they also seek in different ways to strengthen fiscal decentralization, whether it is through ensuring greater fiscal autonomy for the states or by ring-fencing adequate resources for local governments. This tension between the need for centralization to serve some purposes and decentralization to serve other purposes has to be addressed in the context of a different kind of tension between the centrifugal economic forces of the market, which have generated the large development distance between rich and poor states, and the centripetal forces of organs of the state which tend to reduce the development distance among the states.

In a study undertaken a few years ago, we rated and ranked governance performance, defined as public service delivery, of 19 major states in 2001 and 2011.[6] Performance was measured by outcomes of public services covering transport, power, education, health, delivery of justice, maintenance of law and order, etc. Without getting into arcane technical details about the indicators, their indexation and method of aggregation, let me summarize the main conclusions.

First, there is a large development distance between Indian states not just in terms of per capita income but also service delivery outcomes. In infrastructure, for instance, the density of state highways in Karnataka at 10.8 kms per 100 sq kms was five times that in Odisha at 1.95 kms per 100 sq kms in 2011. Power availability in Bihar in 2011 at 117 kWh was three times higher than 36 kWh in 2001, but it was still only 1/15 that of Gujarat at 1559 kWh. In the social sectors, Bihar's literacy rate in 2011 at 47 per cent was only about half that of Kerala at 91 per cent, while the infant mortality rate of 91 per 1000 newborns in Odisha in 2001 was nearly nine times the rate in Kerala, though the difference had narrowed somewhat by 2011.

Second, though there is some churn, performance rankings tend to be sticky. Comparing columns (1) and (6) in Table1, most of the states ranked at the top in 2001 were still at the top in 2011, i.e. Gujarat, Tamil Nadu, Punjab, Kerala, and (undivided) Andhra. Similarly, most of the states ranked at the bottom in 2001 tended to stay there even in 2011, i.e. Odisha, Rajasthan, Jharkhand, Uttar Pradesh and Bihar. Thus there is a strong legacy effect and the states left behind find it difficult to catch up.[7]

Third, and most important, it is well known that the level of development, measured by per capita income, is highly correlated with service delivery outcomes. Hence, to isolate the pure effect of governance inputs like bureaucratic capacity, decision-making processes, etc. it is necessary to control for differences in the levels of development. Controlling for this, there is a sharp improvement in the ranks of some of the poorer states, i.e. Madhya Pradesh, Chhattisgarh, Bihar, Rajasthan while some of the better off states like Gujarat, Kerala, Tamil Nadu, Maharashtra and Haryana slip in their ranking (compare columns 4 and 8 of Table 1).

TABLE 1
Governance Performance Indicators

Governance Performance Index (GPI) 2001				*Governance Performance Index (GPI) 2011*				*Development Adjusted Governance Index (DAGI) 2011*		
(1) Rank	*(2) State*	*(3) Score*	*(4) Rank*	*(5) State*	*(6) Rank Change*	*(7) Score*	*(8) Rank*	*(9) State*	*(10) Rank Change*	*(11) Score*
1	Gujarat	0.66	1	Gujarat	(0)	0.65	1	Chhattisgarh	(+7)	0.64
2	Tamil Nadu	0.60	2	Tamil Nadu	(0)	0.61	2	Madhya Pradesh	(+11)	0.63
3	Punjab	0.60	3	Andhra Pradesh	(+3)	0.59	3	Karnataka	(+3)	0.62
4	Kerala	0.57	4	Kerala	(0)	0.59	4	Tamil Nadu	(-2)	0.61
5	Haryana	0.55	5	Punjab	(-2)	0.58	5	Andhra Pradesh	(-2)	0.61
6	Andhra Pradesh	0.53	6	Karnataka	(+1)	0.57	6	Gujarat	(-5)	0.6
7	Karnataka	0.51	7	Uttarakhand	(+7)	0.56	7	Punjab	(-2)	0.58
8	Maharashtra	0.50	8	Chhattisgarh	(+2)	0.54	8	Rajasthan	(+4)	0.58
9	Himachal Pradesh	0.50	9	Haryana	(-4)	0.53	9	Kerala	(-5)	0.57
10	Chhattisgarh	0.48	10	Maharashtra	(-2)	0.50	10	Bihar	(+8)	0.55
11	West Bengal	0.44	11	Himachal Pradesh	(-2)	0.50	11	Uttarakhand	(-4)	0.5
12	Assam	0.43	12	Rajasthan	(+4)	0.50	12	Haryana	(-3)	0.5
13	Madhya Pradesh	0.38	13	Madhya Pradesh	(0)	0.49	13	Maharashtra	(-3)	0.46
14	Uttarakhand	0.36	14	Assam	(-2)	0.35	14	Himachal Pradesh	(-3)	0.46
15	Odisha	0.35	15	West Bengal	(-4)	0.34	15	Uttar Pradesh	(+4)	0.45
16	Rajasthan	0.34	16	Odisha	(-1)	0.31	16	West Bengal	(-1)	0.43
17	Jharkhand	0.27	17	Jharkhand	(0)	0.3	17	Odisha	(-1)	0.42
18	Uttar Pradesh	0.19	18	Bihar	(+1)	0.29	18	Assam	(-4)	0.41
19	Bihar	0.16	19	Uttar Pradesh	(-1)	0.29	19	Jharkhand	(-2)	0.41

Source: S. Mundle, S. Chowdhury and S. Sikdar, 'Governance Performance of Indian States: Changes Between 2001-02 and 2011-12', *Economic and Political Weekly* 51(36). 3 September 2016, pp. 55-64.

In other words, the observed large and persisting differences in service delivery outcomes across states is the net impact of interaction between economic forces of the market and state action. When the impact of economic forces, per capita income differences, is eliminated, the distance in service delivery outcomes between the stronger and weaker states is reduced. It is an illustration of the centripetal forces of state action moderating the centrifugal impact of economic forces.

That the forces of state action are centripetal should not be surprising. Established by a Constitution which tilts the balance of power in favour of the central government vis-a-vis the states, the key organs of the state (the legislature, the judiciary and the executive) are all structurally uniform across the states and integrated nationally. However, this leads to an awkward conflict of interest between the strong and weak states on the issue of centralization versus decentralization.

Over the years and under different administrations the central government has encroached into the constitutional space of the states through an expanding array of CSS and also, some would argue, through an expansion of the Concurrent List in the Seventh Schedule of the Constitution. That said, it is also the case that some of that encroachment has been in services with externalities that spill over across states or services recognized as merit goods of national interest, where it is important to ensure that citizens of all states have access to a comparable or at least a minimum level of such services, regardless of their state of residence.

In the absence of such encroachment, the stronger states with the capacity to design and implement their own schemes would have been better off with greater autonomy and untied transfers. But the weaker states, which lack the capacity to design their own schemes and raise enough resources, would have been worse off. They need the help of CSS.

Let us illustrate this abstract argument with a concrete example – the case of basic education. It is a state subject but a merit good of great national importance, which is at the core of many of our most important challenges, including the challenge of employment. The Right to Education Act (RTE) of 2009, made eight years of basic education an entitlement for all children. Subsequently, Sarva Shiksha Abhiyan (SSA) was launched as a CSS to help implement the RTE. However, a one-size-fits-all scheme like most CSSs, the SSA was focused on enrolment and the creation of school infrastructure, not learning outcomes.

Pratham's latest Annual Status of Employment Report (ASER 2018) points out that following the enactment of RTE, learning outcomes started declining. The decline was arrested and even reversed only after the Planning Commission recognized the problem. The emphasis of SSA started shifting to learning outcomes, and the RTE itself was finally amended. ASER 2018 points out that private schools, where learning outcomes are better than in government schools, now account for 30 per cent of enrolment. But government schools still account for 70 per cent of schools and the government also regulates basic education even in private schools and especially 'aided' schools. So, the role of the government is writ large over the turnaround in learning outcomes.

However, the report also points out that large variations across states in learning outcomes have persisted. From the perspective of the weaker states, SSA has clearly been beneficial both for augmenting their education spending as well as for the design of the scheme. Without SSA they would have been worse off.

How can the conflict of interest between weak and strong states be resolved? Can the special needs of the weaker states be met while simultaneously reversing the encroachment of the central government in the constitutional and fiscal space of the states? It is important to recognize here that a federal body need not necessarily be a central government body. Like the FCs, the Constitution has also provided for the establishment of a federal body called the Inter-State Council to resolve disputes and deal with subjects in which some or all states, and the central government, have a shared interest.

Unfortunately, this constitutional body was only set up in 1990 following the recommendations of the Sarkaria Commission. It has rarely met and has lost its federal character by being made a part of the central Home Ministry. However, the Inter-State Council could be suitably empowered, through a constitutional amendment if necessary, and reinvented as another effective platform for cooperative federalism like the GSTC. Through this platform the stronger states could help the weaker ones with their best practices in design and implementation of important developmental schemes. The central government could also channel grants through it to support such schemes in the case of merit goods of national interest, including those on the State List.

Most of what has been said above has been limited to the fiscal aspects of the upper tier of federalism, relations between the Centre and the states. I now briefly turn to the lower tier of federalism, the relationship between the state governments and local governments. A long established principle in the decentralization literature is that it is most efficient to assign a function to the lowest governance jurisdiction that aligns with the geography covered by the function. Local public services are therefore best assigned to local governments. But the Indian Constitution never established an independent tier of local governments, leaving the matter to the discretion of the states. This is also a reason why it has sometimes been described as quasi-federal, apart from its centrist orientation vis-a-vis the states.

Article 40, the Directive Principles of State Policy, Articles 280(3)(bb) and 380 (3)(c) relating to the Finance Commission and later the 73rd and 74th Amendments referred to Panchayati Raj Institutions and municipalities. However, in each case it was left to the discretion of the states to enact the necessary legislation for establishing independent local governments suitably empowered and resourced to deliver local public services.

Such independent local government with their own functions, functionaries and funds would have to be carved out of the domain of state governments, curtailing their powers and the influence of state legislators. It is a zero-sum power game between the states and local governments, with the states appointed as arbiters. Not surprisingly, state governments have made little progress in establishing independent local governments in the seventy years post the adoption of the Constitution, and the twenty-five years since the adoption of the 73rd and 74th Amendments.

There are a few exceptions, especially Kerala and Karnataka, where some progress has been made in assigning tax revenues to local bodies. The 13th and 14th Finance Commissions also earmarked substantial funds for local governments in different ways. These are significant steps. Now Kelkar has proposed the creation of an independent Consolidated Funds of Panchayats and Municipalities through a constitutional amendment, to be funded by resources recommended by the FC, state FCs and earmarked shares of the GST, which could be a game changer. But funds, important as they are, will not by themselves create independent local governments unless they are empowered through the transfer of functions and functionaries, as recommended in the 73rd and 74th Amendments.

That can only happen if the interests of state legislators are aligned with those of elected local government leaders. But that would require a radically different federal structure where citizens directly elect only the legislators of local governments, who then elect the legislators to the state assemblies, who in turn elect the legislators to the national Parliament. Of course, that is just a utopian idea which will never be realized. So India is unlikely to have a third tier of government in the foreseeable future. But it is tempting to just plant the seeds of that atrociously radical thought.

* I have benefitted from the comments of C. Rangarajan,V. Kelkar, Y.V. Reddy, and N.K. Singh, respectively Chairpersons of the 12th, 13th, 14th and 15th Finance Commissions, on an earlier draft of this article. However, I alone am responsible for the views expressed in it.

Footnotes:

1. Y.V. Reddy and G.R. Reddy, *Indian Fiscal Federalism*. Oxford University Press, New Delhi, 2019.

2. Government of India, Report of the Fourteenth Finance Commission, December 2014, New Delhi.

3. P.N.Bakshi, *Constitution of India* (13th edition). Lexis Nexis, Gurgaon, 2015.

4. C. Rangarajan, 'Another Look at Fiscal Transfers', *The Hindu*, 25 March 2019.

5. V. Kelkar, 'Towards India's New Fiscal Federalism', *Journal of Quantitative Economics*, February 2019 (online).

6. See S. Mundle, S. Chowdhury and S. Sikdar, 'Governance Performance of Indian States: Changes Between 2001-02 and 2011-12', *Economic and Political Weekly* 51(36), 3 September 2016, pp. 55-64.

7. A recent paper by Mohanty et.al. analysing infrastructure development in the states also found this strong legacy effect. R. Mohanty, N.R. Bhanumurthy and A.G. Dastidar, 'What Explains Regional Imbalances in Public Infrastructure Expenditure? Evidence from Indian States', *Asia-Pacific Development Journal* 24(2), 2017, pp. 113-139.