

Chapter 2

Making Federalism Work for India's Development

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Abstract Fiscal federalism in independent India evolved over the last 70 years has held the country together, provided identity and scope for various religious, ethnic, linguistic groups to function and has provided a reasonably flexible institutional framework for the functioning of the multilevel governance. There is clearly a strong idea of India gained during the independence struggle and cemented over the years after independence. At the same time, it would be erroneous to conclude that the system has worked to the satisfaction of all the groups and surely there is considerable scope for improvement in several areas. Indeed, development of the country and improving the well-being of 1.2 billion people depends on harnessing their energies which can be achieved only when we have an institutional framework to combining the advantages of a large market unfettered by impediments with sufficient scope to achieve regional specialization depending upon comparative advantage and with the regional governments cooperating and competing with one another to provide efficient level of social and physical infrastructure.

Keywords Fiscal federalism • India

2.1 Introduction

Alexis de Tocqueville, in his celebrated work *Democracy in America* written more than 150 years ago extolled, 'The federal system was created with the intention of combining the different advantage which result from the magnitude and the littleness of nations'. In economic terms, this implies reaping the economies of scale while providing public services according to the diversified preferences of people. This provides a large unified common market and enables efficiency gains through

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intergovernmental competition to provide efficient levels of public services. In political terms, this implies a building a strong national policy by combining the subnational entities while providing adequate political space to them. In emotional terms, this provides a national bond while retaining multiple local identities. The realization of these advantages depends on the way in which the different units combine and extent of cooperation and harmony in the functioning of the federal system. Indeed, federalism is not an option but an imperative for a country like India inhabited by over 1.2 billion people with wide social, ethnic, religious, linguistic besides economic diversities.

Fiscal federalism in independent India evolved over the last 69 years, has held the country together, provided identity and scope for various religious, ethnic, linguistic groups to function and has provided a reasonably flexible institutional framework for the functioning of the multilevel governance. There is clearly a strong idea of India gained during the independence struggle and cemented over the years after independence. At the same time, it would be erroneous to conclude that the system has worked to the satisfaction of all the groups and surely there is considerable scope for improvement in several areas. Indeed, development of the country and improving the well-being of 1.25 billion people depends on harnessing their energies which can be achieved only when we have an institutional framework to combining the advantages of a large market unfettered by impediments with sufficient scope to achieve regional specialization depending upon comparative advantage and with the regional governments cooperating and competing with one another to provide efficient level of social and physical infrastructure.

The first 40 years after independence was marked by restricting the role of the market as well as subnational governments. The resource allocation in the country was dictated by plan priorities and centralized planning restricted the role of the subnational governments in resource allocation. The realization that planned development strategy undermined the role of the market as well as subnational governments in accelerating growth, reducing poverty and ensuring human development, economic reforms to liberalize and open up the economy were initiated in 1991. Although the growth rate of the economy has steadily accelerated, from an average of 3.5% during the first 40 years to 5.8% in the next 20 years and 7.5% during 2000–2001, there is growing awareness that the economic performance of the country has been far below the potential. A number of reasons for this have been speculated including the difficulties in building consensus on reforms in a democratic polity and the influence of special interest groups resulting in the crawling pace of reforms. Indeed as Morris and Johnson in their review of the Mirrlees report on Tax reform in England state, those who gain from the reforms are not grateful and those who lose are vengeful and therefore, we experience a tyranny of status quo in reforms.

One of the most important reasons for the gap between the potential and actual growth performance is the lack of coordination between the Union and the States in carrying out reforms. The Seventh Schedule to the Indian Constitution assigns functional responsibilities in terms Union, State and Concurrent Lists. The taxes are assigned according to the principle of separation where the powers are assigned either to the Union and States. However, the separation is only in the legal sense

and there is considerable overlap in the tax bases of the Union and States. Thus, the taxes on agricultural incomes and wealth are assigned to the States whereas taxes on non-agricultural incomes and wealth can be levied only by the Union government. This makes the levy of comprehensive income tax difficult and as the States do not levy the taxes on agricultural incomes, it has opened up a major avenue for evasion of the tax. Similarly, the levy of comprehensive goods and services tax has become difficult as the states which have the power to levy sales taxes on goods cannot levy taxes on services. Furthermore, the Union government has the power to levy excise duty on all manufactured products which is actually the sales tax at the first point of sale, but cannot extend the tax to subsequent stages. There have been serious attempts to harmonize the tax system and levy the GST at both Union and State levels by amending the Constitution for about a decade, but the exercise is mired in political gamesmanship and lack of consensus required for Constitutional amendment. Hopefully, current session of the Parliament will approve the Constitutional amendment to pave the way for the reform which is considered to be an important reform in terms of raising revenue productivity, ensuring a common market in the federation promoting export competitiveness.

On the expenditure assignments too, considerable degree of cooperation is necessary to enable both the Union and states to provide public services according to the diversified preferences of the people while reaping the cost advantages arising from economies of scale. The Constitution assigns expenditure functions in terms of Union, State and Concurrent Lists. However well, it is designed to conform to comparative advantage, the assignment system results result in significant overlapping and there must be a mechanism to promote cooperation, ensure coordination and promote healthy and regulate predatory competition. High degree of overlapping exists in concurrent subjects like energy, environment and education. The spirit of cooperative federalism is particularly important in the case of anti-poverty interventions. Much of the funding for anti-poverty interventions will have to be defrayed by the Centre, but implementation of these programmes will have to be done at subnational levels. The Union government may also have to spend to ensure minimum standards of meritorious public services even if they fall in the State List and this has to be done through specific purpose transfers. Even in the case of Union subjects, it may be necessary to use the States as agencies to deliver the services to take advantage of varying local conditions. Another area where the Union and States have to work together is in ensuring healthy inter-governmental competition. Wallace Oates (1999) called it 'laboratory federalism'. Ensuring a measure of competitive equality among the jurisdictions and avoiding predatory competition through effective regulation is critical to reap the gains from intergovernmental competition. Therefore, there must be a clear mechanism to ensure coordination, promote cooperation and activate healthy competition among the states.

In general, the asymmetry between tax powers and expenditure functions is a feature seen in all federations. General purpose transfers by way of tax devolution or block grants are given to enable the States to provide comparable levels of public services at comparable tax rates. In addition, it is important to ensure minimum standards of meritorious public services with nation-wide externalities. Ensuring

minimum standards of meritorious public services with nation-wide externalities is achieved through specific purpose transfers. In India, the Constitution provides for tax devolution and block grant from the Union to the States based on the recommendation of the Constitutional body, the Finance Commission appointed by the President every five years. So far, 14 Finance Commissions have made recommendations and these have been generally accepted and implemented. Questions have been raised on the design of the general purpose transfers as (i) it does not fully offset the fiscal disabilities of the states and (ii) it entails adverse incentives on tax effort and expenditure economy. The 14th Finance Commission has attempted to meet these challenges by increasing the tax devolution to the States from 32% of the divisible pool to 42%, consolidating all general purpose transfers including those given by the Planning Commission and including revenue and cost disability factors including the forest cover in the States in the devolution formula.

The major problem is in the disbursement of specific purpose transfers. These are given by various central ministries ostensibly to ensure minimum standards of meritorious public services with nation-wide externalities for all citizens irrespective of their place of residence. Serious questions have been raised on the existing centrally sponsored schemes in terms of number of services chosen for equalization, their one size fits all design and inability of many of the states which are in need of such assistance to avail them for want of fiscal space to make matching contributions. Transfers to a large number of schemes for equalization result in the thin spread of resources. The NDA government after assuming power appointed a Committee under the Chief Minister of Madhya Pradesh to rationalize the schemes, but even after consolidation, there are more than 30 schemes and with uniform matching contributions of 40% of the cost required from the states. With such large number of schemes chosen, it is not possible to link the transfers to outcomes. In fact, these schemes seem to serve more a political purpose of appeasing various sections rather than ensuring minimum standards of meritorious public services.

The most important requirement for the successful working of a federation is the institutional mechanism for intergovernmental coordination, bargaining and conflict resolution. Absence of such a mechanism is a major vacuum in Indian federation. It is necessary and important to foster the spirit of trust and cooperation between the Union and the states and among the States inter se, enable health intergovernmental bargaining and resolve conflicts and regulate inter-governmental competition. With the end of single party rule in both the Union and States and emergence of coalition governments at the Union level with regional parties being pivotal members, formal institutional mechanism for intergovernmental bargaining and conflict resolution has become necessary to minimize the coordination and other transaction costs of multilevel decision making. In other words, bargaining, coordination and conflict resolution in a multilevel system are important and at present, there is no institution undertaking this task in India. Indeed, this has resulted in either no coordination/conflict resolution, or ad hoc arrangements. Article 263 provides a basis for creating such an independent institution and the Government set up the Inter-State Council for the purpose. However, instead of setting it up as an independent neutral institution, the Government of India constituted the Inter-State

Council under the Union Home Ministry. Similarly, with the establishment of the Planning Commission under a Cabinet Resolution in 1950, the National Development Council was constituted to facilitate collaborative planning exercise. The Council comprised members of the Union Cabinet, Deputy Chairman and Members of the Planning Commission and the Chief Ministers of the States. However, rather than being a cementing institution and a neutral referee, the Council became a speech making body. The meetings became a forum for voicing the opinions and grievances. The meetings too became infrequent and since 2005 there were just two meetings of the Council. With the abolition of the Planning Commission, the NDC too has seen its last. However, one of the mandates of NITI Ayog established in the place of the Planning Commission is to promote cooperative federalism and enable healthy intergovernmental competition. While the jury on its functioning is still out, it is important to make this a Constitutional body rather than based on the Cabinet Resolution. Hopefully, with passage of time, Inter-State Council will be merged with the NITI Ayog and given a Constitutional Status to make it an independent body to promote trust and cooperation between the Union and States.

One of the major shortcomings of Indian federalism is the failure to decentralize below the State level. Some of the States are larger than many countries and therefore, decentralization is necessary to ensure effective delivery of public services in response to the diversified requirements of people and effective participation in the political processes. Indeed, everyone wants decentralization, but only up to his level. This is amply demonstrated by the States with few exceptions, which in spite of the amendments to the Constitution to devolve powers to urban and rural local governments have failed to do so. Inability to achieve sub-state decentralization is one of the most important shortcomings of Indian federation.

The above discussion makes it clear that making federalism to work effectively for India requires reforms in decentralization policies and federal institutions. Sustained development requires the participation of diverse groups in a harmonious manner. It is important to nation-wide product and factor markets which requires creation of nation-side markets for goods and services as well as capital and labour unhindered by impediments. Similarly, for reasons of both efficiency in service delivery and accountability, it is important to foster the spirit of cooperation and achieve efficiency gains through intergovernmental competition.



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