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Fiscal and Economic Federalism

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Union-state relations and intergovernmental relations in India have largely conformed to the model of cooperative federalism by and large, some irritants and tension areas notwithstanding. Using its larger resources and spending powers, the Union had initiated Centrally Sponsored Schemes (CSS) with the consent of State Governments in all major policy areas, even in matters under exclusive jurisdiction of State Governments. Some State Governments have, however, been complaining about fiscal domination of the Centre over the states and demanding redistribution of powers and revenue resources between the two orders of governments. But neither the Sarkaria Commission on Centre-State Relations nor the National Commission for Review of the Constitution (NCRWC) nor the M.M. Punchhi Commission on Centre-State Relations has recommended any substantial review in this arrangement. The Sarkaria panel had suggested the setting up of another Commission to study and report on the taxation system. This has not been done, though taxation system has been tinkered with in an ad hoc manner. Economic liberalization has augmented the autonomy of the private sector as well as of State Governments. Federalization has accentuated the tendency towards political as well as economic regionalism.

Fiscal federalism in India is faced with challenges of calibrating reforms in policies and institutions to meet the requirements of markets and globalisation. The fiscal system in the first 40 years was shaped by the requirements of public sector dominated, heavy industry-based import substituting industrialisation strategy and this has to be reoriented to respond to market-based development. The transition involves
difficult initiatives in reforming both policies and institutions to ensure free flow of factors and products across the country. The states which have more developed markets and with greater market friendly environment will attract capital and skilled labour and develop faster than others. Furthermore, both central and state governments have to respond to the globalising environment. This requires creation of market friendly policy environment and institutions. In the past, centralised planning had limited role to play in the sub-national governments in development. In addition, regulations and controls on quantities and prices introduced both as instruments to deal with centralised planning and to meet scarcity conditions, severely segmented the market.

Market-based development of the economy in a globalising environment requires significant change in the nature and quality of government intervention and in a federal fiscal system the

roles of the central and sub-central governments will have to undergo a significant change. Ensuring a stable macroeconomic environment in a multilevel fiscal system requires coordination in stabilisation policies. Similarly opening
up the economy results in loss of revenue from customs duty and recouping the revenue loss requires coordinated calibration of tax reforms at central and state levels

2. Important Features of Efficient Fiscal Federalism

The theoretical developments in fiscal federalism are classified into the first- and second-generation theories. While the traditional theories called the first-generation theories formerly assumed a benevolent state, the second generation theories draw on the developments in the theory of public choice and industrial organisation. In the first, the trade-off is presented in terms of efficiency gains from meeting diversified preferences and inability to internalise the spill overs at the sub-national whereas, in the second, the trade-off is in terms of better "accountability" of decentralised levels versus better coordination of policies to internalise spill overs (Seabright, 1996; Oates, 2005). There are three different strands in the second-generation theories which analyse fiscal federalism in (i) the principal – agent framework; (ii) problems arising from the soft budget constraints and deriving motivation from the fiscal crisis precipitated by exploitation of "fiscal commons" leading to perverse behaviour of sub-national governments, particularly in Latin America; and (iii) outcomes from "yardstick competition" under the rubric of "competitive federalism". These developments help to identify some important features of efficient fiscal federalism which are summarised in the following.

One of the most important pre-conditions for efficient fiscal federalism is clarity in the assignment system. Not only that the assignment system should be clear as far as possible, but when there is overlapping, there should be systems and institutions to resolve it. Clarity in assignments does not only imply mere assignment of revenue and expenditure powers; it is also necessary to ensure that the functions of different functionaries within a level are unambiguous. Furthermore, the functions should be assigned according to comparative advantage.
An important feature of a successful system of fiscal federalism is the assignment of adequate revenue powers to sub-national governments to forge a strong link between revenue and expenditures at the margin. This is necessary for both efficiency and accountability reasons. Assignment of revenue powers is also necessary to ensure a hard budget constraint.

3. Salient Features of Indian Federalism

(i)Role of the States in Indian Economy

While much of the discussion on economic reforms in India has focussed on economic liberalisation at the central level, there is relatively less attention on the reforms at the sub-national level.
2This is not very surprising because, despite the crying need, reforms at the state level have been slow and inadequate. This is also unfortunate because, in spite of a heavy centripetal bias, Indian Constitution assigns a predominant role to the states in the provision of social services and co-equal responsibility in the provision of physical infrastructure. In fact, education and health are state subjects and their expenditure share is over 75 per cent of the total in spite of the recent initiatives by the central government in introducing schemes for universalising elementary education through Sarva Shiksha Abhiyanand National Rural Health Mission. In agriculture and irrigation too, where the states have a predominant role, there are serious problems still to be tackled in terms of liberalising policies and creating infrastructure for agricultural extension, transportation, storage, and marketing. A large number of irrigation projects continue to languish at various stages for want of adequate resources to complete them. In the power sector which is a concurrent responsibility, investment by the states in recent years in generation, transmission as well as distribution is negligible mainly because the electric utilities are unable to generate the surpluses needed for reinvestment on account of irrational pricing of electricity and poor operational efficiency

(ii)Impact of Political Developments

The increased involvement of the centre in states' domain and substantial central investments in concurrent subjects is, in part, the reflection of the political developments in the country. Although, the central intrusion into states' domain by introducing a large number of central sector and centrally sponsored schemes has been in vogue for a long time, the recent political developments have resulted in the centre
bypassing the states and making direct transfers to the implementing agencies with adverse consequences on both accountability and efficiency. The emergence of coalition governments at the centre, regional parties in power in the states, and some regional parties being pivotal members of the coalition, has changed objective function of the political parties in a substantial measure.

(iii) Resolving Horizontal Imbalances

Indian fiscal federalism is characterised by a very high degree of horizontal fiscal imbalance. The per capita net state domestic product (NSDP)in the richest state (Haryana) in 2007-08 was over 5.4 times that of the poorest state (Bihar) even when only the large states are considered. Of course, the state with the highest per capita GSDP is the small state of Goa and if this is considered, the difference between the lowest and highest per capita GSDP state is 9.5 times. In this environment, fully offsetting the fiscal disabilities of poorer states would require massive transfers to be made to them which could significantly soften their budget constraints. In any case, in the Indian context, multiple agencies giving transfers and poorly designed transfer system has resulted in only a limited equalisation. In addition, regional policy of the centre and various sources of "invisible transfers" have led to a significant volume of inequitable resource flows. Given the large differences in fiscal capacities of the states and the failure of the transfer mechanism to offset the fiscal disabilities of poorer states, there are wide variations in the standards of infrastructure and services provided across states, depending on their fiscal capacity. This in turn has led to significant differences in the flow of private investments. The inability to offset the fiscal disabilities of the states has also led to the introduction of several specific purpose transfer schemes to ensure minimum standards of services.

(iv) Co-ordinating Tax Policies in Fiscal Federalism

The principle of fiscal federalism requires linking of revenue-expenditure decisions of sub national governments at the margin. However, sub-national governments may not consider the overall interest of the economy while exercising their tax powers and this may result in significant inefficiencies. It is important to ensure that the taxation by the states does not violate the principle of the common market by impeding mobility of factors and products. It is also necessary that sub-national taxes do not entail exportation of tax burden to non-residents. Furthermore, states may indulge in unstable competition by reducing the tax rates to attract investments or divert trade in their favour. Such a competition resulting in "the race to the bottom" only results in the states losing revenue and creating distortions in resource allocation.

(v) Ensuring a Stable Macro Economy

An important precondition for a successful market promoting federalism is the prevalence of hard budget constraint at sub national levels. The fiscal arrangements instituted in the constitution recognised the importance of this and had constrained the states from having recourse to unlimited borrowing powers. Unlike the Latin American countries where unlimited

international borrowing powers of the states was a cause of profligacy and bailouts resulting in soft budget constraints, the states in India do not have powers to borrow internationally. However, Article 293of the Constitution empowers the state governments to borrow from the domestic market, but if a state is indebted to the centre, it has to seek the permission of the latter to borrow. The plan assistance from
the centre to the states until 2003-04 was partly in the form of loans. therefore, all the states are indebted to the central government. States' borrowing, in effect, means the Union Finance Ministry, the Planning Commission, and the Reserve Bank of India together determine the quantum of market borrowing to be allowed to each of the states every year.

4. Incentivising Reforms: Indian Experience

In this section, we discuss the experience of the central government providing incentives to the states to carry out fiscal reforms in India in terms of their efficacy. We discuss the extent of success in providing incentives to the states to complete their long pending irrigation and power projects. We also examine the effectiveness of the incentives provided for improved fiscal management of the states, specifically in terms of containing their fiscal and revenue deficits. Another important reform selected for some detailed analysis is the incentive provided to undertake tax reforms at the state level. Finally, the paper critically evaluates as many as 12 grants made by the 13th Finance Commission for undertaking reforms in a variety of areas. While the incentive-based reforms in irrigation and power sectors were introduced by the central government directly, the reforms to draw the roadmap for fiscal consolidation, incentivise the adoption of GST and a variety of other grants given in diverse areas have been based on the recommendations of the Finance Commissions.

i) Incentive Based Reforms Directly Introduced by the Central Government.

(a) Accelerated irrigation benefit programme

Accelerated Irrigation Benefits Programme (AIBP) was started by the central government to provide funds to facilitate completion of ongoing large and medium irrigation projects that could be completed within four years so that their benefits are availed of relatively quickly. For projects in Kalahaandi Bolangir, and Koraput (KBK) districts of Orissa, funding for project start was also available. Similarly, although only one project at a time was to be funded in a state, projects dating back to the Fifth Plan or earlier could be taken up together. For getting funding, only a project that did not have
any other funding except through the budget was normally considered.

b) Accelerated Power Development and Reform Programme (APDRP)

The availability and quality of power supply has become one of the major constraints to economic growth in India. In this sector, distribution (largely in the public sector under state electricity boards or companies) has been identified as the key problem area, impacting other aspects of power supply too. Hence, reform in the distribution of power has been a public priority for some time. Among various initiatives including fresh legislations during the last decade, Accelerated Power Development

Reforms Programme (APDRP) was a central government initiative to provide the state level power utilities adequate funds for undertaking the necessary measures to strengthen the power transmission and distribution system through upgradation of worn-out assets, reduced power losses, improve commercial viability with universal metering and pricing, and such other steps. The funding was through central assistance to the tune of 50 per cent of the approved project costs, of which half was given as grant, and the other half as loan. The states were to raise the other 50 per cent as counterpart funds, through loans from sector-specific sources like Power Finance Corporation or any other source of their own, including market borrowing

c) Urban reforms

Jawaharlal Nehru National Urban Renewal Mission (JnNURM) is a central government programme for urban development with two broad sets of objectives – (a) improvement in the coverage and supply of urban infrastructure along with rejuvenation of urban local bodies; and (b) tackling the problem of urban slums through resettlement and other measures and providing basic services to the urban poor. Areas covered under (a) include urban transport, sewerage and sanitation, water supply, and construction of public facilities, among others. Assistance is given to implementing agencies, usually urban local bodies, parastatals or special purpose vehicles set up to carry out the proposed programmes, on the basis of city development plans prepared by them. The assistance is provided as grants, with the expectation that these resources would be adequately leveraged by generating further investment including private
investments.

d) Education sector reforms

In the area of elementary education, Sarva Shiksha Abhiyan
(SSA) or 'Education for All' programme has been a large central government intervention to speed up full coverage of children aged 6-14. The basic idea that drove this programme was to substantially increase access to education through establishment of primary schools within one

km. and upper primary schools within 3 km. of every village with a minimum prescribed population. Thus, the focus was on school infrastructure and included assistance for repairs and maintenance, and additions to existing infrastructure as per norms. Additionally, the programme provided for assistance towards district level and block level resource centres, teachers' training, teaching-learning material and a small untied grant for teachers. Some encouragement was given in the scheme to build up the stake of the local bodies and parents of schoolchildren in the affairs of the school as well. Assistance was available for innovative activities (left unspecified) too. However, the overwhelming part of the cost of providing education, namely the salaries of teachers remained by and large the responsibility of the state governments.

ii) Reforms Undertaken on the Basis of the Recommendations of Finance Commissions

(a) Tax reforms

As mentioned earlier, the lack of coordination in tax reforms was one of the reasons for the decline in the tax ratio during the decade of 1990s. Although the Tax Reform Committee (India, 1991, 1993) and the NIPFP study on domestic trade taxes (NIPFP, 1994) provided the blueprint for reforms and there was considerable discussion among the states through the Committee of State Finance Ministers, which was renamed
as the Empowered Committee of State Finance Ministers, the actual implementation lagged behind

(iii) Fiscal Restructuring and Consolidation Reforms
(a) Recommendations of the 11thFinance Commission
Although macroeconomic stabilisation is predominantly a central function, coordination in fiscal management is extremely important in calibrating counter-cyclical fiscal policy. Right from the late 1980s, lack of fiscal discipline at both central and state levels has been a matter of concern and various Finance Commissions beginning the Sixth have expressed their misgivings about this. However, it is expected that the
central government will behave in a responsible manner as the adverse consequences of poor fiscal management could impact electoral outcomes. In order to motivate the states to follow fiscal discipline, providing appropriate incentives was thought to be the right method. Thus for the first time, the Eleventh Finance Commission (EFC) was given the task of inter alia, "review the state of finances of the Union and States and suggest ways and means by which the Governments collectively and severally may bring about a restructuring of the Public Finances so as to restore budgetary balance and maintain macro-economic stability."

The Commission pooled 15 per cent of the fiscal gap grants it had recommended in the main report and added an equal amount from the centre to create an incentive fund and allocated it according to the population shares of the states. Individual states were to get this incentive amounts in full on the basis of the extent to which they fulfilled the single monitorable target – a minimum improvement of 5 percentage points in the ratio of revenue deficit/surplus and revenue receipts every year with 1999-2000 taken as the base year. The available incentive grant was not to lapse for any state until the last year of the award period, when the lapsed amounts were to be added to total pool available for qualifying states. The Ministry of Finance, Government of India, was the agency implementing the scheme and a Monitoring Committee was also set up with official and non-official members to oversee the implementation of the scheme. '

b) Thirteenth Finance Commission

The revised road map for fiscal consolidation charted by the 13th Finance Commission is, in many ways, a continuation of the map laid down by the 12thFinance Commission. The fiscal deficit target is set to be consistent with the targeted debt to GDP ratio. The consolidated debt to GDP ratio is targeted to decline from 78.8 per cent 25in 2009-10 to 67.8 per cent in 2014-15. In consistence with this, the fiscal deficit is supposed to be reduced from 9.5 per cent to 5.4 per cent during the period. The central government is required to reduce its outstanding debt to GDP ratio from 54.2 per cent in 2009-10 to 44.8 per cent in 2014-15 and its fiscal deficit target is set to reduce from 6.8 per cent to 3 per cent and revenue deficit from 4.8 per cent to a surplus of 0.5 per cent during the period. The 13thFinance Commission has recommended the revised roadmap for fiscal consolidation and in order to impart effectiveness to the process, it has made a series of recommendations to make the FRBM process (i) transparent and comprehensive; (ii) sensitive to countercyclical changes; and (iii) institute a system to effectively monitor the compliance. The measures to make the system comprehensive and transparent include preparation of a more detailed medium term fiscal plan (MTFP) to put forward detailed estimates of revenues and expenditures and to make it a statement of "commitment" rather than merely one of "intent". It has recommended a number of micro measures such as putting forward the economic and functional classification of expenditures as a part of MTFP, preparing the detailed statement on central transfers to states, reporting compliance costs on the major tax proposals, presenting the revenue consequences of capital expenditures, fiscal fallout of PPPs, preparation of an inventory of vacant land and buildings valued at market prices by all departments and enterprises. The Commission has recommended that the values of parameters underlying the projection of revenues and expenditures in the MTFP should be made explicit and the band within which the parameters can vary when there are exogenous shocks while remaining within the FRBM targets. It has also recommended that the nature of shocks warranting the relaxation of FRBM targets should be specified. The stimulus to the states should be in terms of larger devolution rather than

increased borrowing limits and the centre should meet this additional cost. Most importantly, the Commission has recommended the setting up of a committee which will eventually transform into a Fiscal Council to conduct an annual independent public review and monitoring of the FRBM process. The Council should be an autonomous body reporting to the Ministry of Finance, which in turn should report to the Parliament on matters dealt with by the Council.

5. Concluding Remarks

The experience of incentivising reforms at the state level cannot be termed an unqualified success by any means, nor is it a total failure. There are elements of incentives which have succeeded though, but on the whole, it has not been able to accomplish the objectives in entirety such as ensuring standards of essential physical and social infrastructure, motivating the tax reforms in states, urban renewal, or fiscal prudence. The fact that the experiments were not an unqualified success does not mean that the attempt should be given up. They provide valuable lessons for improving the design and implementation mechanisms. Firstly, it is important for the central government to follow what it preaches. In particular, the central government should provide a clear lead in fiscal consolidation and only then can it motivate the states to follow disciplined calibration of fiscal policy. Unfortunately, there is no way the central government can be incentivised in undertaking reforms. It is difficult to solve the problem of soft budget constraint at central level and only electoral dissatisfaction arising from poor policy calibration can motivate reforms. Second, the reforms should have an impact on the margin of the targeted variables. Therefore, considerable effort should be made to design the targets. Third, the incentives should be strong enough for the states to adopt them. If they are not strong enough, they will fall on the wayside. The example of the 11th Finance Commission to link the grants with the reduction in revenue deficits was simply not accepted by the states. Similarly, there were grants recommended for the creation of data banks on panchayats by the 11th Finance Commission which was simply not undertaken. It must also be noted that while incentivising reforms at the state level can motivate reforms in a limited way this cannot be a substitute for hardening the budget constraint. In other words, it is important to undertake reforms to ensure hard budget constraints at the state level. The reform recommended by the12thFinance Commission, of avoiding the centre lending to the states and bringing market discipline to states' borrowing is therefore an important one. The compulsions of coalition politics have resulted in several measures through which the states have been able to soften the budget constraint and bringing about market discipline among the states is an important challenge. In the final analysis, political incentive is the best incentive to undertake economic reforms and there are examples, though isolated, to show that the long-term reform policies can also be the political winners. The important long-term reform of governance and developmental policies undertaken in Gujarat and more recently Bihar, have been politically rewarding as well. In fact, this has the potential to

trigger healthy intergovernmental competition at the states level thorough the "Salmon mechanism" which can lead to improved developmental outcomes. Under this, the electorate as well as the opposition parties in the state benchmark the performances of the better performing states and pressurise the incumbent government to provide the benchmarked standards of services (Breton, 1996; Salmon, 2006). While this can be a long-term solution, in the meantime, it is necessary to experiment with various types of incentives.

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