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Some thoughts on Fiscal Federalism

(By Shri Shaktikanta Das, Governor, Reserve Bank of India, delivered at the launch of the book 'Indian Fiscal Federalism' in Mumbai on Tuesday, March 19, 2019)

I am honoured to be invited for the launch of the book "Indian Fiscal Federalism" authored by Dr. Y.V. Reddy and Shri G.R. Reddy. This is the latest in a prolific body of work that draws from Dr. Reddy's hands-on experience with the Indian economy and public policy. These insightful expositions are interwoven with glimpses of Dr. Reddy's professional life and his 'insider' views.

2. As Governor of the Reserve Bank of India during 2003-2008, after his stint as Deputy Governor during 1996-2002, Dr. Reddy's journey was studded with many milestones. His tenure as Governor can be best characterised by the words he used on assuming office in September 2003 to describe what his approach would be. He had said "continuity and change will be mixed together appropriately." Of course, it will be remiss of me if I do not mention the response of Dr. Bimal Jalan, the outgoing Governor, who said "Dr. Reddy will change whatever I did and will continue where he left off [as Deputy Governor]."

3. For a Central bank, proactive action is of immense importance. When risks were brewing in the pre-2008 period, Dr. Reddy sensed them pre-emptively. Drawing from his speeches, the word 'overheating' entered the lexicon of monetary policy in India. During the build-up of financial excesses in advanced economies with possible knock-on effects on bystanders like India, he resolutely set about preparing India's defences - building investment fluctuation reserves in the banking system; recalibrating risk weights for vulnerable asset classes; and setting prudential limits on inter-bank liabilities. In short, when the world

was behaving in a pro-cyclical manner, Dr. Reddy had turned counter-cyclical ahead of the curve. As events later showed, these bulwarks became critical in protecting the Indian economy from the ravages of the global financial crisis of 2008-09.

4. I have been an avid follower of Dr. Reddy's work. Having worked for several years on fiscal and economic issues, both at national and sub-national levels, I am emboldened by the occasion provided by the theme of his book to share some of my own thoughts on the subject.

5. From a fiscal perspective, India's federal system has three important components: (1) Article 1 of the Constitution states that India, that is Bharat, shall be a union of states; (2) the Seventh Schedule of the Constitution allocates subjects to the Union and the States under different Lists, with overlapping functions contained in a separate Concurrent List; and (3) Article 280 of the Constitution mandates formation of the Finance Commission every five years to recommend vertical and horizontal devolution of net central taxes and various other grants.

6. Over the past decades, the actual working of these constitutional provisions have generated considerable debate. Successive Finance Commissions have made efforts to address the emerging issues and challenges, but in a vibrant democracy like India the debate goes on. Geopolitical risks have necessitated higher expenditure on defence and internal security. Natural calamities and disasters have called for higher expenditure on relief and rehabilitation. In parallel, aspirations of the people and the country as a whole have required that the government spends more on developmental programmes.

7. The interplay between such developments in the real economy and certain features embedded in our constitution have thrown up issues which need to be addressed. I would like to highlight some of these issues. While doing so, I must hasten to stress that the points I am bringing out do not represent the deliberations or the direction of thinking of the 15th Finance Commission where I functioned as a Member for more than a year.

(7.1) Over past several decades, Finance Commissions have adopted different approaches with regard to principles of tax devolution, grants to be given to states and fiscal consolidation issues. While at one level, there has to be a framework for fresh and innovative thinking by every Finance Commission; at another level, there is a need to ensure broad consistency between Finance Commissions so that there is some degree of certainty in the flow of funds, especially to the states. This has become even more critical in the post GST scenario. In other words, there has to be continuity and change between Finance Commissions. Increasingly, therefore, it is felt that there is a need to give permanent status to the Finance Commission. The Commission can function as a leaner entity in the intervening period till the next Finance Commission is set up in a full-fledged manner. During the intervening period, it can also address issues arising from implementation of the recommendations of the Finance Commission.

(7.2) The principle of decentralisation works better when powers and functions are delegated based on which tier of governance is best suited to fulfil that responsibility. The constitution has already provided for delegation of certain functions to the urban and rural

local bodies; but it is seen that there is still good distance to traverse when it comes to devolution of funds to these local bodies. It is, therefore, essential that the State Finance Commissions are constituted every 5 years as per the mandate in Article 243-I of the Constitution and arrangements are made for their robust functioning. Although the provision under Article 243-I is identical to the provision under Article 280, its implementation has fallen short. There could be reasons for the same, but they need to be addressed on priority.

(7.3) Recent initiatives in fostering co-operative federalism have opened new chapters of co-operation between Centre and States. The GST Council is functioning on the principle of shared sovereignty. As Dr. Y.V. Reddy and Shri G.R. Reddy point out in their book, the sacrifice of fiscal autonomy at both levels of government in favour of the Council needs to be seen as a 'trade-off' so as to reap the benefits of tax harmonisation. Indeed, the Indian model of GST preserves the essence of Indian federalism. India is, however, a union of states in which both the union and the states have to be fiscally strong. While this issue has to be addressed by the Finance Commission, the challenge for the GST Council now is to realise the full potential of GST for enhancing tax-GDP ratio and work on other areas of our economy to enhance its competitiveness. For instance, can the GST Council expand its scope and agree to work on other areas of reforms to generate national consensus?

(7.4) Co-operative federalism should not, however, breed inertia. Alongside co-operative federalism, there has to be competitive federalism. The ranking of states on the parameter of 'ease of

doing business' has generated very healthy competition among states. Indices developed by the NITI Aayog on health, water management, implementation of SDGs, etc. have the potential to generate similar healthy competition. The program of Aspirational Districts is another such model for competition and development.

(7.5) There is now general agreement in the country about the importance of fiscal consolidation roadmap both at national and sub-national levels. While adhering to fiscal deficit targets and debt to GDP ratios, it is equally important to undertake robust expenditure planning based on a 'commonly agreed expenditure code' to address the socio-economic challenges without diluting the goals of fiscal consolidation.

8. These are some thoughts which come to my mind while participating in this event today. Steps like these will go a long way in strengthening fiscal federalism and overall fiscal robustness of our economy. I am sure the book authored by Dr. Y.V. Reddy and Shri G.R. Reddy will generate substantive debate and contribute to our understanding of issues connected with fiscal federalism. I congratulate Dr. Y.V. Reddy and Shri G.R. Reddy on their new book and thank them and the organisers of today's event for giving me opportunity to be present here.