

## *Fiscal Federalism: Ideology and Practice\**

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I am greatly privileged and honoured to speak at this prestigious L K Jha Memorial Lecture. For me this is more than a lecture for several reasons. First and foremost, my own personal association, with Shri L K Jha, (to me LK Uncle), dates back from my childhood days. He not only came from the same district as my father but they went to London together - while he went to Cambridge my father was at the London School of Economics. Both joined the Indian Civil Service in the same year of 1936. By the time I joined the civil services, LK's fame and reputation as an administrator, policy maker, with domain understanding of economics and finance had spread far and wide. There are several anecdotes about him which I have mentioned in my forthcoming autobiography and would not like to repeat them here. Irresistibly I must mention one.

When I was serving as Minister of Economic and Commerce in the Indian Embassy in Japan, LK had led a preparatory mission to Japan in 1984 comprising of senior policy makers and senior corporates to prepare for the forthcoming visit of Prime Minister Indira Gandhi. I recall that during that visit, a small dinner was hosted for him by Nisho Iwai who was also part of the fabled Shoga-shosha - meaning a very large Japanese Company that trades internationally in a wide range of goods and services. During this dinner a very old gentleman, who had since retired from the company, shook hands with LK and then gave him a card that had his name and designation as Joint Secretary, Ministry of Industrial Development. He had met LK decades ago and since then LK had travelled

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a long distance - as Secretary Industry, Secretary Economic Affairs, Secretary to Prime Minister and Governor of RBI. LK was stunned on why and how he had preserved this old visiting card of his Joint Secretary era. The old man said he had been struck by LK's brilliance in his first meeting and decided to preserve this card for so many decades hoping that he might meet him again and certain that he would, no doubt, rise to a high public office. While LK was amused, the old man's quest had been realised.

LK represented what may be quintessentially called a liberal mind. He constantly endeavoured in multiple responsibilities to seek measures which would free up the economy, enhance productivity through competition, contribute to growth and provide enough fiscal room to address issues of poverty and welfare. Indeed, this mind set was endemic to him and anecdotes suggest that when he left the responsibility of Secretary to Indira Gandhi to move as Governor of the Reserve Bank of India, the South Block was bereft of a liberal approach. For successive years thereafter, there was the dominance of a left oriented approach believing excessively in enhanced public outlays and strengthening regulations.

My last meeting with him was when he came to Patna to file his nomination for the Rajya Sabha in 1986. By then I had already returned to Bihar and was Principal Secretary Industry. Sitting out on the lawns of my parental house, he recalled with nostalgia about the days gone by, his long association with our family and how he missed my parents with whom his family had a strong association. Regrettably, this was my last meeting with him because he passed away while he was still a Member of Rajya Sabha, from Bihar. Understandably the Washington Post in its obituary, said that *'Jha epitomised the steel frame of Indian government'*. It had also said a little earlier that *'Jha moved as comfortably with the power brokers of Washington and London as he did with those of New Delhi. Even after he ended his formal government service, his views were constantly sought out by*

*leading political figures and as similarly were heeded whenever he felt it necessary to speak about on any major issues'.*

I have selected today's broad theme on this subject of *fiscal federalism*, given the fact that one of the last public offices which he held was to head the Economic Administrative Reforms Commission in the 1980s which had multiple ideas on restructuring our governance rubric in an era of what he called Globalisation.

At today's lecture, I intend to discuss the *changing landscape of Centre-State relations* and the *Dynamic Federal Polity of India*. Federalism means different things to different people. There are federal romantics who believe that the future of India lies in greater autonomy and power to States and that the evolution of the polity has deprived the States to make a more meaningful contribution in our development process. They could equally say so about the third tier of the government namely Panchayat and Urban Local Bodies. There are others, however, who look at this issue in a more clinical way broadly examining the architecture of fiscal federalism and its adherence to the original architecture. But as Charles Kennedy said that *'we have to win vocabulary before we succeed in the vision'*. The same holds true for Fiscal Federalism.

Indeed, the term was first introduced by the German born American economist Richard Musgrave in 1959. According to Wallace E. Oakes writing in 1999 much later on Fiscal Federalism said that *'it is concerned with understanding of which functions and instruments are best centralised and which are best placed in the sphere of decentralised levels of government. This concept applies to all forms of government: unitary, federal and confederal'*.

### **Evolution**

It would be useful to dwell for a while on the evolution of Fiscal Federalism in India. Many of its features are intertwined with the history of East India Company and the British Crown.

The East India Company was granted a Charter of incorporation by Queen Elizabeth in 1600 CE, which gave the Company exclusive right of trading with India.

East India Company set up a number of factories and trading centres at different places in India. Bombay, Madras, and Calcutta became the main settlements and were declared as presidencies.

Under the Act of 1773, the Calcutta Presidency was given full powers over the other two presidencies of Madras and Bombay, which for the first time resembled setting up of a Government. However, only in the Charter Act of 1833, did a central fiscal authority with Presidencies as constituents was formed, which vested the financial and legislative powers in India solely in the Governor-General of Bengal, who was designated the Governor-General of India making the entire administration centralised.

The current system of the financial year ending on 31<sup>st</sup> March along with the principles of the English budget system were adopted with crown taking direct control in 1858.

Union, State and Concurrent Lists in the current Indian Constitution have their genesis from the first Budget, which was presented in 1860-61 under the new system.

A system of diarchy, dividing the administrative subjects into two categories - Central and Provincial was a result of the Montague-Chelmsford reforms enacted in the Government of India Act, 1919. Under the Act, provinces got power by way of delegation and the Central Legislative retained the power to legislate for the entire country relating to any subject. The sources of revenue were also divided between the Centre and Provinces.

In 1927, to review the working of the Act of 1919, the Simon Commission was appointed. The commission favoured the formation of Indian Princely

States and Provinces, which were the administrative divisions of British Government.

The Government of India Act, 1935 established a federal system with Provinces and Indian States as two distinct units. Under the act, legislative powers were distributed under three lists - Federal List, Provincial List, and the Concurrent List. The Act made the revenues and finances of the Provincial Government distinct from those of the Federal Government. The act provided for collection and retention of levies by the Federal Government and spelled out details of the distribution of financial resources and grants-in-aids to provinces.

As per the Act, such sums as prescribed by his majesty in Council were to be charged on the revenues of the federation. *The Government of India Act, 1935 established the basic structure of fiscal federalism in India, one that survives even today.*

Constituent Assembly was constituted in 1946, which adopted a unitary form of government. The federal framework evolved, however, indigenously over a period. The final shape to the federal form of government and federal finance was incorporated in the Government of India Act, 1935. It also had some features of a parliamentary system. However, the nature of the relationship between the proposed federal Government and the Provinces of British India relative to that of the Princely States was resolved only after independence, but before the Constitution was adopted.

### **Post-Independence**

At the time of Independence, India had nine Provinces and over 500 Princely States. The Princely States accounted for 40 per cent of the territory and 30 per cent of the population, and were diverse in size, character, systems, and in the nature of their relations with British India. They were integrated with India after Independence, and the Union of States came into existence on 26<sup>th</sup> January 1950.

The evolution of fiscal federalism in India thus has a long genesis. It primarily dates back to the government of India Act of 1919 and 1935. While the Act of 1919 provided for a separation of revenue heads between the Centre and the provinces, the 1935 Act allowed for the sharing of Centre's revenues and for the provision of grants-in-aid to provinces.

Article 1 of our Constitution describes India, that is, '*Bharat as a 'Union of States' rather than a 'Federation of States'.*

There was no unanimity in the Constituent Assembly with regard to the name of the country. Some members suggested the traditional name (Bharat) while others advocated the modern name (India). Hence, the Constituent Assembly had to adopt a mix of both ('India, that is, Bharat')

Secondly, the country is described as 'Union' although its Constitution is federal in structure. On November 4, 1948, while moving the Draft Constitution in the Constituent Assembly, B.R. Ambedkar responded to the question as to why India is a 'Union' and not a 'Federation of States':

*'The Drafting Committee wanted to make it clear that though India was to be a federation, the federation was not the result of an agreement by the States to join in a federation and that the federation not being the result of an agreement no State has the right to secede from it. The Federation is a Union because it is indestructible.'*

Political scientist Alfred Stepan classified India as a '*holding together*' as opposed to a '*coming together*' federation. Unlike the federal form of government in the United States, which is described as an indestructible Union composed of indestructible States, India is an indestructible Union of destructible States.

The units of Indian federation have undergone multiple transformations since 1947. This is because

Article 3 of the Constitution empowers Parliament to create new States. While such a provision can be seen as giving the Union too much power, it has arguably been central to holding India together since it allows the federation to evolve and respond to sub-national aspirations.

While initially, in 1950, the Constitution contained a fourfold classification of the States of the Indian Union, into Parts A, B, C, and D. By the States Reorganisation Act (1956), the distinction between Part-A and Part-B States was done away with, while Part-C and Part-D States were abolished. *After the State of Jammu and Kashmir has become a Union Territory, we now have 28 States and nine Union Territories; the latest addition to the list of union territories are J&K and Ladakh, added on 31<sup>st</sup> October 2019.*

Broadly speaking, in the evolution of Fiscal Federalism there has been a marked stability in the process and procedures. The annual budgetary processes of both the Central and the Federal Governments are independent exercises and have to go through the Parliament or State Legislature. The Finance Commission which was first constituted in 1951 under Article 280 of the Constitution has had an unbroken legacy. It performs the functions broadly enshrined in the Article 280 of the Constitution.

*Article 280 reads as:*

- (1) *The President shall, within two years from the commencement of this Constitution and thereafter at the expiration of every fifth year or at such earlier time as the President considers necessary, by order constitute a Finance Commission which shall consist of a Chairman and four other members to be appointed by the President.*
- (2) *It shall be the duty of the Commission to make recommendations to the President as to*

- (a) *the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under this Chapter and the allocation between the States of the respective shares of such proceeds;*
  - (b) *the principles which should govern the grants in aid of the revenues of the States out of the Consolidated Fund of India;*
  - (c) *any other matter referred to the Commission by the President in the interests of sound finance.*
- (3) *The Commission shall determine their procedure and shall have such powers in the performance of their functions as Parliament may by law confer on them.*

For most of the post-independence era, the existence of the Planning Commission injected centralising dependence in more ways than one. The Planning Commission became a parallel institution for the transfer of resources from the Union of States. While focus of the Finance Commission remained on the revenue account, the Planning Commission was concerned predominantly with the capital account. Successive Finance Commissions commented on this as being inconsistent with the spirit of the constitution in the devolution of resources. There were other developments like the 73<sup>rd</sup> and 74<sup>th</sup> amendments of the Constitution in 1992 giving status to Panchayat Raj institutions and Urban local bodies with specific functions assigned to them under the eleventh and twelfth schedules.

As a coordinating entity between the Centre and the States the two key institutions have remained, the National Development Council constituted in 1952 to oversee the work of the Planning Commission, to approve their five year plans and their mid-term



appraisal and the formation of the Inter State Council by a Constitutional Amendment in 1990 based on the recommendations of the Sarkaria Commission Report. The question which I wish to ask myself is have Centre-State relations and their dynamics kept pace with the changing needs of the time? India has changed imperceptibly in its economic policies and its governance rubric.

**As we Look Ahead I Perceive there are a Few Key Challenges.**

First and foremost, the future of the VII<sup>th</sup> Schedule. I need to dwell on this a bit. The VII<sup>th</sup> Schedule of the Constitution broadly demarcates the functions of the governance into three entities. This schedule distributes the legislative and financial powers between the Union and the States. List I pertain to subjects of the Union, while List II pertains to subjects which belong to the States and List III in a category called the Concurrent List belong to both the Union and the States and in the event of conflicting legislation, the law passed by the Union shall prevail.

Over a period of time the Concurrent List has sought to occupy increasing space. This is not only by the 42<sup>nd</sup> Amendment of the Constitution (1975), which shifted the subjects of forest and education from the State List to the Concurrent List.

While this was formal act entirely through constitutional amendment there are other ways in which the original demarcation was sought to be whittled down and often metamorphasized. Take for instance the issue of Entitlement driven legislations. Some time ago we entered an era of Entitlement based Standalone Legislation. The classic examples are the Mahatma Gandhi National Rural Employment Guarantee Act of 2005, the Right of Children to Free and Compulsory Education Act 2009 and the National Food Security Act 2013. How do these stand-alone entitlement legislations mesh with the VII<sup>th</sup> Schedule of the Constitution? Do they transgress the earmarked

borders? And how is it that none of the States, at any stage opposed the transgression of these limits. This was the area where the fiscal romantics should have really intervened as employment, education and food were entirely intended to be in the domain of the States. The issue of the States autonomy, I scarcely remember ever came up for serious analytical critiques. Political expediency pervaded Constitutional misgivings.

Second, the issue of incongruence of Article 282 of the Constitution with the letter and spirit of the VII<sup>th</sup> Schedule. Article 282 of the Constitution which says, 'The Union or a State may make any grants for any public purpose, notwithstanding that the purpose is not one with respect to which Parliament or the Legislature of the State, as the case may be, may make laws.'

Originally in the Constitution, it was not expected to be an overarching provision but an extra-ordinary one to be used very sparingly and If I quote Shri K Santhanam, Chairman of the 2<sup>nd</sup> Finance Commission on Article 282, he said - *'This was not intended to be one of the major provisions for making readjustments between the Union and the States, if that was the idea, then there was no purpose in evolving such a complicated set of relations of shares, assignments and grants. There is no purpose in having two Articles enabling the Centre to assist the States - one through the Finance Commission and the other by more executive discretion. In the latter case, even parliamentary legislation is not needed. Of course, it will have to be included in the Budget. But, beyond being an item in the Budget, no further sanction need to be taken. Therefore, in my view, this Article was a residuary, a reserve Article, to enable the Union to deal with unforeseen contingencies. That was how this Article was used both by the British Government and, after transfer of power, before the first year of the First Five Year Plan. Under this Article, only some grow-more-food grants and some rehabilitation grants were given.'*

N A Palkhivala, Constitutional expert, in his opinion given to 9<sup>th</sup> Finance Commission, opined - *'Art. 282 is not intended to enable the Union to make such grants as fall properly under Art. 275. Art. 282 embodies merely a residuary power which enables the Union or a State to make any grant for any purpose, irrespective of the question whether the purpose is one over which the grantor has legislative power.'*

The legitimacy of all Centrally Sponsored Schemes most of which are in the domain of the States emanates from the use or misuse through recourse to Article 282. Indeed, *raison-de-etre* of the Planning Commission in many ways emanated from excessive use of Article 282 in the plethora, if not the jungle of what has come to be known as the Centrally Sponsored Schemes. Here again notwithstanding the successive attempts to rationalise these schemes, the last being under the Committee headed by the former Chief Minister of Madhya Pradesh, Shivraj Singh Chauhan, their numbers and diversity remained very robust. Based on the internal exercise of the Fifteenth Finance Commission there are approx. 211 schemes/sub-schemes under the 29 umbrella core and core of the core schemes. Many of these exist masked under the so called umbrella schemes. What is even most staggering being that the total outlay of the Central Government on these Centrally Sponsored Schemes is approx. 3.32 lakh crores in 2019-20 BE. Considering that the States often protest that these schemes are ill designed and not suited to their specific needs and entails significant financial outlays by them, no State has really decided to abandon them. Far from Centrally Sponsored Schemes facing the sunset, some large schemes in the shape of Ayushman Bharat, Jal Jeevan Mission seek to enlarge their reach and diversity.

### **In the Light of the Aforesaid Analysis what is the Forward Path**

First, we must recognise that the Indian polity has evolved beyond recognition. When the

constitution was drawn up, the interdependence among the States fostered by technology and migration had not gathered pace. But the autonomy of States in pre-globalised era was vastly different than an era where both migration and technology erode in perceptively the boundaries for State. While we talk of the global value added chain, we forget that there is Indian Value Added Chain (IVC). Products, Processes and Services commenced in one State could involve several States before it reaches the final consumer. Indeed, the philosophy of Competitive Federalism, the initialisation of Niti Aayog on ranking of States emanates from this approach.

The concept of National priorities and notable initiatives like Swachh Bharat, New Education Policy, Ayushman Bharat, Swachh Jal through Jal Jeevan Mission as major initiatives constitute integral part of the changing nature of obligations between the Centre and the States. The issues of National Priority transcend boundaries because they are designed to address the basic tenets of growth multiplier benefitting every segment of society and addressing welfare tenets on health, housing and employment as inescapable national priorities. This erodes administrative boundaries and their limitations.

View this along with the changes in Part XII of the constitution which resulted in the adoption of GST designed to make India in one common market and entity. In a sense the GST Council which is also a constitutional body takes decisions through its fitment committee on the rates of the GST tax as both the Parliament and State legislatures have assigned their financial powers to this Empowered Committee. In the States that we have visited being part of Finance Commission, the States have often complained that the fiscal autonomy has been circumscribed by the GST and the room for manoeuvre on revenues had been greatly circumscribed. It is a case of pooled sovereignty for the Betterment of Common Good. Nonetheless, GST Council is still in its nascent phase

and needs to revisit its design and decision making process in a more fundamental way. This is also necessary to enable it to fulfil its original purpose.

### **So here are my Five Suggestions for Strengthening Fiscal Federalism**

First and foremost, the nature of governance has changed fundamentally. Is it for instance reasonable for any Prime Minister while visiting a State to explain that he cannot provide any support for drinking water, improved power supply or enhanced agriculture because the subject happens to be in List II of the VII<sup>th</sup> Schedule belonging to the State. This is not a practical proposition because Constitution must serve and must adopt these to the changing expectations of the people.

People invest confidence both at the National and State level in the political leadership that seeks to garner electoral support. As I mentioned before, the nature of polity, technology, increasingly aspirational society, the demographic profile and the power of technology has dramatically altered the contours of the Constitution.

Both in theory and practice, many beliefs and principles which prompted our forefathers to give the Constitution its present shape may need some basic reconsideration. Long before I said this in a report submitted in 1971 by a Committee called Rajamannar Committee formally known as the Centre-State relations Inquiry Committee, said 'that it is desirable to constitute a High Powered Commission consisting of eminent lawyers and jurists and elderly statesmen with administrative experience to examine the entries of List I and List III in the VII<sup>th</sup> Schedule of the Constitution and suggest redistribution of entries'.

The substantive point is re-look of the VII<sup>th</sup> Schedule in a contemporary context. Unless we re-draw the contours of the schedule, some of the incongruities between the contours of the VII<sup>th</sup> Schedule and Article 282 of the Constitution and the

standalone legislation of the subjects primarily will remain cluttered and opaque.

Second, the symmetry in the working of the GST Council and the Finance Commission deserves serious considerations. The Finance commissions recommend distribution of revenues between Union and the States and thereafter, among the States further to the third tier. They look at projections of the expenditure and revenue, but issue of GST rates exemptions, changes, and implementation of the indirect taxes are entirely within the domain of the GST Council. This leads to unsettled questions on the ways to monitor, scrutinise and optimise revenue outcomes. Since both the Finance Commission and the GST Council are constitutional bodies, the coordination mechanism between the two is now an inescapable necessity. For the first five years of the GST, a 14 per cent guaranteed compensation by the Goods and Services Tax (Compensation to states act) 2017 is provided to the States.

This arrangement will come to an end in 2022. But many States are seeking an extension of this mechanism thereafter. As far as the Finance Commission is concerned, the future roadmap on this has a bearing on the recommendations which it is expected to make on the likely revenues of States, the sustainable growth rates and the Revenue Deficit of Grants under Article 275.

Third, its linkage with the first, we need a far more credible policy for rationalisation of Centrally Sponsored Schemes and Central outlays that have been possible so far. Several Committees in the past have made attempts to do so but the outcome has been elusive. This is even more relevant since the role of NITI Aayog, which is primarily a Think Tank institution and not a financial body remains somewhat unclear in the financial sphere. There is no central entity now for an over-view of the Centrally Sponsored Schemes and how many and in what form many of these could

be amalgamated with central sector outlays. We need to constitute an Empowered Group of domain experts to submit to the Finance Minister and Prime Minister on modalities of further and deeper rationalisation of these Centrally Sponsored Schemes.

Fourthly, with the abolition of the Planning Commission, many economists and policy makers have argued about an institutional vacuum. While the NDC is performing an important function, the States have pleaded for a credible institution acting as a link for a policy dialogue with the Centre. In many countries of the world like Australia, States came together in 2005 to set up the council for the Australian federation to jointly represent their interests in Canberra. We have an institutional entity and how to rejuvenate and rekindle Inter-State Council deserves serious consideration.

Fifth area of incongruity is the fiscal story. One of the Terms of Reference made to this Finance Commission is to review the current level of debt of the Union and the States and recommend a fiscal consolidation roadmap for sound fiscal management.

As per the amended FRBM Act, the Central Government shall take appropriate steps to ensure that:

- a) The general government debt does not exceed 60 per cent;
- b) The Central Government debt does not exceed 40 per cent of GDP by the end of FY 2024-25.
- c) The Central Government debt is estimated at 48.4 per cent as a percentage of GDP for 2018-19 RE. It is expected that Central Government liabilities will come down to 48 per cent of GDP in 2019-20 BE.
- d) The outstanding liabilities of the State Governments stands at 25.1 per cent of GSDP in 2017, with a range of 42.8 per cent

in Punjab and 17 per cent in Chhattisgarh (as per the latest RBI Study on State Budgets)

Aligning the Fiscal and Debt path of both the Centre and the States is an arduous but inescapable task. A differentiated Debt path of States which recognises the present constraints and issues of legacy debt must be handled with sagacity and sensitivity.

These developments have posed an important and challenging task for the Commission to arrive at a roadmap for Commission's award period from 2020 to 2025.

Reforms in Public Finance Management Systems are a continuous process. Previous Finance Commissions recommended on various aspects of PFM systems of both Union and States with focus on budgetary and accounting processes, financial reporting, *etc.*

### **Conclusion**

I do believe that if fresh initiatives are taken on some of the suggestions which I have made, it could impart new dynamism to Fiscal Federalism. The ideology is not in doubt but the practice has become increasingly opaque. Setting a new context both on ideology, and practice must receive serious attention. India of today, its governance matrix, its economic quest is vastly different than the India which crafted its Constitution in 1950.

Can we re-think the design and structure of a genuine fiscal partnership which is not merely a race to garner more resources but a creative attempt to move towards a vibrant Indian Value Added Chain which can catapult our growth rate closer to the quest for double digit growth. Times of economic slowdown must be viewed anecdotally as they are transient in nature and cannot impair our vision both on our potential and but more equally to our historical compulsions. I believe that, only when we recast our ideology in a more contemporary context,



the practice will also become more transparent and more meaningful.

We would be doing service to L K Jha by, given his liberal mind set, seeking better synchronisation and symmetry between ideology and practice. Living in a deceitful world of one-upmanship either among the States or between the States and the Centre will only detract our ability to realise India's growth potential.

*In the context of remark that markets may remain irrational longer than I can remain solvent, John Maynard Keynes is reported to have remarked that when facts and circumstances change, I change my mind - what do you do?*

*The facts and circumstances on Fiscal Federalism have changed. Time to change our mind.*

Thank you