RETHINK THE EMERGING DYNAMICS OF INDIA’S FISCAL FEDERALISM

Relevant for: Indian Polity | Topic: Issues and Challenges Pertaining to the Federal Structure, Dispute Redressal Mechanisms, and the Centre-State Relations

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‘Transparency guarantees and public accountability demand that the Union, States and local governments come clean and bring all extra-budgetary transactions to the public domain’ | Photo Credit: Getty Images

A ‘holding together federation’ with a built-in unitary bias, the Indian Constitution was the contextual product of centrifugal forces and fissiparous tendencies in the run-up to Independence. It has journeyed over 73 years with remarkable resilience. Even so, the emerging dynamics of India’s fiscal federalism needs some rethinking. The paradigm shift from a planned economy to a market-mediated economic system, the transformation of a two-tier federation into a multi-tier fiscal system following the 73rd and 74th Constitutional Amendments, the abolition of the Planning Commission and its replacement with NITI Aayog, the passing of the Fiscal Responsibility and Budget Management (FRBM) Act, with all the States forced to fall in line, the Goods and Services (GST) Act with the GST Council holding the controlling lever, the extensive use of cess and surcharges which affect the size of the divisible pool and so on have altered the fiscal landscape with varying consequences on India’s federalism. I raise just four issues.

One, India’s intergovernmental transfer system should be decidedly more equity-oriented. Although the natural proclivity of any market-mediated growth process is to work in favour of the propertied class, the actual experience in India has been astounding. Chancel and Piketty (2019) estimate that the top 1% earners in India captured less than 21% of the total income in the 1930s, but this was drastically reduced to 6% in the early 1980s and then rose to 22% during the liberalisation era. To be sure, the tax exemptions, tax concessions and other revenues forgone in recent times disproportionately favoured the rich and have reduced the size of the divisible pool.

My study on the convergence trajectory of per capita income (PCI) of 16 major States from 1970-71 through 2020-21, based on Economic and Political Weekly Research Foundation (EPWRF) data, shows an increasingly divergent trend, where the standard deviation value of log PCI has increased to 0.231 in 2020-2021 from 0.186 in 1991-1992, registering a compound annual growth rate (CAGR) of 0.72%. On the other hand, following United Nations Development Programme methodology, Oommen and Parma (in a forthcoming paper in the EPW) argue that the Human Development Index (HDI) across 15 States shows a convergence during the post-

reform period. The standard deviation value of HDI is reduced to 0.268 in 2018 from 0.611 in 1991. Instructively the disaggregated picture since 2005 that spans FRBM legislations shows a declining rate of convergence with a high CAGR of minus 2.85%. Indeed, equity should be the overarching concern of the 16th Finance Commission and that HDI could be considered as a strong candidate in the horizontal distribution of tax devolution. Second, there is a case for revisiting Article 246 and the Seventh Schedule for a denovo division of powers, functions and responsibilities for a variety of reasons.

First, India is no longer the one-party governance of post-Independence times. It has become a truly multi-party system. The nature of polity, society, technology, demographic structure and the development paradigm itself have significantly changed.

Second, under the changing dispensation, several pieces of central legislation such as the Mahatma Gandhi National Rural Employment Guarantee Act 2005, the Right of Children to Free and Compulsory Education Act 2009, the National Food Security Act 2013 and many others impose an extra burden on the States. The Tamil Nadu Chief Minister recently raised the issue of shifting education from the Concurrent List to the State List.

Third, at the time of constitution-making, we never asked the pertinent question of who should do what and who should tax what? We borrowed copiously from the Government of India Act 1935 and failed to apply the subsidiarity principle, viz., that whatever could be done best at a particular level should be done at that level and not at a higher level, in the division of functions and finance. Although the 73rd and 74th Constitutional Amendments provided an opportunity to re-examine the issue, nothing was done. In fact, more confusion was added with the introduction of Schedule XI and Schedule XII, which, respectively, list out the subject matter for the panchayat raj institutions and municipalities by simply lifting items from the State list and Concurrent list. They lack operational meaning unless they are broken down into activities and sub-activities, as Kerala and a few others have done. Again, the retention of the irrelevant item No. 5 in the State list is an affront on the third tier. A new local list that will map out the functional and financial responsibilities of the panchayat raj institutions and municipalities is but inevitable.

Fourth, the persistent failure to place the third tier properly on the fiscal federal map of India is a serious issue. The absence of a uniform financial reporting system (standard budgeting rules for all tiers, introduction of the accrual-based accounting system long recommended and so on) comprising all levels of government is a major deficit which the coming Union Finance Commission may be required to address. Although the Constitution refers to the third tier as ‘institutions of self-government’, policymakers, experts and even the UFCs generally refer to them as ‘local bodies’ and have not given the respect and the handholding they deserve. The failure in building the local democratic base of India, which has over 3.2 million elected representatives, and 2.5 lakh rural and urban local governments, is an enigma. is well-recognised that the prime objective of our federation with deep heterogeneity is to provide basic services of standard quality to every citizen irrespective of her choice of residence and they have a critical role to play. Will the terms of reference of the next Commission consider this?

Fifth, there is a great need to review the off-Budget borrowing practices of both the Union and the States. Off-Budget borrowings mean all borrowings not provided for in the Budget but whose repayment liabilities fall on the Budget. They are generally unscrutinised and unreported. That all income and expenditure transactions should fall under some Budget head or other is a universal principle. State public sector undertakings and special purpose vehicles raise resources from the markets, but their servicing burden often falls on the State government. In cases where the government is the ultimate guarantor, the burden of repaying the debt also falls on the State.

The central government that should set good examples is probably more guilty of off-Budget borrowing than the States. Although the States are disciplined through Article 293(3) by the Union and through the FRBM Act, the Union often escapes such controls. The liberal utilisation of the National Small Saving Fund (NSSF) for extra-budgetary financing of central public sector undertakings and central ministries by way of loans is not reflected in the Union fiscal deficits. This is because only the Consolidated Fund of India balance is considered for calculating fiscal deficit, and items in public accounts such as the NSSF are kept out. While the borrowing space of States is restricted, the Union escapes such discipline. There is also a huge area of special banking arrangements using public sector banks to facilitate cash and credit flow outside the budgetary appropriations to help various agencies involved in quasi-fiscal operations with the government. Transparency guarantees and public accountability demand that the Union, States and local governments come clean and bring all extra-budgetary transactions to the public domain.

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In sum, the dynamics of the emerging fiscal federalism of India entails significant rethinking especially in the context of the 16th Finance Commission.

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