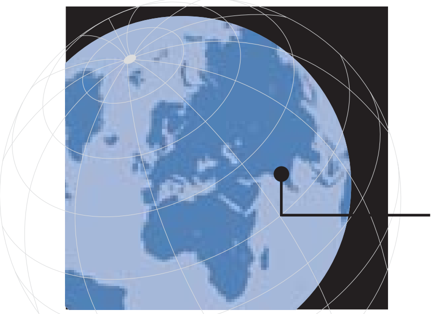

India decentralizes, but do the poor benefit?

Recent efforts to decentralize India's fiscal system may be exacerbating disparities between the haves and have-nots.

THEME III: THE ASSIGNMENT OF RESPONSIBILITIES AND FISCAL FEDERALISM

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***The** process of economic liberalization – in the wake of globalization – has caused great changes in the practice of fiscal federalism in India. There is pressure for restructuring, devolution and decentralization of powers and the demand for fiscal decentralization has become particularly pervasive. Deregulation, disinvestment and privatization in the fields of industry and trade and the monetary and fiscal spheres are influencing intergovernmental structures, institutions and practices.*

India is moving towards greater "federalization" with an emphasis on local responsibility and government effectiveness.

In Indian federalism the fiscal powers have been uneven and highly centralized. This is true despite the fact that according to the Constitution the centre, state and local governments had their own fiscal jurisdictions and they have clearly defined revenue sources and responsibilities.

Distinguishing two Commissions

The Indian Finance Commission is composed of five members, most of them economic and financial experts. The President appoints the Commission every five years.

The Commission draws its authority directly from the Constitution, not from the governments of the day, whether at the federal centre or in the constituent states. Its principal mandate is to award shares out of the proceeds of a number of constitutionally specified federal taxes and excise duties to the governments at both levels, and also among the states. It also determines how much extra assistance should be diverted to the resource-poor states, naturally at some cost to the better off, to help them improve their resources.

The total amounts of transfers to the states the Finance Commission handles are sometimes smaller than those transfers handled by the Planning Commission, which is a federal government body established by parliamentary resolution in 1950 and chaired by the Prime Minister.

Both Commissions draw only upon the resources of the federal government for transfers to the states. The federal government is obliged by the Constitution to share the proceeds of certain taxes according to a fixed formula specified in the Constitution and distributed on the recommendation of the Finance Commission. But the additional amount the federal government may give to states is discretionary, is funnelled through the Planning Commission, and depends on how the federal government views the state's "Five Year Plan". Distribution of additional funds to the different states the states is also in accordance with certain principles, which have evolved over the years.

Centralized at the outset

Early on India adopted a centralized planned economic system to ensure growth and economic development in a country of vast size with various diversities and regional economic disparities. The nature and magnitude of interstate disparities and the backwardness of physical and human resources in some states was so deep that it was felt that they required direct action of the centre.

As a result states were given lesser autonomy in fiscal resource distribution. This made the states dependent on the centre on the one hand and vulnerable to the centre's interventionist policies on the other.

As well, fiscal federalism in India functions in a highly centralized manner partly because the Congress Party was in complete majority both in the centre and states for about two decades after independence. The centralization of fiscal powers had grown under the guise of planning for development.

Fiscal transfers from the centre to the states are budgetary transfers, carried out on the recommendations of two central bodies known as the Finance Commission and the Planning Commission (*see box*), and of the key economic ministries of the central government. Financial assistance is also distributed through All India Financial Institutions, Industrial Banks and Commercial Banks. The union government shares tax levied by it and collected by the states. Some taxes are levied and collected by the union and shared by the states.

The centre is not bound to accept all recommendations of the Finance Commission. For instance the federal government did not carry out the Finance Commission's most recent recommendations for the financing of health, education and drinking water. This was because the main focus of the government's economic planning has been on industrial development and import substitution policy.

As well, the Finance Commission is precluded from making recommendations on grants-in-aid and discretionary grants. These grants are within the jurisdiction of the Planning Commission and with regard to these, the latter can play a more effective role than the Finance Commission in fiscal transfers from the centre to the states.

The central government has tended to give Planning Commissions recommendations priority in the monetary, fiscal and economic planning of the country. Central Plan assistance to state plans is project specific and states cannot divert that money for any other projects. This form of tight central control sometimes causes a waste of resources as investments are made according to the plan and not according to actual need.

Since the Planning Commission is perceived to be a political body, the states have been demanding a greater role for the Finance Commission over the years.

Another sort of fiscal transfer involves central Ministries financing some of the states' requirements without necessarily consulting either the Finance Commission or the Planning Commission. These transfers are for schemes relating to education, agriculture, infrastructure, national calamities, improvement of roads, upgrading of salaries of teachers, relief and rehabilitation of displaced persons and other contingent requirements arising from time to time such as police and housing. The terms of these discretionary transfers are more liberal than those of "Plan" transfers.

Highly inequitable

Nevertheless, all types of budgetary transfers including market loans and central investment in public enterprises located in states, and non-budgetary transfers and input subsidy, show that the distribution of fiscal transfers has been highly inequitable. Fiscal flows have gone to states in a manner that have created distortions, controversies and even conflict between the centre and some states.

The functioning of important Union institutions influencing fiscal relations such as the National Development Council, the Interstate Council, the Rajya Sabha and the Supreme Court has also been ineffective. There has been a lack of regular coordination among these institutions and they have failed to address "federal" problems efficiently.

The high degree of central control in the name of equity, efficiency, and economic planning has not brought about equitable development in India. Disparities between different regions continue even in the reformed and liberal economy. One reason for this is that the pattern of fiscal distribution in the public sector ignores differences among the resource rich and North Eastern states.

Public investment by the centre has focused on areas with raw materials and existing infrastructure facilities. The centre did not pay much attention to develop the states lagging behind in infrastructure facilities. More than fifty years after Independence, a large number of states lack physical and human resource development and this pattern continues even in the reformed economy. In practice only developed areas attract Foreign Direct Investments and other investment flows. Industrially developed states such as Tamil Nadu and Maharashtra continue to attract the lion's share of the total proposed investment. The share of state of Maharashtra alone is as much as the combined share of all the relatively poor states such as Assam, Bihar, Madhya Pradesh, Orissa, Rajasthan and Utter Pradesh.

Marginalized states such as Bihar and Uttar Pradesh have large populations but receive negligible investment proposals. Bank credit operations are also highly favorable to high-income states. Resources mobilized by all India financial institutions are flowing to relatively developed states.

Liberalization and economic "retreat"

Globalization has encouraged a trend towards decentralization and devolution of power and resources. Due to the changing political and economic system the states have mounted joint attacks against the centre's dominant fiscal position. The centre has been unable to set its fiscal house in order without the states' cooperation. Economic liberalization has brought about a retreat by the central government.

There is a decline in fiscal transfers from the centre to the states. Budgetary support by the central government for the central plan has declined with serious repercussions for state budgets. This has been particularly hard on those states that are the weakest economically.

The central government has withdrawn as a promoter of socially desirable production activities by withdrawing their fiscal and monetary incentives. It has also withdrawn as a regulator that prescribes certain rules and regulations in order to achieve certain macro- economic and other socio-economic objectives. The Centre's declining capacity to reduce regional economic disparities is likely to further widen the gap between states in the years ahead.

In this post liberalization and economic reform period there has been a decline in urban poverty rates but rural poverty remains. Interstate disparities have not only tended to increase but have shown a qualitative deterioration in many ways. In the post reform period, poor states such as Rajasthan, Uttar Pradesh, Orissa have not shown any reduction in poverty whereas rich states such as Andhra Pradesh, Gujrat, Karnatka, Maharashtra, Tamil Nadu and Punjab recorded poverty reduction. The trend towards increasing disparity among states is likely to make centre-state relations more complex and could pose a serious threat to national unity and integrity.

Many kinds of disparity

In view of the changing economic scenario, interjurisdictional competition among states is replacing intergovernmental relations. The industrially developed states try to redesign their policies to dilute tax laws, giving fiscal concessions and incentives to attract foreign investment. These states have the capacity to reduce their dependence on the centre and generate their own funds. They seek more autonomy in fiscal and political affairs.

Even in some of the economically rich states some regions are deplorably poor and require the centre's assistance. How this assistance is distributed across the states and how states react to such transfers has been an issue of controversy in the recent years.

In line with a more decentralist fiscal federalism, a wide range of powers has been devolved to the local governments. The eleventh Finance Commission fixed the aggregate state share of the centre's divisible pool at 29.5%. These fiscal transfers are more favorable to populous and economically backward states. For the first time, the Finance Commission made recommenda-tions for the provision of fiscal transfers to local bodies. It recommended the transfer of Rs. 16 billion and Rs. 4 billion for Panchayats (rural, local governments) and municipalities respectively. And the 73rd and 74th Constitutional amendments require each state to appoint a state Finance Commission to consider and make recommendations on the financing of local, self-governing institutions.

Cooperative federalism is perceived to be the best device to meet the complexities of fiscal federal relations in India. It would help to bring prosperity to the nation, as different levels of government would share national resources and markets. Cooperative federalism could develop harmonious relations between the centre and the states and among states themselves, while encouraging healthy competition among states. A new federal arrangement to increase the autonomy of states and the activation of grassroots intergovernmental institutions would transform India into a cooperative and constructive federal polity.