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on

The Recent Evolution of Indian Federalism

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1. I want to thank Ambassador David Malone, the distinguished President of IDRC for inviting me to speak today. I am going to speak on ***The Recent Evolution of Indian Federalism***. I have had the pleasure of coming to IDRC last October when Ambassador Malone had kindly hosted the visit of the Finance Commission. After submitting the report to the President of India, I demitted office of the Chairman of the Finance Commission in January this year. I have now the honor of being the chairman of Forum of Federations. This Forum is undoubtedly one of the great initiatives that Canada has taken to share its “soft power” with the international community so as to foster democracy and improve global governance.

2. Over the last 10 years, the Forum has done splendid work towards the strengthening of theory and practice of federalism in the world. This was possible only because of the wise leadership of the distinguished Chairmen and Presidents over the last ten years and I want to particularly salute Mr. George Anderson, the present President for his outstanding contribution.

3. Federal system is essentially a post-industrial revolution phenomenon. I do believe there is an organic link between the growth of modern market-economy and federalism as there is synergy in these two systems or organizing principles viz., one relates to the governance of economic markets or exchanges and the other which relates to the governance of political markets or political interaction. Therefore, it is no wonder that federalism has seen even more dynamic growth over the last several decades and today almost 30 countries, accounting for more than 40 per cent of the world population, have federal structure. George Anderson's lucid book on Federalism published recently by the Oxford University Press, is an excellent resource material on Federalism. This book makes an interesting observation that almost all democracies which are either large in area or has a population of more than 100 million have a federal system.

4. Although I have lived in three Federal Systems such as United States, Switzerland and India, I am more familiar with the federal system

of India and hence my today's remarks will focus on some of the key aspects of India's federalism.

5. India as a federal system is about 60 years old, compared to more than two centuries of the United States or Switzerland or Canada. The federal system has served extremely well for India to promote our democracy, to strengthen the national unity and to achieve economic progress.

6. One of the reasons why India has been successful in this is perhaps the Indian federal system has one important attribute and that is the "flexibility" of the system. The design of the Constitution as well as the approaches adopted by our political elite, or to put it differently, the political economy of Indian federalism is responsible for this happy outcome. When I say political economy of federalism, I mean the strategic interplay between the political and economic forces.

7. While describing federalism, people have described it in many ways. For instance, some scholars have described federalism as

“administrative federalism;” some have argued for “market preserving federalism” and some others have described it as “coming together federalism” vs. “holding together federalism”. Countries like USA are supposed to be examples of “coming together” federalism while India is supposed to be an example of “holding together” federalism.

8. In my view, the important feature of Indian federalism is what in India we call the “cooperative federalism” feature with formal and informal rules for maintaining the political system as well as for the peaceful change management. This is the feature that gives the “flexibility” to our Federation.

9. I think that it is this “flexibility” which helped the country to maintain unity while strengthening the democracy and I do believe that the democracy is one of the deep determinants of India’s growth performance. The U.S. constitution, over its 200 years or more of existence, has been amended only 27 times while in India, we have amended the Constitution 94 times in the first sixty years. In my view, this is the strength and not weakness of our system.

10. There is perhaps no other country which is as heterogenous as India in terms of religion, language, ethnicity, levels of income etc. When India became independent, the States were formed which were more or less on the pattern that British had organized for administration in terms of various provinces. But there was a political demand that we need States organized on the basis of language as an organizing principle. This was a reflection of sub-nationalism and in 1956 the States Reorganization Commission divided the country into States on the basis of language. Now, fifty years later, there is a new demand coming up claiming for smaller units of administration as a language based big states are turning out to be too large to address the regional aspirations within a State. The country is responding to this demand and some large States like Uttar Pradesh and Bihar have already been bifurcated though language remains the same. However, I do foresee some further restructuring of the States. In the coming decades, there may be a few city states emerging as growing urbanization makes some of these cities so large that they will demand a separate political space.

11. The other examples of this flexibility are the 73rd and 74th constitutional amendments which were first introduced by Prime Minister Rajiv Gandhi and later piloted by Prime Minister Narasimha Rao. This resulted in the creation of the third tier of the government, namely Panchayati Raj in rural areas and elected urban bodies. This was in response to the need for effective decentralization or for the adoption of the “subsidiarity” principle in governance. I can give more examples of such politically alert responsiveness. What I wish to emphasize is that such a constitutional flexibility has been the secret of the Indian recipe for successfully nurturing democracy in a very large, but poor developing country.

12. I seek now your indulgence to highlight the other aspects of Indian federalism which is fiscal federalism. It is in this area that I think India’s performance is in contrast with many other emerging nations of Asia and Africa. I am going to spend more time on fiscal federalism because I know a little bit more about this area and its great importance in sustaining India’s federalism.

13. Like other federal countries, Indian federation has two major fiscal issues, namely vertical imbalance and horizontal imbalance. Vertical imbalance refers to the imbalance faced by the different levels of the government in their relative ability to raise revenues vis-à-vis their expenditure responsibilities. Unlike the federations of United States and Canada, in India, the vertical imbalance is somewhat more acute as the taxation powers of the Union (the central government) are overwhelming compared to those of States or provinces. Indian Constitution envisages the States to tax income from land, sales tax on goods and of course other local taxes such as property tax, while the Union government has the taxing powers for corporate income, personal income, taxes on foreign trade, taxes on manufacturing and services sector as well as on major mineral resources. Such division of labour made sense in the formative years of the country as the capitalist class or the national bourgeoisie wanted taxes on the mobile factors of production to be solely with the union government, while the large farmer and landlords or to use a more evocative phrase, the kulaks wanted that the powers of taxing income from land to be retained with the States. Regarding the expenditures, according to our constitution,

the expenditure responsibilities of the States are much higher calling for, as compared to the central government, much greater revenue expenditure for the supply of employment-intensive public services such as health, education, law & order, etc. A ratio measuring the share of revenue expenditure by the States in total revenue expenditure by the centre and the States together has been almost like a gravitational constant in India and has been about 57-58 per cent for the last 60 years while the share of the revenues collected by the States in the total revenues has been around 40%. These two ratios indicate the high degree of vertical imbalance in our federation. In addition to this vertical imbalance, there is also the acute problem of horizontal imbalance occurring among the constituent members of the federation or amongst the different states because of the differences in their fiscal capacities to supply essential public goods or services.

14. Once again, the degree and nature of horizontal imbalance in fiscal capacities is much acute in India compared to the advanced federations such as USA, Canada or Australia. For instance, in advanced countries, the ratio of highest per capita income and the lowest per

capita income amongst the states would be probably between 1.5 to 1.8, while in India it is in the ratio of 8:1. Even if we take off the outliers, this ratio will be 5:1. Hence, the fiscal capacities diverge sharply. As if such a high ratio problem is not enough, the poorer states are also some of the largest states in terms of population making the issue of horizontal equalization even more challenging. So, meeting the challenge of these twin imbalances is a fundamental issue facing India's fiscal federalism.

15. Since 1982, in the Canadian constitution, there is a clear mandate for horizontal "equalization". Section 36(2) of the Canadian Constitution commits the federal government to the "*principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonable levels of public services at reasonably competitive levels of taxation*" and this exercise is done annually. In India, the Constitution does not give such clear instructions.

16. To meet these fiscal challenges of vertical and horizontal imbalances, our Constitution has created an institution called the Finance Commission, which is an independent Constitutional body, appointed

every five years and which reports to the President of India. Its basic terms of reference are set by Art 280 of the Constitution:

- i. 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 Chapter I Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds;
- ii. the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States which are in need of assistance by way of grants-in-aid of their revenues under article 275 of the Constitution for purposes other than those specified in the provisos to clause (1) of that article; and
- iii. the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.

The first two tasks are aimed at meeting the challenges of vertical and horizontal imbalances while the third task has been added in 1993 when a Constitutional amendment formally added the third tier of government to the country's governance structure.

17. Unlike the Constitutions of Canada or Australia, Indian Constitution does not give any precise guidance to the Finance Commission as to how horizontal equalization is to be achieved. In the absence of such guidance, each Finance Commission works out its own approach, devising a formula for sharing of the taxes, i.e. for vertical sharing and horizontal distribution. The recommendations are usually based on the Commission's overall judgement for vertical devolution which takes into account the resource availability and needs of the Union government for fulfilling its own functions such as defence, internal security, debt repayment etc.

18. As regards horizontal distribution, it is formulaic, where the formula is based on objective and transparent parameters. The

preferred parameters are (i) area (ii) population (iii) fiscal efforts index and (iv) fiscal distance index.

19. Fiscal distance index is aimed at equalizing amongst the states the resource envelope for supplies of public services, while the fiscal efforts index is to minimize the “moral hazard” in such equalization payouts by incentivizing the tax efforts of the states. Area and population are indicative of the fiscal needs of the states.

20. Such an institutional arrangement has served the country well. The reports of all past twelve Finance Commissions were unanimously accepted by the Parliament and the country. In my view, this has been an important reason for the durability of the Indian federation.

21. The Finance Commission is not the only channel for fiscal transfers in India. There is yet another institution, namely the Planning Commission. Also, block grants are given by the different Ministries. Historically, the share of Finance Commission transfers have been roughly 65-70 percent and the remaining have been the other transfers,

including Planning Commission transfers to States. The Planning Commission is an executive body and not a Constitutional body like the Finance Commission. While the Finance Commission's role is to ensure adequate resources for assuring reasonable levels of public services in every state for meeting their current expenditure needs, the Planning Commission transfers are for improving developmental outcomes through increased infrastructure and related public investments in the States. These are direct transfers to the state governments. Of course, from the budget, there are also indirect transfers from the central government. Subsidy programs such as food and fuel subsidy or schemes involving tax expenditures are examples of such indirect transfers. The Finance Commission's remit is only for devolution of the tax revenues and does not cover what in Canada you describe "spending power" of the central government.

22. The Finance Commission's devolution of taxes takes place under Art.280 of the Constitution, but there is also Art. 275 which enjoins the Commission to give State specific grants to ameliorate particular problems faced by individual States. It is through these grants that the

Finance Commission meets the requirements of what we call 'special category' States, which are essentially micro States which have geographically difficult terrain such as mountainous regions and which are relatively more sparsely populated. The share of these Art 275 grants in the total Finance Commission's transfers has been between 15-18 per cent.

23. While the Finance Commission transfers are predominantly formulaic, the Planning Commission transfers tend to be more state-specific depending on the developmental needs of an individual State.

24. While historically, the Constitution recognized only two tiers of government, namely the Union and the States, a major Constitutional amendment introduced by Prime Minister Rajiv Gandhi formally created the third tier of government, namely Panchayats in villages and urban local bodies. These are elected bodies. Technically, the third tier is still under the political authority of the States and it is the States through their legislative assemblies that exercise political control over the third tier. Of course, it is recognized that the third tier do have fiscal needs and

these are supposed to be predominantly met by sharing States' revenues. The Constitutional amendment also created "State Finance Commissions" for the devolution of state governments' revenues to the third tier. Recognising that these resources may not be adequate, the new Amendment also gave the third task of the Finance Commission which is to give grants to the third tier which are supplementary to the devolutions by the State Finance Commissions. This has become now an important function of the Finance Commission.

25. Over time, India's fiscal federalism has been flexible enough to change its structure. For instance, till 15 years ago, the Constitution envisaged sharing of revenues tax-wise; in other words, share could be at different rates for corporate tax, personal income tax or manufacturing taxes or import duties. This feature created a perverse incentive structure for India's tax policy. For instance, this gave no incentive for central government to reduce import duties as constitutionally, it could retain all earnings from such import tariffs. When India embarked on its new economic policy in 1991, the Tenth Finance Commission recommended the pooling of all these taxes and have a common sharing

formula in order to rationalize the fiscal system. In my view, this paved the way for India's tariff reforms which saw one of the most dramatic reduction in tariffs when they came down from 150 per cent to 10 per cent. Similarly, the support to the third tier through Finance Commission grants has also given momentum to effective decentralization programme in India.

26. However, there are now new challenges for India's fiscal federalism. Hence, in our recent report, we have proposed "a new architecture" for India's fiscal federalism. What are these challenges? What are the elements of the "new architecture"?

27. As I mentioned, compared to the other federations, India has much higher incidence of vertical imbalance and it is increasing thanks to growing share of services sector in the Indian economy which only the Union government can tax, while the responsibilities on the States are increasing due to new "social entitlements" arising out of the "human rights" approach to economic development. This mismatch needs to be corrected. Towards this, what we have proposed in our report is a

common indirect tax base for the central and state governments by introducing GST (Goods and Services Tax) which is a consumption tax. Our GST proposal is on the lines of the Canadian system. This means a dual GST system where both the Union and the states collect taxes, but with a common tax base. Such a GST system will substantially reduce the vertical imbalance as States will have now powers to tax services sector, the largest and growing sector of Indian economy. Hence, an introduction of the GST is a key element of the proposed new architecture. We have also proposed a “Council of Finance Ministers” as a consultative and supervisory institution to manage the new tax system which will be jointly run by the centre and the states. This would give the States a greater say in India’s indirect taxes.

28. India is now on the path of rapid urbanization requiring new public goods and supply of efficient urban public services. Given this new challenge of urbanisation, the States now demand for further reform of India’s fiscal federalism to give an enduring fiscal base to the third tier. The proposed GST which is a consumption based tax, provides such an opportunity of offering a tax base to the third tier. Such a sharing on the

constitutional basis will enormously improve India's cities and villages. Another issue which has now come up for fiscal federalism is the share in the rents from "national commons". India is now discovering large off-shore reserves of hydrocarbons. There will be large rents from these vast resources and sharing of these resource rents has now become an issue for our fiscal federalism. Currently, such rents including the rents from "spectrum" allocation to telecom companies are the preserve of the Union government. The States want a share in this. In our report, we have proposed a Constitutional amendment to achieve this.

29. Yet another challenge for our fiscal federalism is the challenge of environment i.e., green federalism. Our current system of fiscal transfers do not recognize adequately the environmental externalities. For instance, States with large forests are now asking to be compensated for their providing public goods or environmental services to the entire federation. Similarly, States with large hydel power potential would like to be compensated for providing clean power for the federation. Similar issues have also come up regarding water transfers between different States sharing the same river basin. Towards this, we have made a

modest beginning in Finance Commission's report by outlining an incentive structure to the States that supply environmental services.

30. These are some of the new challenges facing India's fiscal federalism requiring new approaches. I am quite confident that given our "cooperative federalism", we would be finding innovative solutions to such issues and create a new architecture for India's fiscal federalism.