FISCAL FEDERALISM IN INDIA: EMERGING ISSUES

Presidential Address

By
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Professor Kamaiah, Dr. Sen and Friends,

I am thankful to the organisers for giving me this opportunity to participate in this Seminar and deliver the Presidential Address.

I have gone through some of the papers and I find them very interesting, stimulating and illuminating. I do not have much to add to what has been said, but I am taking this opportunity to highlight the emerging issues due to two significant events in fiscal federalism in India.

In our Constitution, the Finance Commission was devised as a mechanism for providing predictability in the fiscal federal relations for five years and flexibility to review and revise the relations generally every five years only. Planning Commission was an innovation of Union Government that gave flexibility to accommodate fiscal compulsions of socio-political developments from time to time. The Finance Commissions, thirteen of them and the Planning Commission determined the federal fiscal relations for well over six decades since independence, till recently with the abolition of Planning Commission in August,
2014, the report of Fourteenth Finance Commission in December, 2014 and establishment of NITI Aayog (National Institute for Transforming India) as part of “cooperative federalism” in January 2015 constitute significant developments.

The origins of NITI Aayog could be traced to the disenchantment with the Planning Commission on two important fronts, viz. the perception that it was not able to capture what has been described as the new realities of macro-economic management at the national level, and that it has not been conducive to sound fiscal relations between the Union and the States.

Though the nomenclature of NITI Aayog is different, the process of setting up is similar to Planning Commission, viz. through a Cabinet Resolution based on the initiative of Prime Minister. The National Development Council has been replaced with a Governing Council but with a similar composition. However, NITI Aayog has an additional option of creating Regional Councils. NITI Aayog’s composition and structure remain similar to Planning Commission in terms of its being co-terminus with political cycles of the Union Government.

It is different from the Planning Commission in terms of articulating what has been described as “the new realities”, and expressing intention to change the nature of working of the organisation to capture the “new realities”. The articulation also emphasizes that States have been co-opted as partners and will be consulted in the formulation of policies. Further, its role has been defined to go beyond the limited sphere of the public sector and the Government of India, and it is intended be a catalyst to the developmental process.

The Fourteenth Finance Commission submitted its report in December 2014, a few days ahead of the announcement about establishment of NITI
The 14th Finance Commission took cognizance of concerns relating to Union-State fiscal relations gathered from its interactions with Ministries in the Union, States, Political parties and intellectuals. Accordingly, a comprehensive view of Union-State fiscal relations was taken, recognising that there are three channels of fiscal transfers. The first one relates to tax devolution as a share of divisible pool of taxes, which is in the nature of entitlement of the Union and States based on assessment of their resources and needs by the Finance Commission. The second relates to grants-in-aid in the recommendations of Finance Commission, which are in the nature of transfer of funds from Union to States, unlike devolution which is sharing of funds. The third channel is transfer of resources by Union to States outside the award of Finance Commission, essentially by the Union Government which in the past was, on the advice of Planning Commission. Consideration of the contours of the third channel of transfers was considered essential by the 14th Finance Commission for taking a comprehensive view of fiscal relations in making its recommendations mainly on core mandate.

There were suggestions that the Finance Commission could be made a permanent body and that the working of the Planning Commission should also be entrusted to the Finance Commission. The 14th Finance Commission expressed itself against such a suggestion. However, it suggested that the transfers from the Union to the States outside the recommendations of the Finance Commission should be through a new institutional arrangement that should involve Union, States and domain expertise, ideally under the aegis of inter-state Council. In a way, therefore, the importance of involvement of the States in designing the transfers from the Union to the States outside the Finance Commission was
emphasised. There is, thus, a convergence between this approach of the Finance Commission and the objectives of NITI Aayog.

It is very clear that the Finance Commission has recognised the importance of transfers from the Union to the States outside the mechanism of the Finance Commission. It made some recommendations for institutional arrangements for such transfers outside the Finance Commission that would strengthen the Union-State fiscal relations. In many ways, therefore, the rebalancing of Union-State fiscal relations contemplated by the Fourteenth Finance Commission will depend on the manner in which transfers outside the Finance Commission are designed. As per the official notification, NITI Aayog appears to be the agency that would be central to this task, since its functions described in fifteen heads under the title ‘New Role’ include ‘Cooperative and Competitive Federalism; Shared National Agenda; States Best Friend at the Centre, Decentralised Planning and Vision and Scenario Planning’.

In the inevitable process of rebalancing Union State relations consequent upon the recommendations of the Fourteenth Finance Commission, several issues emerge and NITI Aayog has a responsibility to address those, as per its mandate. I propose to address these issues now.

Firstly, the 14th Finance Commission has provided an operational framework to dispense with the distinction between Plan and non-Plan. This should enable NITI Aayog to take a comprehensive and in-depth view of the strategies and policies of each sector in general and public expenditures in each sector in particular. The removal of a distinction should also enable reversal of the neglect of non-Plan activities like maintenance and “general services” often
described as non-developmental expenditure and also maintenance of existing public assets created under the Plan.

In the budget speech for 2015-16, the Finance Minister, Mr. Arun Jaitley, said: “This is the last year of the 12th Plan. Successive committees have questioned the merit in having Plan and Non-Plan classification of Government expenditure. A broad understanding over the years has been that Plan expenditures are good and Non-Plan expenditures are bad. This results in skewed allocations in the Budget. We need to correct this and give greater focus to Revenue and Capital classification of Government expenditure. We have, therefore, decided that the Plan-Non-Plan classification will be done away with from fiscal 2017-18. The Finance Ministry will closely work with the State Finance Departments to align Central and State Budgets in this matter.” The removal of distinction is not merely an issue of classification; it is more than that, and NITI Aayog has a legitimate role in it.

Secondly, the indicative ceiling on transfers outside the Finance Commission has been removed. At the same time, the rationale for such transfers has been clearly indicated in terms of externalities, minimum standards of services across the country, and inter-state infrastructure in select States. In some ways, the legitimacy and the rationale for transfers through a body such as NITI Aayog has been established by the Finance Commission – a Constitutional body. In this regard, NITI Aayog may consider the experience of mechanisms of fiscal transfers in other federations since almost all of them deal with fiscal transfers as distinct from sharing of divisible pool of taxes which is the remit of Finance Commission.
Thirdly, a new institutional mechanism has been proposed for transfers outside the recommendations of Finance Commission in the interest of sound fiscal federalism. NITI Aayog could take advantage of the underlying logic of such institutional mechanisms and devise its work methods consistent with the spirit of the recommendations. The sectors and activities for which Union transfers to States should take place, the design of such schemes and the distribution of resources among the States will have to be worked out in a forum that has representation of the Union, the States and the domain expertise.

Fourthly, the 14th Finance Commission has eschewed prescribing conditionalities or policies that are considered desirable at a national level. Some of the overlap between the Finance Commission and the Planning Commission has been addressed by the Finance Commission by relinquishing most of the State specific or project specific grants-in-aid and associated conditionalities, in its recommendations. For example, incentives or disincentives or rewards to States for appropriate policies have been left out of the Finance Commission’s considerations and, thus, legitimately fall under NITI Aayog. By relinquishing its marginal role as promoter of economic reforms periodically, the Finance Commission has put additional responsibility on NITI Aayog to promote appropriate policies and schemes both in the Union and among States on a continuous basis.

Fifthly, successive Finance Commissions have recognised the fact that budgetary situation of the Union government had direct bearing on state finances, but could not impose any conditions for reform of finances of the Union government nor could evolve a system under which the Union government adhered to its commitment to fiscal responsibility. In the current federal fiscal
structure of India, revenue account transfers from the Union to the States constitute more than one-third of the total revenue resources of the States, and hence if Union’s revenue performance declines, states also get affected. The creation of incentive fund suggested by the 11th Finance Commission, the conditional transfers and debt relief linked to fiscal responsibilities of States by the 12th Finance Commission and, incentive grants recommended by 13th Finance Commission were instrumental in bringing about prudent management of State finances. Currently since challenges relate to Union finances, the 14th Finance Commission emphasised the importance of fiscal councils. A weak fiscal position of the Union not only has bearing on macro-economic management and stability, but also impacts State finances. NITI Aayog has an opportunity and, indeed, an obligation to contribute to fiscal responsibility in both Union and State Governments consistent with developmental priorities and sound fiscal-federal relations. NITI Aayog is in a better position to contribute to these objectives since it is a continuing body and plays a critical, though advisory, role in regard to Union finances, State finances and transfers from Union to States on a continuous basis.

Sixthly, the Finance Commission has eschewed categorization of States, but this does not, in any way, restrict freedom of NITI Aayog for categorization for specific purposes relating to development. In particular, the States of North-eastern region would require special attention in this regard as explained in the report of the 14th Finance Commission itself. In a way, therefore, the responsibility relating to special problems of select Stats would squarely be that of NITI Aayog.
Finally, areas under Schedule VI of the Constitution in North-eastern States remain outside the ambit of the measures recommended by the 14th Finance Commission for Panchayats and Municipalities. These have been excluded from the consideration of the Finance Commission in the Terms of Reference. This was necessitated by the fact that the Constitution mandates the Union Government to play a direct role in supporting the development of these areas. However, the quantum of assistance given over the years to these regions by Ministries in the Union Government has been very limited. NITI Aayog could consider a larger assistance and more effective intervention for the up-gradation of administration as well as development of these areas to make-up for what the Finance Commission was not permitted to do.

It is quite conceivable that Way Forward, the constitution of the Finance Commissions could also undergo some changes. Finance Commission is essentially an institution in the nature of an arbitrator giving award in matters relating to sharing of divisible pool of taxes between Union and States, and among the States. However, in this framework, having a serving Member of the Planning Commission, who is a functionary of Union Government associated with political parties, in the Finance Commission as a part time Member, clearly indicates that an interested party is also officiating as an arbitrator – a clear case of conflict of interest. Since the distinction between Plan and non-Plan has been dispensed with by the Finance Commission, and since the overlap between transfers through Finance Commission’s recommendations and other transfers have been almost eliminated, this is an appropriate time to discontinue the practice.
The 14th Finance Commission emphasised the role of State Finance Commissions and recognised the critical role of States in regard to local bodies. In this, there is an element of empowering of States in the fiscal management. NITI Aayog could revisit the institutional arrangements for planning at State level to make State level planning institutions more effective. Approach to planning at level of local bodies could be reviewed, taking account of the recommendations of 14th Finance Commission, especially on resource mobilization, including bond financing.

The Terms of Reference of Finance Commissions other than the core Terms of Reference have been expanding over a period and have also been varying. Many of them had overlap with work of the erstwhile Planning Commission, while a few others related to tax reforms, expenditure reforms, public enterprise reforms, pricing of public-utilities, etc. Further, the recommendations in regard to other Terms of Reference have provisionally been treated as some suggestions and seldom acted upon vigorously. At the same time, the other Terms of Reference reduce the focus and the attention that the Finance Commission could give to its core Terms of Reference. The 14th Finance Commission recognised this and limited its recommendations relating to non-core Terms of Reference essentially to areas that have fiscal implications. NITI Aayog may legitimately address on a continuous basis the undeniably important policy issues often incorporated in other Terms of Reference of the Finance Commissions. NITI Aayog may also contribute to rationalisation of the other Terms of Reference of the 15th Finance Commission by attending to them on its own initiative.

The success of NITI Aayog will depend on the manner in which new realities of economic management are captured in the processes of planning
being evolved by it. It will also depend on the processes that it institutes to rebalance the fiscal relations between the Union and States, mainly relating to transfers from Union and States outside the devolution recommended by Finance Commission. There are two institutional structures that determine the nature of fiscal federalism in India. One, namely, Fourteenth Finance Commission has done its job of addressing new realities. The second, Planning Commission in the past, and NITI Aayog now will also hopefully address new realities, sooner than later, to avoid a vacuum.

Thank you very much.