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Fiscal Federalism in India: Some Reflections

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Friends,

I had a brief exposure to the expertise available with Vidhi Centre for Legal Policy in connection with the work relating to the 14th Finance Commission. I was impressed with their professionalism and commitment. I, therefore, felt that my admiration for their valuable work should be demonstrated by my participating in this event, to release the Briefing Book on Cooperative Federalism.

This book is valuable because it addresses specific issues of contemporary relevance, and suggests approaches around which discussions may take place, and way forward contemplated. This book, therefore, should be of interest to a broad range of policy-makers, academics and jurists.

The book gives a succinct account of the concept of cooperative fiscal federalism currently under intense debate. Theory of fiscal federalism and its practice in India is one but important element of cooperative federalism and it is well documented in great detail by many eminent scholars. In particular, my friend, Professor M. Govinda Rao is an acknowledged authority on the subject. I cannot add anything more today to what has been written by him on the subject.

One of the reasons for considerable contemporary debate on the subject of this book is the report of the 14th Finance Commission, and perhaps, I am expected to dwell on it. Having been a co-author of the report, it may not be appropriate for me to explain, elaborate or defend, what has been stated.

So, I consulted the organizers on what I should do. We agreed that I will share with you personal reflections in terms of anecdotes that are relevant to the themes covered by the book, and then give an overview of Fiscal Federalism in India

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As a Student

As a student of political science and as a lecturer in Economics in the University, I had occasion to get familiar with the broad contours of Federalism, Federal Constitution and Indian Federation. In the interview by the UPSC for my IAS examination in Feb., 1964, half of the time was taken related to the reorganization of States on a linguistic basis. At that time the fear expressed was that the division of the country into States based on language may have the potential of serious conflicts among them, undermining national unity. In this regard, a member of the Commission recalled the recent history of European countries where it took almost two world wars to settle the differences among nations, based on language. I argued that organisation of States based on language was appropriate for Indian conditions, and that it would strengthen but not weaken the national unity. That did not fetch me good marks in the interview.

At State level

My first official exposure to the Union-State fiscal relations was in my capacity as Deputy Secretary (Planning) between 1969 and 1976. We looked to the guidance of the Planning Commission for expertise. Even as a young Deputy Secretary, I came into contact with three different Members of the Planning Commission, viz., Mr. B. Venkatapaiah, Dr. Sukhamoy Chakravarty and Dr. Minhas. Dr. Chakravarty constituted a Task Force on multi-level planning to identify the parameters for deciding on optimal distribution of functions at different levels of planning, viz., Union, State, District and Local Bodies. I was nominated as a Member. Dr. Minhas, Member (Planning Commission) and Mr. Ashok Mitra, ICS, Secretary of the Planning Commission, ignored the protocol, and visited me in my office to have some discussions on regional planning. On the basis of our suggestions, changes were made in the identification of areas for providing incentives for industrial development, development of drought areas and what was then called rural manpower program. Among those who encouraged such interaction in the Commission were Dr. Vaidyanathan, Mr. Anand Sarup and Dr. Kanungo, all chiefs of Divisions. In brief, there was mutual trust and considerable interaction between States and Union with full recognition of the high level of expertise available with the Planning Commission.

There were moments of lighted hearted comments also. For instance, Professor Minhas said in a meeting "Planning is best in Andhra Pradesh but development is most rapid in Punjab, with no planning."

At a political level, however, there have been some interesting incidents. After the adoption of Gadgil formulation for distribution of plan assistance among the States, the State Government did not consider it necessary for obtaining a formal approval of its plans

from the Planning Commission in order to get plan funds. Mr. Brahmananda Reddy as a strong Chief Minister wrote a letter to the Prime Minister, Mrs. Indira Gandhi, who was the Chairman of the Planning Commission, suggesting that the Planning Commission may send their comments on the draft plan of the States so that the State Government may consider their suggestions. He added that it was a waste of airfare for a large team of officials from the State Government to visit Delhi and spend two to three days, having elaborate consultations through various Working Groups. Deputy Chairman, Planning Commission, however, persuaded the Chief Minister to send a small team for one day.

After the imposition of emergency, the equations between Union and States seem to have changed. For example, for some time, the Planning Commission was keen that each State should have a Planning Board. The State Government was not keen, though central assistance was available for the State. We were aware that the central assistance will disappear in five years, and the State will have to hold the baby for decades. However, Mr. Vengala Rao, then Chief Minister, on return from a visit to Delhi, said: "I have been told in Delhi that we should have a Planning Board. Let us have one." At the suggestion of my Secretary, I scribbled a few names for consideration, which were simply approved. That was the seriousness with which the persuasion from the Union was accepted.

In Union Government

I also had some exposure to some aspects of Union-State relations between 1977 and 1983 in my capacity as Director in the Ministry of Finance and Advisor in World Bank assisting Indian Executive Director dealing with finance and implementation of World Bank projects. In these discussions, at a technical level, the concerned Ministry at the State and Union level seemed to be on the same page, and keen to adopt World Bank standards. The Finance and Planning Departments at the State and the Central level generally wanted to maintain their policy autonomy. In these cases, the tension was more between the sectoral Ministries and Finance as well as Planning Departments both at Union and State levels.

The State Governments are expected to deal with World Bank only through the Government of India. The States, by and large, accepted this position. Once, Mr. M.G. Ramachandran as Chief Minister visited World Bank. He called on the vice President Mr. Hopper. Mr. Hopper asked the Chief Minister as to how the World Bank could fund projects when the priorities of the party in power in Government of India differed from the priorities of the party in power at the State level. MGR, as usual, replied crisply in two sentences in Tamil. The Secretary to the Chief Minister translated it, but in ten sentences. After the meeting, the Vice President commented to me, in private: "Tamil must be the most eloquent language in the world. It required ten sentences of English to translate two

sentences of Tamil.” Actually, MGR said: “He is asking a tricky question. Answer carefully.” The Secretary in his translation explained how the priorities may differ, but there are processes by which they converge and agreements are reached between Union and Tamil Nadu.

In brief, generally the States and the Union come together when they approach the World Bank. This shows the general attitude of the Chief Ministers in dealing with multi-lateral institutions or other countries, which is always with due respect to the Union Government. Of course, a part of the reason for this is the relevant constitutional provision.

With State again

I joined as Secretary in Andhra Pradesh in Sept. 1983. Mr. N.T. Rama Rao had by then taken over as Chief Minister. I went for discussions with the Planning Commission, seeking approval of the annual plan. The Planning Commission officials insisted that allocation should be fully provided for all on-going schemes before taking up new ones, since it will be a waste to take up new projects when incomplete projects are starved for funds. We from the State tried to convince that we are aware of these general principles, but we had to take into consideration the changing priorities in any Government. The Planning Commission was adamant. Finally, I had to say: “If the people of Andhra Pradesh wanted allocations to be made only to on-going projects, they would have elected the on-going Government. Their preference was for new schemes and that is why they have elected a new Government.” After that, I added: “In Government of India also, there are many on-going projects which are starved of funds, but new projects are taken up even if there is no change in the Government.”

Of course, we had lighter moments also at professional level. For instance in the financial resources meeting, the concerned advisor compared the comfortable fiscal position of Tamil Nadu with the difficult position of Andhra Pradesh, and asked us to follow the example of Tamil Nadu. I responded: “Sir, give us a Chief Minister who cannot talk. MGR is in the hospital for a long time and cannot talk. Therefore, there are no new expenditures in Tamil Nadu. For us in Andhra Pradesh, we have a very active Chief Minister who talks and makes promises, and hence large expenditures.”

The change in equations between the Union and the State was also evident in the infrequent meetings of NDC and the declining importance of the National Development Council by 1980s. In one instance, there was a tension before the meeting because some Chief Ministers were expected to walk out of the meeting of NDC as a protest against the Union Government’s dismissal of some State Chief Ministers. As usual, I sent in advance a

draft copy of the proposed speech of NTR to the Planning Commission, and confirmed on the morning of the NDC meeting, that the Chief Minister had actually rehearsed the speech at 8 a.m., ahead of the meeting at 10 a.m. In the NDC meeting, as usual, Andhra Pradesh was called first. NTR did not read the speech that was rehearsed in the morning and supplied to the Planning Commission. Instead, he pulled out a sheet of paper from another pocket and read out a political speech. He led a walk out of the NDC. I was shocked at the surprise thrown at us. As he was walking out, he signaled to us that we could continue to be in the meeting. After a few minutes, an announcement was made that all the officials who had come to assist those Chief Ministers who have walked out of the meeting, should vacate the hall. In brief, we were thrown out of the meeting of the National Development Council, though we would have been only observers. That did not augur well for the functioning of NDC or for relationships between State Government officials and the Planning Commission officials. The divide between Union and States was in contrast with the trust and the respect till 1969 and early 70s.

During this period, I had an occasion to participate in a seminar in which Mr. C. Subramanian, former Finance Minister of India and former Deputy Chairman of Planning Commission participated. I argued with him that the Planning Commission's hyper activity was inhibiting the dynamism of several states like Andhra Pradesh. His argument was that greater freedom to some states like Bihar would do greater harm to such States, and hence to the country. Hence, according to him, it was necessary for the Union to give detailed guidelines, and to avoid discrimination such guidelines had to be uniform. At that time, it did not strike me to explain to him that there can be competition for performance among the States which could replace the competition for backwardness to attract funds from Government of India. Also, it did not strike me to say that the resources may be allocated or the priorities determined by the Union, but the implementation was still left to the individual States concerned. Nor could I explain the then recent developments in regard to public choice theory on the functioning of governments. With my experience in RBI, I feel that periodical structured interaction among the State Governments will facilitate both cooperation and competition among them.

Professor Govinda Rao reminded me of one of my interactions from Andhra Pradesh with a Finance Commission, and I quote: "Perhaps, you do not recall an incident when the Ninth Finance Commission called a meeting of the State Finance Ministers to discuss the "Normative approach" they were required to adopt as per the ToR. There was a background paper prepared by the Secretariat of the Commission of the Commission (I was the Economic Adviser!). My recollection is that nobody from the Finance Department attended from AP. You came in briefly to the meeting to state that the Union Government had no

business to tell the Commission what approach it should adopt and, therefore, the discussion on any approach paper on the issue is not fruitful. I did not know you much at that time, but I thought it was a brilliant intervention.

With Reserve Bank

I had occasion to interact with the State Governments as soon as I joined as Deputy Governor, Reserve Bank of India, in 1996. I proposed that we should have a Conference of the State Finance Secretaries every six months and, in any case, at least once a year. Such a Conference could consider not only matters relating to their borrowing programme, but all aspects relating to the relationship between RBI and the State Government. The agenda for the meeting itself was finalized in consultation with the State Finance Secretaries. It covered some subjects which overlapped with the Ministry of Finance of the Union Government. The invitees included Finance Secretary, Comptroller and Auditor General, Controller General of Accounts and Planning Commission. This was a forum for discussion and deliberation among the State Finance Secretaries periodically, but technical work was done by RBI or through working group of the Finance Secretaries with support from RBI. This initiative was supported fully by Dr. Rangarajan, and later by Dr. Jalan. It is interesting to note that some State Governments passed legislation limiting debt and guarantees, even before the Union Government ventured on it. Reserve Bank of India was transformed from being a wing of the Union Government to that of being a national institution serving the Union and the States. In brief, Reserve Bank of India became a fiscal adviser to the States, in addition to being fiscal adviser to the Union.

Mr. Vinod Rai who was Finance Secretary of Kerela at that time told me that he had requested a Finance Secretary of Union Government to convene a similar meeting of State Finance Secretaries every year so that they could discuss issues of common interest with the Union Government. Apparently, the then Finance Secretary responded to him: "We do not want such meetings. The State Finance Secretaries may gang up against the Union Government." This was in late 1990s.

After I became Governor in 2003, I continued this tradition of annual meeting of the Finance Secretaries. In addition, I used to call on the Chief Ministers whenever Board Meetings were held. We opened RBI offices even in smaller States, though the offices were small.

I recall a comment made by Montek after he attended one of these meetings. He said: "I say, Venu, the State Finance Secretaries are a very bright lot and very impressive."

I jocularly responded: "State Governments are more careful than the Union Government when they select their Finance Secretaries. They have hard budget constraints."

Incidentally, in regard to Urban Cooperative Banks, RBI proposed changes in law relating to Cooperatives, and Governor Jalan announced the need for it in a Statement on Monetary Policy. The proposal, in original or in any modified form, was not acceptable to Government of India. Hence, we in RBI took recourse to second best option, i.e., an institutional mechanism to coordinate with individual States. Most of them signed a Memorandum of Understanding with RBI for this purpose; starting with BJP ruled Gujarat and Congress ruled Andhra Pradesh.

With Finance Commission

I must confess that I had given a speech in July 2012 arguing for empowerment of States, and that was not a secret since there were articles critically criticizing my stand in the speech, I think by Suman Berry and Swaminathan Iyer. It was, therefore, a surprise that I was chosen as Chairman of Finance Commission by the Union Government immediately after the speech.

In fact, my name was proposed without my consent. I was persuaded by the leadership then, viz., Pranab Mukherjee, Manmohan Singh and Chidambaram, to accept the position. Mr. Chidambaram said that the Union Government was keen to have a person who in their view would be acceptable to Chief Ministers also, some of them being very sensitive to decisions of the Union.

I made it clear in a public appearance in Delhi, a day before I took charge as Chairman, Fourteenth Finance Commission that I totally disown whatever I said till then on Union-State relations!

I was persuaded to be Governor of Reserve Bank and Chairman of Fourteenth Finance Commission, by the Union Government. So, I cannot be against the Union Government, even if I was considered to be pro-State Governments in my inclinations in earlier avatars!

An Overview: Some Thoughts

Based on what I read (including in this book), my experiences and interactions, let me share some thoughts on fiscal federalism in India.

First, in the context of working of the Constitution, it is remarkable that national integration in India has been facilitated by the Union which recognised and accepted

diversity as it emerged and asserted from time to time. This is reflected in the process of States' reorganization since 1950. India had to simultaneously design units constituting federation that are supposed to constitute a "Union". That unprecedented task has been performed well, ingeniously, despite recent aberrations. The practice of federalism has, in many ways, strengthened our national integration.

Second, in regard to political context, there are very few developing countries which can boast of peaceful change of political regimes in a systematic manner. Credit for that should go as much to the States as to the Union. All elections, Parliamentary as well as State Legislative, are conducted wholly by the bureaucracy belonging to different States under the aegis of Central Election Commission. Union Government has no machinery of its own to conduct such operations, and the Election Commission operates through State Governments.

I want to make a comment not so irrelevant to the theme. The anti-defection law, as it operates today, undermines the role of Rajya Sabha as Upper House representing States. The Members of Parliament are bound by party disciplines imposed through issue of whip. In fact, in recent years, even the distinguished members nominated to Rajya Sabha by the President are aligned to parties. But, the standards of governance in recognised political parties, is not reassuring in terms of conduct of intra-party elections funding, etc. Normally, when an entity is given legitimacy by a public authority, be it a corporate or a bank, the relevant authority accepts the responsibility to assure the public about the standards of governance.

It appears that many political parties, be it at State or Union level, are individual leader centric in the absence of enforceable standards of governance in them. This is a broader issue, but has consequences for Union-State relations. Political choices for rank and file in a party on issues affecting States may be restricted to conformity or confrontation than deliberation and debate since the latter may be perceived as purposeless or of no consequence.

Third, it is interesting to note that since 1969, leadership at national level, while extending promises in the context of Parliamentary elections, does not distinguish between what the Union is expected to deliver under the Constitution, and what should be left to States. In a way, in this process, Prime Ministers may be gaining political legitimacy for the Union to encroach into the territory of the States contemplated in the Constitution. The electoral manifestos are seldom scrutinised, even in public debates, about relative roles of Union and States. This blurring of responsibilities of Union and States in the election

manifestos may tend to encourage a blaming game between Union and States. It may also encourage labeling of schemes after the leaders by the Union, as well as relabeling of the same schemes at the State level, depending on the political equations.

Fourth, in terms of economic management, many if not all States, have improved their capabilities to plan, allocate resources, and implement policies and programmes. The gap between expertise at Union level and at State level in many cases has narrowed in recent years for several reasons, especially technological development and globalisation. Many States have devised their own models for development, be it 'Gujarat' or 'Bihar' or 'Andhra Pradesh'. In fact, many States legitimately claim that almost all flagship schemes of Union Government in recent years were, in fact, initiated at State level in some States. They were initially viewed with dis-favour by Union Government. The net result is that in current debates, Union is often being urged to follow this State model or that State model, rather than the States being urged to follow a model prescribed by Union Government. The practice of federalism in India has, in many ways, empowered the States, despite increased recourse to discretionary fiscal transfers from Union to States. States are being encouraged to compete, to perform and deliver.

Fifth, in regard to external sector, in some developing countries, especially in Latin America, and in some developed countries of Euro Area, sub-national governments borrowed heavily, often in foreign currency, which resulted in crises at national level, warranting assistance from IMF. Our constitutional provisions virtually prohibiting external borrowings by States ensured that we do not face such problems. Similarly, in view of the constitutional limitations warranting Union's approval of borrowing programme of a State as long as it owed debt to Union enabled Union to exercise restraint on borrowings by States. The Union has exercised its powers responsibly, despite some complaints. The fact that the States entered into an agreement with RBI to manage their debts provided comfort of the financial markets. In brief, the fiscal federalism as practiced in India has not put pressure on external sector or public debt management, unlike in many emerging economies.

Sixth, the States in general, with a few exceptions, managed their fiscal affairs responsibly, albeit with considerable support from Union Government. The 12th Finance Commission chaired by Dr. Rangarajan laid a solid foundation for fiscal responsibility of States in general. Their fiscal management during the recent years has been, for most part, far more prudent than that envisaged by the 13th Finance Commission. Some analysts aver that in recent past Union took advantage of fiscal consolidation by States to expand its fiscal space. The main issue in federal fiscal relations in recent years has been the States' contention of over reach or encroachment of Union Government into States' functional and

fiscal space, both quantitatively and qualitatively. I believe that this issue has been significantly addressed very recently.

Seventh, the States, especially under the leadership of regional parties, perceive the efforts of Union Government to empower local bodies as politically motivated in order to undermine the policy space available to Government at State level. They suspect that a centralizing tendency in several schemes of Union Government coupled with the thrust towards empowering local bodies has the effect of squeezing the appropriate policy space to States in regard to activities legitimately and rightly allocated to them.

Eighth, there is considerable frustration with the delay in adoption of Goods and Services Tax. Yet, we cannot ignore the fact that an extra-ordinarily messy tax system that we had inherited has been rationalized in an impressive manner with valuable inputs from several Finance Commissions.

Ninth, in terms of arrangements for fiscal transfers to sub-national grants and their efficacy, it will be appropriate to compare our experience with other federations among emerging economies, such as South Africa, China, Brazil, and Indonesia. The arrangements for transfer in these countries provide a far greater discretion to the federal government than in India. The primary mode of transfers is grants from the higher to lower level of government, and such transfers are often, discretionary. These countries do not have constitutional provision for sharing of national level taxes, unlike in the case of India and Pakistan. Indian federal fiscal system has provided both flexibility and predictability in transfers because of the constitutional provision of sharing of taxes to close the vertical fiscal imbalance and specific transfers to address other priorities. It is no exaggeration to say that India has a far more robust fiscal-federal framework, in law and in practice, than any other comparable federation in the world.

Finally, and to conclude, we in India can be legitimately proud of working of our federation that simultaneously strengthened governance capabilities of States, contributed to national integration, and enabled robust fiscal federalism, though there are several areas that need to be improved. The work initiated by Centre for Legal Reform is an excellent initiative to build on what we have achieved so far, address issues as they emerge, and contribute to the closely inter-related reforms in both law and policy. I eagerly look forward to benefit from intellectual stimulation and debates that would be inspired by this Briefing Book.

I wish you all the best.