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The Centre and the States

Excessive Centralisation Hampers Economic Freedom

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The economic freedom scores and inter-state rankings in this report facilitate the tracking of a state's performance over time. India is a federal country, and this is set out in the Indian Constitution. However, one doesn't often appreciate how centralised India is, and the extent to which the centre impinges on the freedom of the states.

The widespread use of the phrase centre-state relations is itself symptomatic. It is an expression that is very widely used but reflects a patronising mindset, suggestive of a centre and a periphery. The bedrock of all Indian policy should be the Constitution, which always refers to a union government, not 'the centre.' Yet the Commission that was set up to study relationship between the union and the states, as a successor to the Sarkaria Commission, with a report submitted in March 2010, was also called a Commission on Centre-State Relations.[1] The point that India is excessively centralised, especially in comparison with China, has often been made.[2] In part, the reason was historical and colonial and this was reinforced by developments after Independence. "Looking back and as is well known, in the first three decades after the independence centralisation of powers had been accentuated due to various factors such as the predominance of a single political party at the Centre as well as in the States; adoption of planning as a strategy of national development in which investment decisions determined by the Union, albeit through a consultative process, generally set the priorities for state budgets; the system of industrial licensing and control; and nationalisation of major banks. The trend of judicial pronouncements during this period also tended to follow a similar spirit."[3]

This is in contrast to a considerable amount of cross-country literature on the benefits of decentralisation. One has to be careful in using the word 'decentralisation', because it can be used to mean different things and not all of these have something to do with governance. Within the ambit of decentralised governance, there are many aspects such as political decentralisation, administrative decentralisation, fiscal decentralisation and economic decentralisation. Some arguments in favour of decentralisation are based on efficient provision of public goods and services, and on optimal levels of governance relating to economies and diseconomies of scale in providing these public goods and services. Others are linked to making decision-making participative. However, decentralisation is not only about union-state relations. It is also about decentralisation and devolution within a state, and about empowering local governments, the third tier of governance.

The Problem of Excessive Centralisation

There are some issues that the Commission on Centre-State Relations called Constitutional Governance and the Management of Centre-State Relations.[4] The Constitution has one list of subjects that are under the jurisdiction of the union government, another list of topics under the

jurisdiction of the states and yet another list of concurrent subjects involving the joint jurisdiction of the union and the states. This raises several issues.

First, it has often been the case that even when subjects are in the Concurrent List of the Seventh Schedule, the union has not effectively consulted states on key issues, such as the drafting of legislation before introduction in Parliament.

Second, the Inter-State Council provided for in the Constitution has not functioned efficiently.

Third, there is a strong case for moving non-tax-related residuary powers from the Union List to the Concurrent List. As of now, all residuary powers vest with the union.

Fourth, when a bill has been passed by a state legislature and sent to the state governor, and the governor in turn refers it to the President, there are no time limits prescribed. The system is completely open-ended, and this empowers the President—who acts on the advice of the union government—to put off approval or disapproval for as long as the union government feels like it.

Fifth, New Delhi has often misused its authority in appointing and removing governors of states, who have no executive powers but can recommend the dismissal of state governments and holding of fresh elections. This provides the ruling party in New Delhi with a lever of control over the states: it can appoint party hacks who will do its bidding to the extent possible.

Sixth, discretionary powers of the governor, including invoking Article 356 (dismissing the state government), have been misused in the past. These should be curbed.[5]

Seventh, the states participate in the Inter-State Council, the National Integration Council and the National Development Council. But other key decision-making bodies such as the Planning Commission and Finance Commission function as extensions of the Union Government, and have no representation from states. They should.

Eighth, the Rajya Sabha (the upper house of Parliament) is elected by state legislatures and is meant to reflect the interests of states. But in 2003, the law was changed to allow persons from anywhere in India to be elected to the Rajya Sabha from any state.[6] This contravenes a basic principle of federalism: the representatives of the state should be local persons.

Ninth, the all-India services are elite cadres that provide the top bureaucratic and technocratic staff of the states as well as the union. This reduces the flexibility of the states.

In sum, although India is a federation, it has strong unitary biases. These militate against the spirit of federalism.[7]

Need for Equitable Access to Services

Irrespective of which state they live in, all citizens of the country should have equitable access to private opportunities and to public goods and services. This requires assignment of sources of revenue and provision of public goods to different levels of government. The primary responsibility of the union ought to be the provision of public goods and services that cut across various states and resolve inter-state issues. For example, it can set rules for horizontal competition among states on the supply of various services. However, if one scrutinises the tax and expenditure responsibilities assigned to the union and states in the Seventh Schedule, one detects an imbalance. On an average, states raise 34 per cent of all government revenue and incur 58 per cent of all government expenditure.[8] This 58 per cent expenditure share is also slightly misleading. About 15 per cent of state expenditure is on what are called Centrally Sponsored Schemes (CSSs), given on condition that matching grants come from the states. Consequently, the untied, flexible share in state expenditure is below 58 per cent. State expenditure on CSSs has been increasing over time, so their flexibility in determining expenditure has progressively been declining. The ability of states to finance current expenditure through their own revenue is low and has been declining. This has been compounded by an inability or unwillingness on the part of the states to increase capital receipts (by, for instance, sale of government assets). Hence, states have resorted mainly to borrowing on the capital account to finance not just capital spending but even current expenditure. New Delhi often lectures the states on lack of fiscal prudence. But there is a 'centripetal' bias in the assignment of tax responsibilities: New Delhi decides too many of these.

In one sense, this should not matter. Since 2000, following the 10th Finance Commission's recommendations, all central taxes are treated as a common divisible pool between New Delhi and the states. However, this is a finite kitty, and there are competing claims between states. Standard questions regarding vertical equity (between the union, states and possibly local governments) and horizontal equity (between states) have been examined by all Finance Commissions. The 13th Finance Commission observed, "There is spatial inequality in the fiscal capacity and fiscal needs of different states. The reasons underlying this spatial inequality vary considerably, depending on the state in question. Further, different states are at different stages of the development transformation, so their fiscal needs also vary over time. The Constitution provides general guidance on addressing the needs of the states and the Centre as well as taking account of state-specific needs."[9]

States have different fiscal capacities. But the broader background must also be remembered. For example, as a result of post-1991 reforms, a sector that has grown fast is services, and to a lesser extent is manufacturing. Therefore, states that could best stimulate these sectors have grown faster, and this has been reflected in faster revenue generation. States that could not stimulate these two sectors have suffered in relative terms.

Central Public Sector Enterprises (CPSEs) have been used for decades to develop disadvantaged regions, to try and produce balanced regional economic development. However, this has not worked well. Many such investments were capital-intensive and generated little local employment (as in the Rourkela steel plant in the tribal wilderness of Odisha). Besides, attempts at regional development were foiled for decades because the union government mandated a freight equalisation policy that made raw materials like steel, coal, iron ore and aluminium available at uniform prices throughout the country. The aim was to promote industry everywhere. The aim failed because many commodities were produced in backward states that would normally have become hubs for conversion of commodities into value-added manufactures. But freight equalisation took away this natural advantage and shifted it to states that already had major industrial hubs, good infrastructure and cheap access to international trade through ports. West Bengal and Bihar were among the biggest sufferers of freight equalisation, and they complained that they were getting de-industrialised and losing out to coastal states like Maharashtra, Gujarat and Tamil Nadu. However, the subsequent abolition of freight equalisation in the 1990s did not produce an automatic return of industry to Bihar and West Bengal: the dynamics of change had permanently made the coastal states much more attractive to business.

Bank nationalisation in 1969 was meant to help spread banking throughout the country. While this did indeed happen, the credit/deposit ratios turned out to be low for many poor, backward states and high in the advanced states. This means that the savings of backward states were diverted to investment in richer states with high credit-deposit ratios.

The unit cost of providing public services varies from state to state. States with difficult mountainous terrain and inaccessible areas bear higher costs for service provision. The citizens of such states suffer from horizontal inequity. They can migrate to other states, of course, but that is not the aim of policy.

The more advanced states are in a position to tap private sources of funds, including capital markets. This option is not easily available to relatively backward states, which tend to have a history of weak governance and poor policy. Thus, financial markets tend to widen development differences between states. However, states with improved policies and governance can narrow the differences.

Article 293 of the Constitution does allow states to borrow. But this is circumscribed by Article 293(3).[10] This means that, without the permission of the union, states cannot borrow from the market, as long as they are indebted to the union. It is impossible to think of scenarios where states will not be indebted to the union. Thus, borrowing by the states from the market is controlled by the union. Since 1985, state overdrafts with Reserve Bank of India (RBI) are also controlled by the union. This disadvantages the states greatly.

Many poorer states possess forests and minerals. If forests are to be preserved, then these should be considered a national public good. Environmental issues also crop up in many sorts of global negotiations. The Government of India's standard reaction is that the premium placed on protection of the environment should bear some relationship to a country's level of economic development. Yet, the same logic is not applied when it comes to protecting the environment in a relatively backward state. No special financial provisions are made for states that bear the brunt of the financial burden (and lack of development opportunities) arising from forest conservation, biodiversity conservation and other sorts of conservation. Enormous reserves of coal and iron ore lie in protected forests where mining is banned. This is one reason why India, which has some of the world's largest reserves of iron ore and coal, nevertheless imports both.

Horizontal Equity between States

Once the vertical share of the union and states has been determined, one needs to ensure horizontal equity (fair distribution between different states). Union-state fiscal transfers (sharing tax revenue) take place through the recommendations of periodic Finance Commissions. New Delhi also borrows for capital spending, and this sum is shared with the states via the Planning Commission. This provides New Delhi with discretionary power over what and where to invest, through central investment and CSSs. The Constitution lays down a mechanism for transfers only through the Finance Commission. It does not provide for any other channel to distribute the net proceeds of taxes to states. There is no provision in the Constitution for what are called Plan-transfers. These have been justified under Article 282, but the Constitutional legality of this is questionable.[11] Even if this is constitutionally legal, it cannot have been the spirit of Article 282. In any event, before 1969, such Plan transfers were on the basis of specific schemes. However, with these becoming broad-based and with the Planning Commission increasing in importance, the Finance Commission's transfers are restricted to tax devolution and grants to cover non-Plan current expenditure, with grants-in-aid covered by Article 275 of the Constitution. This excludes Plan spending (on public investment). The distinction between Plan and non-Plan spending is artificial and questionable. It prevents one from taking an integrated view of spending,

even for the limited purpose of transfers to states. For instance, the building of a school is Plan investment but salaries to teachers are non-Plan spending, and putting the two into separate compartments hurts the interests of integrated education.

Besides, after the economic reforms of 1991, the role of government planning itself is questionable. From the 4th to 9th Finance Commissions (that is, 1964-1990), Plan expenditure and grants for capital expenditure have been excluded from the purview of the Finance Commission, whose terms of reference have been progressively diluted.[12] One therefore needs to abolish the Plan *versus* non-Plan distinction and drastically reduce transfers through the Planning Commission. This will restore the Constitutional primacy of the Finance Commission.

Let us first look at the transfers, which are based on formulae. The formulae used by the Finance Commission vary from one Finance Commission to another, but are generally based on population, income, area, tax effort and fiscal discipline. There is a conceptual problem with this. Grants are meant to address the backwardness of a state, and backward states are clearly entitled to larger grants. But having already been compensated in this manner, why should they be compensated a second time through the use of backwardness indicators (population, distance, area) in the formulae for sharing tax between states?

The intent of Article 275 of the Constitution was to provide grants-in-aid to backward states. But if Finance Commissions adopt a gap-filling exercise to compensate backward states for their poor service provision, this can provide a perverse incentive to states to keep their services in bad shape. Hence, indicators like tax effort and fiscal discipline are taken into consideration by Finance Commissions. States are divided into general category states and special category states. General category states get 10 per cent of their devolved funds as grants and the rest as loans, but the share of grants is 90 per cent for the special category states.

The special category states are Arunachal Pradesh, Assam, Himachal Pradesh, Jammu & Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura and Uttarakhand. These are not necessarily the most economically deprived. There are low income states within the general category too. Special category status is not cast in stone and there have been progressive additions to the list. The Planning Commission lists hilly and difficult terrain, low population density and/or sizeable share of tribal population, strategic location along borders with neighbouring countries, economic and infrastructural backwardness and non-viable nature of state finances as criteria for determining special category status. But there is non-transparency and arbitrariness in its application. Being a border state is apparently one of the most important criteria, and it’s far from obvious why this should be the case.

Grants-in-aid should aim at reducing gaps in physical and social infrastructure, making special provisions for tribal populations and funding internal security problems (Maoism, secessionism) that a state might face.

The current indicators of backwardness (population, income, area) are all imperfect. As regards population, the formula sticks with the 1971 state population figure. This aims to avoid penalising states that promoted family planning and rewarding states that did not. It may be desirable to have low rates of population growth, but the concept has been greatly eroded by the fact that what used to be called 'population explosion' is now called 'demographic dividend.' In any event, why should tax devolution be used as an instrument for rewarding family planning? Public services must be provided to all, whether a state has a high or low birth rate.

Finance Commissions use variations of income and area in deciding how revenues should be shared between states. In fact neither income levels nor area are good criteria: they tell us very little about the quality or effectiveness of public services, for which they are getting a share of central revenues. It would be better for Finance Commissions to stick to output indicators such as actual service provision.

Finance Commissions compute tax effort and fiscal discipline in different states. This is a difficult exercise. In attempting this, the Finance Commissions make no attempt to estimate the overall resource position of a state. Instead, they start with base-year figures and make normative projections into the future. In no case have the projections of Finance Commissions matched actual outcomes, especially for backward states.[13] This has unwittingly but seriously punished backward states. [14]

Reduce Flows through the Planning Commission

We must reduce fund flows through the Planning Commission. Such transfers have both discretionary and non-discretionary elements. For non-discretionary transfers, the Planning Commission used the Gadgil formula from 1969 onward and a modified Gadgil-Mukherjee formula from 1991 onward. The current formula provides that 30 per cent of available funds are reserved for the special category states. Many others, notably Bihar, have argued that if the economic backwardness is a relevant criterion for transfers, many other backward states should also be in the special category.

Typically, the special category states are given funds on the basis of plan projects. But the general category states obtain funds, out of the balance, on the basis of population (60 per cent), per capita state domestic product (SDP) (25 per cent), performance (7.5 per cent) and special problems of these states. Of these, special problems of these states only amount for a 7.5 per cent weight. Unlike in the case of special category states, the devolution of central funds to general category states is not based on

planned investments or the resources already with states. This is not logical. The difference in the grant/loan ratio to the two types of states is not based on any good logic either.

Next, consider discretionary transfers by the Planning Commission through central sector schemes (investment of New Delhi) and CSSs. CSSs are limited. Most transfers occur through CSSs that require matching contributions from general category states. “Thus, these schemes have grown both in volume and number over the years, in spite of the states’ objection to the proliferation of such schemes and the decision of the National Development Council (the country’s apex planning body, which includes all Chief Ministers of states) in 1970. The Planning Commission’s own view on CSSs, at least in the course of the Tenth Plan, was the following.”[15] “It would be better to do a fewer things well rather than messing up with a larger number of activities. …One of the ways to reduce the mismatch between the lofty intentions of the GoI and its poor implementation capability is by re-examining the whole concept of Centrally Sponsored Schemes, and by radically limiting its number and improving its flexibility. The share of the CSSs in the Plan budget of the Central Ministries has now increased to 70 per cent against 30 per cent in the early 1980s. This massive increase has however not been matched by improved monitoring, and effective control over diversion of plan funds for salaries and other non-plan expenditure. Therefore, the number needs to be curtailed drastically from more than 200 today to just about 20 to 40 so that systems for their monitoring can be developed. No Ministry should be allowed to run more than 3 or 4 CSSs, and the outlay for each scheme should not be less than ₹ 100 crores a year. At present, less than 20 per cent of the CSSs have an outlay of more than ₹ 100 crores a year. Weeding out smaller schemes will therefore reduce the total number of CSSs from 210 to about 40.”[16] The Commission on Centre-State relations also recommended, “The number of Centrally Sponsored Schemes (CSS) should be kept to the minimum…Once a programme has passed the pilot stage and has been accepted as desirable for implementation on a larger scale, it should appropriately form part of the State Plan. The Central assistance towards CSS should be kept to a minimum in relation to the Central assistance for the State Plans.”[17] No such dramatic pruning has yet been done.

Other than efficiency, delivery and focus, there are other problems with CSSs too. They encroach on items that are on the State List. In 1996, at a conference of Chief Ministers, it was agreed that all CSSs that impinge on the State List should be transferred to states. But that has not happened. Conditions for CSS transfers are imposed on states, often in areas that are the legislative domain of states. CSS transfers are often made to autonomous bodies, bypassing the states. Some CSSs require the creation of a fresh and new bureaucratic system of delivery. In any event, CSSs amount to a unilateral decision by the union to divert resources that would

otherwise have been available to states. Therefore, CSSs should be pruned, and more untied funds should be made available to states. These need not be completely untied: there can be overall guidelines and some indication of the sector for which the funds can be used. Subject to these, states need to have far greater flexibility in spending. If, for instance, the aim is to reduce infant mortality, the best way to accomplish it will not be same in Jharkhand as in Kerala. For that matter, the priority of infant mortality reduction will vary from one district to another within the same state. The design of CSSs is extremely centralised and is done in Delhi, without any bearing on what a state really needs. With such central templates, it is understandable that implementation leaves a lot to be desired.

This report focuses on economic freedom in the states. But the union comes in the way of ensuring such economic freedom and imposes many constraints. True economic freedom requires far more decentralisation and devolution of powers and revenues to the states.

Endnotes

1. *Report of the Commission on Centre-State Relations*, Government of India, March 2010.
2. See, for example, Bardhan, Pranab (2010). *Awakening Giants, Feet of Clay, Assessing the Economic Rise of China and India*. Oxford University Press.
3. *Report of the Commission on Centre-State Relations, http://interstatecouncil.nic.in/volume1.pdf*
4. This was the title of the second volume of the report, *http://interstatecouncil.nic.in/volume2.pdf*
5. There are also issues on Article 355, which has implications for the deployment of central forces.
6. Through an amendment to the Representation of the People Act.
7. See, Jha, L.K. (1991). *Towards a Decentralized Polity*, Raja Chelliah Memorial Lecture, The Fiscal Foundation and Guhan, S. (1993). "Centre and States in the Reform Process," in Robert Cassen and Vijay Joshi (eds.), *India: The Future of Economic Reform*. Oxford University Press.
8. Govinda, M. Rao and Nirvikar Singh (2005). *Political Economy of Federalism in India*, Oxford University Press. The data in this book are dated, since they are from the late-1990s. However, though the numbers will change if updated, the thrust of the argument will not.
9. *Report of the Thirteenth Finance Commission, 2010-2015*, December 2009.
10. "A State may not without the consent of the Government of India raise any loan if there is still outstanding any part of a loan which has been made to the State by the Government of India or by its predecessor Government, or in respect of which a guarantee has been given by the Government of India or by its predecessor Government."
11. "The Union or a State may make any grants for any public purpose, notwithstanding that the purpose is not one with respect to which Parliament or the Legislature of the State, as the case may be, may make laws." Constitution of India.
12. That pressure from the Planning Commission was responsible for this dilution is evident from the account given about non-acceptance of the recommendations of the Third Finance Commission. See, Chanda, A. (1965). *Federalism in India* George Allen and Unwin.
13. This shows up clearly in the survey done in Srivastava, D.K. and C. Bhujanga Rao (2009). Review of Trends in Fiscal Transfers in India. Madras School of Economics. July.
14. See, Govinda, M. Rao (2009). "Reform of Intergovernmental Fiscal Arrangements for Balanced Regional Development in a Globalizing Environment," and Govinda, M. Rao and Subrata Mandal (2009). "Resource Endowment, Fiscal Flows, and Regional Equity in Indian Federalism", in M. Govinda Rao and Anwar Shah (eds.), *States' Fiscal Management and Regional Equity, An Overview*. Oxford University Press.

15. *http://planningcommission.nic.in/reports/articles/ncsxna/ncsax2a.htm.* More accurately, this was the view articulated by N.C. Saxena, but it was also a general view.
16. *Report of the Commission on Centre-State Relations*, Government of India, March 2010.
17. *http://interstatecouncil.nic.in/volume3.pdf. http://interstatecouncil.nic.in/volume7.pdf* is also relevant.