

Towards Cooperative Federalism

G.E. Public Finance, B. Com (H) 4th Sem

Part-B: Unit – 4 Fiscal Federalism in India

Readings 2: Report of the Fourteenth Finance Commission, Chapter 12

Under the Chairmanship of Dr Y V Reddy the Fourteenth Finance Commission (FFC) was delivered on Dec 2014 for the implementation of its recommendation from 2015-2020. The FFC after taking into account the needs of states recommended tax devolution, grant-in-aid to meet their revenue deficit. It should be done with the available fiscal space. Health, education, drinking water and sanitation are important public sectors among public services that has to be transferred from union to states. New institutional arrangements be put in place duly assisted by domain experts with the involvement of the Union and the States.

Many of the functions in the Concurrent List have traditionally been undertaken by the States and are in their area of responsibility. However, even in the State and Concurrent lists, there are functions which are best carried out by both the Union and State Governments in the spirit of cooperative federalism. For example, specified minimum standards of certain public services should ideally be available to people, irrespective of where they reside. Thus, both the Union and State Governments have an overlapping responsibility to ensure such specified minimum standards.

Existing Arrangements for Transfers:

From 2014-15 onwards, direct transfers to State implementing agencies have been done away with, and all transfers to States for Centrally sponsored schemes are now being routed through the Consolidated Fund of the State. The non-Plan grants constitute a very small part of the 'other transfers'. Plan grants are utilised both for capital and revenue expenditures, though the share of the latter has been increasing in recent years.

The share of untied normal Central assistance has shown a sharp decline, particularly after ending the intermediation of Plan loans to the State Governments by the Union Government, consequent to the recommendations of the FC-XII within Plan Transfers. This decline is described as 'formula-based' grants due to the expansion of Centrally Sponsored Schemes. It is even sharper when the grants transferred to the implementing agencies. In recent years, the aggregate transfers from the Union to the States (including direct transfers), as a percentage of the gross revenue receipts of the Union, have ranged between 44.7 per cent and 53.7 per cent

Views of the State Governments:

The significant increase in the number of Centrally sponsored schemes and the funds allocated for them have led to a corresponding decrease in the untied resources available to States. This also reduced the fiscal space of the states and forced them to adopt expenditure patterns that do not reflect their own priorities.

The States have emphasised that there is a need to enhance the existing level of formula-based fiscal transfers, with such transfers conforming to the principles recommended by the Finance Commission.

Some States felt that the situation can be redressed through: (a) transfer of Centrally sponsored schemes to the States, along with funds; (b) provision of greater fiscal autonomy to States, thereby enabling them to design their own expenditure priorities and undertake state specific development schemes, based upon their own assessment; (c) allocation of more funds to States, as compensation for the implementation of Central legislation; and (d) reducing/ rationalising the number of Centrally sponsored schemes and, above all, remedying the design problems in the architecture of these schemes in order to avoid rigidities/inflexibility in implementation.

Views of the Union Government:

The Ministry of Finance highlighted the limited resource base available with the Union Government in the coming years. Therefore, the burden needs to be shifted to them. It also highlighted that the intervention is to ensure equalisation, promotion inter-state projects and ensuring specified minimum standards of services in sectors of national priority. The Planning Commission mentioned that the Centrally Sponsored Schemes (CSS) funds flow from the Union to the critical sectors ensure the state a matching contribution.

Discussions in the National Development Council (NDC):

The transfer of these schemes to State Plans, reduction in their number by consolidating schemes with similar objectives and curbing the growth of these schemes in areas such as education, health and agriculture is suggested by the States in the NDC. Funds flow to be done in untied manner, with a flexibility to design state specific conditions, preferences and requirements.

Views of Commissions and Committees:

In the context of Central transfers, the First Administrative Reforms Commission (1966) had observed that the role of the Union Government in areas which are covered by the State List of subjects in the Constitution should be largely that of a

'pioneer, guide, disseminator of information, overall planning and evaluator. Except in the most essential areas and that too for a limited duration, the Union Government should not take upon itself the functions and responsibilities which are legitimately in the States' domain.

The Commission on Centre-State Relations, headed by Justice R.S. Sarkaria (henceforth, 'Sarkaria Commission'), in its report submitted in 1988, had recommended that the number of Centrally sponsored schemes should be kept to the minimum.

The National Commission on Review of the Working of the Constitution (2002), chaired by Justice M.N. Venkatachaliah, had observed that the rationale of the Concurrent list stems from the fact that certain subjects require simultaneous jurisdiction of the Union and the States. Harmonious operation of the Concurrent List could well be considered to be creative federalism at its best.

The Commission on Centre-State Relations, headed by Justice M.M. Punchhi (henceforth, 'Punchhi Commission'), in its report submitted in March 2010. It observed that the number of Centrally sponsored schemes should be restricted to flagship programmes of national and regional importance.

A Committee constituted by the Planning Commission to consider the issue of 'Restructuring of Centrally Sponsored Schemes', under the chairmanship of Shri B.K. Chaturvedi (henceforth, 'Chaturvedi Committee'). In its report submitted in September 2011, the committee reiterated the need for a "national effort in education, childhood care, health, unemployment and old age, and for minimising inequalities in income amongst States", guided by the Directive Principles of State Policy.

Views of Previous Finance Commissions:

FC-XI had recommended that these schemes need to be transferred to the States, along with funds. It also recommended that all other schemes be implemented by panchayats and municipalities, on the basis of plans prepared by the District/ Metropolitan Planning Committees. The FC-XII had recommended that there should only be a grant element for all Centrally sponsored schemes without any grants linked to loans. It had further recommended that States be given their total entitlement of grants and allowed to select their own mix of Centrally sponsored schemes, within the limit of the total grant. The FC-XIII had recommended reduction in the number of Centrally sponsored schemes and restoration of the predominance of formula-based Plan transfers.

Issues and Approach:

To arrive at a comprehensive view of the fiscal relations between the Union and the States, the existing transfer arrangements and views of the Union and States had been reviewed. This review leads to few conclusions:

There is a convergence of views about the need for some specific purpose transfers from the Union to the States, differences persist in regard to the desirable magnitude and current manner in which such transfers are taking place outside the tax devolution and Finance Commission grants.

Second, there is a convergence of views that the objective of transfers from the Union to the States should be for supplementing the transfers recommended by the Finance Commissions.

Third, there are differences of views about the scope or purposes for which such transfers outside the Finance Commission should take place.

Fourth, the recommendations of various Committees have indicated their discomfort with the fact that the Union has been unilaterally deciding about the scope, nature and design of the Centrally sponsored schemes.

Fifth, most States have repeatedly expressed concerns that the Union Government exercises excessive discretion in distributing the resources among them through the transfer mechanism, especially in regard to Centrally sponsored schemes. The States have generally described these transfers as being 'non-formula-based' and 'discretionary'. Data reveal that the share of formula based distribution (such as transfers based on the Gadgil-Mukherjee formula) in the aggregate transfers has been decreasing.

Sixth, for several years, concern has been expressed that many of the Centrally sponsored schemes are based on a 'one size fits all' approach and that often the design of schemes is inappropriate for several States.

Seventh, various Commissions and Committees have supported rebalancing the transfers of funds from the Union to the States in favour of formula-based untied transfers.

Eighth, the previous Finance Commissions have also expressed their views in regard to the significant quantum of Central transfers being made particularly through Centrally sponsored schemes.

Ninth, despite some differences of opinion, there is virtual unanimity on one issue - that there is universal dissatisfaction with the existing system of transfers from the Union to the States outside the awards of the Finance Commission.

Therefore, there is a need for changes in the existing reform of fiscal transfers and if needed institutional changes should also be considered.

There are three possible ways in which specific-purpose grants for nationally important schemes or overlapping functions can be determined. First, the Finance Commission may recommend specific-purpose grants for programmes and schemes in a comprehensive and significant manner to encompass all fiscal transfers. Second, the Finance Commission may identify sectors with overlapping responsibilities between the Union and the States, indicate the volume of assistance for these schemes and leave it to the Ministry of Finance and the relevant Union ministry to design and implement them. Third, the Finance Commission may determine the fiscal space available for specific-purpose grants, both those for which the States have made a strong plea for assistance with the Commission as well as those coming under the rubric of Central schemes.

The Union Government should continue to have fiscal space to provide grants to States for functions that are broadly in the nature of 'overlapping functions' and for area-specific interventions. To avoid issues in regards to transfers institutional arrangements is necessary, consistent with the overarching objective of strengthening cooperative federalism, for: (i) identifying the sectors in the States that should be eligible for grants from the Union, (ii) indicating criteria for inter-state distribution, (iii) helping design schemes with appropriate flexibility being given to the States regarding implementation and (iv) identifying and providing area-specific grants.

North-eastern Region:

Most of these States are largely dependent on the resource flows from the Union Government, both for balancing their revenue account and for capital investment. There is, in addition, currently a special dispensation for flow of Plan grants to them.

The commission assessed that these States would continue to need a special focus, particularly in terms of social and economic infrastructure with inter-state significance. FFC therefore, believe that the proposed new institutional arrangement should have a special focus on these States, particularly in terms making investments in infrastructure.

Natural Resources:

As the ToR requires a consideration of balance management of ecology, environment and climate change consistent with sustainable economic development, the Union and the States need to become partners in addressing the challenges of development

in a manner that is sustainable and preserves the ecological balance. Therefore, there is a need for new institutional arrangements.

Towards a New Institutional Arrangement:

As per accepted theories of institutional design, as well as international practice, there is a need for the state to play the decision-making process in relation to fiscal allocations. This is a crucial element of co-operative federalism, that requires an institutionalised continuous consultation between the Union and the States.

Role of the Inter-State Council:

The Inter-State Council was established under Article 263 of the Constitution, through a Presidential Order dated 28 May 1990. The Inter-State Council, as presently constituted, is a recommendatory body, invested with the following duties: (i) investigating and discussing such subjects, in which some or all of the States or the Union and one or more of the States have a common interest, as may be brought up before it; (ii) making recommendations upon any such subject and, in particular, recommendations for the better coordination of policy and action with respect to that subject; and (iii) deliberating upon such other matters of general interest to the States as may be referred by the Chairman to the Council. However, inadequate power and under staffage leads to less meeting than the required times.

Institution for Cooperative Federalism: Redesigned Inter-State Council:

The study showed that, in both theory and practice, the role of an inter-governmental forum is limited to consultation and recommendation to the Union Government on matters related to fiscal allocations. We recognise that the Inter-State Council has the potential to ensure that there is meaningful participation by States. therefore, suggest that the present role of the Inter-State Council be expanded to include the functions consistent with the overarching objective of strengthening and co-operative federalism, identifying and recommending resources for inter-states infrastructure schemes in the North-Eastern States, as well as for integrative development decision keeping in mind the environment and ecology.

Aggregate Transfers:

The FFC recommended, the tax devolution to the states is 42 percent of the divisible pool. The aggregate grants recommended by us, expressed as a percentage of the divisible pool, are in the range of 6.4 per cent to 5.2 per cent, with an average of 5.7 per cent, over the award period.

When the direct transfer component is added, the level of aggregate Union transfers to States, as a percentage of gross revenue receipts, went up from 48.9 per cent in

2010-11 to 53.7 per cent in 2011-12 before declining to 49 per cent in 2012-13. Therefore, the Union Government is recommended to continue with the prevailing level of transfers to states of about 49 per cent of the gross revenue receipts.

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Recommendations:

- i. We conclude that a compelling case has been made for reforming the existing system of fiscal transfers from the Union to the States in a comprehensive manner. We recommend that the existing system be reviewed and necessary institutional changes be considered. (para 12.23)
- ii. We believe that the existing arrangements for transfers between the Union and the States need to be reviewed with a view to minimising discretion, improving the design of transfers, avoiding duplication and promoting cooperative federalism, insofar as such transfers are required to be made outside of the recommendations of the Finance Commission. (para 12.27)
- iii. We recommend for consideration the evolution of a new institutional arrangement, consistent with the overarching objective of strengthening cooperative federalism, for: (i) identifying the sectors in the States that should be eligible for grants from the Union, (ii) indicating criteria for inter-state distribution, (iii) helping design schemes with appropriate flexibility being given to the States regarding implementation and (iv) identifying and providing area-specific grants. (para 12.28)
- iv. We urge that the suggested new institutional arrangement also consider taking up issues related to identifying and recommending resources for inter-state infrastructure schemes in the North-eastern States. (para 12.32)
- v. We urge that the new institutional arrangement should also become the forum for integrating economic and environmental concerns in decision making (para 12.35)
- vi. We suggest that the present role of the Inter-State Council be expanded to include the functions envisaged in paragraphs 12.28, 12.32 and 12.35. (para 12.46)
- vii. We expect that the Union Government will utilise its available fiscal space to continue to address the needs and expectations of the States and ensure the prevailing level of transfers to States of about 49 per cent of the gross revenue receipts during the award period. (para 12.49)