Fiscal reforms in a federal framework

NITI Aayog should strive to be a vibrant think tank albeit with substantial financial muscle, says the writer in the first of a two-part series

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By all accounts, Indian economy today is on a growth turnpike, not very different from the growth miracles experienced by Asian tigers as well as China in earlier decades. Indian economy experienced an upward structural break in the mid-eighties. In my view, the most important of these factors has been our democratic framework, indeed a key foundational institution. In a country as beautifully diverse as ours, federalism as an organising principle is clearly the only way to succeed.

Our approach to federalism is idiosyncratic. I think it is better described as "cooperative federalism", where governance has a multi-level form with evolving relations between different levels of government. As an aside, I may mention here that some people also talk about competitive federalism. I have some hesitation in deploying this term as I fear that it can only lead to a race to the bottom via competitive populism. I want to argue that fiscal federalism has been one of the most important pillars for the success of our enduring democracy. In the framework of fiscal federalism, federations all over have tried to tackle two important issues, that is, vertical imbalance and horizontal imbalance.

Vertical imbalance essentially arises due to the fiscal asymmetry in powers of taxation vested with the different levels of government in relation to their expenditure responsibilities prescribed by the Constitution. In India, the central government has far greater or larger domain where it may tax. Consequently, the central government collects around 60 per cent while its expenditure responsibility for carrying out its constitutionally mandated responsibility such as defence is only to the tune of 40 per cent of the total public expenditure. Thus arises the vertical imbalance.

Horizontal imbalance arises because of the differential capacity to tax amongst the states as against the expenditures required for providing public goods of comparable quantity and quality to those residing in their states. This, in turn, arises because of the vast regional imbalances in terms of per capita incomes, physical and social capital endowments, natural resources availability and geographical differences. The unevenness of developmental outcomes, of course, gets further compounded by the differences in the levels of effective governance.

In our county... the regional disparities, in terms of per capita incomes, are much sharper due to yet another imbalance, that is, "development or growth imbalance". The differential growth rates could be due to several reasons. [In particular,] the stock of infrastructure that gets accumulated over a period of time and lends a character of path dependency to this process... This underlines the fact that when it comes to accelerating growth, it's not just geography, physical and natural resources but indeed, [even] history matters!

Our Constitution and creative democratic politics addressed these issues by creating two institutions viz, Finance Commission and Planning Commission. The Finance Commission

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... to meet horizontal and vertical imbalance, ... the Planning Commission to address "development imbalance". This arrangement... served well. The replacement of Planning Commission by NITI Aayog is considered by some to be a major reform for our cooperative federalism. I have a somewhat different perspective in this regard.

In the present scheme of things, the collapsing of two different sources of transfers, aimed at differing objectives, is deeply problematic... and needs to be rectified. One has to do with the differing levels of per capita consumption of basic public goods and services. The other has to do with the differing levels of stock of infrastructure leading the differential growth accelerating potential. These are two distinct policy goals but the Tinbergen assignment principle warrants two distinct policy instruments. Eliminating the Planning Commission and replacing it with NITI Aayog merely as a think tank leaves us with only one instrument, namely Finance Commission. This approach, if not reviewed, can lead to a serious problem of increasing regional and sub-regional inequities.

I would, therefore, argue strongly that there is a deep analytical foundation for a case where the NITI Aayog gets significant levels of resources for allocating to the different states. Given our political economy, these grants need to be conditional and formulaic. I believe we need to reinvent the [Gadgil-Mukherjee] formula [used by Planning Commission] by using somewhat different variables and emphasis while being mindful of macroeconomic conjuncture and structural needs. This would mean that NITI Aayog will be responsible for allocating development or transformational capital grants to the states. Given the overall resource constraints, what this would mean is that the future Finance Commissions, as against what has been done by the 14th FC, will have to revert to the modest percentages increase in their devolution formula as was indeed the historical trend. This, of course, does not mean an overall reduction in the overall transfers but only in their composition and their source.

Let me hasten to add that I am not suggesting for a moment that NITI Aayog should take the form of the old Planning Commission. On the contrary, it should take care to eschew micro-management of yesteryear vis-à-vis central ministries and the state governments via excessive bureaucratisation. It should rather strive to be a vibrant think tank albeit with substantial financial muscle. I need to mention here that the key conditionality for the success of this approach that we recommended was an effective democratic decentralisation via empowerment of urban local bodies and Panchayati raj institutions as envisaged by the letter and the spirit of 73rd and 74th Constitutional Amendment Acts.

The writer is chairman, National Institute of Public Finance and Policy. These are the edited excerpts of the Shankar Aiyar Memorial Lecture. The second part will appear tomorrow