

Lecture -1

Reorienting public finance in Indian fiscal federalism with reference to local governments*

M A Oommen

Distinguished Professor, Gulati Institute of Finance and Taxation, Thiruvananthapuram

Abstract

The 73rd and 74th constitutional amendments heralded a new era in the structure and progress of Indian federal polity. In this context rethinking the Indian public finance accommodating the 3rd tier of government as a viable component is a great need. This lecture is the first in the series of two lectures that attempt to define the concepts of public finance, federalism especially fiscal federalism as a back drop to this exercise.

Keywords: *Public Finance, Fiscal Federalism, third tier.*

Introduction

The Indian federalism consisting of the Union and States was a dual set up before the 73rd/74th Constitutional Amendments (CAs). But this momentous amendments turned Indian public finance into a multi-layered federalism. This lecture on 'Reorienting Indian public finance' addresses this issue from a broader canvass. The lecture is organised under the following heads: The first lecture examines only the first three questions.

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1. What is Public Finance?
2. What is Federalism?
3. What is Fiscal Federalism?
4. Received theories of Fiscal federalism and the 73rd/74th CAs
5. Union Finance Commissions and the Third Tier
6. State Finance commissions
7. Towards reorienting public finance with reference to the third tier.

1. What is Public Finance?

When I studied for M A economics, long before Musgrave wrote his Theory of Public Finance, the acknowledged authority of public finance was Hugh Dalton and the various theories he formulated. He defined public finance as a discipline "concerned with the income and expenditure of public authorities and the adjustment of one to another". In other words it is budget, to be prudentially adjusted to balancing the income and expenditure side. It was probably Keynes' general theory and his rationale for deficit budgeting that made public finance really public economics and part of the management of the economy. Macroeconomics was also born. In the Soviet Union and in Communist economies like China with over 50 per cent in the public sector, the role of finance is different and certainly not comparable to other capitalist mixed. But in a mixed economy the discipline has assumed more importance and a critical understanding of fiscal functions and tools has become important.

The Musgravian tripartite functions of public finance have found a place in classrooms since 1959. They are (a) allocation function, the public provision of certain goods or social goods (b) distribution or adjustment in the state of distribution of income and wealth and (c) stabilization ie measures to deal with unemployment, inflation and promotion of growth. These indeed are a brilliant summing up. Wallace Oates 2005 (which I refer again below) speaks of a first generation theory of fiscal federalism called AMS school, the essence of which is practically rooted in the Musgravian, trinity. AMS refers to Kenneth Arrow, Richard

Musgrave and Paul Samuelson. I know all of you are familiar with this. But my main objection is that it does not present a normative approach within a social democratic framework. I maintain that neoclassical and Keynesian mix which AMS postulate are not universal principles that are relevant to all places from Robinson Crusoe island to China, to tribal habitations to New York market. Economics is a socially embedded science and its principles are contextual rather than universal..

In India fiscal functions should be governed by the preamble and the directive principles of state policy and therefore from the principles of social justice. Richard Musgrave on his own and the work with Peggy Musgrave take pains to show that whatever theory they say are relevant to USA. Look at what Musgrave and Musgrave note in their Preface to the Fifth edition that the 'distribution of the tax burden has come to be of less concern' and a little later 'massive deficits in the federal budget emerged following tax cuts in the early eighties'. With no comments the ideology of the book is made clear in these words. At this point as a teacher of economics, of an older vintage, but as one who has read Thomas Piketty's three books Capital in the 21st Century, Ideology and Capital and A brief history of Equality, I would say [these books provide profound criticism of contemporary economics and politics] they give evidence to show that the phenomenon of rising inequality in wealth and income is perpetuated by the ruling class through the rationalization of their ideologies and this could be and should be controlled for building a democracy built on social justice. His main tools of social transformation are public finance. The title of chapter 14 of the Capital in the 21st Century is Rethinking the progressive income tax and chapter 7 of his latest book. A brief history of equality is titled Democracy, Socialism and Progressive taxation. I say all these to drive home the point that public finance has to be understood contextually and that in the Indian context it is a social state based on Indian constitution.

2. What is Federalism?

The word federalism is derived from the Latin word foedus which means agreement. Quintessentially federalism and its success depends on agreement among the federating units which are combined under a common sovereignty. Based on the constitutional division of powers, governments of the world are broadly divided into unitary and federal. In a unitary government all major government functions are centralized and the sub-units are subordinate entities. **A federation on the other hand is "a multi-level system of government, in which different levels of government exist each of which has some independent authority to**

make economic decision within its jurisdiction"[Boadway and Shaw (2009):4]. Although there are only 25 federal countries in the world today, they account for 40 per cent of world's population and therefore constitute a critical mass in the economic and political governance of the world.

Federations are broadly classified into 'holding together' or 'coming together' varieties depending on the manner of their formation. India as a federation, does not represent a "coming together" variety, but rather a "holding together" category evolved and shaped historically. The Indian constitution that provides its defining features interestingly does not use the term federal. We may include India in the "holding together" view of federalism also called "new federalism"[Boadway and Shaw (2009):4] which represents an attempt to decentralise responsibilities further down to state and below. The 73rd/74th Constitutional Amendments (CAs) and the introduction of Part IX and Part IXA to the constitution that followed provide for this decentralisation and multi-level system of governance. In brief These amendments have turned the dual federalism comprising only the union and states into a multi-level federation.

One can mention a dozen types of federalisms. We mention only five most important of them found in the literature: dual federalism, competitive federalism, market-preserving federalism, cooperative federalism and environmental federalism. These are not water-tight divisions. They help to highlight the possibilities of federalism and their multiple dimensions in practice.

Dual federalism, is a political arrangement in which power is divided between the federal and state governments in well-defined terms with state governments enjoying complete autonomy in their domain. It is a case of divided sovereignty. The residuary powers generally rest with the apex government. United States is a typical case of dual federalism. In a dynamic system it is difficult to practice.

Competitive federalism, is more a theoretical construct rather than an operational arrangement. It postulates that all authorities with over-lapping responsibilities should compete both vertically and horizontally to establish their clientele of services (see Boadway and Shah (2009)]. Under this model states need to compete among themselves as also with the centre for benefits.

Market-preserving federalism, envisages a decentralized federation that incentivizes the institution of market and economic rights of citizens as against a Leviathan state. It was Qian and Weingast (1997) who advanced this "new perspective in the study of federalism" which they called a 'second generation federalism'. The first generation federalism which I already mentioned was also for a market based system advanced importantly by Kenneth Arrow, Richard Musgrave and Paul Samuelson, the so-called AMS perspective. This was considerably modified by Wallace Oates and summed up in his famous 'decentralisation theorem'. For your benefit, I may quote him:

"Each public service should be provided by the jurisdiction having control over the minimum geographical area that would internalize benefits and costs of such provision"[Oates (1972):p.55].

This really means assignment of functions such as defence to the centre or federal government and functions such as streetlight or garbage collection to the local government. In this type of federation all levels of government will have to face the hard budget constraints. That is governments will have to face the consequences of their action. In a strict market preserving system which really is the essence of second generation theories bailing out of failed projects or continuing costly, inefficient, large scale public programmes and so on are ruled out. Most writers who advance the market preserving system while theorizing on economic rights and evils of 'state predation' fail to address the question of social justice. Any federalism that fails to address equity issues and social goals cannot be truly legitimized.

Another type of federalism, mostly used in Indian public finance discourse is **Cooperative federalism**. Under cooperative federalism, the federal and state governments cooperate with each other for the overall development of the nation. Boadway and Shah (2009) classify cooperative federalism into three viz., *inter-dependent spheres, marble cake and independent spheres*. In *interdependent spheres* (e.g. Germany and South Africa), the federal government determines policy, while the state and local governments act as implementation agencies. Of course the voice of second and third order governments (state and local) are generally taken care of via second chambers and such other institutions. In the marble cake model of cooperative federalism, (e.g. Belgium) all, orders of government have overlapping and shared responsibilities and all tiers have equal status. In the independent spheres of government (Brazil is the best example) all levels enjoy autonomous and equal status and coordinate their policies horizontally and vertically. Where does Indian federation fit in this tripartite

classification of cooperative federalism? Policy makers, politicians, economists, journalists and others speak of India as a good case of cooperative federalism. But it is difficult to pigeonhole India into any one of the above. Although the nearest approximation is the marble cake model, it does not fit in here because we have exclusive union, state and concurrent list. But there is no local list in spite of an eleventh and twelfth schedules listing the subjects of jurisdiction of rural and urban local government, 29 for panchayats and 18 for municipalities or urban local government [ULG]. There is no clarity and much over-lappings. This was precisely why the Subrato Sen Committee (1996-1998) of Kerala ventured to break down the subjects into activities and sub-activities for the three tier panchayats, called Panchayati Raj Institutions as well as for the nagar palikas, municipalities and corporation that comprise the ULGs. The lack of a well-defined local list has added much confusion in Indian public finance. Several contemporary trends demand a reexamination of the idea of cooperative federalism, a concept frequently invoked both by the centre as well as by the states as convenient to them. If the power relations keep growing unevenly and mutual mistrust widens the very basis of cooperative federalism will be under threat. The growing share of non-divisible cesses and surcharges as a share of divisible pool, which increases the continuing inroads into the states' autonomy, appropriating more and more tax handles (e.g., goods and service tax), expanding concurrent list, unilateral action where consultation is needed (e.g., lock down in March 2020) are typical cases against building mutual trust which is the real key to cooperative federalism. The growing divergence in interstate income disparities [for an elaborate discussion see Oommen and Chakravartti (2023)] will raise the problem of equity in the Indian federal context. It will be difficult to continuously subsidise laggard states by better performing ones via the common fiscal resource pool. All these are to be seen against the background of the continuing neglect of decentralization reforms by the ruling party as well as by most regional parties and state governments. As already noted NITI Aayog has been putting the burden of transforming India into the shoulders of states by encouraging competitive federalism rather than cooperative federalism.

Environmental federalism refers to the strategy of optimal management of natural resources in a multi-order government system and is important in modern times with climate change assuming a crisis dimension. To be sure it is much more than an assignment problem and issues range from the local to the global. Broadly it refers to a multi-dimensional natural resource management policy framework that seeks norms of air pollution, water pollution, conserving forest cover, river system, biodiversity, climate change and many others.

Although it is difficult to strictly follow a subsidiarity principle, it is important to pursue environmental decentralisation in a large federation.

Wholesome environment is a local public good. Wallace Oates who examines the problem in great depth, assigns an important role in the setting of environmental standards and the design of regulatory programmes to local governments. He points out that the central government, in addition to setting standards for national "pollutants", has a fundamental role in supporting research in environmental science and pollution control technology and in providing needed information and guidance to state and local governments to facilitate healthy environmental system [See Oates (1998,1996) among his other works on fiscal federalism and economics of environment].

Different federations have approached the problem differently. Environment has come to occupy a prominent place only recently in Indian federation. True, Schedule VII of the constitution mentions the sharing of powers and responsibilities between Union and States with respect to environmental and natural resources, along with the concurrent jurisdiction thereof. For example, land, water and agriculture are state subjects, interstate river system figures in the union list and forests and wild life are concurrent subjects. It is Article 48A introduced following the 42nd Amendment, 1976 that really placed environment protection prominently in the policy agenda of India. India has responded positively to the climate concerns of UN and other agencies. A series of Notifications and legislations have been promulgated. In the context of fiscal decentralisation, I may mention in particular Article 243ZD which provides for district planning and environment conservation at the local level. This is indeed a good example of environmental decentralisation in Indian federalism.

3. What is Fiscal Federalism?

The term fiscal federalism was first used by Richard Musgrave in 1959 and has acquired considerable theoretical and practical corpus since then. I do not propose to go into the principles of federal finance of Musgrave except to say that they have endeavored to fit the tripartite fiscal functions within the theory of federal finance I do not enter into that big literature built around the first generation and second generation fiscal federalism except tangentially. Briefly fiscal federalism is decentralized fiscal system. The many works of Wallace Oates, a great scholar on decentralisation considers fiscal federalism as "understanding which functions and instruments are best centralized and which are best

placed in the sphere of decentralized levels of governments". For our purpose let me outline the important characteristics which a multi-level federal polity like India has to facilitate a rational, efficient and equitable system of public finance in the context of India's decentralisation reforms. They are examined under four heads:

(i) Functional mapping/Assignment of expenditure responsibilities

In a multi-layered federal polity the basic question to be asked is who should do what Indian polity never asked this question and will have to reap the consequences of that failure. Without mentioning the voluminous edifice of first generation and second generation theories of fiscal federalism, let me introduce the subsidiarity principle which is very meaningful in our context. What can be done best at a particular level should be done at that level and not at a higher level is the ideal principle of expenditure responsibilities. This will ensure allocative efficiency on which the fiscal federalism theorists swear by and invoke even the Pareto-optimality conditions.

The Indian Constitution which borrowed heavily from the Government of India Act, 1935 was a two tier federation of union and states. It borrowed approximately 250 Articles verbatim or with minor modifications in phraseology from the 1935, Government of India Act, 1935[M.Brecher (1959):p.207]. With several states waiting to stay away from the union and the horror of partition threatening the fabric of Indian polity, the Indian constitution makers had no option but to opt for a quasi-federal system. But the 73rd/74th Constitutional Amendments offered another grand opportunity to raise the question of who should do what once again? Instead of asking these questions, the Constitution added Schedule XI for panchayats listing 29 subjects and schedule XII for municipalities listing 18 subjects, taken mostly from the state list. These have added much confusion with overlapping of functions. Disaggregated mapping of functions into activities and sub-activities with assignments appropriate to the three tiers of PRIs and urban local governments was the way out. The Subrato Sen Committee in Kerala (1996-98) did this disaggregated functional mapping admirably well. When the Ministry of Panchayati Raj [MoPR] was started in May 2004, Union Minister Mani Shankar Aiyar promoted a campaign for disaggregated functional mapping largely based on the Kerala pattern and even entered into Memorandum of Understanding [MoU] with several states to facilitate functional mapping.

(ii) Revenue assignments

The fundamental question of financing the expenditure responsibilities raises another important question: who should tax what and where? Patterned on the Government of India Act, 1935, these questions were never raised in the division of tax assignments when the constitution was framed. The constitution envisaged a two tier system where more productive and elastic sources of taxes like income tax, corporation tax, customs duties were placed in the union list and taxes like land revenue, sales taxes, stamp duties etc., kept in the state list. Local bodies (only after the 73rd/74th CAs given government status) being a state subject had no independent tax handles except those assigned or shared by the state. Actual situation after adding the third stratum of government vary considerably from state to state depending on the devolution of the 3Fs (Functions, Funds and Functionaries) pursued by each state [For state-wise details of functional assignments and taxes see Oommen M A (2004)].

Local governments despite the two amendments do not enjoy much autonomy (strictly speaking violating Articles 243G and 243W which mandate to create institutions of self-government) in the exercise of taxing powers. But they can vary tax rates as per law and even charge user fees in certain cases. Own Source Revenue (OSR) is important and the question of hard budget constraints certainly assume importance. OSR is important not only to ensure autonomy but also to ensure better fiscal prudence. As Richard Bird (2000) has pointed out the voter residents will hold local politicians and bureaucrats more accountable if public services are financed by taxes they pay.

(iii) Evolving an efficient and equitable transfer system.

This essentially means making institutional arrangements for rectifying the vertical and horizontal imbalances arising in inter-governmental fiscal relations. Ideally the expenditure responsibilities of a government and its revenue capacities should match. This matching called the principles of 'fiscal equivalence' seldom happens in practice in a multi-level federation. The vertical mismatch between responsibilities and resources has to be bridged through relevant fiscal choices and arrangements. Besides the vertical imbalances, inter-jurisdictional disparities in fiscal and economic capabilities due to differences in resource endowments, historical developments and social disabilities of the residents the visible phenomenon of caste cannot be ignored. In a democracy like India avowedly committed to removing regional disparities, horizontal disparities have to be continuously addressed.

Transfers to carry out some agency functions on behalf of a higher level government (it could be the federal or state governments) do not strictly form part of the general transfer system.

Now what are the task of a good inter-governmental transfer arrangements? They are:

- (a) to determine normatively the size of the divisible pool which ideally will have to be related to the expenditure responsibilities a government has to shoulder and the revenue potential and performance which of course has to be normatively screened to discourage imprudence;
- (b) to equitably distribute the pool among the sub-national governments keeping the objective of the decentralisation laid down in the constitution and state legislations; and
- (c) in the absence of institutions like the planning commission where market dominates resource allocation, the union finance commission has to work towards reducing regional disparities. It is important to contains self-reinforcing forces.

The Union Finance Commission (UFC) established as per Article 280 and the creation of State Finance Commission (SFC) created as per 243I and 243Y on the pattern of the UFC are the arrangement designed by the constitution. In brief the 73rd/74th CAs which have added part IX and IXA to the constitution have virtually restructured the public finance of Indian federation. The moot questions is How far we have pursued this during the last 32 years?

(iv) Accountability Mechanism

Decentralised governance and for that matter any government is legitimized through appropriate accountability mechanism. As Richard Bird observes:

"Budgeting, financial reporting, and auditing should be comprehensive, comprehensible, comparable, verifiable, and public. It is equally important, however, to ensure that budgeted resources are applied as efficiently and effectively as possible to achieve desired public outcomes". [Bird (2000)p.40]

By creating the institution of Gram sabha, the assembly of voters at the village level (article 243A) with powers to review budgets, hear audit reports and so on the 73rd Amendment has

connected the accountability institutions to the door steps of the people. It is important also to look back and review where we are now in making gram sabha a viable institution.

In concluding this part of the lecture, let me say that what is said so far is a simple stylized presentation largely accommodating the Indian decentralized reforms. Logically I should have added my objections to western theories here. But I am postponing this for the next event. I deliberately leave out the huge edifice of fiscal federalism to simplify matters. The theory of fiscal federalism and much theories in public finance owe a great deal to Musgrave. Although many people have ruthlessly criticised Tiebout (1956) and his 'voting by feet' model, he was a pioneer in regard to the theory of fiscal decentralisation. Please note that I have skipped the so-called AMS (Arrow, Musgrave, Samuelson) theory or first generation theory (FGT) because what is relevant is due to Musgrave. Wallace Oates (2005) has a paper on 'Towards a Second-generation theory of fiscal federalism'. Having carefully read that, I thought we may skip that because that is not going to throw much light on the topic we have on hand.

All the received theories of fiscal federalism are ways of preserving the market. Both the FGT and SGT however focused on market failures and rectifying that. Seeing the state as a 'Leviathan' that seeks its own aggrandizement that maximizes the revenues from the economy [Brennen and Buchanan (1980)] and approaches like that are totally irrelevant. The FGT envisioned a major role for the central government in establishing equitable distribution of income and maintaining the economy at high levels of employment with price stability and want decentralized levels of governments to handle in the efficient provision of 'local public goods'. Many theories are built around this. If any central government has perfect information many theorists will argue for Pareto-efficient levels of output of local public goods in each jurisdiction as I have already said. But local level governments know the preferences of the local citizens. Wallace Oates' decentralisation theorem follows from this. Following from this and the various theories that have emerged as an offshoot of this are against all 'bailout' of provincial or local governments and argue for hard budget as we have already noted. But this however thematically relevant is hard to implement.

Let us conclude this part by quoting two public finance scholars De Figueirido and Weingast (2002) point out that a federal system is subject to two basic threats:

- (i) Central intrusion(or takeover) leading to the destruction of an effective federal structure through the loss of power at decentralized levels;
- (ii) The impairment of federal institutions through opportunistic efforts at decentralized levels to raid the fiscal commons and obtain 'local' benefits at the expense of other jurisdictions.

Indeed the stability of a federal system is a delicate balancing act as the emerging issues in India loudly proclaim.

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