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FISCAL FEDERALISM IN INDIA AT CROSSROADS: REFLECTIONS FROM A NATIONAL SEMINAR ON ADDITIONAL TERMS OF REFERENCE FOR THE 15TH FINANCE COMMISSION

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PREFACE

The Gulati Institute of Finance and Taxation (GIFT) has a mandate to organize outreach activities through publications, advocacy programmes and policy debates on various topics of contemporary importance in the field of Public Economics, including fiscal and monetary policies, resource mobilization, public expenditure and social spending. The present Discussion Paper is the first in a series of studies and reports being published by GIFT in fulfilment of its mandate. Initially the Discussion Papers will be published through the electronic media. They can be downloaded from the GIFT web address.

This paper aims to bring out a summary of the themes, discussions and conclusions of a National Seminar on the topic: "Additional Terms of Reference of the 15th Finance Commission", organized by GIFT in New Delhi on 14 September 2019. The additional ToR was requisitioned by the Union Government at a time when the Finance Commission has nearly completed its tenure. The addition to the ToR has, as it raised a host of conceptual and procedural issues, caused alarm bells to ring in a number of Indian States including Kerala. As such it was perceived to have far-reaching consequences on the volume of fiscal transfers to States from the divisible pool of resources, to be mobilized in the coming years. In this regard, Dr Thomas Isaac, Chairperson GIFT and the Honourable Finance Minister of Kerala, who is also the lead author of this paper, initiated the convening of a National Seminar to discuss the fiscal, legal, and political implications of the additional ToR. The Seminar, organized with support and participation of a broad spectrum of the political leadership, academic community, jurists, media and policy makers of India, was inaugurated by Dr Manmohan Singh, the former Prime Minister of India.

With much appreciation to all the participants for their contributions that they offered, we have presented their views in detail in the seminar report, from which this paper is derived. The seminar report is made available in the website of GIFT (www.gift.res.in). Hopefully this Discussion Paper will serve as a source material for policy dialogues concerning the structure and content of fiscal federalism in India, which the GIFT wishes to anchor in future. I wish to acknowledge the guidance by Dr A V Jose, former Director of GIFT, the superb work done by my colleagues in the faculty and administration, the timely support from Shri N D Jayaprakash, Dr Dinesh Abrol and Dr Sachin Chaturvedi, DG RIS, New Delhi and his colleagues in organizing the Seminar. Valuable inputs from Dr Pyaralal Raghavan towards preparing this paper are also gratefully acknowledged.

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Introduction

Federalism is a fundamental feature of our constitution, which has clearly defined the roles of central and state governments as specified under the Union, State and Concurrent Lists. As states are entrusted with larger expenditure responsibilities and their taxation powers are smaller than that of the centre and the fiscal capacities vary widely across states, the Constitution has given us the Finance Commission to correct this imbalance. By and large the Finance Commissions have done a fair job recommending transfers from the centre to the states and among the states despite the centre often nudging the Commissions (through the latitude provided by Article 280(3)(d) of the Constitution) to treat the centre and states with different norms.

The Terms of Reference (ToR) of the 15th Finance Commission notified end of November 2017 were unprecedented, went beyond anything seen in the last 70 years. It required the Commission to review the 42% tax assignment award of its predecessor; whether revenue deficit grants be provided at all; propose measurable performance based incentives for states in the areas of moving towards replacement population growth, achievements in implementation of flagship schemes of

Government of India, and control or lack of it in incurring expenditure on populist measures. In addition, the general convention of using 1971 population data while making recommendations was changed to 2011 population data. Then, towards the end of the tenure of the Commission, just three months before it was due to submit its recommendations, and when all the state governments had already submitted their memoranda, an additional ToR with far reaching consequences was issued by the centre. The ToR read as, "the Commission shall also examine whether a separate mechanism for funding of defense and internal security ought to be set up and if so how such a mechanism could be operationalized".

The states were greatly concerned seeing some of the ToRs. Government of Kerala took the initiative to convene a meeting of the Finance Ministers of states in Thiruvananthapuram in April 2018 to discuss the ToRs of the Commission. Andhra Pradesh, Karnataka, and Puducherry participated in the conference. A large number of public finance experts and administrators deliberated on the ToRs. In the next few weeks a draft memorandum requesting the President to amend the ToRs was prepared. It was discussed in a larger convention in Vijayawada in May 2018 where Finance Ministers of Delhi, Punjab and West Bengal too participated. A memorandum was submitted to the President of India. The deliberations of the two conventions were widely covered by the media and there was a feeling that the Finance Commission may be listening to the 'voices' of the states. But post Parliamentary elections, the picture changed. Emboldened by a larger majority, the Central government was almost issuing a directive to the Commission to treat expenditure on defense (the first item on the Union List) and internal security before deciding on the Divisible Pool.

Sensing that the Centre is pushing the claim of more fiscal space using the politically sensitive defense, which in the process might change the federal structure altogether, the Gulati Institute of Finance and Taxation (GIFT) (that coordinated the drafting of the memorandum during April- May 2018) organised a one-day seminar on the additional ToR in Delhi on 14 September 2019. The seminar was inaugurated by Dr Manmohan Singh, Prime Minister during the UPA regime, who also released the book, *Challenges to Indian Fiscal Federalism* by T M Thomas Isaac, R Mohan and Lekha Chakraborty published in 2019.

The seminar was organized in six sessions in addition to the inaugural and concluding sessions. The session titles and participants are shown below:

Inauguration

Chair: Sitaram Yechury;
Speakers: Manmohan Singh, T M Thomas Isaac, Jairam Ramesh, D Raja, Harsh Mander, Dipankar Bhattacharya and Indira Jaising.

Session 1: **Setting the Context: 15th Finance Commission Story So Far**

Chair: T M Thomas Isaac;
Speakers: Manish Sisodia, Haseeb Drabu, and Abhijith Sen.

Session 2: Union Government Responsibilities: Perspective of Finance Commission

Chair: Balveer Arora;
Speakers: Sudipto Mundle, Indira Rajaraman, Govinda Rao, Atul Sarma, D K Srivastava, and Abhijith Sen

Session 3: Implications on Fiscal Stability and Governance

Chair: Jayati Ghosh;
Speakers: Venkatesh Athreya, Himani Baxi, D Narayana and N J Kurien.

Session 4: Response of the 4th Estate

Chair: T N Ninan;
Speakers: T K Arun, Harish Damodaran, Sukumar Muralidharan, Mihir Sharma, M K Venu and D Vijaya Mohan.

Session 5: Constitutional Implications of the Additional Terms of References

Chair: A P Shah;
Speakers: P D T Achary, M G Devasahayam, Mridul Eapen and A V Jose.

Session 6: Fiscal Health and Development Implications for the State

Chair: Prabhat Patnaik;
Speakers: C P Chandrasekhar, Pravin Jha, Sushil Khanna and K Raviraman.

Concluding Session: Summing up,

Chair: T M Thomas Isaac and Abhijith Sen.

Inauguration

The Inaugural session highlighted the theme of how the Additional ToR of the 15th Finance Commission is not only a threat to fiscal federalism, but also one among the many moves of the central government threatening the very federal structure of the Constitution. It is not very uncommon for any government at the centre to encroach upon the rights of the states but this is a qualitatively new attack. This is the government, which since coming to power in 2014 has been talking about co-operative federalism first introduced in 1996 by the UPA government and taken forward by the concept of divisible pool. But it has become competitive federalism in the hands of NITI Aayog and combative federalism in political management by this government. The approach of this government to federalism is a different model of managing diversity where homogeneity prevails both in terms of political thought as well as economic policy. This is dangerous and needs to be resisted.

Democracy in a vast and diverse country like India cannot survive if it is not secular and the republic is not federal. Since our constitution explicitly recognizes India to be a secular country this regime had to target the very concept of secularism and we know what has happened. But since federalism is not explicitly mentioned in the constitution the regime did not have to attack federalism directly; it is being subverted in practice. What we see is a very systematic misuse of the concept of national security to undermine democracy.

The values that lie at the core of our Constitution are, justice, equality, liberty, fraternity, secularism, socialism, scientific temper and federalism. Defence of federalism is fundamental to the defence of all other core values. In a unitary, muscular and centralized nation defence of justice, equality and other values becomes harder and harder. We need to go back to what the

Constitution envisages the role of the centre, what should be the boundaries and the role and freedom of the states. And in this battle over the next five years for the defence of the Constitution we all need to reclaim, reimagine, reassert and reaffirm the defence of federalism and the rights of the states so that they can carve out their destinies according to their mandate.

The Indian courts are confused on what exactly is the meaning of federalism. It means a relationship between the centre and states which is fair and equitable. We citizens have a voice both at the centre and in the state elections. States and centre have equal, and well defined relations. There is a separate chapter on centre - state relations in the Constitution. So, it is not that we are chartering unknown territory but this chapter is less visited by the courts. The courts see it as a political issue and do not enter the terrain. It is wrong to say that the courts should not enter the fiscal terrain. That is a British view. This is changing in Britain and elsewhere. This is of course something we should revisit and ponder upon. Why is it that while the election commission was subjected to very intense scrutiny by the courts and made in some minimal sense accountable to the people a similar scrutiny has not taken place over the finance commission?

Internal security and defence are subjects of great importance and if the central government wished to tinker with the ToRs the best course would have been to go back to the Chief Ministers' conference. There are certain basic issues like allocations for health, education and other important subjects like protection of environment where all states have legitimate interest and what should be done by the government is to evolve a broad national consensus in dealing with these issues. Otherwise there would be bickering and dissatisfaction and this would not be good for the federal polity of our country. Cooperative federalism requires give and take and therefore it is very important that the central government should take initiative to consult states as often as necessary to carry them along rather than imposing their views on a reluctant finance commission.

Setting the Context: 15th Finance Commission Story So Far

The Finance Commission does not consider Delhi a state. Puducherry has the same issue. Sometimes the Finance Commission tells Delhi that they are a state and asks them to set up a finance commission and devolve funds to the local bodies. But when Delhi asks for funds from the Finance Commission then they say it is not a state. Union Territories are not within Finance Commission's ambit. Is Delhi a Union Territory (UT) or a state? This question is complicated by Jammu and Kashmir which used to be a state but now has become a UT. Should it get the same treatment as a UT? The idea of federalism is being eroded by actions taken at various points. In this Finance Commission will merely be a tool as it would not know what is going to be done. In such a situation the Finance Commission should simply disregard the additional ToR. The Centre can choose to spend any amount on defence from its own part of the resource kitty. If it wants additional resources, then it could turn to cess and surcharges. But at the end of the day what we require is consensus rather than compliance and the way to do it is by having consultations at the time of framing ToRs.

Nobody is going to contest that defence requires funds. But Constitution is clear that these are things that the Union government has to deal with its own share of resources. Why does it have to come on to the divisible pool? So, what these terms of reference is trying to do is to undo the recommendation of the 14th Finance Commission in some way or other. What is being done now is exactly what was done to the Gadgil pool in the seventies and eighties. It is not about this government or that government. It is about the Union governments, a certain mind-set. Right through the seventies and eighties the Gadgil pool was created to share the plan grants. The Union government pre-empted resources from going to the Gadgil pool by building up central schemes and centrally sponsored schemes and so on.

The basic thing that is being done today to the Finance Commission divisible pool is what was done to the Gadgil formulae earlier. Another stakeholder is being added: Centre, States and a function. The idea is not to share 42% with the states. There is also the effect of larger factors- a squeeze on resources. Along with eroding the Finance Commission by changing the rules of governance and representation the centre is directly transferring resources to the Panchayaths. The states are squeezed from top as well as bottom. Soon the second layer of governance will disappear and that is when actual centralisation will take place: centralisation through decentralisation.

It is useful to be critical but it is even more useful to be constructive. It is not enough to say that defence should not be there. The relevant question to ask is, is there a way of reorganising the entire federal fiscal system differently? Presently federal fiscal system has two parts: one is revenue sharing, which is Finance Commission, alongside expenditure underwriting. Centre underwrites a lot of expenses of states either through centrally sponsored schemes (CSS) or whichever way. A better way going forward is to abolish expenditure underwriting and maximise revenue sharing. It would give tremendous flexibility to states to decide their expenditure priorities doing away with ad-hocism. There is also a need to move away from sharing just transactional revenues to resource sharing. There also have to be synergy between two constitutional bodies, namely the Finance Commission and the Goods and Services Tax (GST) Council. In the hierarchy, GST Council stands higher because the Council is an elected body whereas Finance Commission is not. Some kind of institutional reorganisation has to be done which will empower the states.

Union Government Responsibilities: Perspective of Previous Finance Commissions

The institutional memory of last four Finance Commissions, how they dealt with ToRs given to them, particularly when the term *shall* appears in it is the subject discussed in this session.

There has been a long-standing demand that states be consulted in the framing of the terms of reference but what has emerged is a very strong tradition of unilateralism. By and large successive finance commissions have retained their freedom to interpret the terms of reference. The independence of thought they have displayed have gone into establishing and consolidating their credibility as autonomous institutions responsible and answerable to the mandate spelt out in the constitution.

The macroeconomic situation is germane to what we are discussing here. Growth has collapsed and there is a crunch of resources. Centre is looking for grabbing resources to finance expenditure. In the last budget defence expenditure has seen significant compression and the centre is feeling squeezed for resources on the one hand while simultaneously undertaking large expenditures on subjects in the State list. There has to be a forum for discussing expenditures at the national level. The GST Council for all its limitations is today perhaps the most successful example of a federal platform where the states have a voice. Though it is limited it is better than anything else. That is on the revenue side. On the expenditure side there is no such institution. There was some consultation during the era of the Planning Commission which is now gone. Some forum is needed to discuss the entire expenditure side of government budget of both central and state governments. A GST type expenditure council with central and state finance ministers, or a much better way is the inter-state council. This got parked in the home ministry completely disempowered. This can be reversed through a constitutional amendment and it can look at the spending side addressing many issues raised here.

A text book characterisation of the central responsibility is that the Centre has a comparative advantage in terms of macroeconomic stability and redistribution and in terms of the allocation it is the national public good, and those public services considered to be highly meritorious or with significant interstate externalities that is where the union government responsibility rests. Obviously, the constitution has taken cognisance of this. The comparative advantage has also led to centralisation in tax powers and since there is centralisation of tax powers there is also an independent finance commission to resolve the vertical imbalance. Now irrespective of the governments that have existed over the years the finance commission, which is a major source of resolving issues, never had overall control over the transfers. The total transfers are essentially determined by the central government. If the FC gives more to the states, then the centre cuts down on CSS or some such. Or it imposes more cess and surcharges as has been done following the 14th FC award.

In the original terms of reference there is already a reference that basically says you must take into account the requirements of defence etc. To have an additional reference, there is something more to it than meets the eye. It is also quite possible that after visiting several states the chairman of the Finance Commission has been saying that the states are asking for 50% or more. So, there is a fear that even in spite of all the nudging that was done in the initial terms of reference the Finance Commission may cut down the share of the Centre. The ideal thing for the Commission to do is that the finance commission is not bound by any of these things. And as far as devolution and grants are concerned, article 280 sub clause a and b in fact it is a constitutionally given power that needs to be exercised. There is no need for union government to impose any restrictions and even if they do the Commission can simply ignore it.

Additional ToRs are not new to Finance Commissions. The 11th FC was given a command to split the revenue deficit cover for states and another to set up a fiscally monitorable program on the reduction of revenue deficit. It raised a furore and did not work well. Turning to the additional ToR of the 15th FC, there is nothing alarming here. It needs to be seen as an opportunity to look at defence funding. Defence expenditure can be met though monetisation of defence assets. The defence establishment has huge tracts of land. It can be used for housing or personnel. There are other multiple uses. This is a rare opportunity for the finance commission to speak about the land holdings of the defence ministry. The 13th Finance Commission report said that the public sector units should take an inventory of land with them and look at ways for their productive use. Probably, the reason for the additional terms of reference in July was because the reduction in budgetary provision for defence pushed the government to reassure the defence establishment by asking the Finance Commission to look into the issue. This is a huge opportunity which should not be lost.

The Finance Commission is already required under the original terms of reference to take into consideration the demand on the resources on account of financing defence, internal security, infrastructure and so and so forth. So, what the 15th Finance Commission can do while assessing the requirements of the government of India is to explicitly take into consideration the fact of declining defence expenditure as percentage of total expenditure and make appropriate provision in expenditure projection as the 14^{th} Finance Commission did. Whatever it be over the last 70 years or more the finance commission has been able to establish itself as a neutral and fair body and it should not do anything against this reputation.

Focusing on the word funding in the additional ToR, funding could be read as financing or financing through a fund. As there is already talk of Rashtriya Suraksha Nidhi, the idea is whether it would be appropriate to create a national defence fund and if so, how it should be financed. There is only one example where a cess financed fund- calamity contingency fund- has been created at the behest of Amresh Bagchi of the 11^{th} Finance Commission. Such a fund has to satisfy a few conditions. The first condition was that there would be an inadequate attention paid to the subject concerned in the normal budgetary process. As far as financing of calamity and particularly funding for preventing calamity was concerned there was hardly any allocation; it was always a response to a calamity. So, it was thought that it may be useful to set up a separate new mechanism where the issue of inadequate allocation of budgetary resources in the normal decision processes could be overcome. But defence and internal security fund does not meet this because it has the first claim. Defence is the example of a pure public good to be financed by the mother tax, not cesses and surcharges. It is the first claim of any taxation by any government which has the responsibility of defence.

The second condition is that it should be a shared responsibility between the Centre and the States. Calamity relief is met jointly by the Centre and States and nowadays even by local bodies. Defence when supplemented by internal security could also be interpreted as a subject of shared responsibility. So, that test will be met. The third condition is that it should be subject to unanticipated shocks leaving to spikes in concerned expenditure. Calamity is like that and defence too has these twin characteristics. There is an on-going demand for expenditure on defence that is also subject to spikes of expenditure particularly during war time or during other internal security emergency. Defence thus meets the third condition.

The fourth condition was that the mechanism should be such that there is a constant flow of funds. It will never go short of finances. And for that purpose, a separate contingency fund was the answer. Because the moment you spend money out of the contingency fund, it is to be refilled and it has the first claim to refill. In the case of defence and internal security fund actually a contingency fund can come to the rescue of the Union government. A contingency fund of course exists, but it is very short funded. So the mechanism already exists. The fifth condition is that the fund should be such that it should be non-lapsable. It should go into the fund and should accumulate. It is this last fact that has bothered the central government right now. It is the main motivation why the additional terms of reference have been given.

Implication on Fiscal Stability and Governance

States are directly close to the people dealing with issues they face. Centre is more remote in such areas of governance. Therefore, the centre can afford to say tighten your belts but the states cannot do it. They are pretty tight already and have been continuously and illegitimately denied revenue by the unilateral action of the centre in lowering tax rates for the well to do in the country. It is time to revisit the whole regime of neo liberal policies of taxation. And one must raise a demand for greater direct taxation of a form that is sharable by the states. And states need to have additional resources given that they have a very large remit on the ground. Defence and internal security are two of the three largest expenditure areas of the central government and if they are removed from the centre's share of tax revenue then of course they will have lot of money to play with and use for other purposes that would mean more interventions in state subject areas through centrally sponsored programs and others. It is hoped that the Finance Commission will take a very independent and objective line in this regard.

An alternate view finds that the actual overall flow of financial resources from the centre to states has not gone down. Given this background when we look at the additional terms of reference the question is will the new terms of reference hamper devolution? If there is an adverse impact then the states will be in a difficult situation. Already the manufacturing states are suffering from the GST implementation problems. Till 2022 they will have a cushion of 14% compensation. What happens beyond that date? The other concern is at governance level. Many states are failing to implement state finance commission awards. The additional terms of reference if it reduces the resources flowing to the states will cause further problems for the third level of government.

The basic point with regard to the additional terms of reference is a continuation of a narrative that has been built over the last five years of constrained fiscal space of the centre. Such a narrative underlies some of the original terms of reference. For example, ToR 6 (iv) is the unprecedented review of the award of the 14th Finance Commission. The concern was that the states have been given more funds and the centre is squeezed. The implicit message in TOR 6 (v) is also that the resource flow to the states are protected. The impact of GST, the 14% compensation and so on. So, the message conveyed is that the revenues of the states are protected and that if this continues the centre will have no money to pay for defence. It has been shown by many researchers that the fiscal space of the centre has not come down but the narrative of constrained fiscal space of the centre continues.

A look at the capital expenditure in the total budget and that on defence during the last 12 years shows that between 2008-09 and 2013-14 there was a doubling of capital expenditure both total and that on defence. But in the next five years while total capital expenditure went up by 70% that of defence went up by only 35%. That is in nominal terms. Taking into account inflation the capital spending on defence in real terms has virtually stagnated. The result has been that defence capital spending in total capital spending has fallen from over 40% before 2014-15 to 30% now. This period also saw the fiscal deficit go down from 6.2% of GDP to about 4% of GDP that is 2.2 percentage point drop. Along with that is seen a 1.8 percentage point drop in revenue deficit. But in the next 5 years the fiscal deficit came down by 0.7 percentage point and the revenue deficit by about 0.6 percentage point. What it really means is that while revenue expenditure has been going up by around by 10% per annum the capital expenditure has not been growing at that rate.

And in some years the growth of revenue expenditure has been much higher. Like in the latest year, an election year it is over 20%. Why has such a situation come about? That is the revenue expenditure growing by such a high rate. This has been answered by the 14th Finance Commission: the Union government's spending on state subjects has increased from 13% to 20% of total expenditure and on concurrent list subjects from an average 13% to 17% and they conclude that expenditure functions under the union list fall predominantly under general and economic services and the share of these has progressively declined from 66.3% in 2001-02 to 53.2% in 2014-15. In fact, this trend continues after 2014-15 as well. So, the centre is spending more on the revenue expenditure and squeezing the capital spending. The implication of that for GDP growth and also for defence capital spending is well known and it looks like this additional ToR is somehow to protect that.

Response of the 4th estate

The additional ToR is not out of the need for fiscal consolidation but as part of the overall centralisation. As 14 to 15% of the overall revenue of the central government is raised through cess and surcharges not shared with the States, resources is not the problem. And asking the Finance Commission to make a provision for defence is not the only form of centralisation that is being resorted to. The Commission has been asked to set up a committee to deliberate on the desirability of transferring health from the state to concurrent list. This government has started funding health insurance as a form of central largesse to the people of the country. Each level of government confining its expenditure to its assigned areas in the constitution and therefore optimising the use of its resources is not something acceptable politically to this government or its ideology. And it is in this light that the state finance ministers who want to resist the move must approach the ToR.

An alternate point of view is that we are debating the additional terms of reference because there is a full squeeze on revenues. There is no spending happening. This would not have been a problem in 2006 or 2007. The entire revenue of the government is squeezed. That is why the debate. What we see now is possibly one of the greatest de-industrialisations since the colonial times. Jobs are disappearing. There is no possibility of spending in such a scenario. There is no circulation of cash. This is a classic recession. So, the government wants to increase its revenues in all possible ways. It is not just the centre which is trying to protect its revenue turf. Many states are also trying to raise revenues.

In the last few decades there has been a shift in distribution against the working class and farmers and this cannot be pushed further without an overt recourse to authoritarianism. So, it is no coincidence that after an election a directive is being given to the Commission. This has ominous implications for the practice of politics. The word federal occurs just a few times in the constitution. Federalism has been largely built up through practice. That practice has gained traction after the erosion of the monopoly power of Congress. This has also been triggered in many ways by increasing political participation and greater inclusiveness in politics. The older hegemonic classes had to yield space to newer emerging classes in the practice of politics. It is more pronounced at the state level.

Greater and greater centralising and also authoritarian tendencies seek legitimacy through frequent invocation of national security imperatives. This particular aspect of current politics which we are discussing today is one element of the larger canvas and it is important that we resist it at every possible level and every possible way. But it is just one part of a much larger struggle against the greater marginalisation of various sections of our people from politics. It is a virtual overturning of the promise of equal opportunity and participatory democracy that we made to ourselves at the time of independence.

A larger narrative of political centralisation is very clearly reflected in the bureaucratic language of the ToR. It is different from ToRs before. There is a narrative of centralisation that is politically very powerful and which has demonstrated its political power by winning elections. If a counter narrative is to be formed it will have to demonstrate its power by winning elections. Then it will be able to push back the kind of things seen in the terms of reference. Again, in this narrative centralisation has wrapped itself around questions of identity and so on. The fear is that the counter narrative will also be wrapped around questions of identity rather than on more nebulous concepts like fiscal federalism.

The media responded in a certain way to the new terms of reference, especially the 1971 population issue taken up by the southern states. It was seen in the southern media. The outcome was a south versus north contest. But the narrative was there. By some estimates the southern states were expected to lose around Rs 1.5 lakh crore due to the use of 2011 census. In fact, the southern states piped down in spite of the assumed losses. Northern newspapers, especially the Hindi ones, with around 100 million circulation, were not very concerned because they were the gaining states.

In the present context, there is no doubt that the centralising tendency is gaining momentum in a big way and rapidly. The Kashmir 370 is one example. There are now unexpected moves at a sharp pace. We knew it was in the manifesto. But not that it will come so soon. The point is the idea of carving out a new fund for defence and internal security is actually of a piece with a larger narrative of national security, which was a big theme in the last elections and this theme will intensify, remain for some time and Pakistan and Kashmir will be the pretext for doing all sorts of things. It can be an electoral issue. The media is increasingly finding it difficult to speak the truth. The economic downturn has also hit the media. Spending on news gathering and real reporting has gone down. There is not much hope for building a more objective counter narrative in regard to erosion of all forms of federalism.

Constitutional Implications of the Additional Terms of References

The Indian federal structure has been viewed by the Supreme Court generally in favour of a strong centre. In case of discord usually the central views prevail. Secondly, it is not clear if fiscal policies are justiciable. Scope of judicial review has expanded considerably now. Courts may be expected to take a view. Maybe even the award of the finance commission may be justiciable if it violates the federal structure of the country. But there will be tremendous limitation on the Courts' power to review ToR or any decision taken by the finance commission. Courts normally try to keep out of the matters falling in the economic sphere. Experts have given warnings about the emergence of a very strong centre and have warned about developments that may be constitutional but not democratic. A federation can give rise to a dictatorship. A government which is allowed to kill parliamentary democracy in the states may also kill it in the centre.

What are the implications of the additional ToR from a legal and constitutional point of view? An answer to the question takes us to Article 280. The President can refer any other matter to the Commission in the interest of sound finance. The Commission is duty bound to examine it from that point of view and give its recommendations. States now fear that the additional ToR will pull down their fair share from the Divisible Pool. If it adversely affects the programs of the states, then it is not in the interest of sound finance. Further, the non- lapsing fund will lock up huge amount of money the opportunity cost of which may not be small.

India should have had a national security doctrine before going in for any national security fund. We do not have one. Human security is the best form of security and that is why the top 3 goals of Sustainable Development Goals are no poverty, zero hunger and good health. Democracy centred human security should replace threat centred state security. It is time India framed a national security doctrine based on these realities before thinking of a national security fund.

There is a need to expose the political agenda of creating a sort of insecurity and fear psychosis in the economy that there is imminent danger from neighbours and so on. This is the political agenda of the government. Secondly, the hunt for resources is not just by the centre but the states too are in the hunt. The states prioritise their expenditure. The Centre should also do this instead of spending on subject areas which are not of theirs but of the states. Thirdly, is it legal or technically permissible to frame terms of reference in a way which is nudging the Commission to help the centre. Finally, the constitutional implications of this particular ToR need to be examined. Suppose this TOR goes through and the share of states gets reduced, then social sectors get affected which would affect women and vulnerable sections of society. What happens to their constitutional rights? This has serious implications that have to be kept in mind.

We are all provincial identities that came together under a federal banner for economic reasons and there are compelling political reasons to maintain the federal structure. Any unilateral intrusion violating the fiscal autonomy of provincial entities has got to be resisted. There is a genuine apprehension that the state's autonomy is going to erode in the days to come. It is time for us to think of ways to strengthen the federal polity, which essentially means redefining the rules of the game that can strengthen the federal structure. In any case the financial autonomy enjoyed by the states cannot be compromised.

Fiscal Health and Development Implications for the States

It is now fairly well established that an additional rupee transferred from the state governments' kitty to defence expenditure is net welfare reducing. Here welfare expenditure includes not only health and education but also agriculture and other such subjects which are under the domain of the state governments. As growth slows and revenue growth decelerates and the fiscal deficit of the government is fixed government expenditure goes down. So, it is pro cyclical. In a situation where there is a shift of a rupee of expenditure from welfare towards defence then you will find that welfare expenditure would go down even more sharply than GDP growth rate. So, it is a matter of concern quite apart from the centre - state relationship as this is going to bring about a significant shift in the pattern of government expenditure. Now this is particularly significant at this moment for another reason. Defence is import intensive and then any such shift from welfare to defence spending will reduce demand for the domestic economy. So, the idea at this moment should be to try and shift resources from defence to welfare or other such things which are demand augmenting and to look after defence by having reasonable foreign policy, a policy of good neighbourliness, rather than going the other way round which is both welfare decreasing as well as demand diminishing that will only accentuate the economic crisis we are caught in.

The defence security fund was in a sense already in the pipeline. This is something the 14th Commission had considered. Looking at centre's net tax revenue from 2015-16 to 2019-20 as projected by the 14th Finance Commission, it may be seen that the states will have a substantial shortfall and simply as a share of GDP the state's share in divisible pool would fall from 3.7% to 2.6% of the GDP in 2015-16 and in 2019-20, from 3.8% to 2.8%. Obviously these are very substantial reductions if the 15th Finance Commission were burdened by this amendment. We don't know how the 15th Finance Commission will do the computations. The decline can be slightly less or slightly more.

The discussion since the inaugural session suggests that there are two views regarding the additional ToR. Some former finance commission members seem to look at it as a benign mild directive which is normal procedure if you look at the previous commissions. Some said the government only wants a non-lapsable fund in which case they don't need finance commission's permission. Vajpayee had implemented a non-lapsable fund for the north eastern states. The other view is that it is an attack on federalism, an attack that goes far beyond finance. And this begins with the abolition of a state and it is surprising how muted the response has been. The finance commission members who were invited were afraid to be seen here. This was not the case before. The times are different. We are living in a country where states can be abolished. Fiscal rights of the states are only a minor part of the story. This calls for much bigger fights including legal ones.

Concluding Session: Summing up

If the Centre wanted a separate fund for defence they could have done it. The 14th Finance Commission had allocated around 14% of the funds for defence. Why should there be a separate fund? Centralisation is happening due to the proliferation of the centrally sponsored schemes whose share is now around 16-17%. In contrast the share of central funding on the subjects in the Central list has come down. The expenditure clarity that has been distorted has to be corrected now. Most of the redistributive expenditure are in the states' domain. So, the additional ToR is a political economy question.

The Finance Commission has to be located in the current context. It has the right to interpret the meaning of the term *shall* in the additional terms of reference. But given the current scenario with the collapse of innumerable institutions we have to be cautious. The objective of the seminar was to focus on Centre- State relations. The Centre has strayed into areas like fisheries, electricity, education and even healthcare- all state subjects. Coming to the additional terms of reference one thing is clear. You cannot have a third component apart from the centre and the states in the Divisible Pool. Anything else will be challenged. Objective of the new terms of reference is to pressurise the Commission and reduce the 42% share devolving on to the states. The 13th Finance Commission only looked at non plan spending. Considering that the 14th Commission took into account total spending, plan and non-plan, the net increase due to the higher tax share allocated by the 14th Finance Commission has been marginal. Therefore, this is an attempt to reduce the share of the states in the name of defence. This design of the centre has to be fought with all our might for protecting our federal structure.

Gulati Institute of Finance and Taxation (GIFT), Thiruvananthapuram, Kerala, formerly Centre for Taxation Studies, was conceived as a premier national institute to promote theoretically grounded and empirically based research within an interdisciplinary perspective to aid policy making at the national and sub-national level. Affiliated to Cochin University of Science and technology, GIFT is also mandated to facilitate research leading to PhD, apart from being a highly acclaimed institute undertaking training programs for capacity building of different stakeholders, including Government officials. It also offers a Post Graduate Diploma in Goods and Services Tax.

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