

Federalism in India: Political and Fiscal

PK Chaubey



There is a need for better delineation of resource bases so that dependency of units reduces but the access to resources does not. In whatever remains, the unit states get a matter of right, not be as charity. ... It can happen only when unit states are treated as responsible states and the basis of federation is fraternal, not paternal

WE PROPOSE here to delineate the difference between political federalism and fiscal federalism as they are understood today. While it is well

understood that the two are not co-extensive, there is still a need to differentiate between decentralization and federalization. Scholars delving into fiscal federalism have a tendency to suggest that all countries, barring city-states like Singapore and Monaco (and, one can add, Vatican City), are fiscally federal simply because there too exists a level of government, which is called local. We also propose to posit the complexion of Indian polity with respect to political federalism and fiscal federalism but almost as an illustration.

Present Categorisation of States

States are often categorized by structure as unitary, federal and confederal though very few constitutions have called their states as federal or for that matter, even unitary or confederal.

Unitary State

A unitary state may have several layers of 'local' governments, where 'local' includes 'regional'. State is the principal and local governments are the agents of this principal. In modern

times, as citizens are accepted as the 'principal' rather than consumers or subjects, state is being increasingly conceived as an 'agent' rather than the master.

Confederal And Federal States

In other two systems—confederal and federal, there are two levels of states; the two share the sovereignty between them by the constitution. For analytical purposes, we can call them 'union state' and 'unit state'. When a number of sovereign states come (voluntarily or forced to come) together to form a union state, the form of the emerging polity might become an issue. If constituting units lose their sovereignty altogether, the resulting polity becomes unitary. The UK could be taken as a good case. But if the unit states retain their sovereignty substantially, the resulting polity becomes co-federal. If however the constituting units surrender a good amount of sovereignty and yet retain it too in a good measure, the emerging polity is called federal. All constituting unit states here have common rules in certain matters through the union state, known in literature as 'shared-rule' and they also continue having their own rules, known in literature as 'self-rule'. Accepted as father figure in federalism literature, Kenneth, Who tried to impress upon that units and union are coordinate and independent in their

The author is Professor of Economics at Indian Institute of Public Administration, New Delhi. He has previously taught in Banaras Hindu University, Devi Ahilya University and GB Pant Social Science Institute. He is an eminent economist and has to his credit about a dozen books and about 250 research papers and articles in refereed journals. He has been associated with several learned bodies and government committees.

respective spheres. One can interpret it to say that none are subordinate but are equal.

If functions which require common dealing or there is substantial economy of scale like defence or money or foreign affairs, are devolved to the union state, then emerging polity can be said to be co federal. It was the case when the term 'The United States of America' was coined for the 'perpetual Union' formed between original 13 states, each of which was to retain 'its sovereignty, freedom and independence, and every power, jurisdiction, and right, which is not by this Confederation expressly delegated to the United States, in Congress assembled' (See Articles of Confederation and perpetual Union). In fact, Article 3 puts emphasis on 'each other' for friendship, cooperation and assistance between states. But a provision said that there shall be a common treasury to meet common defence and general welfare. Under Confederation phase of the USA, constituting states were supposed to raise army and navy too.

However, many politicians argued in the 'Federalist' papers that the confederation or the perpetual union is too constrained and is toothless, as for each penny, it has to depend on contributions by the constituent unit states. Then, they decided to form a 'more perfect Union' in order to 'establish Justice, insure domestic Tranquility, provide for the common defence, promote the general Welfare, and secure the Blessings of Liberty to (themselves) and (their) Posterity' (See The Constitution of the United States, words and parentheses added) and imposed certain restrictions on constituting states and asserted power to impose taxes, duties, imposts and excises but also to provide for common defence and general welfare. The Constitution came into operation when 9th State (New Hampshire) ratified it on June 21, 1788. However, now, the 'union state' shares sovereignty with constituting units which continue to be states in their own right. The emerging polity would assume the form of federation. It is from here that the world

learnt of democratic republican form of federalism so much so that Switzerland, said to be a confederation since 1291, chose to pattern its polity along the American lines in 1848 for a federal set up while leaving cantons all right to self-government on local issues. It may however be mentioned that use of referendum and an element of direct democracy are unique features of Switzerland. India is often described as a federal, quasi-federal or semi-federal and federal with unitary features. And it is true. For example, governors of the states and judges of the High Courts are appointed by the President of India and they are transferrable across the country. In the case of judges of High Courts, salaries are paid by the state they serve in, while pensions are paid by the union.

State and Local Government

We have noted that a unitary state may have different levels of governments. All confederal and federal states do have their local governments too, exception being Saint Christopher and Nevis (popularly called St. Kitts and Nevis). Local governments may be at several levels under unit states. But, in many cases, there may be some local governments under union state as well. Australia, Canada, Malaysia, India, Pakistan, the US and many other countries have federal territories which are not sovereign and the laws for them are made by the union state¹. In India, laws for self-government in union territories and cantonment boards are enacted by the Parliament of India with two exceptions, NCT of Delhi and Pudduchery, in certain matters.

The relationship between a union state and its unit states is constructional, delineating their separate and concurrent powers, while that between a unit state and its local government is legislative whereby, a unit state delegates some of its powers to its local governments.

In India, the constitution provides for perpetual existence of local government, political reservation for certain sections of the society, constitution of state election commission and of state finance commission.

Process of Federalisation

In history, we find two processes of federalization. In one case, pre-existing unit states came together to form a union state. The United States of America is a prime example. In the other, a pre-existing unitary state creates unit states with legislative powers through constitution, not just (local) governments which it can do through legislative acts or administrative actions. The case in point is Belgium which, for long ruling as a unitary state, finally decided to go federal in early 1990s, respecting cultural and linguistic sentiments. There may be a mixed case too. India is said to be such one. It is said that, while princely states were brought within the fold, after Independence, with what was British India (Dominion of India) and provinces of British India were made 'states' by given better legislative powers. To begin with, all territories were divided into four categories of states but later, after various combinations and permutations, there emerged states and union territories. In any case, for rest of the world, this cultural expanse was known and recognized as India which, unlike Europe, was not so much known by its sub-cultures.

Here, one can well note that federalization does not automatically connote decentralization. With passage of times, both unitary states and confederal ones are found to be moving towards the federal structure. Therefore, decentralization of government below the level of a unit state does not make the state as the multi-order, multi-layer federal.

State and Super-State

Difference Between Confederal State and Federal State

Though many states are not claiming these days to be confederal, this conceptual difference is very important. In a confederation, a citizen belongs to a constituting unit state while the unit state in turn belongs to the union state and there is no transitivity. In a unitary state, a citizen belongs to the state and there is only one level of

state as such, call it union or not. In a federation, a citizen simultaneously belongs to the unit state as well as to the union state. As a result, the citizens (and hopefully other legal persons) are under the jurisdiction of only unit state in a confederation (and under one state in a unitary state) while they are simultaneously under jurisdiction of both, his/her unit state and the union state, in a federation.

There are certain countries in which unit states retain their constitutions too. States in the USA and Australia do have their own constitutions wherein some of them explicitly assert sovereignty of their people². Most federal countries have a single constitution. In India, only one state, viz., Jammu and Kashmir, has a separate constitution³. Powers of the two levels of states are delineated in the (national) constitution. One level cannot encroach upon the delineated areas. Still there are two kinds of asymmetries. One relates to the concurrent areas and other relates to residuary power. Generally, union state is given supremacy in concurrent areas, which is true of India. Residuary power rests with unit states in the USA but with union state in India. And this is vertical asymmetry.

Under democratic dispensation, confederal and unitary (with exception of the United Kingdom) states are both likely to have a unicameral parliament but, using Indian nomenclature; a confederation will have a Council of States whereas a unitary state will have a House of Representatives. A federal state will have both, a Council of States—representing constituent unit states, and a House of People—representing citizens in domicile⁴.

Federalism: Political and Fiscal

Political federalism is different from fiscal federalism. Political federalism is a relationship between sovereign States while fiscal federalism is a relationship between fiscal matters of different tiers of government. In view of Broadway and Shah (2009), some unitary countries like China might be fiscally more decentralized than are some federal countries like Australia, India and Malaysia. Fiscal decentralization is

perhaps one thing and fiscal federalism is another. Yet economists have a habit of asserting that federal fiscal principles are equally applicable in all countries irrespective of the fact that the country is politically unitary, federal or confederal because their approach to polity is overly economic, that is, in terms of relationship of the state with the market. In their reckoning, 'a federation is imply a multilevel system of government in which different levels of government exist, each of which has some independent authority to make economic decisions within its jurisdiction' (Broadway and Shah, 2009, p.4). We might well differ and hold that economic decisions are only a subset of decisions that the states and governments are allowed to undertake on behalf of the people. But more importantly, the relationship between states (not governments) at different levels defines complexion of a national polity whether it is confederal or federal. A state may have a decentralized government structure is a different matter.

In a confederal state, matter is very simple. Unit states contribute (or pay tribute) to the union state to carry out its functions. In a unitary state, the state can, by legislation, grant power to local governments to collect and appropriate tax proceeds. We might recall only a sovereign has the right to tax its people and their activities and a state, as a sovereign, has that right through their legislative bodies. Governments collect taxes and, if allowed, appropriate the proceeds. In a federal state, both union state and unit states are granted separate and concurrent rights to tax. The Constitution of India has a clear-cut distinction. Local governments are also authorized to collect taxes on behalf of their unit states as are the state departments. We can further note that user charges are charges for commercial activities of the government. There may be a few pecuniary charges, fees and fines, which are of regulatory nature.

Fiscal constitution divides the sources of resources and areas of disbursement. Most scholars concentrate on tax-revenue on resources side and

expenditure on disbursement side⁵. Howsoever neat division is carried out, there emerge two imbalances. One is called vertical fiscal imbalance and the other is called horizontal fiscal imbalance. Under the assumptions that sum total of resources available for nation as a whole are equal to sum total of resources required, vertical imbalance would be that a level of government has more resources than it requires. It is found that union level government raises more resources than it needs and therefore it passes on resources through revenue sharing or grants to the unit states to support their expenditure. Thus, even if states at two levels are constitutionally sovereign, independent and autonomous, fiscally the governments are not. For example, in India, of the total revenue, union government collects more than 60 per cent while of the total expenditure, it spends around 40 per cent, including expenditure on centrally sponsored schemes. Obviously the opposite is true for all the states put together. Thus, roughly 1/3rd of revenue is transferred from the union to the state governments. Eleventh, Twelfth and Thirteenth Finance Commissions had recommended respectively 29.5, 30.5 and 32.0 per cent of net tax proceeds of the union as transfer to the state governments while Tenth Finance Commission had suggested 29.0 per cent of gross tax proceeds. Of gross revenue proceeds of the union (including non-tax receipts), overall indicative limits were 37.5, 38.0 and 39.5 per cent. Looking from one angle, it all looks good, progressive but from another angle, it is not so good because dependency of the states is on increase. In the background, all transfers are lateral, the union is only a mechanism.

Indian Constitution on Legislative and Expenditure Domains

Scholars more often than not point out intervention of the union government in the state domain and detest the tendency as an encroachment on matters included in the state list of the Seventh Schedule. What they tend to forget is that the Seventh Schedule has to be read with Article 246 which is about subject-matter of laws to be made

by Parliament and the Legislatures. So, the Parliament cannot ordinarily make law in the domain of State (Legislature). The Constitution has very clearly provided in Article 282:

The Union (or a State) may make any grants for any public purpose, notwithstanding that the purpose is not one with respect to which Parliament (or the Legislature of the State, as the case may be) may make laws. (parentheses added)

The activities of Planning Commission and Centrally Sponsored Schemes get support from this Article, which is in addition to those dealt with by the Finance Commission. Planning Commission also used provisions made in Article 292 about borrowing by the states in giving loans (as part of plan assistance). There are other Articles in the Constitution of India which suggest state executive to comply with the laws made by Parliament and the executive power of the Union to give directions to States (Article 256) or which suggest the executive power of the States not to conflict with that of the Union (Article 257). There were commission and committees that dealt with issues of so-called Centre-State relations.

Intergovernmental Transfers of Resources

Resources are transferred these days from union level to unit levels across the spectrum⁶. There are two major ways to do it: through revenue-sharing and a variety of grants. In most cases, both are adopted.

Revenue sharing is carried in a variety of ways. First, it is tax by tax basis or a by pool of certain/all taxes. Where there exists a comprehensive commodity tax on value added basis, they have generally gone for a pooled basis. India since 2000 has gone for pooling of most of taxes, direct and indirect. We adopt a mix of several criteria with judgemental weights to decide the share of individual states. Some of the criteria like population are neutral, others like income distance/income-inverse are equity-oriented, and still others like tax efforts are incentive-based.

Grants are provided in a variety of ways but generally categorized as block and specific (categorical). Block grant can be spent by a recipient state anyway it likes but categorical grants for a particular, often narrowly defined, purpose. However, in western literature, even block grant is for broadly defined purpose like education. According to the General Accounting Office, from 1980 to 2001, the number of federal block grant programs went from 450 to 700. But in India, plan assistance and non-plan revenue grants are block grants. Literature also discusses conditional and non-conditional as well as matching and non-matching grants. Each one creates a different type of incentive in the recipient's behaviour and impacts the pattern of expenditure of the recipient state. We might not take it up for want of space.

If we take example of Thirteenth Finance Commission, there were recommended five kind of grants made to unit states by the union: (i) grants-in-aid-in revenue to offset non-plan revenue deficit, (ii) grant to help meet goal of universalisation of elementary education, (iii) grant as performance incentive, (iv) grant for maintenance of roads including roads in PMGSY, (v) grant for environment protection. It is understandable that each one seeks a different goal. They might distort the priorities of the states.

Generally, resources are passed on from the union government to the unit governments and from a unit government to its local governments. However, the way constitutional provision has been interpreted in India by the Finance Commissions, resources do flow from union government to local governments via state governments

Channels of Transfers

There are a variety of channels to transfer resources from government of the union state to governments of the unit states. In some countries, a Ministry (Finance, Home Affairs, Local Governments or Rural development); in some other countries, Legislature; in some countries, inter-government forum; and in some other countries,

an independent commission carries out the exercise of transfer of resources, specifying the form, the manner, the amount and the purpose. Australia, South Africa and India have opted for an independent commission. In India, Finance Commission, which springs up every fifth year, does this job. Constituted under Article 280, it distributes resources between the union and states and uses Article 275 for grants from the union to states.

However, in India, a permanent extra-constitutional body with the name Planning Commission was instituted only a few days after promulgation of the Constitution which had only mentioned economic and social as a subject matter in the concurrent list of the Seventh Schedule. Prime Minister being its Chairman, the Planning Commission assumed a lot of importance in economic sphere and the Finance Commission choose to shrink its sphere to non-plan revenue gaps. Union Ministries too have some discretion in using funds, appropriated by them, in various states through schemes and programmes. Thus, in India, we have three channels: Finance Commission, Planning Commission and discretionary grants from union ministries.

Though Fourteenth Finance Commission has submitted its report, its recommendations are not out and TORs to the Commission were given during earlier regime and Planning Commission is not in place, it is difficult to guess out how fiscal scene is going to change for the next five years (2015-2020) while the present plan has two more years (2015-16 and 2016-17). Union Budget (2014-15) had taken into consideration the plan-budget financial exercise. It is expected that a mid-term development perspective is kept in view.

With change in intervention policy matrix and emphasis on cooperative federalism as well as change in political environment, we expect better availability of resources to the unit state governments (and in turn to local

government) and yet not increasing their dependence on the union kitty.

Resources in the final analysis pass from one part of the country to another, one section of the people to another, from one generation to another and from one set of activities to another. But the present mechanism of federal transfers creates an impression as if resources are flowing from one level of government to another level. There is a need for better delineation of resource bases so that dependency of units reduces but the access to resources does not. In whatever remains, the unit states get a matter of right, not be as charity. Grants may not become zero but they should not so conditional that the priorities of the unit states do not get compromised. It can happen only when unit states are treated as responsible states and the basis of federation is fraternal, not paternal.

Endnotes

1. There were many such territories in the US between 1789 and 1959, which slowly got the status of unit

state. A very similar case exists in India where many areas with union territory status were granted statehood.

2. For example, the Constitution of Queensland asserts in its Preamble that 'the people of Queensland, free and equal citizen of Australia, adopt the principle of sovereignty of the people,...
3. There was constituted a Constituent Assembly of the State of Jammu and Kashmir to recommend to the President on the operation of Article 370 and the President did so on 17th November 1952 with some modification in the *Explanation* in clause (1) of the Article.
4. Federation of Saint Christopher and Nevis, with two islands and a population of 50000, has only a unicameral parliament, called National Assembly. The island of Nevis has Nevis Island Assembly.
5. In Gulf countries, all revenues are non-tax revenues. There may be a lot of transfers through loans

which can come back and therefore it may not be exactly treated as expenditure.

6. In history one finds that tax collection was highly localized in Russia and China and revenues were passed up to the union government.

References

Larry Cata Backers (1999), *Critical Turnings in Federalism*, accessed through internet

Robin Broadway and Anwar Shah (2009), *Fiscal Federalism: Principles and Practice of Multiorder Governance*, Cambridge University Press, New York

Terry Timmins (2010), *A legal Review of More than Forty Years of Home Rule Jurisprudence in Iowa: The Path Travelled and the Road Ahead*, www.state.ia.us/government/ag/patc/SEWRF/105/Goers.pdf, accessed on January 18, 2015

[Several authorities, websites, and constitutions were consulted for confirmation of the contents.] □

(E-mail: pkchaubey@yahoo.com)

DO YOU KNOW?