NITI Aayog and Indian Fiscal Federalism

Nirvikar Singh

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INDIA'S NEW national government, which took office in May 2014, took a potentially momentous step with the shuttering of the venerable Planning Commission. The main premise for this step appeared to be a desire to strengthen the role of the States in the process of economic development. Representation of the States in the successor organization, NITI Aayog, is stronger than in its predecessor, but the source of real change will be changes in the way in which Central transfers are made to the States. This has to be done in ways that increase the flexibility and control of the States, but at the same time, increase their accountability. Simplicity, timeliness, transparency, monitoring and evaluation of Centre-State transfers-all need improvement. Without these fundamental changes, new think tanks, or claims of cooperative federalism, will not make a difference to India's economic development.

It is natural for a federal system to have vertical transfers. The central government has advantages in raising funds through taxes, while the states and local governments have advantages in making expenditures for many public goods and services. India has made, and continues to make, considerable progress in improving the efficiency of its tax system, but mechanisms for expenditures and intergovernmental transfers still need significant reforms.

With respect to transfers, a system that subsidizes marginal sub-national expenditures embodies a common pool problem.[1] Gap-filling transfers are an example of this inefficient approach. On the other hand, transfers that do not affect the cost of marginal spending by recipient governments will not create distortions. One has to be careful here to distinguish between cases where the goal is to increase sub-national fiscal capacity, and those where there is a divergence between sub-national and national benefits. As an example of the latter, spillovers across state boundaries from state-level expenditures could justify transfers that change the marginal cost of that spending.

Barry Weingast and his co-authors (e.g., Careaga and Weingast, 2001) have attempted to tackle an even more important issue for developing countries, namely the growth effects of federal institutions governing revenue authority and sharing. At the risk of some oversimplification, we can distinguish the two sets of questions

The author holds the Sarbjit Singh Aurora Chair of Sikh and Punjabi Studies at UCSC (University of California, Santa Cruz). He also directs the Business Management Economics Program and the UCSC South Asian Studies Initiative. He is a member of the Advisory Group to the Finance Minister of India on G-20 matters. His current research topics include entrepreneurship, information technology and development, electronic commerce, business strategy, political economy, federalism, economic growth and the Indian economy. He has authored over 100 research papers and co-authored three books: Joint Ventures, International Investment and Technology Transfer; The Political Economy of Federalism in India; and Waiting to Connect: India IT Revolution Bypasses the Domestic Industry. He has also served as an advisor for several startups and knowledge services firms in Silicon Valley and in India.

as follows. The standard public finance question takes the subnational jurisdiction's income as given, and looks at the incentive effects of tax assignments and transfers. The growth perspective examines the effects of the tax and transfer system on incentives to increase income (e.g., through public or private investment).

Careaga and Weingast (2001) use a model in which government decision-makers can either capture rents, or increase their jurisdiction's income, and hence its tax base. From this perspective, the marginal sub-national retention rate of *all* taxes levied on the sub-national tax base comes into play. According to this approach, growth-enhancing federal systems have high sub-national marginal retention rates. In the Indian case, this logic might support a case for modifying the Finance Commission transfer formula, or even changing the assignment of tax authorities across different levels of government to reduce the size of vertical transfers. It also suggests rethinking the role and mechanisms of other transfer channels in India.

Singh and Srinivasan (2013) re-emphasized a recurring idea in recent discussions of Indian fiscal federalism, namely, that centre-state transfers through the Finance Commission, Planning Commission (now its successor, NITI Aayog) and the ministries have to be looked at in a unified framework. Ignoring many details and simplifying a lot, there are essentially three types of transfers: from current revenues as determined by the Finance Commission, capital transfers for financing investment (formerly the domain of the Planning Commission), and transfers for internalizing positive externalities that one state's fiscal actions may have on other states and the country's economy as a whole (currently, the domain of centrally sponsored schemes).

Following Singh and Srinivasan (2013), it is still reasonable to argue that: (i) the centre take full responsibility for financing investment and operational costs of projects that have spill-over across states, regardless of the authority that implements them (centre or state). The current system of centrally sponsored schemes, under which the centre provides partial funding for the project's investment cost and for its operational cost for a limited period has had the unfortunate effect that projects get started and completed, but once completed are not fully utilized because states have not provided the needed costs of operating them once it became their exclusive responsibility to provide them. The centre assuming full financial responsibility will avoid this waste. (ii) The NITI Aayog serve as a Fund for Public Investment (FPI) for both the centre and states. Its shareholders would be the state and central governments. The Fund, much like a multilateral development bank, would appraise the projects proposed for their economic and social returns as well as feasibility and soundness of proposed financing (from the centre or state's own resources, borrowing from domestic and foreign sources and capital transfers from the centre, if relevant.

However, NITI Aayog has to think beyond its own role to consider many other structures of Indian federalism. Weingast (1993) introduced the idea of Market Preserving Federalism (MPF), defined by five conditions: (1) a hierarchy of governments with delineated authorities (the basis of federalism); (2) primary authority over local economies for subnational governments; (3) a common national market enforced by the national government; (4) hard subnational government budget constraints; and (5) institutionalized allocation of political authority. Earlier, the idea of cooperative federalism (Wheare, 1953), emphasized the mutual gains from different subnational jurisdictions as well as subnational and national governments working in concert. Similarly, Riker (1964) conceived of federations as constitutional bargains, designed to enhance security and stability. An alternative approach stresses the benefits of competition among subnational units, and between national and subnational governments. This competition enhances efficiency by improving the incentives of political leaders to act in the interest of their constituents (Tiebout, 1956; Brennan and Buchanan, 1980; Breton, 1995). Breton also notes that competition among governments may be destabilizing or lead to inequitable outcomes, and does not see it as something that is always best left unrestrained. MPF encompasses key aspects of competitive federalism, but goes beyond it in several ways, particularly in conditions (3) and (4). At the same time, except in the restrictions embodied in (3), the view of MPF is more sanguine about competition than is Breton. It emphasizes both the decentralization and the restraint of the regulatory power of governments vis-à-vis the market. Singh (2008) discussed the applicability of these ideas in the context of India and China.

In federal systems such as India's, general issues of quality of governance become intertwined with the features and operation of the hierarchy of governments. The MPF perspective is that, given basic good governance, what matters especially is restricting inefficient government interference in the market, and the right kind of federal institutions can be important in achieving this. From this viewpoint, certain kinds of decentralization of governance may be complementary to market-oriented reforms that redraw the boundary between government and market.

To the extent that India's fundamental governance problem is one of accountability, one can argue (Rao and Singh, 2003) that India's centralized traditional accountability mechanisms, relying as they do on hierarchical political and bureaucratic control and monitoring, have been ineffective. A more robust federal structure, extending political accountability more effectively at the sub-national level, is important to consider as a way of increasing the efficiency of governance. At the same time, the MPF perspective emphasizes the importance of having the right restrictions on the sphere of action of sub-national governments vis-à-vis the market.

Decentralization of government to improve efficiency does not remove all higher-level government oversight. If certain individual rights are a national level merit good, then the central government can still monitor their sub-national provision to ensure

there is not a case for direct or indirect intervention. This is very different from primary control for expenditure on local public goods (which may themselves be inputs into providing basic rights) resting with the centre. Thus, decentralization of some government powers need not lead to local elite capture and exploitation, as was the fear after independence. Singh and Srinivasan (2013) characterized this possibility of improvement in governance as Governance Enhancing Federalism (GEF).

To summarize, the new NITI Aayog has to define its own role carefully, but at the same time limit its direct intervention in the Indian economy. It can serve as a foundation for rethinking tax authorities for sub-national governments, improving the efficiency of government expenditures at all levels, decentralizing where possible, and streamlining and integrating the system of intergovernmental transfers. This conceptual reform program would be ambitious, but extremely beneficial for improving governance quality and increasing economic growth.

Readings

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Endnotes

1 This material draws on Singh and Srinivasan (2013).

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(E-mail:boxjenk@ucsc.edu)

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