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Fiscal Challenges and Federalism in India

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Abstract

Over the past seven decades, the United States federal system has gone from being universally despised to being lauded as an exceptional example of federal governance. This paper seeks to address the recent developments and problems in Indian federalism. In era of liberalisation, Indian federalism has gained increasing significance. As India transitioned from a command to a market economy, the states climbed from a position of subordination until the late 1980s, when they assumed a pivotal role. It is not surprising that the Centre started to show greater interest in bringing states into even taboo subjects like foreign policy. Several states are currently shifting away from divisive politics and toward developmental politics. There is a lot of mutual learning and competition among the states. It is believed by the Centre that the states will propel India's economic growth.

Introduction

As a result of India's transition to a market-based economy, the role of the states has grown increasingly important in the country's economic landscape. Overseas banks and institutions have been actively courted by the central government to engage in direct loan and FDI negotiations with individual states since the 1990s. State governments are now vying with one another to attract foreign direct investments (FDIs), since reliance on federal funds for funding has dwindled. It would suggest that the battle among states to acquire FDIs has become symmetrical, with the Centre no longer perceived as a hindrance but as a facilitator. The ability of states to entice additional investment is correlated with the market-friendly and future-oriented stance of their leaders, who frequently go overseas, frequently accompanied by corporate delegations from within the state, to negotiate foreign direct investments. Bordering subnational governments have started setting up trade offices in the industrialised states of India. It is now common practise for the capitals of Indian states to host delegations led by their governors or premiers. All throughout the political spectrum, state leaders have come to the realisation that polarising the public will not get them re-elected and have instead shifted their attention to developmental politics and leadership. The Indian federal system has become somewhat of a laboratory due to the rise in informal connections between states and the tendency for other states to mimic successful schemes and programmes initiated by one state. Reforms are being implemented by all Indian states, including the historically marginalised northeastern area, so that they can compete with other states. The Goods and Services Tax (GST) and other recent reforms have brought India one step closer to a unified national market. These new developments point to a shift in India's federalism towards more practicality.

Centre–States Relations: Then and Now

The import substitution economic model, together with India's command economy—which is actually a mixed economy—has resulted in pervasive government inefficiencies and corruption. The federalist concepts are frequently held captive by the federal government, which has an impact on relations between the federal government and the states. Rapid import substitution industrialization (ISI) through the public sector within a socialist framework was an ambitious programme that India's post-independence leadership pursued in response to nationalist views that the colonial legacy had been one of capitalist exploitation and neglect of industrialization. Import substitution and local industry protection were goals of the ISI programme, which naturally led to high customs duties and other quantitative limitations on imports. But the programme also needed a lot of money to spend in the public sector, which was growing at a rapid pace. The deficit financing, which had a negative effect on pricing and so made life difficult for the poor, and the excessive use of indirect taxes and nearly confiscatory direct taxes were the means by which these were amassed. Tax rationale was sometimes overshadowed by the socialist desire for more resources, justice, and progressiveness, or the pretence of having such desires. The pre-liberalization era saw the federal government making politicised decisions about the states' industrial growth. This was the main gripe that the states had, according to the Sarkaria Commission, which looked at the relationship between the federal government and the states in the 1980s. The State of Karnataka, which was not under the control of the Congress Party at the time the Commission was conducting its investigations, claimed that businesses had chosen not to set up shop there due to political factors. Politics played a role in deciding where public sector units would be located, but the Karnataka government also took note of private sector companies' interest in setting up shop in the state, including Glaxo, Tata Electric Locomotive Company, and Tractors India. The Congress Party-led federal government had previously requested that these companies look elsewhere for their industrial plans. The state government of Kerala said that the federal government did not use any objective standards to determine where to invest in the public sector. Prior to liberalisation, vertical competition via Centre was the main medium of regional competitiveness. Until very recently, states could use one of two approaches to influencing federal policy, either they followed bureaucratic channels or they adopted political and coalition-influenced paths. For instance, while some states like Gujarat have taken a more bureaucratic approach, focusing on lobbying and monitoring within the bureaucracy, others like Andhra Pradesh, West Bengal, and Tamil Nadu have taken a more partisan approach, hoping to use their party influence at the federal level to reap greater economic benefits.

Centralization was greatly aided by the command economy and political centralization, which manifested as the "one-party dominance" during the Congress regime tilted towards the Centre. As a result, the states were essentially seen as subordinate entities. Frequently, federal principles were disregarded. To exert more control on state governments, the federal government established new agencies, programmes, and policies. To encourage governments to implement planning strategies in order to guarantee quick growth, organisations like the Planning Commission (PC) evolved as extra-constitutional agencies. The Finance Commission (FC), a constitutional authority tasked with distributing and deciding on state revenue transfers, was undermined by PC. The central government tightened its grip on the Licence/Permit Raj in 1970, making it mandatory to get a licence from the government before establishing any kind of industry. Along with the general insurance business in 1972 and the majority of private banks in March 1970, the federal government likewise nationalised both. Private sector growth was governed by the central government via licencing and oversight. Additionally, the position of the states was further eroded as a result of central planning, control over financial institutions and industrial policy, and All India Services. The relationship between the central government and the individual states followed the classic principal-agent paradigm, with the latter frequently viewing the former as subservient to the former. A further feature of the command economy was the enormous expansion of state-level centrally supported schemes that were established to further national objectives. The political factors were the only determinant in how the

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federal government distributed funds to the states, distorting both equality and efficiency. Economic and social policies are part of the concurrent list in the Constitution, which allowed the federal government to meddle in areas traditionally handled by the states, including rural development, health, agriculture, and family welfare. Perhaps much worse was the fact that states in the aforementioned areas were almost never asked for their opinion on major issues. Until recently, the main irritants in Centre-state relations in India were the central government's appointment of governors without consulting the states, the partisan allocation of resources from the centre to the states, and the imposition of president's rule in states. These practises have not yet been fully resolved. India was characterised by a leading expert on federalism as having a quasi-federal structure. "Centralised, dysfunctional, anachronistic union system" is how Khan (1997) has described India.

Since Indira Gandhi believed in the conceptually incorrect polarity that a strong central implies weak states and vice versa, one might say that she was the only leader who wanted to question the overall principles of federal functioning. The shift in Centre-state relations in India may be attributed to a number of major elements, including state dissatisfaction, changes in the party system, regionalization of politics, liberalisation of the Indian economy, and the influence of the judiciary. Another key actor in limiting the authority of the Indian federal government has been the country's judiciary.

States' Para diplomacy

The nation's involvement in para diplomacy removed international economic policy from its traditional sphere of influence. Due to economic globalisation, Indian states started interacting with their foreign investors in a de jure, if not a de facto, sense. Proving this point are the high-profile investment-promotion efforts of the United States overseas. Some states' economic progress and independence from the federal government have been aided by such initiatives. Subnational para diplomacy cannot be effectively explained by the centralization of political parties into regions or by coalition government. Prior to liberalisation, para diplomatic operations might be pursued via either the political or bureaucratic channels. Due to the Centre's newfound function as an enabler of states' international economic activity, these avenues are now useless. The result is a horizontal rivalry among governments to engage in para diplomatic efforts in order to attract foreign direct investment (FDI), which is de jure symmetrical. In this context, nations' ability to participate in economic para diplomacy is mostly dependent on promotional methods, public relations efforts, building pro-business environments, and other subnational commercial ties. It encompasses a wide range of tools that states have implemented thus far. Participating in international forums such as the World Economic Forum, visiting abroad for trade prospects, negotiating loans directly with the World Bank, showcasing states' achievements abroad, hosting foreign diplomats, foreign ministers, and even heads of state, organising an annual meet, conference, and seminar, wooing NRIs through their diasporas, and setting up sister cities, twin cities, and border haats are among these. Other ways to influence the central government to sign or not sign international treaties affecting their region or interests are also possible. Para diplomacy on the part of states may have a major impact on the tourist industry, which is one of the world's largest and has the potential to employ 200 million people. By 2020, experts predict that there will be roughly 1.6 billion tourists spending $5 billion every day. The obvious is that India has untapped tourist potential to a massive extent. Such efforts are underway by states like Bihar and the northeastern area, which have lagged behind in foreign direct investment (FDI), in an effort to attract FDI and tap into their tourist potential. Attracting foreign direct investments (FDIs) has grown more dependent on public relations campaigns. The media has evolved into a powerful medium for nations to highlight their accomplishments. The chief ministers of states often take to the media to boast about their industrial strategies and accomplishments, as well as to draw comparisons to other states. Press conferences, road shows, exhibits, and conferences are given a lot more weight. At conferences, states showcase their cutting-edge technology, including computers and video-conferencing, in presentations. The states entrust the task of creating promotional materials for the sale of the state to private advertising organisations.

The battle for public opinion and self-presentation has heated up. Following the Enron scandal, the Indian state of Maharashtra invested heavily in a public relations campaign aimed at attracting investors. The campaign was co-ordinated with the Indian Engineering Trade Fair in New Delhi. Foreign investors are starting to understand that India's states are increasingly taking charge of crafting foreign economic policies that suit their interests, and that the traditional way of pursuing commercial ties at the state level by contacting the central government is no longer effective. As a result, it should come as no surprise that several foreign trade offices have opened in capitals around the country. A newspaper had a fascinating storey about it. Taiwan does not have an official embassy in New Delhi, but rather a trading office. Taiwanese enterprises have large interests in Tamil Nadu, thus it sought approval from the Ministry of External Affairs (MEA) to create a satellite office or consulate in Chennai some years ago. Fearing Beijing's response, MEA was hesitant. Last but not least, Taiwanese urged the then-DMK administration in Chennai to exert its political influence with the UPA. Para diplomacy on a subnational level can operate in either a vertical or horizontal fashion. There has never been (horizontal) inter-subnational cross-border trading between Indian states before. The capitals of Indian states have recently been the usual stops for delegations from other countries led by their governors or premiers. But Indian states cannot set any trade offices overseas. Countries like the United States, Canada, Brazil, Australia, China, Japan, and many more have used states' para diplomacy to their advantage while trying to forge stronger relationships with other nations. This may be the first effort by any state to establish such permanent facilities abroad to directly attract FDI; it was the 2014 decision of the Gujarat government to establish international desks independently in countries like the US, China, and Japan to facilitate investment in the state by overseas investors. The process of attracting foreign direct investments (FDIs) in Gujarat is now ongoing throughout the year, rather than just in the months leading up to the Vibrant Gujarat Global Investors Summits. This is because international desks have been set up in many of the countries where Gujarati government officials used to travel. Like his predecessor, Manmohan Singh, Prime Minister Modi backs para diplomatic efforts by states. The Union government asked chief minister of Andhra Pradesh, Chandrababu Naidu, to head a high-level delegation to China in April 2015. A states section has been established by the Ministry of External Affairs (MEA) to facilitate outreach to the states. But the division of states has sparked a lot of interest in working with other states to promote commerce and investment with other nations.

However, para diplomacy also has its difficulties. Many believe that nations are ill-equipped to handle political affairs and other aspects of responsible foreign policy because they do not employ adequately qualified diplomats. The fact that the majority of India's neighbours are antagonistic adds another layer of worry. Therefore, para diplomacy on the part of governments might endanger India's independence and security from terrorist, insurgent, and separatist groups, some of which receive funding and support from India's adversarial neighbours. The needs of an increasingly open global

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economy pose a challenge to national security policies. This obstacle must be overcome today. When states engage in it, particularly on a political level, it can have a detrimental impact on its foreign policy. In order to appease its coalition government partner, the Centre neglected its national duty and put regional interests ahead of national ones on the Teesta River treaty and the US-led resolution in the UN General Assembly. The Indian government might face severe consequences if it allows regionalists to control foreign policy and make arbitrary decisions. Central government officials risk betraying the country if they give in to narrow regional interests. Consequently, there have been unfavourable responses to governments' political para diplomacy. Its acts driven by patriotism pose a serious threat to our country's interests. Some areas and sub nationalities in the nation have not yet completely recognised the oneness of the country, say policy experts. It might be hasty to provide constituent units such liberties under these conditions.

Common Market

To offer to the constituents to operate in a big market is one of the main benefits of federalism. The European Union (EU) is a prime example of how numerous nations have come together to form a single market despite their reservations about giving up their independence, all in pursuit of the attractive economic benefits that come with free trade and the movement of products and production factors across vast regions. A unified market was suggested by the Punchhi Commission on Centre-states relations (Government of India, 2010, p. 98). With a clear mandate in its opening article (Article 301), trade, commerce and intercourse through-out the territory of India shall be free, our founding fathers of the constitution dedicated one full part of the constitution (Part XIII) to trade and commerce within the country. They recognised the great potential of a large common market. According to Bagchi (2004), the policymakers who controlled India's fate after independence were wary of the market and used public Interest arguments to limit the country's trade and commerce through a variety of rules. In an effort to loosen regulations on trade and commerce throughout India, the Centre has just succeeded in introducing a proposed Goods and Services Tax (GST).

Issues and Challenges before Indian Federalism

Regionalism

Many see it as a major obstacle to India's federalism. When the balance of power between the federal government and the states is not overly concentrated, federalism works well as a democratic system. Many causes, including regionalism, arise from India's pluralistic character. Those living in the country's southern, more populous states often feel ignored, while those living in the country's distant northeastern regions often feel an overwhelming distance from New Delhi.

Despite India's history of effective federal administration since independence, the concept of regionalism—or love of one's area—remains prevalent in some regions.

Following the 2014 establishment of Telangana, the call for further states has gained significant traction in recent years. As an example of aggressive regionalism, recent requests such as dividing Uttar Pradesh four times and separating West Bengal into Gorkhaland constitute a danger to India's federal framework. Gorkhaland, Bodoland, and KarbiAnglong agitations have been reignited. This is in addition to the recent calls for the creation of new states in Uttar Pradesh (Poorvanchal), Maharashtra (Harit Pradesh), and Vidarbha (Maharashtra). The greater the number of states, the greater the likelihood that the federal government would be manipulated by state parties on issues of paramount significance. For example, because to concerns about the expenses to West Bengal, India's Teesta River waters deal with Bangladesh was jeopardised. The effectiveness of foreign policy might be impacted by even more powerful regional authorities if the federal government gives in to the demands of specific states. As a result of pressure from Tamil Nadu, India backed Sri Lanka's UNHRC resolution in 2012.

Division of Powers

In India, the distribution of power is governed by three lists included in the seventh schedule of the constitution, unlike in the US and Australia. The Union list and the State list both detail the particular authorities of the federal and state governments, respectively, while the Concurrent list details the authorities shared by the two levels of government. The Central government is granted the residual powers.

According to the division of powers theory, the federal government handles issues of national significance (such as defence, foreign policy, railways, and currency) while the states and municipalities take care of issues mainly affecting their own populations (such as public health, education, law enforcement, and local administration). In the Concurrent List, you'll find issues like criminal law, forest policy, economic and social planning, and others that call for joint federal-state action. But if there's a disagreement about a law pertaining to one of the Concurrent List items, the federal government takes precedence.

Article 200 (the governor's ability to hold state bills for the president to consider), emergency provisions (Articles 352, 356, and 360), and the states' mandatory submission to the federal government's executive authority (Articles 256 and 257) all contribute to the concentration of power that the states are deeply concerned about. Indian federalism is greatly endangered by centralization.

Absence of Fiscal Federalism

While the Indian Constitution does give the federal government more taxing authority, it also establishes a system to ensure that the states get their fair share of federal tax money by establishing the Finance Commission.

The vertical imbalance between the federal government and the individual states, as well as the horizontal imbalance between states, must be taken into account by the Finance Commission when making decisions about tax devolution and grant distribution.

Currently, the States get grants from the Central Ministries and the Planning Commission equal to about 40% of all income collected by the Central government, including tax and non-tax revenues.

The 80th Amendment expanded the shared pool to include all central taxes, although there has been little change to the revenue accruals of the Centre and the States.

Uneven development across the nation is a consequence of resource scarcity and unequal distribution of income. Many Indian states are concerned that the present Goods and Services Tax proposal undermines fiscal federalism in the country. It has consolidated all of the taxes into one, and the funds will be distributed to the states according to a formula. Greater fiscal independence is a goal of some Indian states.

Unequal Representation of Units

Most federations around the world have implemented constitutional safeguards, such as a system where all units or states have an equal say in the Second Chamber and where all amendments to the Constitution must be ratified by the states, to avoid the problem of bigger units having too much power over smaller ones.

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Not only do the states in India not have a significant role in the periodic constitutional revisions that take place, but there is also no provision for equal participation of states in the Rajya Sabha, the Second Chamber. The authority to alter the Federal Constitution is often divided among the several parts of a federation. According to Article 368 and other clauses, the Indian Constitution grants the Central Government the authority to change the Constitution.

The Indian Union states have almost no say in this crucial sector of government, even if approval from half of the states is requested in a few limited areas.

The Indestructible Union with Destructible Units

No mechanism for the secession of states from the Union of India exists in the Indian Constitution, in contrast to other federations that have been successful. In order to safeguard India's unity and integrity, the Union has been rendered unbreakable.

This conventional Indian system, however, thwarts the rising tide of independence movements within India. A severe danger to India's integrity and sovereignty is the growing desire for Dravida Nadu, which would include the southern states, as well as a separatist voice in the country's eastern and western regions.

It may seem anti-federal on the surface, but in reality, it has been a godsend". If the states had been granted absolute authority over determining their own area, the result would have been utter anarchy and lawlessness.

A state's right to self-determination is guaranteed in the founding documents of every major federal democracy by the prohibition of state mergers and divisions. This is what federalism is all about. The authority to create or abolish states, however, rests with the Union Parliament.

It was prudent of our nation-builders to tailor the Constitution to our needs. Although the Constitution does not specify that previous approval of the state was required, in reality, prior approval has been obtained by every state that has been founded, often following a thorough and unbiased review by an independent commission.

Nevertheless, when it comes to the partition of their physical region, the Union Government frequently disregards the states in question. One recent example is the creation of the Telangana state. Indian federalism and unity are under severe jeopardy due to the Union government's determined attempts and repeated assertions that Andhra Pradesh will be partitioned regardless of the legislature's opinions.

When dealing with delicate issues, such as redrawing the borders of an Indian state, the federal government should listen carefully to the concerns of the individual states. If the central government makes an arbitrary choice without state approval and a negotiated solution, India would become a unitary state and its states will be reduced to municipalities. This was not the goal of the framers of the Constitution or the founders of the United States. Attempts to unite India at this late date will jeopardise the country's future.

Single Constitution and Citizenship

While the United States Constitution grants each state the authority to determine its own constitution, the Indian Constitution specifies a national framework that all states must adhere to, with the exception of Jammu and Kashmir.

In contrast to all other federal constitutions in the world, the Indian Constitution establishes a single citizenship. 'One nation, one citizenship' is its foundational principle. No matter the state a person

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resides in, they are all considered citizens of India. Being a citizen of one state does not provide automatic citizenship of that state.

Integrated Services

The Indian federation is characterised by its integrated judiciary. Unlike in other federal systems, the highest court in India is the Supreme Court, which has delegated authority to all lower courts. There aren't any specialised state courts in the United States. Elections, accounting, and auditing systems in India are all interconnected.

Many states and detractors view the All Indian Services and central services as anti-federal. Because they provide India's unique character to government, these services are crucial when thinking about the breadth and depth of Indian administration. The Union Government will use these services to administer its operations. While social and economic planning are included in the Concurrent List of the Seventh Schedule to the Constitution, the Union Government has complete control over planning at the national and regional levels in India.

The states are weak and meek because of centralised planning through the now-NITI Aayog Planning Commission, the Union's overwhelming legislative authority, the states' financial reliance on the Centre's compassion, and the states' administrative inferiority.

When it comes to planning, the states merely fill in the blanks. The Indian states do not have their own planning commission. In addition to making things worse for states, it threatens the country's ability to operate under a federal spirit.

Economic Incompatibilities of the units

An additional challenge for a federation would be the existence of divergent economic norms and significant fiscal and economic incompatibility among the member states. Economic planning and development, regional economic equality, and state financial autonomy are forces that are creating imbalances in the sector. Federations face challenges when regions demand financial equalisation.

On the basis of equalisation, certain states in India are designated as impoverished and get grants-in-aid. But the problem with federations is that overall income growth and national income would take a hit if equalisation is strictly enforced. Equalization of all units is impossible to achieve if economic development receives a lot of focus.

Conclusion

Over the past seven decades, India's federal system has gone from being universally panned to being lauded as an example of excellence. In a nutshell, after liberalisation, Indian federalism gained political clout and became more practical. That about-face is covered up in the piece. As India transitioned from a command to a market economy, the states climbed from a position of subordination until the late 1980s, when they assumed a pivotal role. The federal government advocates for states to deal with foreign investors face-to-face. Now that states know the market would punish them for being wasteful, fiscal discipline is their top priority. Since states can directly approach the market for foreign direct investment (FDI) or borrowing, their ability to develop or undertake developmental works is not dependent on their relations with the federal government, but on the development of infrastructure, a probusiness environment, and a forward-looking leadership style. The 1935 Government of India Act established federalism in the Indian subcontinent. Taking into account India's heterogeneous nature, the authors of the Indian Constitution sought to give it a federal appearance. Two governments, a separation of powers between the federal government and

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its individual states, bicameralism, an independent judiciary, the supremacy of the Constitution, and its rigour are all essential federal elements included in the Constitution. The Indian federation, in contrast to actual federal states like the United States, did not arise from an agreement among many sovereign units but rather from the transformation of a unitary system into a federal one.

The necessity for a strong central government to ensure the country's unity, integrity, and sovereignty, as well as the states' autonomy within the constitutionally mandated boundary (the State List), were both taken into account in the compromise. The constitutional unitary aspects include a singular document, a unified citizenship, judicial integration, a central government appointed by the people, the All India Services, and provisions for emergencies. In times of national or state emergency, the Union Government of India takes full and absolute control of the country. For reasons of national interest (Articles 249), international treaty implementation (Articles 252), and even on issues of the State List, the Parliament can legislate. Plus, it still has last say on all matters of policy and administration. Last but not least, the Union's indestructibility and the units' destructibility by the Union provide support for the stated opinion.

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