

## **Stanford re-examines federal complexities**

N K Singh

*Posted online: Sunday, June 04, 2006 at 0000 hrs IST*

The seventh annual conference on India's economic policy reforms is being held this week at the Stanford Center for International Development. I am here both to participate in and moderate the sessions on 'Business Environment in Asia' and 'Demographic Management'. This year, even while focusing on India, the conference dwells on a broader set of issues, making cross-country comparisons among Asian countries. The theme of the conference is 'Challenges of Economic Policy Reform in Asia', and it has brought together policymakers, academics and the corporate sector from China, India, Japan and Pakistan. The President of the Asian Development Bank and representatives of the World Bank bring the perspective of multilateral lending institutions.

Kapil Sibal spoke persuasively on India-centric issues, bringing out our inherent economic strengths but without underplaying the policy challenges. Yashwant Sinha, while emphasising continuity, had caveats in view of the tardy progress in several areas but underpinned bipartisan support for the liberalisation strategy.

As in the past, these conferences are a learning experience and make a worthwhile contribution in shaping policy perspectives. This year, comparisons with other Asian countries, particularly China and Japan, highlight the need to reinvigorate multilateral trade efforts in preference to bilateral or regional arrangements. They also have multiple lessons on health and rural development. The session on 'State Level Perspectives and Reforms' focused on issues of fiscal federalism. Two state governments—Punjab and Bihar—made presentations on policy challenges and efforts to improve fiscal health, mainstream the rural economy and attract investment. Punjab took credit for its improved finances; the Nitish Kumar government of its efforts even in the last six months to improve governance and enact investment-friendly legislation like 'The Single Window Act', and 'Infrastructure Development Act'.

The panel on 'Federalism and Decentralisation' moderated by Ronald McKinnon made interesting proposals based on a paper on 'Federalism and Economic Development in India' by T N Srinivasan and Nirvikar Singh. It explored the several approaches of federal systems which have co-existed. The first, of cooperative federalism, emphasising mutual gains from different sub-national units; sub-national and national governments acting in concert to enhance security and stability of all participating entities. The second, where federalism stresses the benefits of competition among sub-national units and between national and sub-national governments designed to enhance efficiency by improving the incentives of political leaders to act in the interest of their constituents. The third, developed by Weingast who coined the term "Market Preserving Federalism (MPF)", driven by hierarchy of governments with delineated authorities, primary authority over local economies for sub-national governments, common national market enforced by national governments, hard sub-national government budget constraints and institutionalised allocation of political authority.

Whereas the Chinese clearly fall in the MPF category, the Indian system would be somewhat between cooperative federalism and MPF structure. Notwithstanding other details, the paper argues that given the unitary characteristics of India's federal

model, the Centre has disproportionate financial powers compared to the responsibilities obligated on the states. This was more so in the pre-liberalisation era where licences and permissions directed both public and private investments. In addition, credit policy, foreclosing of resources by the Bank, interest-rate structure, insurance, and market borrowings remain with the Centre.

As long as governments in states and the Centre belonged to one party, any conflict of interest was muted. However, coalition politics and the rise of regional political parties make the prospect of such conflicts very real. There are already multiple examples where state governments which are part of the ruling configuration at the Centre or are well-disposed towards the ruling configuration have derived significant advantages from somewhat discretionary transfers.

The paper makes three specific suggestions. First, given the somewhat ceremonial, non-purposive discussions at the National Development Council or the tardy functioning of the Inter-State Council, to create a new Fiscal Review Council (FRC). The present Inter-State Council should constitute itself into an FRC and review the medium- and long-term fiscal policies of the states and the Centre collectively and make recommendations. Each state and the Central Government would submit to the FRC its obligations for achieving employment, growth, revenue and fiscal targets. The advantage being that, while reviewing the states, the Central Government would also be willing to subject itself to such a review and the proposal would be analogous to the mechanism created by the European Union under which members each year submit to the European Commission a National Action Plan on employment, growth and macro targets.

Second, the Centre and the states' transfers through the Finance Commission, Planning Commission and other ministries should be looked at in a unified framework. Investments and projects which have a spillover effect across states and centrally sponsored schemes should be entirely financed by the Central Government to secure coherence, avoid waste, secure symmetry in implementation and provide for long-term maintenance.

Third, reconstitute the Planning Commission as a 'Fund for Public Investment' for both the Centre and the states. The stakeholders will be states and the Central Government and the Fund will function like a multilateral development bank to appraise projects proposed for economic and social returns as well as feasibility and soundness of proposed financing. These proposals will evoke divergent responses. The inertia of continuing with what we have inherited may have advantages of stability and broad national acceptance. Nonetheless, structure and procedures we have inherited may not be adequate to meet contemporary challenges. There is a need to dispassionately re-examine the complexities of our federation. They may not also be best suited to meet the ends of equity and efficiency. Unfortunately, there is no forum where these can be rationally discussed without exciting partisan passion.

The Stanford conference has thrown up some new ideas. They are no doubt proactive but this is what makes academic debates worthwhile.