

Annex I

(a) *Abrasions in the Federal system – Issues and Options (2022)* , M.Suresh Babu, Economic Advisory Council to the Prime Minister, New Delhi. Access at: <https://eacpm.gov.in/wp-content/uploads/2022/11/Federal-System-M.-Suresh-Babu.pdf>

Prof. Suresh Babu's paper argues for harmonious intergovernmental policy interactions as a necessary pre-condition for a well-functioning 'flexible federal' structure with enough room for 'give and take' between the Centre and the states. To ensure accelerated economic growth it is important to sustain a harmonious federal relationship which "opens up avenues for win-win situations for both the Centre and the states." The emergence of coalition politics has created a situation where regional parties to have a more significant say in national policy decisions; and as a consequence states today act not only as a pressure groups but have emerged as lobbying entities for fiscal, trade and business policies.

In the changed paradigm of post-1991 reform, there has been a shift towards greater room for the States in economic policies and a marked assertion by the States against the "centralizing tendencies of the Centre." Despite lack of autonomy of the States in terms of revenue raising powers and their dependence on the Centre for revenue transfers, "the give and take equation between the Centre and the states has given way to a more hardened stand by the states, leaving little room to negotiate". He finds three broad areas where the Centre and some states have different policy approaches. They are policies regarding institutional frameworks for governance, issues in regulatory approaches and a set of pre-emptive policies of the states to pre-empt some of the schemes/programs announced by the Centre.

Citing examples, he identifies conflicts in respect of regulatory arms viz. (i) economic regulations: Cooperative Bank regulations between Centre and RBI on the one hand and the States on the other, power of Central Agencies like the CBI and ED; (ii) Environment Regulations; issues pertaining to the National Green Tribunal (NGT) and issues related to the Coastal regulation Zone (CRZ); and (iii) transfer of IAS and IPS officers. In the implementation of Schemes and projects there are conflicts relating to MNREGA, and clearance of infrastructure projects management of ports. Several instances of a tendency to adopt pre-emptive approach by the States have emerged in respect of nation-wide

policies. These relate to (i) going back on New Pension Scheme (NPS), (ii) New Education Policy and NEET, (iii) challenging the decisions of the GST Council, and (iv) delay in appointment of the State Finance Commissions.

Another important implication of the divergences among states is the lack of a cohesive approach to fiscal management. Prof. Suresh Babu has argued that due “to spill-over effects of the actions by the states to the Centre, fiscal management of the Centre gets disrupted. This leads to deviations from the fiscal targets set by the Centre. The channel of spill over from states to Centre is through the widened fiscal deficits of the states”. A major contributing factor for increased fiscal deficit is the increased revenue deficit. The stagnant own tax revenues of states is leading to widening of revenue deficit.

The adverse implications of the tussles between the Centre and the States impact the economy in several ways. First, the problem of ‘Hold-up’ arises where two parties may be able to work most efficiently by cooperating but refrain from doing so because of concerns that they may give the other party increased bargaining power and thus reduce their own profits. Underinvestment when state governments compete on their public expenditure and skew their expenditure structures in favour of more short-term welfare schemes, results in providing lower levels of public goods is seen as a typical “hold-up problem” in the economic literature. Second, competition between Centre and states in creating welfare schemes and institutions results in increased transaction costs, poor access to information and inefficient coordinating mechanisms leading to worse instead of better policy outcomes. Third, a long-term impact of friction in the federal system is the possibility of ‘race to the bottom’. Conventionally race to the bottom is through tax subsidies to attract investment. However, in recent times a new form of it has emerged among Indian states through subsidized welfare provisioning. Fourth, another long-term impact is the unobserved under performance of states by having lower investments due to high transaction costs combined with lower infrastructure quality in states which indulge in welfare competition.

Prof. Suresh Babu offers a two-step fiscal correction process and second a series of nudges to reform states on three areas. For fiscal correction which is to be achieved in the short-term, he advocates (i) ‘fiscalisation’ of ‘off-budget’ finances; and (ii) reform of the subsidies prevailing in the states through better targeting, prevention of transition of

subsidies into freebies leading to ‘welfare competition’; prevention of the transition of subsidies from merit to non-merit goods, with clear list of merit goods; and a move to direct benefit transfer system (DBT). Three reforms proposed for the medium-term are : (i) revenue, expenditure, debt management and reforming the non-tax revenues; (ii) creation of a Debt Sustainability Index to guide investors who would in turn force reform of public finances, bringing more transparency and accountability; and (iii) restructuring of state-run Public Enterprises

Three nudge priorities have also been advocated. These are: (i) enhancing state level investments through various channels; (ii) augmenting finances of local governments; and (iii) increase non-tax revenues of the states.

In conclusion, he urges constant engagements with the States to build an atmosphere of mutual trust which are prerequisites for a harmonious federal system.

(b) Comments on the above study by M. Govinda Rao, Former Member 14th Finance Commission and former Director, NIPFP.

Prof. Rao has argued that while harmonious intergovernmental interactions necessitate a well-functioning ‘flexible federal’ structure with enough room for ‘give and take’ bodies, ensuring “cooperation” through voluntary action can take place if all parties gain from cooperation. As he writes, “If some gain and others lose or if some gain more than others, the gainers will have to compensate the losers to agree to cooperate. In other words, ensuring ‘cooperation’ has challenges in a constitutional democracy, and even in areas where cooperation is feasible, you need an institutional mechanism to enable and promote intergovernmental coordination, bargaining and conflict resolution.” Unfortunately, in his view, India lacks an effective forum to negotiate inter-governmental coordination and bargaining. Even the Inter-State Council which was designed to provide a forum for this purpose has been placed under the Union Home Ministry! As a result, instead of cooperation there is competition, both vertical and horizontal. What is needed is ensuring a measure of competitive equality and cost-benefit appropriability to prevent predatory competition for which it is important to have institutional mechanism to minimise transaction costs and promote efficient competition.

Further, Prof. Rao points out that providing public services according to varying preferences is the major tenet of federalism and forcing uniformity in policies and provision of public services is a negation of federalism itself. In order to ensure that the states provide comparable levels of public services at comparable tax effort which may or may not result in reduction in inequalities, besides basic infrastructure and public services, the nature of institutions is extremely important as it determines the structure of incentives. In many of the examples of abrasions cited in the paper, the problem is one of undertaking reforms to minimise overlapping assignment system. Assignments should be done to minimize spillovers and with changes in development and technology, even assignment system may have to be revisited. Whether these are in relation to the institution of the Governor, RBI, CBI or ED, food distribution, stubble burning, subsidies or “freebies”, most issues raised in the article by Prof. Suresh Babu can be resolved by revising the assignment system or institutional mechanisms or referring to the Courts.

Even with respect to the centrally sponsored schemes, which are in the nature of ‘specific purpose transfers’, the schemes should be designed to ensure minimum standards, introduce flexibility and trust in lower level institutions, whether it is a State, or District or Municipality or Panchayat. Citing the example of setting up of State Finance Commissions and acting on their report, a constitutional responsibility of State Governments, Prof. Rao cites a remark made by his mentor Raja Chelliah, “Everyone wants decentralization, but only up to his level”.

(c) *Federal Dimensions of India's Response to the Covid Pandemic - Challenging the*

Idea of the “Flailing State”, Nirvikar Singh, Indian Public Policy Review 2023, 4(1): 27-48

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The main contribution of the paper is a new evaluation of the federal dimensions of India’s governmental responses at different levels. The paper highlights the areas in which the Central government did well but there were failures, particularly in the manner in which the national lockdown was made in March 2022 and the handling of the second phase of Covid in April-June 2021. The paper also highlights the effective and extensive coordination across levels of government. By contrast, State governments, both state and local, did better than might have been expected. It challenges the view that India’s governance in recent decades reflects a

“flailing state” and that the concept of “cooperative federalism” can be made more effective by strengthening capacity at the local level, despite the resilience of the federal system in handling the pandemic induced crisis.

Studies have emphasized the complexity of federal vs. unitary systems of governance, the resulting importance of intergovernmental cooperation in circumstances such as the pandemic, and the great variation in effectiveness of that cooperation across their 24 case studies. They classify the cases into three categories: national dominance, strong collaboration across levels, and weak collaboration across levels. In the responses across nations, initially there was centralizing impulse, denser interaction among political leaders, an emergence of local governments as key actors, erosion of subnational fiscal capacity, and a certain degree of resilience of the existing structures of governance.

When the first instances of Covid -19 were reported in States, social distancing rules and guidelines were introduced at the State level, but with slack enforcement. When cases rose, a national lockdown was suddenly introduced on March 24, 2020 using a legislative framework of the Disaster Management Act, 2005 by the Centre. As the study points out, these emergency response mechanisms overrode “the constitutional assignments, in which health is a state subject; this means that once the central government asserted its authority, state governments were required to follow its lead.” However, when phased relaxations of lockdown began, the States were given considerable leeway to regulate the pace and details of their “unlocking.”

Unlike the first phase of the pandemic, in the second phase, though more severe, no national lockdown was imposed. Prof Singh argues that two reasons could have influenced this decision. First, the Centre did not want to repeat the severe economic consequences of the earlier national lockdown. Second, recognition of the fact that many state and local governments had proved themselves in the face of the first shock. Restrictions had to be tailored to local or regional situations given the uneven spread of the pandemic, besides better enforcement of local mandates by local and state authorities.

Based on the secondary research and his own analysis, Prof. Singh concludes that “the lack of definitive knowledge about prevalence in the absence of universal or large-scale random testing, uniform reporting and treatment of cases, and the actual adoption of mask-wearing and social distancing, or enforcement of mobility restrictions, all combined, also makes it difficult to offer a general evaluation of the balance between centralization and decentralization in the

latter part of 2020.” He also avers that “the State and local bureaucracies are an important implementation arm of the subnational level, and details of policy making can also often be left to these subnational levels. States like Kerala have greater decentralization to the local level, so there are elected representatives and local officials in cities, towns and rural jurisdictions who have appropriate expertise and authority, but it is the collaboration between state and local bureaucrats and politicians that matters in such cases, whatever the details of local governance structures. If anything, what took place was the reverse. Many state, city, and even rural local governments made heroic efforts to manage the pandemic, instituting whatever measures they could manage in terms of contact tracing, local lockdowns, testing and so on. What ultimately matters are the myriad details of action and coordination among different levels of government. Several of the India studies note that the central government did much of what it was supposed to in the first phase of the pandemic, seeking policies that would be beneficial at the national level, and acting where it had authority and comparative advantage, including managing emergency healthcare responses, production and procurement of personal protective equipment (PPEs) and medical supplies, and incentivizing development and production of vaccines. However, it tended to fail in aspects of detailed follow-up, especially when the states were involved.”