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Subir Gokarn: The other side of devolution

The benefits of greater devolution depend on major changes in the structure of government

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The 14th Finance Commission (FFC) recommended a significant increase in the share of tax revenues collected by the central government transferred to the states without any restrictions. Under the previous dispensation, 32 per cent of central revenues were transferred by mandate and an additional 7.5 per cent were given to specific states for explicitly stated purposes. Consequently, while the total share of states hasn't increased by that much, the significance of the FFC's recommendations is the quantum of funds that is available to the states to use at their discretion.

The FFC's recommendations represent a significant structural change in India's federal fiscal structure. In combination with the goods and services tax (GST), this structure is converging towards a potentially highly efficient division of labour between the centre and the states. The GST embodies the principle that the optimal arrangement for taxing all mobile goods, services and factors of production is to do it at the national level. Sub-national taxes should be levied only on immobile things, such as property, or as user charges on local services.

The FFC's devolution formula reflects the premise that public spending on development and welfare is most effectively done at the state or the local level. This allows resources to be allocated in ways that best reflect local conditions and imperatives. State and local governments are in a far better position to design, monitor and course-correct programmes, all of which should lead to improved outcomes. Given the diversity across the states, greater devolution of spending autonomy is an important, perhaps even critical, instrument of convergence.

In short, the new federalism, comprising the combination of the GST and the FFC, does create the framework for both mobilising more resources by government and spending them with greater impact. However, like all good things, realising these potential benefits will require several conditions to be fulfilled. Let me raise a few of these.

The first relates to the capacity at the state level to make best use of the enhanced resource base and expenditure autonomy. It is generally accepted that the wide disparity of development outcomes across states reflects, at least partly, differences in institutional capacity across states. How and why these emerged is a long story, but the immediate concern is whether the greater freedom of expenditure can be used optimally, particularly by the states that are lowest on the development scale.

More money and more freedom without the capacity to spend wisely could worsen development outcomes for the country as a whole. One significant implication of the FFC recommendations, therefore, is that significant investments have to be made in increasing the capacity of some, perhaps all, states to use their autonomy productively.

This will, of course, be an ongoing process, but there are two institutional mechanisms available to the central government to speed up the process. The first is within the mandate of the National Institution for Transforming India (NITI) Aayog, which is, among other things, expected to become a knowledge and capacity-building hub for states. Using this as a platform for states to learn meaningfully from each others' successes and failures, and backing up the process with systematic research will be an intrinsic aspect of the new federalism. To make this process effective, capacities will have to be created both in the NITI Aayog itself and most importantly, in the states. Frank self-assessment on everybody's part is an essential requirement for this process to be effective.

An important aspect of the NITI Aayog's role, which is also explicit in its mandate, is the need to reconcile inter-state implications of the decisions of individual states. Many such decisions relating to, for example, transport facilities or water will have spillover impacts on neighbouring states. Complementary investments may need to be made, which may not be on the neighbours' priority lists per se. If these are not done, the aggregate benefits of specific investments may diminish.

The second will require discontinuous change in the structure of the bureaucracy. The state cadre-central rotation system is a hub-and-spoke system that presumes that knowledge and experience has to be intermediated by the central government. This goes against the very grain of devolution. It is reasonable to ask: why should government officials who have a successful track record of implementing programmes in one state not go directly to another state seeking to replicate the experience? Why must his or her expertise be transmitted only through central intermediation mechanisms?

Civil-services reform is an ongoing agenda for governments, but the primary focus has been on performance appraisal and accountability. Devolution warrants going beyond these dimensions and introducing formal mechanisms of inter-state mobility of civil servants involved in the development and public services domains. Inter-state mobility is not unknown, but the instances thus far have been exceptions, generally motivated by circumstances perceived to be in the national interest and, of course, personal considerations. This flexibility now needs to be broadened and driven by the objective of transmitting experience and expertise in specific domains directly across states.

A second big requirement of the new federalism is a reorientation of the roles and responsibilities of central ministries and other institutions. Ministries have, quite understandably, evolved more in the direction of "doing" organisations, focused on implementation of government programmes in their domain and coordinating with states as necessary. Over the past few years, as scepticism about the merits of this top-down approach has heightened, attempts to pass the responsibility down to states have been made. The FFC devolution formula gives financial substance to this process but, in doing so, also makes many mechanisms and capacities in central ministries redundant.

The new circumstances require central ministries to transform themselves into "thinking" organisations, complementing the Prime Minister's Office and the NITI Aayog's macroperspective with knowledge and capacity-building roles within their domains. They are, then, less about spending money and more about ensuring that it is spent effectively by states. The number of people and, more importantly, the skills that will need to do this will change significantly.

In sum, the new federalism provides an opportunity to significantly improve the effectiveness of public finances, both in terms of revenues and expenditure. However, its full potential will only be realised if appropriate institutional mechanisms and capacities are created both at the centre and the states. These are as necessary as they will be challenging.

The writer is director of research, Brookings India, and former deputy governor, RBI. These views are his own