

# **Optimal Concurrency – A question in the context of Fiscal Devolution**

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Dr. Rathin Roy, Director NIPFP, Dr. Thomas Isaac, Finance Minister of Kerala, Dr. Santosh Mathew, Gates Foundation and friends,

Thank you very much for inviting me to this august assembly. I look forward to hearing Dr. Thomas Issac, the Hon'ble Finance Minister of God's Own Country, who is also a fellow economist and friend, and hear and read what the other experts from across the world have to say on experience across a host of countries. For me, because of my past association with NIPFP, any seminar or event organised by NIPFP has a special attraction. But, you can see how important your seminar is from the fact that my distinguished member colleague from the Fifteenth Finance Commission – Dr. Anoop Singh is also attending the seminar.

I wish I was speaking after a few months, then I could have told you what the Fifteenth Finance Commission recommends in its report and why. Unfortunately, the report is still under preparation and I cannot do that. I cannot even speculate with a fair degree of certitude what the report is going to recommend. So, rather than trying to answer questions, I will raise two questions. Two questions which are relevant in the context of fiscal devolution not only in India but most probably in every other country with a federal structure. The questions relate to the optimal extent and the optimal design of concurrency in the policy space and spending on particular public goods and services by both the national and sub-nationals governments. In simple language what I ask is whether the Union government or any State government should be doing all that the other is doing, or doing only some of the things that the other is doing, or doing none of the things that the other is doing. If they do what the other is doing, then how differently should they be doing it?

In my country we call the national government Union or the Central government, and the sub-nationals the States or the Provinces. We also have local governments – the *panchayats* or village councils, block *panchayats* and *zilla* or district *parishads* or councils in the rural areas, and municipal councils and municipalities in the urban areas. The problem of concurrency can arise even between the second and third tiers, that is, between state and local governments, but I shall confine myself to the Union and States on the issue of concurrency.

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<sup>1</sup> Member, Fifteenth Finance Commission, this paper is Special address at the Inaugural Session of International Seminar on Federalism, NIPFP and Bill & Melinda Gates Foundation, Kochi, Kerala 27-28, August, 2019

Most federations have Constitutions that assign expenditure responsibilities and taxation powers to different levels of government. Thus, in the Seventh Schedule of the Indian Constitution, List I or the Union List describes the items under the Union's jurisdiction, and includes obvious items such as defence, foreign affairs and railways for expenditure and taxes such as tax on income and customs duties on imports. List II is the State List and describes the items under the jurisdiction of the states, and includes items such as public order, public health and sanitation for expenditure and taxes such as tax on land and buildings, motor vehicles tax, agricultural income tax and entertainment tax.

Beyond the Union and State lists, the Seventh Schedule of the Indian Constitution also has a List III entitled concurrent list. As expenditure items, it includes items such as social security and social insurance, and labour welfare; and under taxes and fees, it includes stamp duties other than those collected by means of judicial stamp paper. Problems arise in the context of concurrent jurisdictions. For the items listed in the Concurrent List, the Union and States share their responsibilities of supplying public goods and services, and exercise their rights to tax.

As you all know, one of the basis of the division of taxation powers and expenditure responsibilities in a federation is the principle of subsidiarity. The principle of subsidiarity states that powers to decide should rest at the lowest level appropriate to its purpose. State governments may be expected to be more responsive to individual citizens in their states than their counterparts at the federal level. Their decisions can reflect regional preferences and variations. And, voters can more easily replace unresponsive state leaders than their federal counterparts. The European Union follows the principle of federal subsidiarity whereby a specific governmental role or function is left with the lower level of government, unless the higher level of government can handle it more effectively.

The concept of subsidiarity follows from Mancur Olson's principle of fiscal equivalence.<sup>2</sup> Public or collective goods, for example, better law and order, generate externalities in the form of non-exclusivity. No one, irrespective of whether she has or has not contributed to its financing, can be excluded from their benefit from a relevant jurisdiction. If the benefits of the collective good or service reaches beyond the geographical jurisdiction of the government that provides it, then it will be underprovided. If the benefits reach only a part of the constituency that provides it, again it will be underprovided.<sup>3</sup> Allocative efficiency will be achieved, and a Pareto-optimal amount of the public good will be supplied when the

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<sup>2</sup> Mancur Olson, Jr.: "The Principle of "Fiscal Equivalence": The Division of Responsibilities among Different Levels of Government," The American Economic Review, Vol. 59, No. 2, Papers and Proceedings of the Eighty-first Annual Meeting of the American Economic Association (May, 1969), pp. 479-487.

[http://www.andreasladner.ch/dokumente/Literatur\\_Unterricht/Olson\\_1969.pdf](http://www.andreasladner.ch/dokumente/Literatur_Unterricht/Olson_1969.pdf)

<sup>3</sup> In one special case, the benefit boundaries smaller than jurisdictional boundaries may lead not to less than a Pareto optimal level of public expenditure, but a higher one. The special case is when x percent of the voters in a constituency are required to vote affirmatively before a measure is declared passed and more than x per cent of the voters are benefitted by it.

boundaries of the government coincide with the boundaries of the area where the benefits of the public good or service accrue.

Constitutions of federal countries, including that of India, try to map expenditure items according to the principle of fiscal equivalence. Formal or legal arrangements differ across federations. The oldest surviving federation from 1789, the US, follows a single list approach. Article I(8) of the US Constitution has only an exhaustive or limiting list of legislative domains for the US Congress at the federal level. Since Congress approval is needed to spend money, such legislative competence has implications for spending power of the Federal Government. The 10<sup>th</sup> Amendment to the US Constitution in 1791 had stipulated that all powers not expressly delegated to the Federal Government belonged to the jurisdiction of the states. In contrast, the Canadian Constitution Act 1897, like that in India, has a multiple list approach – one list for the federal government, one list for the provinces, and one concurrent list. Again, the Commonwealth of Australia Constitution Act 1900 follows the single list approach of the US. What is important to note, however, is that the problem of concurrency can arise even without a concurrent list. Prime examples are the US and Australia.

Until 1929, in the first 140 years of its existence, the Federal Government played a minor role in the US and spent only 2.5 per cent of GNP on national defence, postal services, customs and foreign affairs, while the expenditure by State and Local Governments was about 7.5 per cent of GNP. With the Supreme Court's strict interpretation of the 10<sup>th</sup> Amendment, the Federal Government was very small. All this changed with the Great Depression in 1929 and Roosevelt Administration's New Deal, followed by the Cold War, Korean War and Vietnam War. Constitutional Federalism, in the strict sense of the term, broke down in the US. By the mid-1930s, the Supreme Court started to take a liberal view of the powers of the Federal Government and the Congress. This the Court did under the 'commerce clause', namely the power "To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." By Indian Tribes it meant not us Indians, but the native Americans, who because of a historical mistake of colossal proportions by Christopher Columbus continue to be lumped with us. By 1954, the federal government was spending 19 per cent of GDP, while the expenditure by State and Local Governments remained more or less constant between 6 and 8 per cent of GNP. Between 1954 and 1978, while increased revenues from higher taxes continued and the Korean War ended, Federal involvement in domestic activity experienced explosive growth and Federal aid programmes to States and Local Governments soared from 38 to 500.

In Australia, the federal government, which is called the Commonwealth Government, is empowered under Section 94 of the Constitution to guarantee the states' financial well-being by empowering the Commonwealth parliament to provide to the states all surplus Commonwealth revenue. With surplus revenues accruing to the Commonwealth from the 1920s, starting with Main Roads Development Act in 1923, there was a proliferation of special

purpose grants to the provinces and considerable concurrency of functions of the Provincial and Commonwealth governments.

In Canada, the *Constitution Act, 1867* laid out the enumerated powers between the federal and the provincial governments, including a concurrent list. The provinces have clear jurisdiction over (i) establishment, maintenance and management of hospitals and asylums, (ii) property and civil rights and hence regulation of professional services such as doctors, nurses and other health professionals, and (iii) matters of a strictly local or private nature and hence health care and public health.<sup>4</sup> But the federal government has powers to make payments to people or institutions or governments, even in matters falling outside federal jurisdiction, provided it does not infringe on a regulatory arrangement falling within provincial jurisdiction. The federal and provincial governments were not supposed to tread on each other's respective jurisdictions. But, the Act said little about health care, and courts had to interpret the implications of the 1867 Act. Thus, the federal government in Canada funded prescription drug benefits for specific groups such as prisoners, indigenous peoples, members of the armed forces and veterans. In 1966, Canada used tied grants to provinces as the means to bring the provinces on board and introduce Medicare, a large-scale policy innovation in the form of national universal health insurance scheme.

In Canada, court rulings have recognised the scope of the federal government to fund provincial social insurance programs and attach conditions to such funding to influence the national design of programs. The wide jurisdiction of the federal government under the 'peace, order and good government clause' has been recognised by the courts as well. The Canadian Supreme Court has recognised three broad areas or branches under this peace, order and good government clause – gap branch or areas (such as aeronautics) overlooked by the Constitution; emergency branch dealing with temporary crises; and national concern branch dealing with areas such as national pharma-care. This legal interpretation of the peace, order and good government clause by the Court has accentuated the scope for the dichotomy between Constitutional assignment and operational reality in Canada.

We could argue that the extensive use of conditional grants, even if consistent with the letter of the Constitution in the relevant federation, it is against the spirit of it. The counter-argument would be that many of these Constitutions were designed quite a long time ago, more than 200 years for the US, more than 100 years in the case of Australia, and, 69 years ago even in the case of India! The constitutions could not have anticipated the public goods and services that are needed in the economy in recent times.

Constitutions get amended. Thus for example, in India, the State List itself has got abridged by the 42nd Amendment Act in 1976 with five subjects, including education,

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<sup>4</sup> Jurisdiction over property and civil rights embraces all private law transactions, which includes virtually all commercial transactions and thus medical, nursing and health services.

transferred to the Concurrent List. Furthermore, in India, the Union has enacted laws such as the Right to Work or National Rural Employment Guarantee Act (NREGA), 2005, the Right to Education Act 2009, and the National Food Security Act 2013, which have resulted in unfunded mandates for the State Governments. Some may describe such unfunded mandates as neither cooperative nor competitive, but 'coercive' federalism. When Parliament enacts such overarching laws, States have no option but to implement them with the necessary resources at their disposal. Furthermore, Article 282 of the Indian Constitution empowers the Union to make any grants for any public purpose, notwithstanding that the purpose is not one with respect to which Parliament may make laws.

Conditional grants provide an easy way to meet these needs without amending the constitutions. Are conditional grants a way of forcing the states to fall in line with national priorities enumerated by the federal government? As far back as 1942, when the province of South Australia challenged the First Uniform Tax imposed by the Commonwealth Government and provided a specific purpose grant for the provinces not imposing their own income tax, Chief Justice Sir John Greig Latham interpreted the grant as an inducement rather than enforcement. Even in the case of India, rightly or wrongly, you could claim that the Centrally Sponsored Schemes or CSS's are inducements rather than a forcible imposition. The states can, if they so wish, not implement the conditionalities and forego the Union's specific purpose grant, for example, the Union's share of a centrally sponsored scheme.

The questions that are relevant are four: What are the advantages of concurrency? What are its disadvantages? If concurrency is taken as a fact of life, how much concurrency should there be? And, what should be its optimal design?

### ***Advantages of concurrency***

Like in the economic sphere, even in the sphere of politics – among political parties and leaders, and among different levels of government -- competition has been generally accepted as a useful tool for enhancing efficiency. In a democracy, electoral competition among parties and leaders tends to produce responsive and accountable governments at least in the medium- to long-term. A federal structure guarantees against a 'winner-takes-all' outcome. Imagine a situation where the voters of say 10 large states vote in unison to elect a particular party at the national level. The federal structure ensures that the other 18 will still be able to elect different parties in their respective territories.

In the competitive federalist framework, state governments compete among each other to introduce reforms, attract investments and skilled personnel, grow faster than the rest and accelerate socio-economic development. This state of Kerala, for example, sets the standards in the fields of education and healthcare for the other 28 states. Tamil Nadu set the example for mid-day meals in schools. Some would even argue that competition among

governments is as important, if not more important, than their mutual cooperation. Intergovernmental cooperation can be achieved even without a political federation. For example, an intergovernmental agreement enables delivery of a letter with an Indian stamp in any country in the world by that country's postal workers. NATO involves cooperation between sovereign nations, not all of them members of a single political federation.

So, why restrict competition among governments only at the horizontal level that is across states? Why not competition between the Union and the States? In Australia, Kevin Rudd of the Labour Party came to power in November 2007 promising to enact "the single biggest health reform in a quarter of a century." In March 2010, he implemented "A national health and hospitals network for Australia's future." The essence of the reform was captured by the slogan "funded nationally, run locally." If the waiting lists for elective surgery are too long, and the states had not succeeded in shortening the waiting lists to the voters' satisfaction, what is wrong with the Federal Government stepping in to compete with the states in health care? Similarly, if some of the States in India have performed poorly in delivering basic public services such as education and health, what is wrong with specific purpose grants to improve these segments of public service delivery?

### ***Disadvantages of concurrency***

No, it is not wrong for the Federal Government to step in to bolster health care in the country, across all states. Problems start when this assistance is given as a specific purpose grant. To begin with, designing conditionalities for specific purpose grants that are equally valid or desirable for every state from Mizoram to Maharashtra is a formidable job. A blame game can start with States complaining about too little federal funding and the Union complaining about states not putting in enough resources and effort in delivery. As long as the states continue as mere service agencies of the Union, the blame game is likely to continue.

With tied grants, the Union is the principal and the State is the agent. The principal must spend some resources to manage the agent and ensure that the agent regularly report to the principal.

When more than one government is responsible for a role or function, voters get confused as to who is funding what. Intergovernmental competition is most beneficial when there is a close relationship between the costs and the rewards of government action. Electoral accountability is enhanced if when a state wants to increase its spending, it has to go to its own source of funding, namely taxes and fees, and enhance them. Similarly, whenever a state reduces its taxes and charges, it should reduce its spending. Specific purpose grants are likely to reduce this accountability. One of the problems arising from specific purpose grants is the difficulty in deciphering the additionality that such grants

actually bring to the table, because of fungibility of money. Suppose State A was spending Rs. 100 on health care, and spends Rs. 150 after receiving Rs. 50 as specific purpose health grant. It is difficult to be certain that the additional Rs. 50 has been spent on health care. Perhaps even without the grant State A would have spent Rs. 120 on health, then the additionality brought about by Rs. 50 specific purpose grant is Rs. 30 only.

### ***How much concurrency***

A critical part of economic policy making is setting the priorities. A developing country such as India supplies practically all public goods and services in insufficient quantities. Prioritising all the goals of socio-economic development will result in resources being spent too thinly across priorities. Little will be achieved in terms of tangible results within a reasonable time frame.

Answer to the question of how much concurrency should there be is intimately related to the surplus revenues of the national government. Concurrency through special purpose grants arises because of vertical fiscal imbalance. Taxes, particularly those on bases which can move from one state to another and also because of economies of scale in collection, have a tendency to get centralised. With sub-national governments empowered to levy only those taxes that are costly to escape by moving interstate and the others assigned to the national government, a vertical fiscal imbalance arises in most federations. Devolution of higher amounts to states results in reduced scope for concurrency through specific purpose grants.

Many may agree that, post-devolution, some surplus funds should be left with the Union government so that it can pursue national goals even in areas where the states have full jurisdiction by the Constitutional assignment of functions. At the same time, many would also agree that such national priorities cannot be in dozens. As I said, every public good and service is in short supply in India. With insufficient funds, it is unrealistic to aim accelerated progress in the provision of all such goods and services to bridge the gap between what should be supplied and what is supplied. Should education and health be the relevant areas for concurrency? How many public goods and services beyond education and health should be considered for intervention by the Union Government through specific purpose grants? I leave it as a question for this august audience.

### ***Optimal design of concurrency***

Politics at the sub-national level can differ from state to state and also from politics at the national level. In 1787, in *Federalist* No. 10, James Madison had warned that factions would have greater influence in a smaller polity than a larger one. As a result, even priorities attached to areas, such as education and health, can differ across states. Lack of fiscal

resources is often cited as the reason for inadequate allocation to, and hence unsatisfactory outcomes in, these sectors. But, there is hardly any guarantee that any particular state which lags other states in the field of education and health, if provided with additional funds without conditions will allocate it to education and health.

It is unrealistic, perhaps even unreasonable, to expect that a country will not have ambitions regarding the availability of some basic public goods and services across the length and breadth of the country. Given this fact, can you object if an Indian in Kerala has strong views about the low literacy rates in some north Indian states?

So, what should be the design of the concurrent intervention? Asking states to act as the Union's agent in spending specific purpose grant funds does little more than 'doing more of the same.' Furthermore, too many public institutions and agencies end up having more than one government master, and hence confused lines of accounting and responsibility. In many cases, specific purpose grants are not so much to increase the level at which an activity takes place as to shape the way it occurs.

Some believe that what is needed is competition among different levels of governments using structurally different ways of doing things, with the institutions or instrumentalities fully controlled by and responsible to one government. In the area of school education, the Kendriya Vidyalayas and Navodaya Schools run by the Union Government provide a good illustration of competing with the states using a structurally different way of doing things. .

As discussed earlier, reducing the vertical fiscal imbalance or converting the specific purpose grants into block grants are two of the obvious ways of getting rid of or reducing the problem of concurrency. But those are rather radical solutions. One solution is broad-banding as was suggested by the Garnaut-Fitzgerald report on Commonwealth–State funding commissioned by the government of Western Australia, Victoria and New South Wales in 2001. The report suggested that most of the 120 then-existing special purpose grants should be rolled into three 'national programs': health and aged care, education and training and Indigenous community development. An Australian Labour Party report in 2007 echoed these same sentiments as the Garnaut-Fitzgerald report. The Kevin Rudd government in its Commonwealth Budget of 2008-09 rationalised more than 90 existing special purpose grants into five new ones: health, early childhood education and schools, vocational education and training, disabilities, and housing. Is that the way to go? I do not have the answer, I hope to hear from you all.

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