

Proceedings Report

Lets Talk About the Economy in a Federated Nepal!

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The discourse of Federation in Nepal has been limited to identity. Successive studies, reports, seminars and workshops have devoted much time in looking at federalism from different lenses sans economic lens. For a federation model to survive in a country, it needs to understand the discourse on how states earn revenues, make expenses and sustain themselves. Professor Bibek Debroy a leading economic analyst, writer and author, is a Professor at the Centre for Policy Research, India's premier public policy think tank. In this neftalk series, he shared the Indian experience with Federalism, wherein lessons for Nepal can be drawn.

In the Indian political context, the constitution refers to a union of states (the union), with no reference to the term 'centre state', however this is the term often used to describe the Indian central government. In comparing India and China, the centralized nature of India is very evident. The extent of this centralization dates back to the British Raj, where the legacy of planning was centralized, from industrial policies to setting up of plants. This is said to be one of the main reasons behind current centralization in India. It is also to be noted that the party forming the government in Delhi at the "center", also forms the governments in other states. The result of excessive centralization leads to building of tensions and deteriorating centre-state relations.

Despite the difficulty of determining optimal levels of distribution of public goods, such economic considerations rather than any other reason should be an important consideration in state formation. According to Debroy, the formation of states in India was not on grounds of economic rationale, but on linguistic and historic geographical divisions. From an economic viewpoint, it is in the nature of public goods (e.g. law and order, physical infrastructure, rural roads, electricity generation, drinking water, irrigation, schools etc) to be optimally delivered only at a certain level, above or beyond which economies of scale and scope are lost.

For India, the optimal level of distribution of public goods lies between populations of 25 – 50 million. When measured in these terms, many states in India are either above or below this optimal level making optimal public delivery of goods and services difficult. Although India has 28 states and seven union territories, in terms of optimal delivery of public goods and services, India should have 50 different states. India currently has over 600 districts and 600,000 villages, of which over 150,000 villages have a population of less than 500. This proves to be an issue for optimal delivery of public goods and services and long-term viability. It is therefore important to accelerate the process of development, through which smaller villages cease to exist as they begin to integrate with larger villages therefore bringing down the number of these sub-optimal villages.

The Indian Government has a third tier in its system: municipalities (urban administrative divisions) in urban areas and Panchayats (local self government bodies) in rural areas. Ideally, the entire planning and implementation process should be decentralized. Since the citizen's interface with the government is not with the central government in Delhi nor the state government, rather it is with the municipalities and Panchayats. Because the decisions are still made at the center, these local bodies have responsibilities, but not the rights, making implementation difficult or even impossible.

Another determinant of optimal distribution is the availability of resources owned by a state. In the Indian system, funds are channeled to the state either through the finance or the planning commission. An approximate of 60% of expenditure in the social sector is from the state. The finance commission is set up every five years to make recommendations on the ratio of tax revenues, and its division between the centre and the states. However lack of adequate devolution within states, leave them fiscally starved. Despite recommendations of devolution, there is a lack of implementation, which impedes the ability of states to implement recommendations or make public goods and services optimally available. Another drawback, from lack of devolution is tax fatigue very evident among the middle class. The reason behind this being the lack of benefits from the payment of taxes, with the public seeing their money paid in taxes sinking into a black hole, with no returns. However contrary to what is widely believed, there is an increased willingness to pay fees rather than taxes, but only on satisfactory delivery of public goods and services such as, electricity, water and schools, etc.

India being a large country is very heterogeneous. The problem here is the per capita income paradox, whereby the per capita income range of the country ranges from figures as high as that of developed countries, to figures as low as the least developed ones. This makes management of taxes difficult. On the one hand there are metropolitan cities and larger municipal corporations that have revenue sources by the charging of appropriate taxes, on the other hand there are villages and local level Panchayats, where tax collection as a revenue source is very minimal, due to which delivery of services becomes an issue. Delivery of services however is also contingent on the capacity of local bodies in terms of their accounting, budgeting, human resources and administrative capacities. The problem here also lies mostly within the backward and small villages that do not have enough potential to generate revenues. Larger villages are able to get by with the help of grants and aids, but the smaller ones have no access to it. Furthermore, with the base of tax revenues being very narrow, benefits are concentrated only on a few items. In such structures, there is a need for dissolving disputes on the sharing of resources. Despite the constitution of India having a provision for an Inter State Council and National Development Council, they have, so far, been inefficient in the resolving of such disputes.

Similarly, India being a heterogeneous country, even within states, a few districts are backward on the grounds of social and physical infrastructure, in comparison to other districts in the same state. Examples of such states include Maharashtra and Andhra Pradesh where market mechanisms have led to swift development in certain parts of the state. This is one of the reasons behind the breaking up of states as in the case of Bihar, Uttar Pradesh and Madhya Pradesh. In the constitution there is a seventh schedule which sets a list of products and services to be rendered by the union alone, and some that are to be rendered by

the state alone. There is also a concurrent list where both union and state must work together in delivery of public goods and services. Based on this schedule, the union and state have the right to take action against each other, however this schedule is yet to be implemented. As a result, the union infringes upon state areas, which therefore must be reduced. In this regard the seventh schedule needs to be relooked at, and a separate local body list incorporated. He also stated that the constitution has not been cast in stone, implying that it has been progressively amended.

Another issue is in regard to the election process to the Rajya Sabha (Council of States or upper house of the Parliament of India), which is supposed to represent the interest of states. Initially to represent a state at the Rajya Sabha, one had to be a resident of that state, however now such practices have disappeared with members being elected from the finance and planning commission. India has problems managing federalism, most of which have not been solved in its entirety. However what India has managed to do is create certain vents to manage these tensions.

A member of the audience questioned Debroy on his statement regarding the optimal population for production of public goods and services in India being between 25-50 million. Since Nepal's total population is below the optimal population for a state, the audience member asked how it is possible to subdivide Nepal, especially with a geographical structure such as that of Nepal whereby villages are separated by hills making it difficult to commute. To this Debroy responded said that, the 25 to 50 million figures is based on the Indian experience and should not be mechanically applied to the Nepali situation. Even in the Indian context subdivisions have taken place, with both smaller as well as larger states having performed better after subdivision. Taking into consideration the northeastern states of India, for instance Andhra Pradesh, based purely on economic rationale, these states should not have been formed, as they are not economically viable. These states function only because they are special category states, whereby they receive special funds, i.e. they are functioning on "*hand me downs*" from other states.

Another question put forward was in regard to the formation of a state based purely on economic rationality. In most cases states are formed on the basis of emotions rather than economic rationality. The audience member asked, in such cases, what should be the role of an economist or other intellectuals? To this Debroy, responded that there have been emotive movements, which have led to the breaking up of states in India. In such cases, it would be better for economists and intellectuals to color their emotions and make decisions based on economic sense rather than emotions. In India there is a climate of competition for domestic investments and for these investments to come through there is a need for a certain level of physical as well as social infrastructure and environment, without which one cannot effectively compete for domestic investments. Therefore states must be built on economic rationale, for them to develop.

A member of the audience put forward the view about states being created out of public demand, and the need for such demands to be viable. The context of competing for resources is very interesting, especially in regard to Narendra Modi being pushed for the position of Prime Minister. This is because of the prosperity of Gujarat, more than anything, which indicates how economic rationality plays a very important role. Profess Debroy agreed with the statement and added that Bihar and Gujarat had been growing at more

than 10% in the last 10 years. This applies to not only Bihar and Gujarat, but also to states in India that were formed on the basis of linguistic grounds, and princely states that later became a part of independent India.

A member of the audience put forth his views regarding the comment made by Debroy that big cities have more revenue while smaller villages have less revenue. He stated that in countries such as Nepal, income taxes and indirect taxes such as VAT are centralized. In such cases even after devolution, these funds do not cover expenses of larger states. The devolution of funds should therefore not be considered as handouts as the states are entitled to them. It is inevitable that states will have developed as well as under developed sectors depending on the availability of resources to that state.

Debroy validated his statement on property and motor vehicle taxes by saying that there is an indirect tax reform agenda in India; however this has only been partly completed. In terms of this agenda, one does not have the discretion to implement what is traditionally called – indirect taxes, including standard duties. Therefore local bodies no longer have the option of introducing stamp duties, entry taxes, etc. He further clarified stating that he did not use the term inequality, which could mean inequality in the distribution of outcomes and this is inevitable - both conceptually and statistically. Taking the example of Maharashtra, devolution takes place from Delhi to Mumbai. In this case the Maharashtra government has focused on the development of the Mumbai-Pune highway rather than on the remote villages such as Vidarbha leading to slow or minimal development of such villages within Maharashtra. The issue here is not regarding federalism but spending of public resources. Since the resources are not being spent in the state, this is what leads to the need for splitting up of states because, with a separate state, one can ensure that the funds are spent in developing areas that would otherwise have been ignored.

Another question put forward was that if India had 540 autonomous states, what kind of consequences would Debroy foresee happening in India? Debroy responded that one has to be careful about mechanically applying numbers and that if India had 540 autonomous states; it would not be a feasible option and would only lead to confusion. This is because then India would have 540 different representatives, which would be a complicated issue. Therefore India chooses not to create 540 states but empower the 600 districts so that they can better utilize the funds to provide adequate delivery of goods and services.

Debroy was then asked to comment on why even now after 60 years of states formation on linguistic grounds, people still want to form states based on ethnicity, such as the case of Gorkha Land. In such cases where would economic sense lie when politicians take calls on state separation based on ethnicity? Debroy replied stating that such ethnic based movements are really a symptom. He further explained stating that the fact of the matter is that regions such as Terengganu in Andhra Pradesh, Vidarbha and even West Bengal are deprived of public goods, which lead to a fundamental resentment coming together in the form of an ethnic revolt. Ethnicity being geographically concentrated therefore becomes a common force to raise issues regarding economic deprivation.

Another member of the audience questioned on the limitations of the interstate council in India. Debroy responded saying that over the years the central government in India has become very arrogant. This has led to reluctance towards accepting the fact that a lot now depends on the state. Meetings that need to have a pivotal role to play occur rarely, and when they do they are largely ornamental. This arrogance cannot continue indefinitely as the union needs to understand that it is not just the centre but a unified front for all of the states.

Professor Debroy was asked to share some key learnings from his work in Gujarat and Jharkhand. In regard to Gujarat, he stated that there has been a great deal of freeing up space for the private sector. This has been easy for Gujarat, which has a largely private entrepreneurial community leading to a retreat in the role of the state. There has also been a great level of empowerment of bureaucracy. Therefore whatever the policy program, it is essential that the bureaucracy deliver. The central schemes are very rigid as pointed out before, however the government of Gujarat has been successful in identifying the loopholes and plugging them through state schemes. This has resulted in a great sense of pride towards the state.

In regard to Jharkhand, the private initiative so prevalent in Gujarat is missing throughout the state. The mindset is to look at the government or state to deliver everything under the sun. Jharkhand was formed after dividing Bihar, which led to all the better bureaucrats opting for Bihar. Jharkhand therefore has an enormous problem in good bureaucracy. It also has enormous problems with regard to violent outbursts across a whole variety of districts, whereas Gujarat has such problems only in one section, which in addition has been successfully managed. Furthermore in Jharkhand there is no remarkable pride in the state, but rather they take pride in their achievements as compared to that of Bihar. Their attitude is such that if Bihar can achieve something, surely they can too. Gujarat has been developing at a rate of 10% per year and Jharkhand at 7.5%. However this growth figure should not be underestimated as Jharkhand has more difficult terrain, which could have a negative impact on growth.

Sujeev Shakya wrapped up the session saying that discussions on federalism have always focused on the formation of states, but the lessons learned here was to also focus on the viability of state formation. The key issue is whether Nepal will be federated or not. Drawing in from the functioning of the interstate council in India, it would be interesting to see how such a body will function in Nepal, where all decisions have to be made in consensus.

To ensure that smaller villages are developed, multilateral and bilateral agencies need to pick up villages and start working on them to avoid duplication and also so that they develop in comparison to the larger states which have revenue sources in the form of taxes. He reinforced the point made by Debroy that if there is economic deprivation, ethnicity becomes a common ground in bringing together people to discuss where this deprivation exists. With the key points highlighted by Shakya, the talk on the Nepali economy in a federated Nepal came to a close.

Nepal Economic Forum is a non-profit organization dedicated to being the private sector interface to Nepal's economic development.