TIF - States’ Loss of Fiscal Autonomy in a Centralised Federal System

M. GOVINDA RAO

June 5, 2020

Vidhana Soudha, Bengaluru: Coercive and not cooperative federalism is now in place | Bikash Das (Wikimedia)

The states bear the larger responsibility in dealing with Covid-19 but they have few resources to do so. The ongoing process of centralisation has weakened the states. We need an institutional mechanism to oversee bargaining between the centre and the states.

The response to Covid-19 has brought out the fragility of the Indian federal system. A tendency towards extreme centralisation during the pandemic and the absence of checks and balances to correct this centralisation is a matter of concern. The process of concentration that happens when a country is at war with another comes from a patriotic zeal to empower the government to fight the war. However, the pandemic has to be fought by both the centre and the states as both have stakes in protecting lives and livelihoods—in fact, the states more so since they are in the forefront. But they do not have the fiscal strength to do so. In such a scenario, the centre is using the states’ distress situation to force them to adopt its economic and institutional agenda.

Pandemic and Centralised Decision Making

The Constitution places ‘public order’ and ‘public health’ in the State List (Entries 1 and 6), and ‘prevention of the extension from one State to another of infectious or contagious diseases or pests affecting men, animals or

plants' as a joint responsibility in the Concurrent List (Entry 29). The common interest in mitigating the pandemic should normally have led to decisions by the centre on broad policy matters relating to inter-state movements and by the states on policies and implementation of the lockdown and on public health interventions.

> *Considering the poor financial situation of the states, the centre should have empowered them fiscally to fight the pandemic effectively. But the union government has completely centralised decision-making.*

Instead, what we have seen are decisions by the union government that have reduced the states' role to being merely agents to implement decisions handed down to them.

Considering the poor financial situation of the states, the centre should have empowered them fiscally to fight the pandemic effectively. But the union government has completely centralised decision-making by invoking the Disaster Management Act, 2005 for reasons of "consistency in the application and implementation of various measures across the country."

The decisions on the lockdown were taken by the centre and so too, until mid-May, were the risk classification of districts and the listing of permissible activities. The first video-conference by the Prime Minister with the chief ministers that took place on 20 March did not have a proposal for a lockdown on the agenda, but the centre decided on its own on 24 March to impose a nation-wide lockdown. The subsequent video conference discussions have been mostly in the nature of a formality.

> *There is little coordination between the centre and the states, leading to avoidable hardship and misery to millions of vulnerable people.*

Faced with loss of employment, uncertainty about the length of the lockdown, little reserves in hand, and the fear of contacting the virus in the cities, there has been an exodus of migrant labour, creating a humanitarian crisis which the states are having to confront. There is little coordination between the centre and the states, leading to avoidable hardship and misery to millions of vulnerable people.

Being closer to the people, the states have a larger responsibility of waging this war. They have had to immediately ramp up their public health infrastructure, deal with the humanitarian crisis arising from the exodus of migrant labour, and meet the basic requirements of the vulnerable sections facing adversity during the lockdown. Kerala unveiled a Rs 20,000 crore financial package immediately to tide over the crisis and decided to go to the market to borrow Rs 6,000 crore at a high cost of 8.9 per cent. Karnataka too unveiled a package to reduce the suffering of various sections of society that have suffered a serious loss of incomes due to the lockdown and loss of employment.

Fiscal Vulnerability of States: Erosion of Revenues

The lockdown has completely eroded the states' revenue from the meagre sources of revenue at their disposal. Even the promised Goods and Services Tax (GST) compensation has not been forthcoming. The constitutionally mandated tax transfers from the centre too are in a precarious situation.

As the Gross Domestic Product (GDP) is expected to contract during the year, tax revenues will fall and the divisible pool of central tax revenue is therefore likely to shrink substantially. Even if the GDP remains at the same level as in the previous year (2019–20), the tax devolution to the states will be lower by Rs. 2.5 lakh crore than the budget estimate of the union government, which the states took into account while formulating their own budgets. If the economy contracts and the tax revenue of the union government is lower than the 2019–20 revenue, the loss to the states will be even higher.

> *Unlike the centre, the states do not have broad-based tax handles nor do they have the autonomy to borrow to tide over their difficulties.*

In this distressed financial situation, the states had hoped that the centre would help them with a Covid-19 grant that would at least partially cover the loss of revenue in their share of central taxes. They had hoped that the centre would settle their pending dues, particularly the GST compensation. Unlike the centre, the states do not have broad-based tax handles nor do they have the autonomy to borrow to tide over their difficulties.

The states had agreed to surrender the right to levy domestic trade taxes in order to implement the GST, based on the undertaking that the centre would compensate for the loss of revenue if actual collections fell short of projected revenue from the subsumed taxes (calculated as the 2015–16 collections with a growth of 14 per cent every year until 2022). Actual collections have fallen short but the compensation has been paid only up to November 2019. This is a clear abrogation of the agreement. Releasing the pending compensation at this juncture would have fiscally empowered the states.

> *Facing a severe financial crunch and the need to release funds to save livelihoods … many states have had to take extreme steps like postponing all payments to contractors and cutting salaries and pensions.*

Similarly, low international crude oil prices presented an opportunity for the states to levy additional value added tax on high speed diesel and motor spirit, which would have helped them to garner some additional revenue. However, with the central government levying additional excise duty on petroleum products to collect Rs 1.4 lakh crore of non-shareable revenue, very little space was left to the states for an increase in taxation of petroleum products.

Facing a severe financial crunch and the need to release funds to save livelihoods and prevent starvation, many states have had to take extreme steps like postponing all payments to contractors and cutting salaries and pensions of their employees. Most states have kept large bills pending. A number of states like Andhra Pradesh, Maharashtra. Odisha, Rajasthan and Telangana have deferred payment of salaries of the ministers by 60–75 per cent and of bureaucrats by 20–50 per cent. Even CPM-ruled Kerala has deferred the salaries of employees by 6 days in a month for up to five months. States like Punjab and Tamil Nadu have deferred increases in dearness allowance payments.

Additional Borrowing Space: Conditions Apply

In such a dire situation, the states were hoping that the announcements made by the union finance minister in May would include a Covid-19 grant and permit additional borrowing to help them tide over their fiscal

difficulties.

The central government's measures, as part of the Atmanirbhar Bharat Abhiyan package, do not address the issue of additional grants but allow the states to borrow an additional 2% of their GDP from the market, up from the current limit of 3% of GDP.

However, there will be a graded increase in borrowing and much of it will be dependent on meeting certain conditions. The states have been allowed to increase their borrowing from 3 per cent to 3.5 per cent of GDP without any conditions.

> *The additional borrowing space for states does come as a relief, but the imposition of conditions raises important questions…*

But they can borrow an additional 1 % of GDP only by fulfilling four reform conditions—meeting each condition will allow the states to borrow an additional 0.25% of GDP per reform . The four reforms are:

(1) Introduction of the 'One nation, one ration card' scheme for all, which will require linking Aadhaar with ration cards and installing point of sale (PoS) machines in all fair price shops;

(2) Improvement in ease of doing business, which requires (i) district level assessment of ease of doing business according to the Department of Promotion for Industry and Internal Trade (DPIIT) norms, (ii) automatic renewal of state industrial and commercial licences to businesses and (iii) making randomised inspections with prior notice and full transparency;

(3) Implementation of power sector reforms, which would entail reducing aggregate technical and commercial losses, direct benefit transfers to farmers instead of charging them lower power tariffs, and reducing the gap between average cost and average revenues; and

(4) Urban local body reforms requiring the states to notify property tax floor rates according to circle property values and to notify water and sewage charges.

Finally, if at least three of the above four reform conditions are satisfied, the states can borrow another 0.5% of GDP as well, with the new ceiling yielding a total of an additional 2% of GDP.

> *Never in the history of independent India has there been any occasion when the union government has put conditions on market borrowings of the states.*

The additional borrowing space for states does come as a relief, but the imposition of conditions raises important questions of the appropriateness of using the distress situation to force the states to implement an agenda set by the union government.

To be sure, Article 293 (3) of the Constitution requires the union government to permit the states to borrow when they are indebted to it and Article 293 (4) enables that: "A consent to borrow may be granted subject to such conditions, if any, as the Government of India may think it appropriate". Also, the reform conditions now stipulated by the centre may not be inherently undesirable.

However, there is no precedence to putting conditions on market borrowing. Never in the history of

independent India has there been any occasion when the union government has put conditions on market borrowings of the states. In 2008, there were no conditions imposed by the union government when, in the wake of the global financial crisis, it allowed the states to borrow an additional 1.5% of GDP.

[C]onsidering the fiscal distress the states are now faced with, the centre seems to have found it opportune to impose conditions on borrowing.

It appears that the union government seems to have been thinking about putting conditions on states' borrowing for quite some time, but was apprehensive about doing so as there is no precedence to this. In fact, the terms of reference (ToR) of the Fifteenth Finance Commission asked it to consider "The conditions that [the government of India] may impose on the states while providing consent under Article 293 (3) of the Constitution." The first report of the commission, covering 2020–21, was silent on the matter and it is possible that the commission had decided to make recommendations on these ToR in its second report, which will cover 2021–22 to 2024–25.

In the meantime, considering the fiscal distress the states are now faced with, the centre seems to have found it opportune to impose conditions on borrowing. Once this precedence is set, it opens up a Pandora's box. The union government can in the future impose on the states conditions that it deems fit, irrespective of their merits.

There may not be anything wrong with the conditions themselves. Linking of ration cards with Aadhaar and enabling the ration shops to have PoS machines is certainly desirable to ensure nation-wide portability of the cards. However, this does not solve the problem of not having the ration card itself.

The union government need not have thrust these reform conditions on the states by taking advantage of their current financial difficulties.

It is also important to resolve the issue of the losses of power distribution companies, which despite repeated attempts has persisted. The problem, however, is not the same for all states. West Bengal and Gujarat have solved the distribution problems in different ways and do not have large deficits in their power utilities, whereas the distribution companies in Andhra Pradesh, Madhya Pradesh, Punjab, Rajasthan, and Tamil Nadu continue to suffer large losses. Again, the problem could be obsolete infrastructure that requires fresh investments, or over-employment in distribution companies, or a failure to raise tariffs, or unmetered supply. The 'one size fits all' reform then may not yield the desired results.

It may be easy to levy charges on water and sewerage, but property taxation may not be easy to implement. There are states like Maharashtra where the implementation of property tax reform is constrained by the Rent Control Act. Moreover, the first report of the Fifteenth Finance Commission has already mandated that property tax reform must be undertaken to avail urban local body grants. Finally, promoting competition to achieve ease of doing business may achieve the outcomes better than micromanaging policies and their implementation through district level assessment according to the DPIIT norms or automatic renewal of industrial and commercial licences.

The union government need not have thrust these reform conditions on the states by taking advantage of their

current financial difficulties. These reforms could have been discussed with the states and each state could have implemented them in a manner best suited to it. In any case, it may be difficult to measure the outcome of these reforms within a year.

The union government will have to go by the initiatives taken, which may not necessarily ensure the desired outcomes. Moreover, it is not possible to ensure that the reforms undertaken will remain. There are not once-for-all reforms but require periodic changes. Revision of power tariffs has to be done periodically. Property tax rates and the base will have to be changed at regular intervals. There is no guarantee that the inspections of manufacturing units will remain randomised and transparent.

> *At a time when it is important to stimulate demand, the conditions stipulated for borrowing could lead to the unintended result of compressing capital expenditure.*

What could be the outcome of stipulating these conditions? The states will weigh these conditions and carry out the reforms they think would be easy to implement. Most of the states have already linked Aadhaar to ration cards and it may not be difficult to install PoS machines in the shops. Hopefully, there will be attempts to ensure adequate supply of the rations.

Similarly, most states may work, at least on paper, on the ease of doing businesses. There may also be attempts to reform the urban property taxes, but to what extent it will increase revenue will have to be seen. As mentioned earlier, this has also to be done to avail the Fifteenth Finance Commission's urban local body grants. Power sector reform will perhaps be the most difficult as reform in the sector is stuck due to strong special interest groups.

Clearly, the states will implement only those reforms that are politically easy. If they are not able to fulfil the three conditions, they may even decide to forgo the borrowings and instead prefer to cut expenditure. At a time when it is important to stimulate demand, the conditions stipulated for borrowing could lead to the unintended result of compressing capital expenditure.

Need for an Institution for Bargaining and Conflict Resolution

The experience of dealing with Covid-19 has underlined the need for an institutional mechanism to enable inter-governmental bargaining, foster inter-governmental cooperation, conflict resolution, and promote non-predatory competition. The absence of such a mechanism is a major institutional vacuum in Indian federalism. This has shown that in emergencies like the current pandemic, the states can be prevented from playing the legitimate role envisaged in the Constitution and be relegated to being mere agencies of the union government. We should have seen the union and the states working in unison in the spirit of cooperative federalism to mitigate the adverse economic consequences of the lockdown, especially in giving relief to the vulnerable.

> *Having created a precedence of imposing conditions for borrowing, the union government will now use the instrument to further its agenda…*

The National Development Council is no longer effective and the Inter-State Council, having been made a part of union home ministry, is not an independent institution. The states do not have a remedy when the union government simply abrogates the agreement to pay compensation for the loss of revenue from GST. The states have to simply take orders when the centre invokes the Disaster Management Act to deal with events like Covid-19 and when the centre treats the states not as partners but as agents.

Having created a precedence of imposing conditions for borrowing, the union government will now use the instrument to further its agenda by imposing conditions irrespective of whether or not they are in the interest of the states. In fact, in a situation of asymmetric power distribution and in the absence of an independent institution to oversee bargaining, coordinate actions and resolve conflicts, excessive centralisation is a natural outcome. This could lead to disharmony and divisions according to political allegiances and does not bode well either for democracy or for federalism.

(The author alone is responsible for the views in this article)

The India Forum *welcomes your comments on this article for the Forum/Letters section.*
Write to editor@theindiaforum.in.

Tags: Centre-State Relations
Federalism
centralisation
fiscal autonomy
states
Constitution
Market Borrowings
reform conditions
atmanirbhar bharat abhiyan
states autonomy in India