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FISCAL POLICY

Does India's current system of fiscal transfers undermine the spirit of co-operative federalism?

In this time of crisis, states are at the mercy of the Union government for additional resources to fight the pandemic.

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To contain the spread of the coronavirus pandemic, the government imposed a nationwide lockdown starting from March 25. As all economic activity came to a standstill, there was a large-scale disruption of livelihoods, accompanied by the spread of starvation and disease. A measure to address the health emergency fast escalated into a humanitarian crisis.

Even before the onset of the pandemic, the Indian economy has been on a downslide. GDP growth has been slowing down in the recent years. Despite several initiatives by the government, the downslide could not be arrested. The real GDP growth at 3.1% in the last quarter of 2019-'20 was the lowest in the last seven years. The real gross domestic product growth during 2019-'20 was estimated at 4.2% as compared to 6.1% in 2018-'19.

In March, the index of industrial production contracted by (-) 16.7%, its lowest level in the 2011-'12 base series. The cumulative index of industrial production for April to March 2019-'20 witnessed a decline with a year-on-year growth of (-) 0.7% versus 3.8% for the same period in 2018-'19.

Crashing revenues

The economic slowdown prior to the Covid-19 outbreak resulted in lower revenues for both the Union and state governments, as evident from their budgets. The Union government's revised estimates of tax collections (net of devolution to states) for 2019-'20 were about 8.8% lower than its 2019-'20 budget estimates, GST revenues were lower by 7.7% and devolution to states by 18.9%. An examination of the 2020-'21 budgets of 26 states show sa similar trend. The 2019-'20 revised estimates of devolution are lower by 15.6% as compared to the 2019-'20 budget estimates, their own tax revenues being lower by 4.6% while total revenue receipts by about 4.3%.

The lockdown not only resulted in a contraction of demand for goods and services as also disruption in supply chains as the economy came to a standstill. Assessments by various agencies have considerably lowered India's growth prospects for 2020-'21. The real GDP growth forecast for the country for 2020-'21 ranges between (-) 5.2% to 4%.

A migrant worker in front of a closed shop in Delhi. Credit: Jewel Samad/AFP

The slowdown in GDP growth in 2020-’21 on account of the Covid-19 lockdown will result in considerable revenue losses for both the Central and state governments. Several state governments have reported huge shortfall in their revenue collection during the first two months of 2020-’21. The fiscal stress on state governments due to revenue loss will be further aggravated by the decline in tax devolution by the Union government. Lower tax collection by the Union government would mean lower devolution to states.

State governments have been complacent in raising revenues. Own tax revenues aggregated across states as a percentage of Gross State Domestic Product declined from 6.97% in 2012-’13 to 6.29% in 2018-’19. The shortfall in revenues in 2020-’21 will further exacerbate the fiscal stress.

Even the promised Goods and Services Tax compensation by the Union government is not being regularly transferred to states. On the other hand, state governments have been on the forefront in meeting the challenges that Covid-19 has thrown up, leading to massive expenditure needs.

Dependence on New Delhi

One outcome of the falling revenues of state governments at one level and huge spike in expenditure needs at another is the inevitable rise in in states’ dependence on transfers from the Union government. The share of transfers by the Union government to states comprising tax devolution and grants has increased from about 40% in 2011-’12 to 46.4% on 2019-’20 revised estimates. The dependence of poorer states and the north eastern states on Central transfers would be even higher. Any shortfall in the states’ own revenues would further increase their dependence on the Centre.

Health being a state subject, state governments have to increase their spending to meet pandemic-related expenditures. They have to spend on building health infrastructure, procuring Personal Protection Equipment and related medical kits, providing extra hospital beds, medications and more.

In addition, they have to spend on the welfare of migrant workers and those left destitute by the lockdown. All this implies a considerable increase in their expenditures. Given that around 45% of states’ revenue expenditure goes towards payment of salaries, pension and interest payments which are committed expenditures, the scope for increasing spending to meet Covid-19 related expenditures by reprioritising expenditures away from other important sectors like education and agriculture is limited. Any shortfall in revenues would further aggravate the problem.

Migrant workers in Surat queue up for food. Credit: PTI

Arm-twisting the states

In the current situation, while the share of states' expenditure will go up on the one hand, their share in revenues would decline on the other. With this financial crunch, the states are at the mercy of the Union government for additional resources in the form of special and additional grants. In the earlier regime, the Planning Commission used to negotiate in a situation such as this, and devised a rule-based transfers to states. In the current era, it is the finance ministry that could provide such transfers. This would be discretionary and arbitrary in nature.

Even for additional borrowing under Article 293(3), states will be required to obtain the permission of the Union government. While the Union government, as part of its Atmanirbhar Bharat package did not provide any additional grants to states but allowed them additional borrowings of 2% of their Gross State Domestic Product in the current fiscal year, up from the current limit of 3%. However, of the additional 2% allowed, only 0.5% is unconditional: the remaining 1.5% is conditional.

The states have to fulfill four conditions specified by the Union government if they were to avail this additional amount. The Union government, by attaching conditions on states for availing the additional borrowing facility is forcing the states to implement its agenda. In a challenging situation such as the current one, is such conditionality in the spirit of co-operative federalism?

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