THE IMMINENT TRANSITION TO COMPETITIVE FEDERALISM

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THE recent Union Budget indicated a swing in the framework of intergovernmental fiscal relations from cooperative federalism to competitive federalism. The FM announced the significance of competitive federalism to achieve optimum 'total factor productivity' by initiating structural reforms on all the factors of production—land, labour, capital and investment—by urging states to do heavy lifting on these reforms.

This is in addition to the budget's emphasis on capital expenditure—in the sense that high fiscal deficit and debt is closely tied to strengthening capital formation at the Central and state levels, and to reduce the 'output gaps'. This also includes transfers to the states of around ₹1 lakh crore for capital infrastructure investment.

Cooperative federalism primarily works through intergovernmental tax transfers, which is unconditional in nature. In India, the transfer is designed on a scientific formula. The criterions incorporated are population, income distance, area, climate change, demographic transition and tax effort. The transfers happen through the Finance Commission, a constitutional body.

Bihar and Andhra Pradesh asked for a special category status based on socio-economic backwardness, propensity to natural calamities and a constrained fiscal space. However, given the available fiscal space, it will be difficult for the government to fulfil their demand. It can also create a bandwagon effect—others including Odisha might strengthen their demand for such a status too. There was a shadow of these concerns in the budget.

How to solve this, given the coalition politics on board? Ideally, the 16th Finance Commission can tackle the issue by increasing the level of tax transfers from the existing 41 percent. According to the subsidiarity principle, the best decisions are taken at the level of government closest to people. As per Schedule 7 of the Constitution, significant functions are assigned at the subnational level, while dynamic taxes are with the Centre. This creates vertical and horizontal imbalances in the intergovernmental fiscal mechanism. Hence, institutions like Finance Commission are constitutionally mandated to look into these imbalances.

Given the tremendous shrinkage in the divisible tax pool due to a disproportionate increase in cess and surcharge, I urge the 16th Finance Commission to increase the magnitude of devolution to approximately 50 percent, as any downward revision can be akin to 'fiscal waterboarding'.

There is debate about efficiency versus equity in the criterions used in intergovernmental fiscal relations. The states that have controlled their populations and materialised economic growth are getting penalised, as significant weightage is given to 'equity' related criterions. The states have increased their bargaining on these counts.

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The budget urges states to raise capex and initiate structural reforms on land, labour, capital and investment. Given this and the smaller divisible tax pool, the Arvind Panagariya-led 16th Finance Commission should increase the level of devolution from 41% to about 50%; lowering it would be akin to 'fiscal waterboarding'

The debt-deficit dynamics

At the state level, the dynamics of debt and deficit has been re-articulated and the fiscal deficit needs to be maintained at 3.5 percent of GDP. Above the 3 percent deficit threshold, extra borrowing is allowed up to 0.5 percent cent if the states engage in power sector reforms. As per Section 4 of the Fiscal Responsibility and Budget Management Act, the general government debt cannot be over 60 percent cent of GDP with the states' public debt at 20 percent.

Given the post-pandemic revenue uncertainties and polycrisis in the form of mounting global inflation, energy crisis, climate change, supply-side disruptions, war and other geopolitical uncertainties, the Centre and states have been engaging in 'hidden debt' in the form of off-budget borrowings through public sector entities. India is yet to construct time series data on public sector borrowing requirement to capture these hidden debt components.

The golden fiscal rule is to have zero revenue deficit. In this budget, the revenue deficit has been reduced from 2.5 percent in 2023-24 to 1.8 percent in 2024-25. The high revenue deficit gives the indication that there was no drastic cut in public spending, given that revenue receipts were buoyant.

Towards competitive federalism

Albert Breton, a Canadian economist, has written extensively on competitive federalism. He narrates the importance of 'benchmarking' a jurisdiction or province to incentivise other units to emulate. However, these mechanisms of benchmarking in a competitive federalism framework can be nebulous in an emerging nation like India. Benchmarking a few states with preferential support can also widen the fissures in the already-acrimonious Centre-State relations. The arbitrary fiscal announcements for some states in the budget can only be a second best principle in tackling their expenditure needs. It is beyond the purview of the budget to address the expenditure needs of states and tax transfer devolution.

The political economy of Budget 2024-25 is compelling. A re-articulation of fiscal rules in terms of threshold ratios is crucial to keep the fiscal policy accommodative, given the constraints of the Reserve Bank in the growth recovery process.

As states are urged to do the heavy lifting in terms of capex on infrastructure and strengthening all factors of production, unconditional fiscal transfers can best support the states' fiscal space. Conditional support through line ministries in the form of centrally-sponsored schemes can affect the fiscal autonomy of the states and the flexibility of finances at the subnational level of government. So any transition in intergovernmental fiscal transfers towards more unconditional transfers through an objective formula would be welcome.

(Views are personal)