Rebuild fiscal federalism : Highlights of a webinar

George Joseph

Consulting Editor, Kerala Economy

There is a consensus that the State governments in India are increasingly constrained in the present federal context to finance development. At the same time, ever new restrictions are being imposed on every innovative initiative to mobilize resources. In this context, Gulati Institute of Finance and Taxation (GIFT) organized a national webinar on 'Financing Development under India's Fiscal Federalism'. The webinar unanimously shared the concern over the unfortunate shift in macro-economic management and fiscal federalism especially in the light of COVID pandemic. India has already been facing a recession and the pandemic added woes to the economic crisis. In the midst of serious revenue crunch States are vested with more responsibility on development initiatives and social welfare measures, along with fighting the pandemic which attracts much higher level of expenditure. The revenue - expenditure mismatch is a serious issue on the fiscal affairs of most of the Indian states. The big shift in the indirect tax system of the country seems to be seriously affecting resource mobilization of states. Some experts even call for a reversal in the GST regime. Rising debt is yet another area of concern as states have limited options for resource mobilization after the GST roll out. Borrowing both internally and externally seems to be the only alternative. But the States have been deprived of powers to attract more resources from abroad. In the webinar, organized in two sessions, a galaxy of eminent economists in the country deliberated on this issue. Prof K J Joseph, Director, GIFT, welcomed the guests to the webinar and highlighted the relevance of the issues being deliberated in the specific context of Kerala.

There should be a new discourse on centre - state relations, and rebuilding of fiscal federalism has become the critical factor for ensuring the unity in diversity of the country, the webinar unanimously opined.

Professor M. Govinda Rao

Professor M. Govinda Rao, Member, 14th Finance Commission and Honorary Professor, GIFT, who chaired the first session of the webinar series, said that government intervention is essential for the macro-economic management of any economy. It is indeed very crucial when the economy fails to perform, especially during the time of a pandemic. He added that the nature of such intervention depends on the nature of failure of private sector in an economy. Macro- economic management is predominantly a central government function, whereas allocation is a major function of sub national level governments.

He said that there is a vertical fiscal imbalance between the centre and the States as the Centre has more powers for mobilizing resources. But the states cannot go bankrupt under any condition. Overall, states have been vested with more fiscal responsibilities in the case of social security and development aspects. Yet, their access to financial resources is limited compared to the centre. According to article 293 of the Indian constitution the States cannot borrow overseas without the prior permission of the Centre. Some countries, especially Latin American countries, allow sub national governments to borrow overseas. But they do face severe macro-economic issues, which clearly indicates the need for some checks and balances in the case of borrowing.

The important question in this regard are how much each government can borrow? What is the limit for borrowing? What is the importance of off budget borrowing? These are questions to be discussed in the context of current fiscal instability, he added.

Professor Sushil Khanna

Professor Sushil Khanna of IIM, Kolkata, opined that the recent methods of centralization of resources would be a major threat to States in the case managing fiscal issues. Constitution had clearly earmarked the powers on tax collection between the Centre and the States. Sarkaria commission on Centre - State relations had pointed out the various responsibilities vested with the Centre and States. It is unfortunate to note that the ability of States to raise revenue is very limited at present.

Hence, external borrowing would be essential for raising financial resources in order to meet development and welfare expenditure which are mainly the responsibility of the States. Here, States must have a cautious approach as irresponsible borrowing may topple the fiscal management. It is notable that all direct tax revenue goes to the Centre's kitty, though there is a revenue sharing mechanism in the form of finance commission.

Here comes the importance of off budget borrowing. The first innovative move in this direction came from Gujarat followed by Andhra Pradesh. Kerala has also made very advanced move in the form of masala bonds and KIIFB has shown an innovative method of debt re-payment mechanism mainly based on future tax collection. " Another important issue is that we undermine planning. We must hedge our risks with proper financial planning," he said.

Criticising the recent acts of C & AG on the auditing of KIIFB, he emphasized the importance of neutral regulators in peculiar economic situations like COVID pandemic.

Professor Sebastian Morris

Professor Sebastian Morris, IIM, Ahmedabad said that the uncovered interest parity condition does not hold for India and for other developing countries, resulting in bias against them. The kind of bias is generally termed as 'country risk'. Due to this bias, capital flows out of developing countries during times of crisis. He opined that financial flow does not ensure equilibrium in capital market due to this bias and The MNCs are able to buy out projects.

FDI inflow towards India is much larger when compared to China and East Asian countries and India's FDI intensity is also higher. However, this lower cost capital may not be needed. There is tremendous opportunity ahead for India and one of the major reasons behind this is the higher rate of savings within the country. The savings is ready to be buoyant when the economy returns to the growth path. Further, the FDI tends displace domestic players. However, the established Indian businesses could make use of the capital market bias borrow from the foreign market.

"We expose to high risk if we borrow for longer period if you don't have dollar in your kitty. Rate of capital formation in India has not increased substantially due to the growth in capital inflow" Professor Morris cited. The rate of capital formation in India is not substantially furthered by the gross capital inflows. There is displacement of domestic businesses, something that is anti-nationalistic. In the case of India's FDI inflows, it is mostly poured into brownfield projects that does not create any expansion in production capacity or generate employment. Further, borrowings in foreign currency cannot be treated as a great idea for development initiatives unless there is a clear-cut plan to avoid exchange rate instabilities. He concluded by saying that for a sub-national entity, instruments like masala bonds are better tools to borrow from foreign markets as the exchange rate risk is on the buyer.

Professor Pulin Nayak

Professor Pulin Nayak, Former director, Delhi School of Economics, said that political diversity would not be a reality without economic power. In this regard three fold division of resources - Central, State and Local self-governments - is a crucial factor. Unfortunately, in India the process of centralization of financial resources become more obvious recently.

State sales tax was a reasonable means for funding at the sub national level. When the country accepted the 'One nation, one market' slogan, States were deprived of economic power which was hitherto enjoyed. Success of single tax system mainly depends on the political maturity of both the Centre and the States. The Centre should have the wisdom to see the totality and diversity of the country. Unfortunately, it is not evident in recent times.

In the case of Centre - State relations, three factors are utmost important; allocation, distribution and stabilization. India is on the lower ebb in the case of distribution of resources. He said that there is nothing wrong in 'one nation, many markets' concept.

Stabilisatation is predominantly wrested with the centre as this affects States in different ways. He also said that public expenditure in health sector in India is 1.2 per cent of GDP, which is one of the lowest across the globe. China has 2.9 per cent and most western European nations spend 8 - 10 per cent of GDP in healthcare segment. States should spend substantially in education and health segments. Going with insurance route in health care will be disastrous for a country like India, he added.

Professor C. P Chandrashekhar

Professor C. P Chandrashekhar of Jawaharlal Nehru University, said that there are opinions that state governments have larger part of responsibility in terms of expenditure and development. Despite the efforts of constitution - makers and some Finance Commissions, there is tendency towards centralization of resources using several means like utilization of cess etc, depriving the States from resources. India had actually moved to a regime that reduced the possibility of raising the tax - GDP ratio. India shifted the focus to fiscal responsibility, budget management etc, leaving out the discussion on how much States can mobilize from the market. Neo - liberalism appealing States' access to the global finance market, adopted to undermine the ability of states to mobilize tax. On the other hand, the private sector is freely allowed to access these markets. Only the State governments should not have that access.

COVID is a classic case of crisis which is not because of the irresponsibility of the State. During this time, the centre should stick on to the promise on GST compensation. The collapse in the case of GST revenue is a national issue. The government says that COVID is an act of God and we are not liable to compensate for the act of God. The Centre said that they would not take the responsibility on that count. Here the States must give larger flexibility. It is not fair on the side of the government to undermine the flexibility of the State in the case of access to the global markets.

The States are trapped in a tight fiscal situation and the Centre should compensate for the shortfall. The Centre is not only merely accelerating neo liberalism / centralization of resources, but giving up its basic responsibilities even in the time of crisis. "Here we need a new discourse about the flexibility of the States in the months and years to come. We should re-visit the system of GST and the States should be given more flexibility", Professor Chandrashekhar said.

Professor D. Narayana

Professor D. Narayana, Former director, GIFT, in his discussion stressed the need of an independent body for settling the disputes between the Centre and States. Absence of such a body is a major issue, confronting the States to raise their problems on inancing. The idea of an inter-state fiscal council was mooted earlier, but did not take off. He said that instead of helping the States to raise resources, the Centre is putting more restrictions that hinder development initiatives. Most of the States in India opt responsible borrowing and their fiscal management is satisfactory. Fiscal deficit of states does not exceed 3 per cent of GDP in most cases.

The serious problem confronting the States is financing development. Finance Commissions do not take into account the sky rocketing of capital expenditure by the States. In such a fiscal circumstance bulk of the indirect tax collection had been given to the Centre. He argued that States should be allowed to tap the financial markets and the Centre should facilitate this. It is unfortunate to see the hostile approach of constitutional bodies towards masala bonds issued by KIIFB, he said.

Professor Prabhath Patnaik

Chairing the second edition of the webinar series, Professor Prabhath Patnaik, Emeritus professor, JNU and Honorary Professor, GIFT said that enactment of GST was a critical turning point in India's fiscal federalism. GST meant a complete handing over of rights that the constitution had given to the States. It is unfortunate that the Centre unilaterally imposes its decisions when it comes to sharing of resources as it happens in cases like terms of reference of Finance Commissions. States have no say in such discourses and there has been enormous centralization of power, especially in the case of financial relations.

Raising some serious issues on Centre - State financial relations, he added that there should be extensive discussions on the scope of the avenues available for the States to raise revenue. Scope of raising revenue is the touch point, as a serious financial crunch jeopardizes the fiscal stability of the States in India.

Professor Jayati Ghosh

"We are no longer a federal country. While there is strong centralization of fiscal resources, most obligations remain with the states. So, this is a kind of unbalanced federalism", said Prof Jayati Ghosh, JNU. She argued that the state governments should have the courage to say that we no longer agree with the GST regime. They have to say that we won't be in a position to simply continue with GST. Federalism cannot be one way. It has to be on both ways. It is not federalism when the States simply accept what the Centre says. Even during the pandemic and that too in the middle of a recession, India does not have a compensatory mechanism. The Central government should promote a demand stimulus in order to bail out the economy. According to the C & AG data the Centre's overall expenditure during April - October period of the current year had increased to Rs 6549 crore, up by only 0.4 per cent increase, compared to the same period last year. The centre has disbursed Rs 1968 crore to states, up 1.9 per cent increase during the period even while expenditure shot up many fold. She said that the less you spend the less economic activity will be there. This is an urgent need for change, she added.

Professor Partha Mukhopadhyay

Professor Partha Mukhopadhyay, CPR, New Delhi opined that the major issue is: that what States can actually do to tide over the current crisis. The States are constrained because the main sources of revenue are controlled by the Centre while the States have the responsibility to revive the economy.

In a context of severe restrictions on borrowing expenditure, rationalization appears to be a relevant strategy. The state government could also consider raising the use of fees especially from those who could afford to pay. Property transaction tax is an essential component to be tapped as there is enormous amount of evasion and avoidance in this regard. Recommendations of 15th Finance Commission and the quantum of grants are expected by next February. He said that significant action should be there in the coming budgets of the states. They have to ensure that they don't get overboard in the case of taxes. Both the Centre and the States are using fuel taxes as a means to compensate the revenue losses otherwise.

Professor K. Gayithri

Professor Gayithri of ISEC, Bangalore focused on the importance of streamlining of expenditure, especially after the pandemic period is over. She said that overall revenue spending had doubled in almost every year and this points out to the importance of managing expenditure. This argument is not undermining the importance of mobilizing resources. Yet there is serious inefficiency associated with expenditure, especially on capital expenses. This gains more importance when resources are mobilized through borrowing. There should be control over expenditure. There should be some mechanism that ensures the borrowed funds are strictly invested in capital expenditure. Optimizing the use of existing infrastructure also gets prime importance, she said.

She added that revenue expenditure is galloping and spending is going on a reckless manner in recent times. On the revenue mobilization aspect, no tax component is also vital. Non tax revenue sources should be reviewed periodically and fee-based revenue should be encouraged. She concluded that more attention should be given on expenditure side when revenue generation is rather difficult.

Professor A. Damodaran

Professor A Damodaran, IIM Bangalore said that there is a shift in the global capital market in the light of COVID pandemic and fundamental liquidity shortage. Because of low yield in various financial instruments like bonds, this is not good time to tap the international markets, especially trying to mobilize on dollar-based instruments.

Here a question arises, whether FDI or borrowing? He said that borrowing is a much better option than FDI as FDI affects the local markets in various ways. While institutional barriers are a serious issue in the case of overseas borrowing, instruments like climate bonds will be a better option in the current economic situation. Kerala can opt this route especially for the development of districts like Idukki and Wayanad. Coupon rates are rather low for climate bonds, he said.

Professor Lakhwinder Singh Gill

Professor Lakhwinder Singh Gill of Punjabi University, Patiala in his discussion pointed out that the higher degree of centralization of powers over a period is a serious issue. Unfortunately, the political system advocates this shift in favour of centralization. Even regional political parties have abandoned the idea of decentralization because of various reasons. He said that politicizing centralization is a historic process. Hence, there should be a relook on Centre - State relationship in the midst of current economic crisis. A coalition of States is the need of the hour at this critical juncture, he added.

Concluding the sessions Professor Prabhat Patnaik stressed that States should come together in order to fight the excessive centralization of power in recent years. This, according to him, is the need of the hour. "We need to enlarge the fiscal deficit in a time like this. Really the Indian economy is going down on many counts like GDP. In order to arrest the decline, we need to pump in more demand into the economy, either through private sector or by enlarging government expenditure". He also said that the States should tell the Centre that they had agreed upon GST regime on the basis of some promises, that still remain unfulfilled. GST roll back is a different issue, but the States should stand united in the case of compensation and sharing resources, he said.