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OVER TO THE STATES

Relevant for: Indian Polity | Topic: Issues and Challenges Pertaining to the Federal Structure, Dispute Redressal Mechanisms, and the Centre-State Relations

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In the World Bank's Ease of Doing Business index released last month, India ranked 63, an impressive jump from its lowly rank of 142 when the Narendra Modi government first came into office in 2014. Yet, there is anecdotal evidence of investors being frustrated by venality, indifference and corruption at the operating level.

Now consider this: When the government amended the terms of reference of the 15th Finance Commission a few months ago asking that allocations for defence and internal security be carved out upfront, before determining the pool of resources to be shared with the states, the latter baulked at the highhandedness of the Centre.

Also consider this: Early in his tenure, Modi attempted to reform the land acquisition law by tweaking the balance in favour of investors, but quickly buckled down as many states took umbrage. This, even though land is on the concurrent list in the Constitution, and a central law would have prevailed notwithstanding states' opposition.

The three snippets above, seemingly disparate, tell an important story — that of the growing importance of states in India's economic management.

It wasn't always like this. In the early years of our republic, the Centre dominated across all domains — political, economic and administrative — and states, even those led by leaders with political heft, acquiesced to this unequal arrangement. The reaction to central dominance came in the early 1980s when strong regional leaders started agitating against "the hegemony of the Centre". Several of them, for instance N T Rama Rao, built their political careers on an "anti-Centre" platform.

As a consequence, the Centre yielded to the states, but largely in the political space. Much of the economic policy control stayed with the Centre which decided not just public investment but even private investment through its industrial and import licensing policies, leaving the states on the margins of economic management.

That arrangement started to change with the onset of reforms from 1991. Three trends, in particular, have shifted the economic centre of gravity from the Centre to the states

The first is the change in the content of the reform agenda. The Centre could push through the reforms of the 1990s without even informing, much less consulting, the states because they all pertained to subjects such as industrial licencing, import permits, exchange rate and the financial sector, which were entirely within its domain. In contrast, the second-generation reforms on the agenda now shift the emphasis, to use economic jargon, from product to factor markets like land, labour and taxation, which need, not just acquiescence, but often the consent of states.

Nothing illustrates the increased clout of the states in driving reforms more than the GST

negotiations. There was a clash of interests not just between the Centre and states but also between producer and consumer states, large and small states and coastal and inland states. The grand bargain that culminated in the GST, admittedly imperfect, involved all parties making compromises. But the deal could not be clinched until the Centre guaranteed to fill the revenue gap, if any, of states according to an agreed formula.

The second factor driving the economic centre of gravity towards states is the changing dynamics of our fiscal federalism. Ballpark estimates suggest that the Centre collects about 60 per cent of the combined revenue (Centre and states), but gets to spend only about 40 per cent of the combined expenditure. This asymmetry is mirrored on the states' side. Together, they collect 40 per cent of the combined revenue, but spend as much as 60 per cent of the combined expenditure.

More important than the aggregates is the greater autonomy that states now enjoy in determining their expenditure. Gone is the Planning Commission. The states now not only get a larger quantum of central transfers but also get to decide on how to spend that larger quantum.

And how states manage their public finances matters much more than before. The RBI in its latest annual report on state finances, raised several red flags — states' increasing weakness in raising revenue, their unsustainable debt burden and their tendency to retrench capital expenditures in order to accommodate fiscal shocks such as farm loan waivers, power sector loans under UDAY and a host of income transfer schemes.

As the RBI pointed out, the quality of expenditure at the state level has a multiplier effect on overall development outcomes. Conversely, fiscal irresponsibility will take a heavy toll on our growth and welfare prospects. The market will penalise mismanagement of public finances; it does not much care who is responsible, the Centre or the states, for an unsustainable debt burden or for even the colour of the fiscal deficit.

That segues into the third major trend behind the states' growing importance in economic federalism — their critical role in creating a conducive investment climate in the country. Much of the responsibility for improving the ease of doing business rests not with Delhi but with the states. This highlights the need for coordinated action.

India's prospects, including our aspiration for a $5 trillion economy, depend on the Centre and the states working together. No one would know this better than Modi who combines over two decades of experience as chief minister and prime minister. Arguably, he has another unique advantage in that more than two-thirds of the states are currently governed by the BJP.

If ever there was an opportune moment for a big push on cooperative federalism, it is now.

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