

VIEW: STATES OUTSPEND THE CENTRE; CRIPPLING THEIR FISCAL CAPACITY WILL HARM THE ECONOMY

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

As India develops, the role of its states in driving growth has become vital. The current centralising tendencies in the polity will harm the [economy](#), besides generating centripetal forces.

Within the dismal realm of economics, some parts can be particularly dreary — public finance, for one. However, a brief dip into Indian Public Finance Statistics can be bracing. In 1990-91, the share of the central government's expenditure in the combined expenditure of the Centre and the states stood at 65%. In 2018-19, the Centre's share stood at 42%.

We might not be Picasso and lack justification for superimposing a second perspective of the same figures on an earlier one. Still, since it will serve to highlight the point, here goes: in 1990-91, expenditure by the Centre was 186% of expenditure by the states. By 2018-19, that ratio had shrivelled to 73%.

Competitive Federalism...

The state governments' combined expenditure has a greater impact on the economy than the Centre's. What this shift in the fiscal centre of gravity means is that things that constrain the states' finances would worsen the slowdown.

India is a union of states, says the Constitution. However, the federal spirit is quite strong within the polity's skeletal architecture and in the beating heart of the beast it holds up. The reaction to the suggestion to make Hindi the common language of the country is but the latest example.

Last Saturday, Kerala's Gulati Institute of Finance and Taxation organised a seminar in the Capital on a last-minute addition to the terms of reference (ToR) of the [15th Finance Commission](#) (FinComm), which asked the commission to make a special provision for defence and internal security.

ET had broken the story (bit.do/ET-FinComm), which made it clear that the commission had been nudged to recommend a non-lapsable fund for defence and internal security, to which funds should be allocated before devolving the states' share of taxes.

Now, devolving a share of the taxes collected by the Centre to the states is not charity. Certain taxes are best collected centrally, such as taxes on income and duties on imports. Just because a company's head office is in Mumbai and it pays its tax on profits in Maharashtra, it does not mean that Maharashtra or the Centre has any privileged claim on the proceeds. Mahindra and Mahindra will sell more tractors and other vehicles outside Maharashtra than in that state.

Every state and the Centre should get a share of the tax on their profits or the incomes of their employees. Similarly, it would be unfair to let customs duty proceeds go exclusively to states with ports and/or the Centre. Power projects in Madhya Pradesh or Chhattisgarh could import turbines that come in through Kandla.

Should Gujarat get the customs duty? The power plant in MP could be supplying power to a factory in Gurugram, whose output is sold across the land. So, every state has a legitimate claim

on the import duty. Duties on petroleum and natural gas fall in the same category.

So, some taxes are collected exclusively by the Centre and shared with the states. How much should be shared (vertical devolution) and how the shared amount should be distributed among the different states (horizontal devolution) are determined by a FinComm, appointed every five years.

...Or Magic Federalism?

Surcharges and cesses collected by the Centre are not shared with the states. The recent proliferation of these cesses and surcharges has the effect of eroding the states' revenues.

How much a state can borrow is determined by the Centre. Central pay commission recommendations have a deterministic effect on state level salaries. Macroeconomic management by the Centre and RBI determine rates of interest. Salaries and interest payments take away the bulk of a state's budget.

In effect, the fiscal autonomy of the states is quite limited. The suggestion to set aside funds for defence prior to devolution could knock a sizeable chunk off the shareable tax collections.

Funding defence and internal security is important. India has to spend a whole lot more on defence, if it wants to maintain strategic autonomy. Suppose India spends 2% of GDP on defence, as it should. If that is taken out of the divisible pool proposed in the 2019-20 Budget, the funds to be divided amongst states would come down by a drastic 17% from the current allocation.

This is why the addition to the 15th FinComm's ToR is a matter of grave concern and former PM [Manmohan Singh](#) called, speaking at the seminar, for the FinComm to consult all chief ministers on the matter before proceeding to make its recommendation. The Centre has also made the Finance Commission produce a committee report seeking transfer of healthcare to the Concurrent List, from the State List. This centralisation is quite unwarranted and inefficient.

Ideally, the Centre should stick to its own constitutionally mandated responsibilities and fiscally empower the states to carry out their mandates.

Instead, the Centre wants to shift responsibilities and funds from the states to itself. This is not cooperative federalism. The right name for it is Msilaredef — federalism running backward.

Views expressed by the author are his own

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