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THE VERY CONCEPT OF COOPERATIVE FEDERALISM NEEDS RESUSCITATION

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

Centre-state relations have soured not just over the GST compensation dispute but also a lack of central assistance to the states

When growth shudders into a decline, as it has this fiscal year, all governmental coffers suffer a revenue loss. If the covid crisis had hit India’s economy before the goods and services tax (GST) was introduced on 1 July 2017, state government revenue would have crashed just as it has today. No formal compensation guarantee from the Centre for a revenue shock existed then. Indeed, no national government in any federation offers that kind of revenue insurance. Even so, states would rightfully expect some fiscal assistance from the Centre. It is the absence of that, rather than the formal GST compensation issue alone, that has soured Centre-state relations in the country.

The dominant component of statutory central assistance to states, as prescribed by Finance Commissions, is a share in central taxes, where states are fully exposed to downside risks to central tax collections, in contrast with absolute grants, where the Centre bears the entire downside revenue risk. When the 14th Finance Commission raised the tax share of states to 42%, with a commensurate decline in the proportion due as grants, the states were happy to accept that change.

One of those statutory absolute grants is for disaster relief. Covid was notified on 14 March as a “disaster", in addition to the standard list. However, that notification was not accompanied by any enhancement beyond the disaster provision made by the 15th Finance Commission for the current fiscal year of 41,373 crore in total, of which 34,574 crore was due from the Centre. In April, I had called for a five-fold ramp up of the disaster provision. That would have meant a 1.75 trillion transfer from the Centre, which would have set the country on a more cooperative Centre-state path. An early promise of disaster funding on that scale would have covered incremental expenditure on testing and quarantine camps, and possibly prevented the subsequent mini lockdowns which have had such a shattering effect on growth.

Compensation to states for GST revenue shortfalls was the first time the Centre took on pure revenue insurance. The promise, and the five-year period over which it was due, was inserted right into the relevant Constitutional amendment. The quantification of it, at a 14% year-on-year revenue increase, starting from collections in 2015-16 (the base year) in respect of state taxes subsumed under the GST, was spelt out in clause 7(3) of the Compensation Cess Act. Configuring the guarantee independently of underlying economic growth was a terrible mistake.

Compensation cover required for the current year 2020-21 has been partitioned by the Centre into two segments. One estimates the compensation shortfall at 97,000 crore, on the basis of state GST collections projected from last year before the covid crisis. The residual is the distance from the projected performance to expected collections in the current year (1.38 trillion). States have been given two options to borrow from financial markets, one for the 97,000 crore, and the other covering the entire shortfall, adding the two segments (2.35 trillion).

The first option is really a transfer because the debt will be fully serviced by the Centre, and not add to the state’s debt stock. It is presumably being called state borrowing so that it does not add to the debt of the Centre either.

In the second option, the Centre does not cover interest servicing, and only offers repayment of principal. Only the second segment of 1.38 trillion will add to state debt, but interest rates on the entire debt will be payable by states at market rates and not under a special window, as the first option will be. Debt support by the Centre under both options will be paid for by extending the compensation cess beyond its original five-year horizon.

The earlier enhancement of state borrowing limits by 2 % of state domestic product (SDP), announced in May, is fully allowed under the first option, but only partially for the second option, in complicated ways that will leave officials in finance departments all over the country gasping as they try to figure it out.

The covid crisis has been a deep synchronous exogenous shock, affecting both the Centre and states. When central revenue growth is in negative territory, the folly of that 14% guarantee becomes abundantly clear. The covid shortfall, measured from last year's actuals, is 1.38 trillion. As against that, states are getting a first option transfer offer of 1.65 trillion (adding the expected cess collection of 68,700 crore to the transfer of 96,477 crore). The first option essentially holds the compensation paid at last year's level of 1.65 trillion.

With the first option, states get full access to the earlier 2% additional borrowing. The conditionalities attached to segments of that are a throwback to India's pre-1991 ways, and should be eliminated. The Centre should also clarify which estimate of SDP will be used.

States have suffered a steep fall in other taxes as well, like excise on alcohol. The corona shock has been double-edged for states, reducing their revenues while adding pressure for expenditure on a function falling squarely in their domain. The Centre should take cognizance of this and provide an immediate central grant of at least 1 trillion under the disaster rubric.

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