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ABRASIONS IN THE FEDERAL SYSTEM
ISSUES & OPTIONS

M. Suresh Babu

EAC-PM
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ABRASIONS IN THE FEDERAL SYSTEM

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M. Suresh Babu[1]

1. The Background

1.1 Harmonious intergovernmental policy interactions necessitate a well-functioning 'flexible federal' structure with enough room for 'give and take' between the Centre and the states. The existence of parallel functionality of the Centre and the states could lead to intergovernmental tensions and policy impasse opening up multiple arenas of conflict. Sustaining harmonious federal relationship can prove to be the route towards accelerated economic growth only if it opens up avenues for win-win situations for both the Centre and the states. Hence it is imperative to examine the current state of federal relations and the frictions it braces and explore the way forward to effectively cope with these tensions.

1.2 Given the unitary features in the Indian constitution, which states that India is a union of states, not a federation of states, the Indian state emerged as 'quasi-federal' in structure. This setup has been a cause of strain between the Centre and the states. With the emergence of coalition politics, states have acquired a crucial role through their regional parties to have a more significant say in national policy decisions. As a result, states today act not only as a pressure groups but have emerged as lobbying entities for fiscal, trade and business policies.

1.3 The Seventh Schedule of the Constitution demarcates the powers and functions of the Centre and the states in the Union and State lists. The concurrent list mentions functions falling under the joint jurisdiction. There is a clear demarcation of fiscal powers between the Centre and the state governments. The unique feature of our system is that, for securing the implementation of many of its laws and policies, the Union depends on the machinery of the States, particularly in the concurrent spheres[2]. The Union can entrust its executive functions in the manner laid down in Article 258 to the State Government or their agencies. The States may also entrust their executive functions, with the consent of the Union, to the Government or agencies of the Union (Article 258A). The States, too, depending on the Union for fiscal resources, administrative assistance and several other ways to discharge their responsibilities. Such interdependence is inevitable, especially in a large, diverse, developing society.

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[1] Adviser, Economic Advisory Council to the Prime Minister

[2] Maheshwari, S. R., State Government in India, Delhi

1.4 The Sarkaria Commission was appointed in 1983 in response to demands for a re-examination of the Centre-State relations in the context of criticism that the limited federalism envisaged by the constitution had been eroded, whether by natural processes or willfully, as a result of increasing centralization of power over the years[3]. The Commission's report attempts to redress the balance to some extent. However, it seeks to do this not by proposing drastic constitutional amendments but by seeking to revive or establish some conventions regarding Centre-State consultation and by activating dormant constitutional provisions. In a dual polity, coordination of policies and their implementation became extremely important, especially given large areas of common interest and shared action. This can only be done through sustained contact, consultation and interaction, for which a proper forum is necessary.

1.5 The current context of economic relations between the Centre and the states is very different from the 1980s and 1990s. Continuing economic reforms since 1991 has provided states with more room for state governments in terms of economic policies. Numerous controls on investments and capital movement have been removed, and state governments now actively compete to attract capital in various ways. However, autonomy regarding economic policies is not absolute as state governments depend on the Centre for their revenue receipts.

1.6 Several states have recently pushed back and alleged the Union/Centre of "centralizing tendencies." As a result, the give and take equation between the Centre and the states has given way to a more hardened stand by the states, leaving little room to negotiate. Signals of increasingly fractious Centre-state ties have chipped away at the edifice of the 'cooperative federalism' mantra envisioned by the government. The straining of Centre-state fiscal relations poses a significant challenge to the institution of federalism and the Constitutional democracy based on it.

2. Taxonomy of Recent Federal Divergence

2.1 Economic theory propounds the convergence in income per capita among regions in a large federal structure overtime. The divergence in economic performance among states raises vital political economy questions of federalism and its discontents in India. Economic disparities among states

[3] "Sarkaria Commission Report and Centre-state Relations". https://archive.org/stream/in.ernet.dli.2015.131703/2015.131703.Sarkaria-Commission-Report-And-Centre-state-Relations_djvu.txt).

necessitates the need for deliberations on whether a greater convergence of economic policies and not just devolution of fiscal and legislative powers to the states should be the way forward.

2.2 Disputes regarding the implementation of federal policies in India have a longer history and they have only been spurred in recent years. Articles 245-263 explicitly demarcate the powers between the Centre and states in terms of legislative, administrative and financial functions, despite the presence of federal divergence between the Centre and the States. Debates on policy issues have cropped up as flashpoints between the Centre and states especially those ruled by the opposition parties.

2.3 In figure 1, we present a taxonomy of the recent federal divergence. It can be noted that there exist serious fiscal underpinnings for non-convergent policies between the Centre and the states. The fiscal implications stem from a competitive approach adopted by the states towards the Centre. On three broad areas we find that the Centre and some states have different policy approaches. They are policies regarding institutional frameworks for governance, issues in regulatory approaches and a set of pre-emptive policies of the states to pre-empt some of the schemes/programs announced by the Centre. We illustrate some of them in the subsequent sections. Prior to that the fiscal implications are presented.

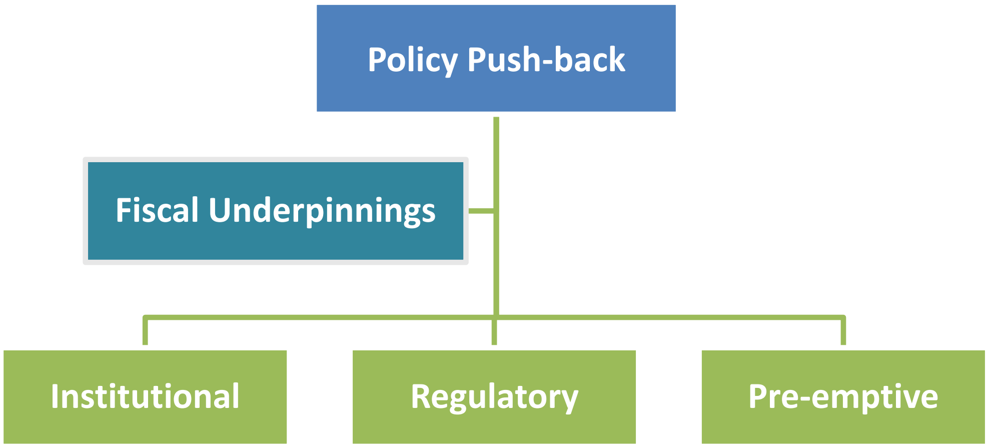


Figure 1: A taxonomy of recent federal divergence

3. Heterogenous Structures at the Sub-National Level

3.1 Recent deviations in the federal system is not limited to the sphere of economic policies. We can broadly characterize these deviations into regulatory departures and institutional divergence. An understanding of these is essential to decipher their implications on the economy. We provide an overview of some selected examples below.

3.2 An overview of regulatory departures is presented in figure 3. Some selected examples are highlighted below.

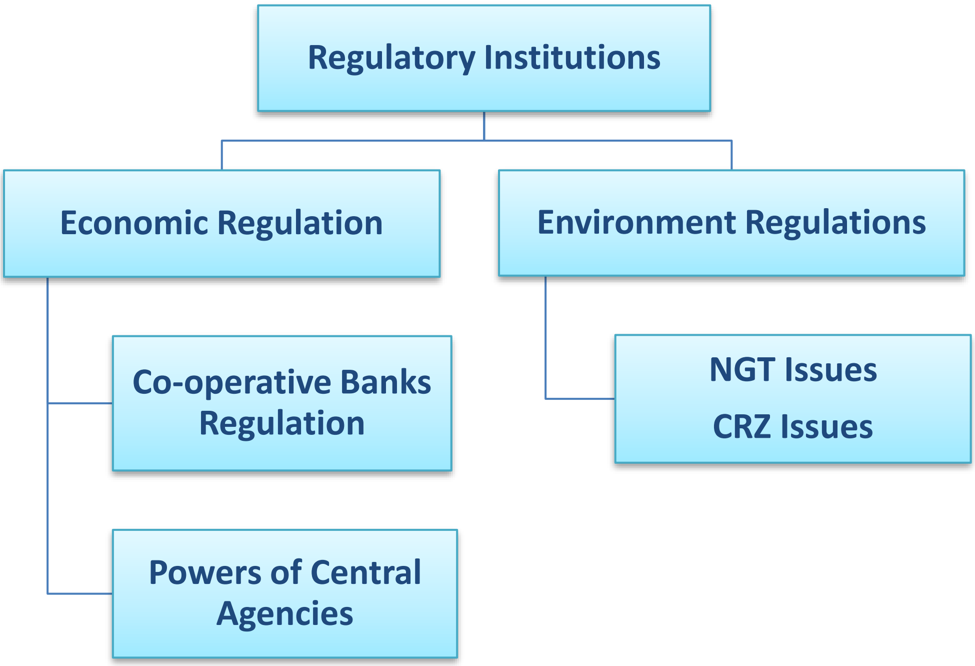


Figure 2: Divergence in regulatory approaches

3.3 **Economic Regulations**:

(a) **Cooperative Bank Regulations**: Through the Registrar of Cooperative Societies, the state governments regulate the smaller cooperative banks, whereas the RBI oversees the operations of larger financial institutions. Over the years the RBI has been implementing various corrective measures for co-operative banks due to various irregularities. The government amended the Banking Regulation Act to bring cooperative banks under the supervision of the Reserve Bank of India (RBI) in order to protect the interests of depositors. It is applicable to those cooperative banks which deal with "bank, banker and banking," as 277 urban cooperative banks have reported losses. This has now emerged as a bone of contention between the Centre and the states, the latter alleging the former of harnessing the 2021 Apex Court judgement, which struck down parts of the 97th amendment that diminished the exclusive authority of the states over cooperative societies. This amendment is viewed an encroachment on federalism, and it interpreted as an attack on "state rights".

(b) **Powers of Central Agencies**: The two central agencies most commonly in such discussions are the Enforcement Directorate (ED) and the Central Bureau of Investigation (CBI). Time and again, States have alleged the Centre of the 'excesses' of its probe agencies being weaponized to target opposition-run state governments. The issue reached a point that the CBI's complaint to the Supreme Court about the decision of some state governments to withdraw the general consent for a probe by the agency in their territory. This has brought the focus again on the states' powers vis-a-vis the central agency. The CBI told the court that the withdrawal of general consent by some states was proving detrimental to the investigation and prosecution of cases. The Central government has supported the CBI's position by telling the court that the states' power to withdraw consent is not absolute. Presently eight states, including West Bengal, Maharashtra and Kerala, have withdrawn their general consent to the CBI under Section 6 of the Delhi Special Police Establishment Act (DSPEA) which governs the agency. After a state withdraws its general consent, the CBI can investigate cases there only on its request in a specific case or on the orders of a court.

3.4 **Environment Regulations**:

(a) **Issues pertaining to the National Green Tribunal (NGT)**: In an important observation NGT stated that "*just like enforcing law to prevent other crimes, the State has to own responsibility to enforce law to prevent pollution. States are not doing this effectively. States must take appropriate action against failure of its officers for preventing pollution caused by crop burning. The strategy could be creating awareness, giving incentives or taking punitive action*". However, the Supreme Court has put its scanner on many instances of NGT passing "mechanical and pre-drafted" orders and said it would soon take up this issue and pass corrective orders. The Supreme Court observed that "*This is not the first instance. Mechanical and pre-drafted orders are being passed (by the NGT) almost every day. We are very unhappy with this and will soon take notice of such orders into consideration and pass appropriate orders*". In another instance the court observed in a judgement that "*The NGT came into existence as a sui generis institution established for the enforcement of environmental rights emanating from Article 21 of the Constitution... NGT was not an extreme case of delegation of powers to the central government*". This has come after the MP Bar Association called out the environment regulator for 'centralizing' tendencies.

(b) **Issues related to Coastal Regulation Zone (CRZ)**: The CRZ notification, 2019, is critical to vulnerable communities. The well-being of around 171 million people, or 14% of India's population living across 70 coastal districts, 66 in mainland India and four in island territories, is directly linked to the health and disaster preparedness of the coasts. States like Kerala, Maharashtra and Andhra Pradesh have raised concerns over such rules as the ministry had proposed eight amendments to CRZ notification, 2019 seeking to delegate powers of giving CRZ clearance to the State Coastal Management Zone Management Authority, exempting statutory CRZ clearance for the exploratory drilling operations, and removal of sand bars from the shoreline. On the amendment delegating powers to the union government for granting CRZ clearance proposed at the CRZ-1 and CRZ-IV areas, states contended that the union is taking the rights of the State government as CRZ-1 and CRZ-IV areas fall under the control of state governments. "It is a transgression on state sovereignty", according to the states. In another instance, the Central Government's refusal to include six panchayats in Kerala in Coastal Regulation Zone-2 has further drawn a wedge between the Centre and the state of Kerala. Centre rejected Kerala's proposal saying that only city corporations or urban panchayats could be included under CRZ 2. Therefore, to change the zone, Kerala should notify grama panchayats as urban panchayats, instead of panchayats with urban characteristics, according to the Centre. However, Kerala is reluctant to change the status of grama panchayats as urban panchayats because the local bodies would lose benefits such as various aid programs and the Rural Employment Guarantee Scheme.

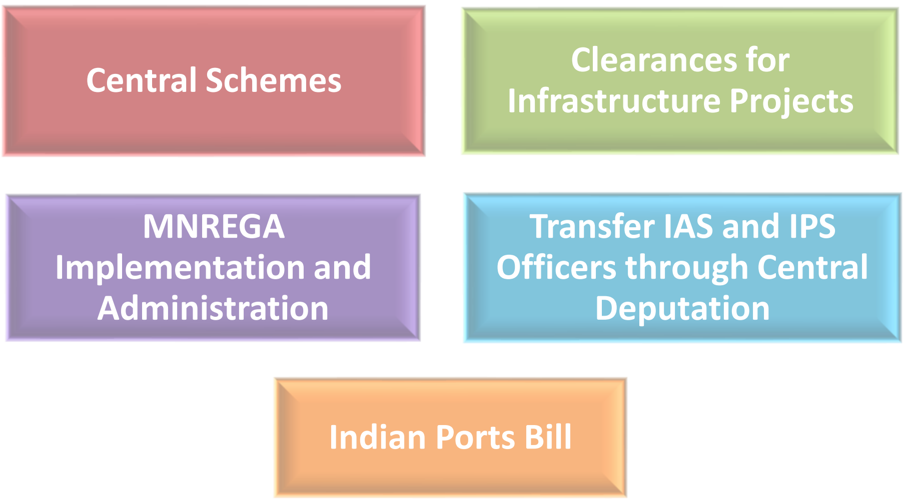


Figure 3: Some areas of institutional divergence.

3.5 **Central Schemes**: Article 246 defines the legislative powers of the Centre and the state governments. However, some of the centrally sponsored schemes fall under the legislative competence of the state or in the concurrent list. As there are specific commitments under the Sustainable Development Goals, Centre provides funds without stringent guidelines, but the states might not spend towards achieving the desired goals. States like Odisha, Telangana, Delhi, Punjab and Kerala propounded their own schemes in place of the 'Ayushman Bharat' scheme, even though this meant losing out on some Central funds which would have been spent in their state. In such situations it would be appropriate that schemes be formulated depending on the success stories of each state, as such an initiative will contribute to the harmonious existence of the central and the state schemes sans any unnecessary political uproar.

3.6 Clearance of infrastructure projects: Infrastructure creation plays a key role in economic development. Land is a state subject, and it is important that the Centre and states work together to make land acquisition a smooth and seamless procedure for investors. The process of granting environmental clearances needs to be more efficient and transparent. Time-bound clearances and implementation norms should be adhered to by all. Typically, time overruns or delays result in cost overruns or higher expenditure – effectively the tax payer pays more for the same and must wait longer in the queue of denial, in the case of large government projects. As land acquisition is a state subject there exists a need for the cooperation of the respective states for multi-state projects. Delay in one state affects the entire project cycle. It is imperative that states make progress on land acquisition and environmental clearance fast, so that Centre can approve the projects as early as possible.

3.7 MNREGA implementation and administration: The MNREGA funds broadly have three components- wage, material and administrative. The wage bill is borne entirely by the Centre and directly transferred to the workers' bank accounts. The delay in releasing funds has become an issue of exchange between some states and Centre. States argue that "instead of providing adequate funds at the start of the financial year, the union government continues to tinker with the technical architecture of the program. The workers should not have to pay the price for bureaucratic problems leading to further complications in Centre-state relations".

3.8 Transfer of IAS and IPS officers: Many state governments have opposed the Centre's new proposal to change cadre rules for the All-India Services. As per the present rule, any officer who has served in a state government for up to 9 years can show their willingness to come to the Centre, through their state governments, at the level of director and above under the Central

Staffing Scheme. This has spurred questions over the separation of powers between the central and the state governments.

3.9 **Draft Ports Bill, 2022**: The 6 major coastal state governments, namely Gujarat, Goa, Maharashtra, Karnataka, Kerala, Andhra Pradesh, Odisha, West Bengal, and Puducherry, will likely disagree with the draft Bill as it is perceived to be concentrating the powers in the hands of the Union. Furthermore, it is feared by the Coastal states that their regulatory authority over non-major ports will be diluted as the topic is listed in the Concurrent List of the Constitution. In addition, the Maritime State Development Council mechanism was introduced in the second version of the draft Bill, which is perceived to extend the Centre's reach over ports owned by the state government and hence was opposed by the coastal states. The states have called the Centre for the need for greater decentralization in the Ports bill, 2022.

3.10 Regarding nation-wide policies, a tendency to adopt pre-emptive approach by states have emerged in recent times Figure 4 highlight some of the recent examples. The stance of some states signals 'trust deficit' and are attempts to undermine the credibility of such national policies.

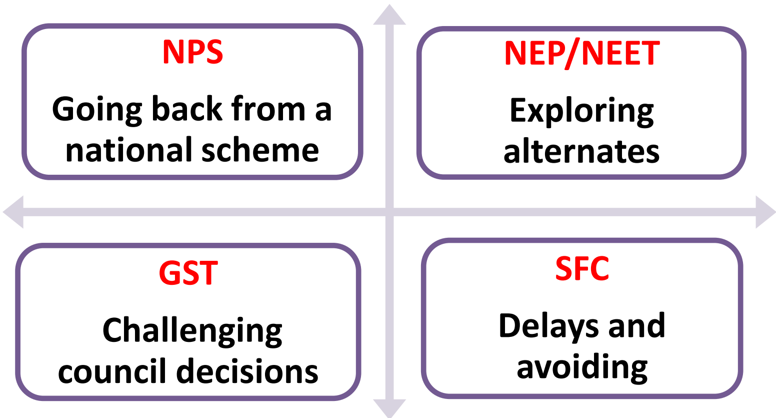


Figure 4: Some areas of states going back on commitments

3.11 National Pension Scheme is an example of going back from a national scheme. The Government moved to a contributory pension scheme in 2004. As a result, all states migrated to NPS except West Bengal and Tamil Nadu since adoption was to be done voluntarily. It was a settled discussion until recently when states like Rajasthan and Chhattisgarh announced implementing the 'Old Pension Scheme'. This is a promise that will appeal to new and old government employees. A research report of State Bank of India highlighted that the primary concern of any pension scheme is its sustainability at the state level. The pension outgo as per cent of revenue receipts is around 13.3 per cent for all states combined and 29.7 per cent of own tax revenue. This is because 56 per cent of the state's expenditure towards payments, salary and pension is met out of state revenue receipts.

3.12 National Education Policy (NEP) and National Eligibility cum Entrance Test (NEET) and exploring alternatives by states: Higher education falls in the concurrent list of the Constitution and is the joint and shared responsibility between the Centre and the states. However, there is constant dissension between the states and the Union in the area of education, more pronounced with regard to NEP and NEET. Several states have called the Centre's implementation of NEP and NEET "cruel and disadvantageous." States like Tamil Nadu, Andhra Pradesh, Rajasthan, Punjab, Odisha, Kerala, Telangana, West Bengal and Jharkhand have opposed NEET because it has been argued that it disrupts state-specific admission processes and is against the spirit of federalism. There is, therefore, a need to bring the states and the Union on the same page on matters regarding education.

3.13 Good and Services Tax: A judgement of the Supreme Court (The *VKC Footsteps Vs UOI & Others)* ruled that the GST Council only has persuasive value and its decisions are not binding. The Supreme Court has emphasized the relevant articles' scope and ambit rather than providing a fresh interpretation. Article 279A of the Constitution uses the word "recommendation", and the Supreme Court decided that duly. States on the corollary have an option to adopt a different stance in relation to rates, exemption, or procedure, but they opt not to do so for uniformity and ease of doing business across borders. Since its inception, states have implemented the GST Council's decisions because they did not want to rip the consistent structure. This does not imply that states lacked powers to do so leading to simmering tensions between the Centre and the states. The States have started to argue that they could act independently in every case, but they chose to return to the GST Council despite having those options. There exists a need to minimize the states challenging Council decisions, even if they do it should be after enough dialectical contemplation and pragmatism, preferably in exceptional circumstances, to best ensure the tuneful functioning of the country's indirect tax regime.

3.14 State Finance Commissions (SFC): It has been observed that the Finance Commissions have not got the benefit of recommendations of SFCs. This is because most State Governments did not constitute SFCs in time, and due importance was not given to strengthening this critical constitutional mechanism. As of now, fifteen States have set up the fifth or the sixth SFCs.

Numerous States have still not moved beyond the second or third SFC. As per the report of the 15th Finance Commission, it, too, faced a similar challenge in suggesting measures based on the recommendations of SFCs. These challenges are mainly in the form of poor administrative support, inadequate resources for their smooth functioning and the delayed placement of action taken reports (ATR). The states of Assam, Bihar, Punjab, Rajasthan, Haryana, Himachal Pradesh, Kerala, Madhya Pradesh, Maharashtra, Odisha, Sikkim, Tamil Nadu, Tripura, Uttarakhand and Uttar Pradesh Andhra Pradesh, Karnataka and West Bengal Chhattisgarh, Goa, Gujarat, Jharkhand and Manipur Arunachal Pradesh, Mizoram Erstwhile Jammu and Kashmir, Telangana have Constituted either their VI V IV III II I SFCs. According to a study by the National Institute of Public Finance and Policy (NIPFP), commissioned by us, the average delay in SFCs submitting their report has been about sixteen months. The delay with regard to the constitution of SFCs have led to delays in the devolution of funds to local bodies. These delays point to a peculiar aspect of the federal system that states demand devolution of funds from the Centre, but are reluctant to pass it on to the next tier.

4. Impact of Federal Divergence: Fiscal Loosening

4.1 An important implication of the divergences among states is the lack of a cohesive approach to fiscal management. As states adopt their own methods for managing the economy and finances, the co-operative federal structure is challenged with important implications of the states' finances. As there exists spill-over effects of the actions by the states to the Centre, fiscal management of the Centre gets disrupted. This leads to deviations from the fiscal targets set by the Centre. The channel of spill over from states to Centre is through the widened fiscal deficits of the states.

4.2 There is a substantial inter-state variation in the gross fiscal deficit – gross state domestic product (GFD-GSDP) ratio of states as portrayed in Table-1. The average GFD-GDP ratio of the states remained modest at 2.5 per cent during 2011-12 to 2019-20, lower than the Fiscal Responsibility Legislation (FRL) ceiling of 3 per cent. There were substantial inter-state variations, while Andhra Pradesh, Kerala, Punjab and Rajasthan incurred average GFD of above 3.5 per cent of GSDP, Assam, Gujarat, Maharashtra, Odisha and Delhi ran ratios less than 2 per cent. States' fiscal positions deteriorated sharply in 2020 with a sharp decline in revenue and spending and a sharp rise in debt to GSDP ratios[4].

[4] Reserve Bank of India - RBI Bulletin. https://m.rbi.org.in/Scripts/BS_ViewBulletin.aspx?Id=21070

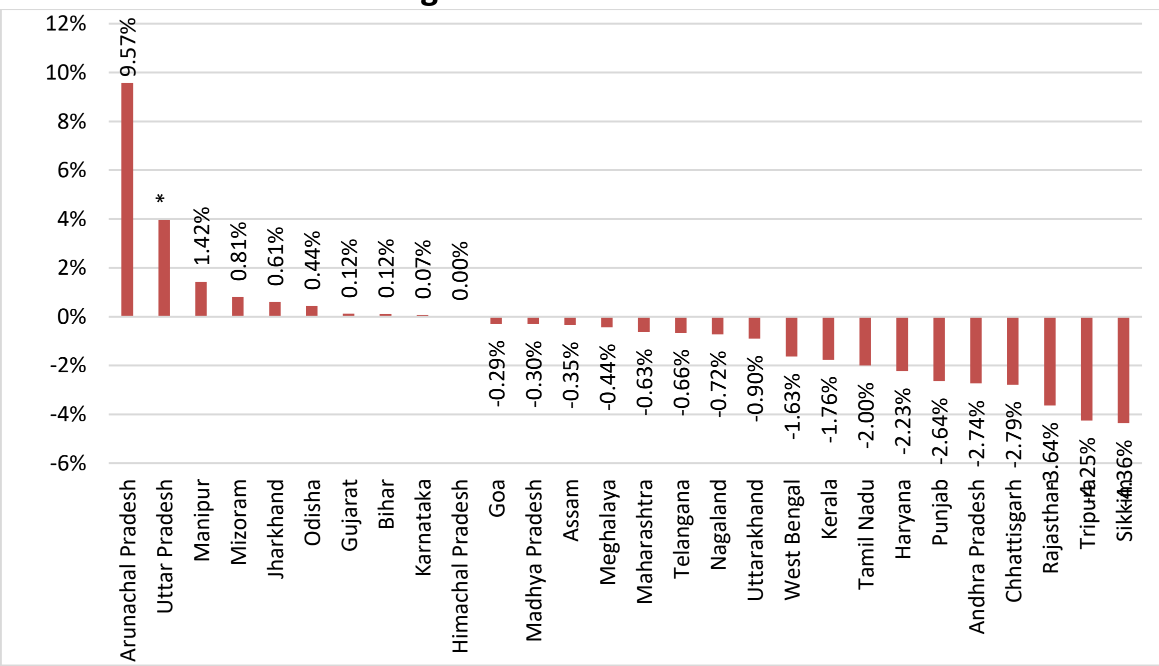
Table 1: State's Fiscal Deficit

States' Fiscal Deficit (% of GSDP)				
States	2020-21	2021-22 (BE)	2021-22 (RE)	2022-23 (BE)
Andhra Pradesh	5.6	3.5	3.2	3.6
Arunachal Pradesh	2.3	2.2	2.6	2.2
Assam	3.0	4.0	8.5	3.2
Bihar	4.8	3.0	11.3	3.5
Chhattisgarh	4.5	4.6	3.8	3.3
Gujarat	2.4	1.6	1.5	1.6
Haryana	2.9	3.8	3.0	3.0
Himachal Pradesh	3.6	4.5	4.1	5.0
Jharkhand	4.2	2.8	3.0	2.8
Karnataka	3.7	3.5	2.8	3.3
Kerala	4.4	3.5	4.2	3.9
Madhya Pradesh	5.4	4.5	4.2	4.6
Maharashtra	2.6	2.2	2.8	2.5
Odisha	1.8	3.5	0.4	3.0
Rajasthan	5.9	4.0	5.2	4.4
Tamil Nadu	4.6	4.3	3.8	3.6
Telangana	5.1	3.9	3.9	4.0
West Bengal	3.4	4.0	3.5	3.6
Average of 18 States	3.9	3.5	4.0	3.4

Source: SBI Research

4.3 It can be observed from figure 5 that, some states register fiscal surplus, while most of the states have fiscal deficit for 2019-20. The range of the ratio of GFD/GSDP varies considerably across states.

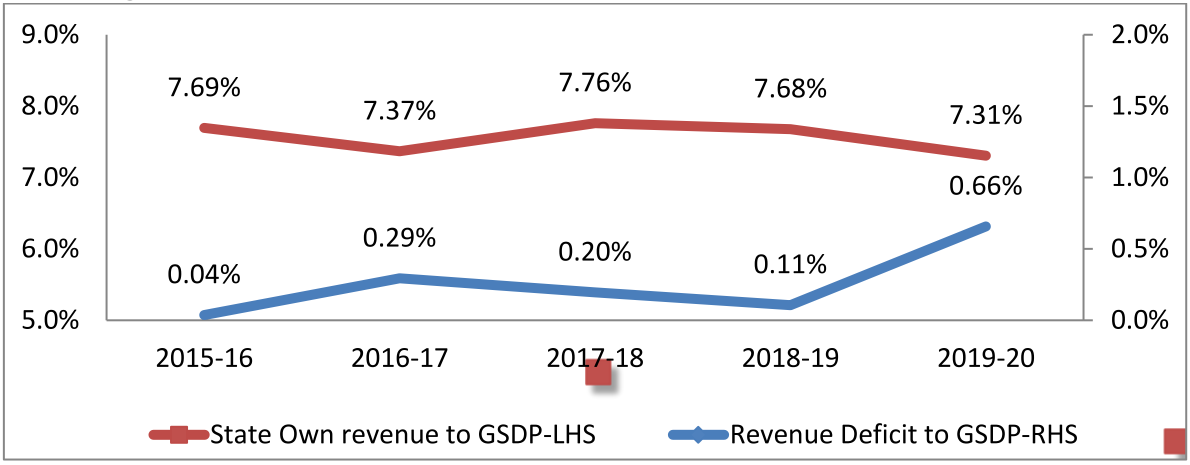
Figure 5: Revenue Deficit



Source: RBI, State Finances: A Study of Budgets

4.4 The major contributing factor for increased fiscal deficit is the increased revenue deficit. The stagnant own tax revenues of states is leading to widening of revenue deficit. As portrayed in figure 6, the revenue deficits have increased and state's own revenue mobilization has been stagnant as share of GSDP during 14th FC award period (2015-20)

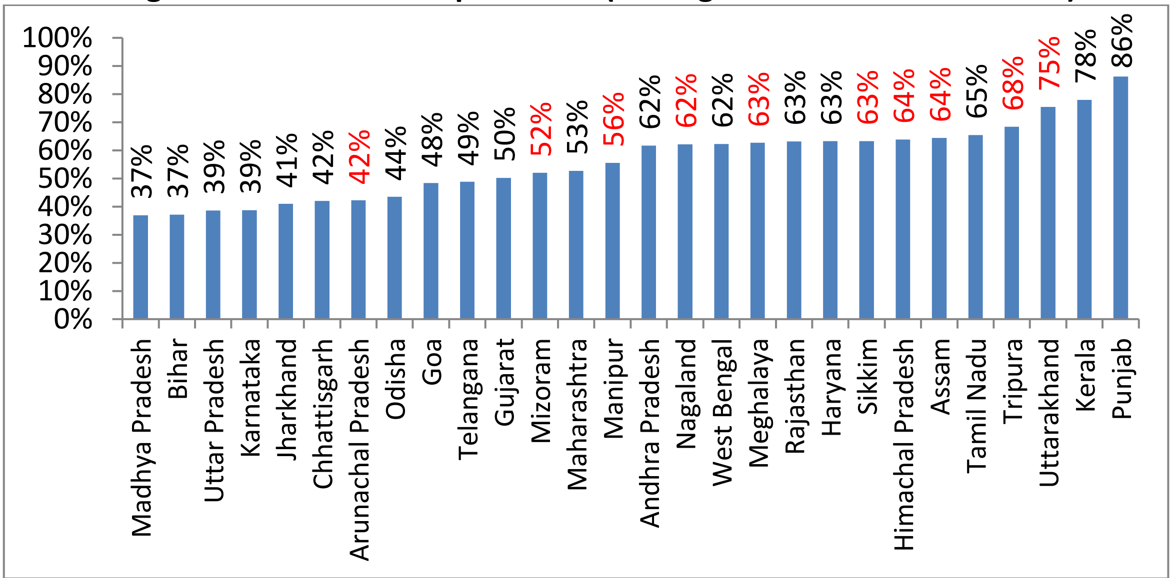
Figure 6: State's Own Revenue and Revenue Deficits (combined)



Source: RBI, State Finances: A Study of Budgets

4.5 Deteriorating quality of expenditure: The stagnant tax and non-tax revenue of states are affecting the expenditure planning of states and are increasing their dependence on market borrowings. Committed expenditure accounts for a significant portion of state expenditure, leaving limited fiscal space for undertaking developmental expenditure. As shown in figure 7, committed expenditure, in terms of salaries, pensions and interest payments, account for more than 60 percent of revenue receipts for a number of states and for Punjab it is more than 85 percent.

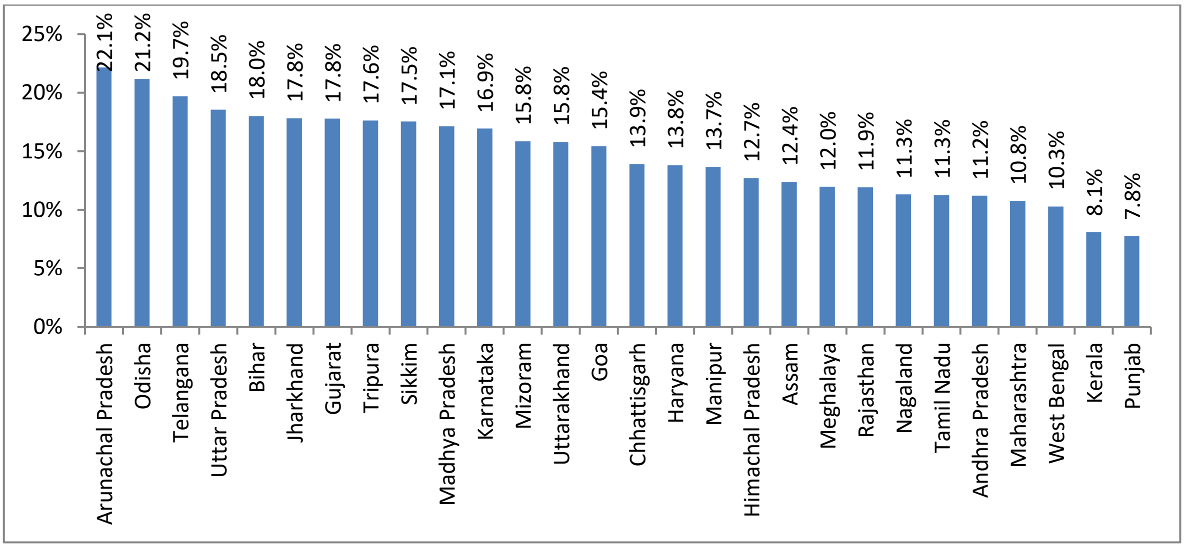
Figure 7: Committed Expenditure (Average for 2017-18 to 2019-20)



Source: PRS, State of State Finances

4.6 An important outcome of compromised quality of expenditure, especially the inability to reduce committed expenditure leading to high revenue spending, is reflected on capital outlays. As can be observed from figure 8, majority of the states have an average of around 15 percent or less of their total expenditure as capital expenditure for the period 2015-2020. States with high levels of committed expenditure such as Punjab and Kerala have lowest levels of capital expenditure. Low capital expenditure ratios imply possibilities of lower GSDP growth, slower revenue growth and higher interest outgo in the future.

Figure 8: Capital Outlay (Average for 2015-2020)



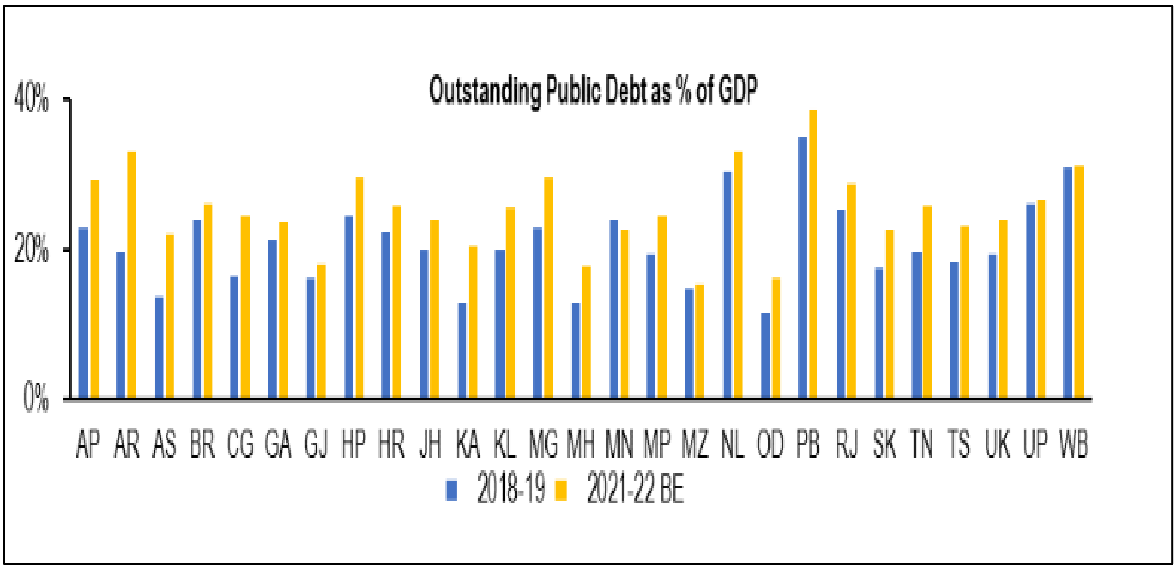
Source: PRS, State of State Finances

4.7 Bihar, Kerala, Punjab, Rajasthan and West Bengal are highly stressed due to a sharp decline in revenue, increase in spending and rise in debt to GSDP ratios. On the other hand, states like Andhra Pradesh, Bihar, Rajasthan and Punjab exceeded debt and fiscal deficit targets. Whereas Kerala, Jharkhand and West Bengal exceeded their debt target. The state governments have generally tried to keep their fiscal deficits within limits imposed by their fiscal responsibility laws (FRL), often by cutting essential expenditures[5]. Yet, state debt burdens have been rising because of contingent liabilities.

4.8 As can be observed from figure 9 all major states have witnessed an increase in outstanding public debt as percentage of GSDP in 2021-22 compared to 2018-19. Notable is the case of Punjab which already had high levels of debt in 2018-19.

[5] Opinion | India's fiscal responsibility rules for states might-need-a-relook. https://www.idfcinstitute.org/knowledge/publications/op-eds/opinion-indias-fiscal-responsibility-rules-for-states-might-need-a-relook/

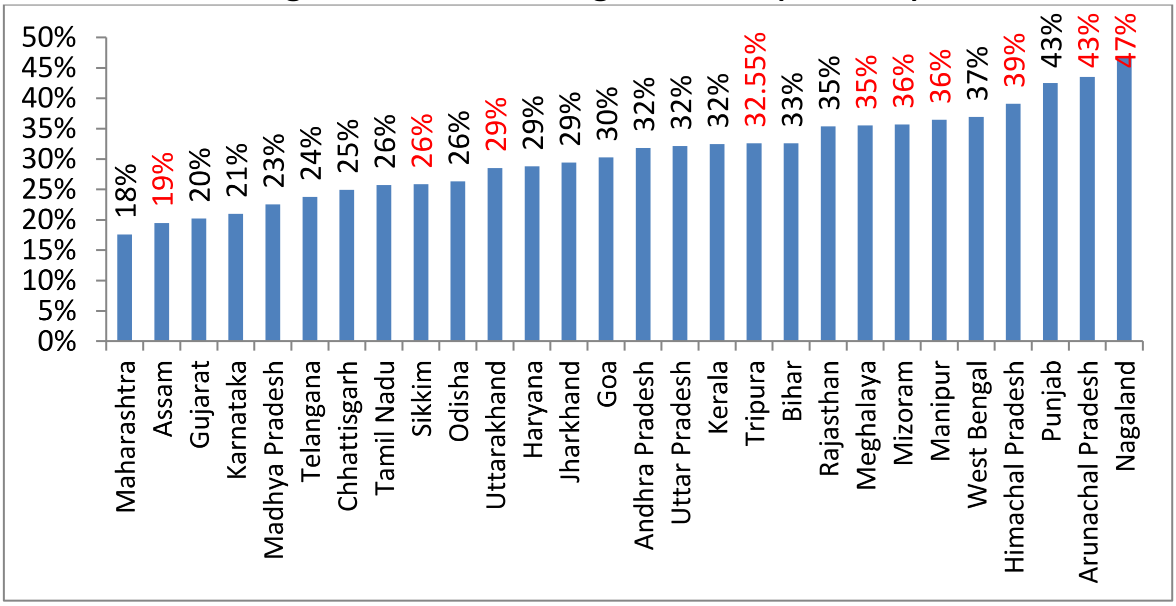
Figure 9: Public Debt of States



Source: PRS, State of State Finances

4.9 Outstanding liabilities for 2019-20, in terms of revised budget estimates, are shown in figure 10. Majority of states have more than 30 percent of GSDP as outstanding liabilities. North Eastern states have registered high levels of outstanding liabilities.

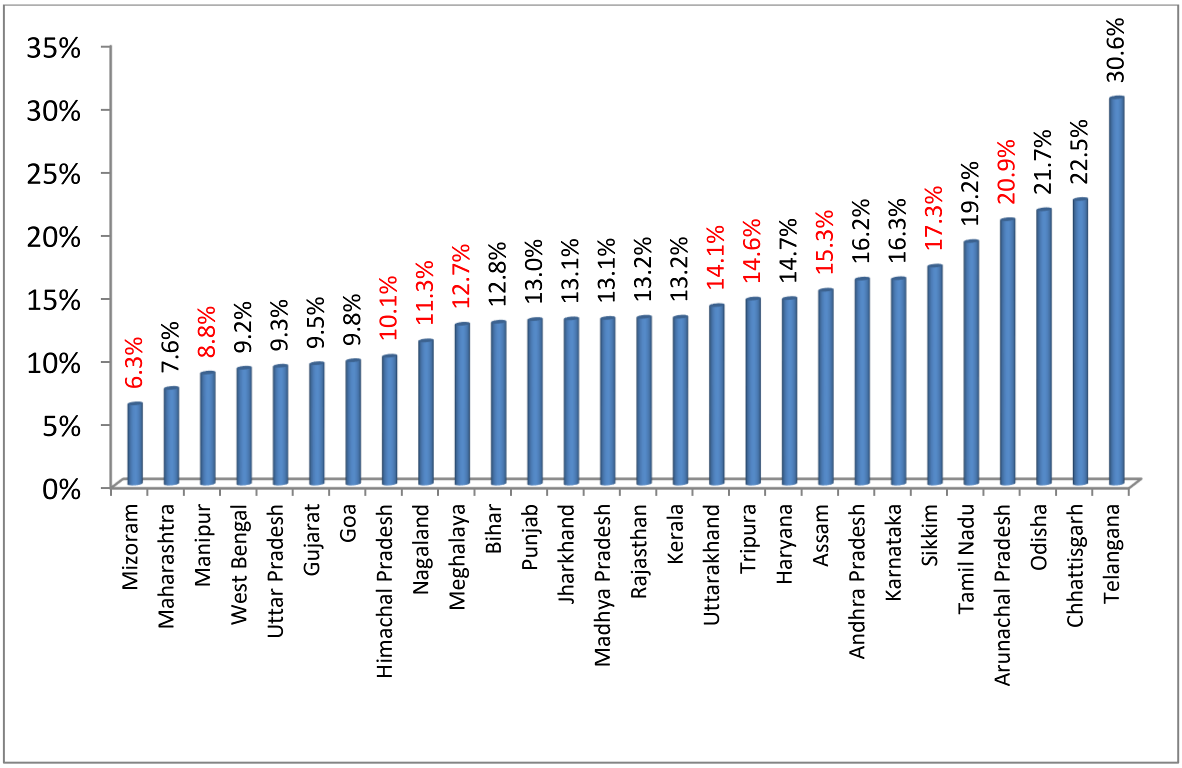
Figure 10: Outstanding Liabilities (2019-20)



Source: RBI, State Finances: A Study of Budgets

4.10 Viewed from a long-term perspective, there is a worrying rise in debt in some states. Figure 11 show the annual growth rate of debt for the period 2015-2020. Andhra Pradesh, Odisha, Chhattisgarh and Telangana have witnessed very high growth in debt, with Telangana registering 30 percent growth rate. The high growth in debt could eventually lead to a situation of unsustainability of state finances.

Figure 11: Growth of outstanding liabilities 2015-2020

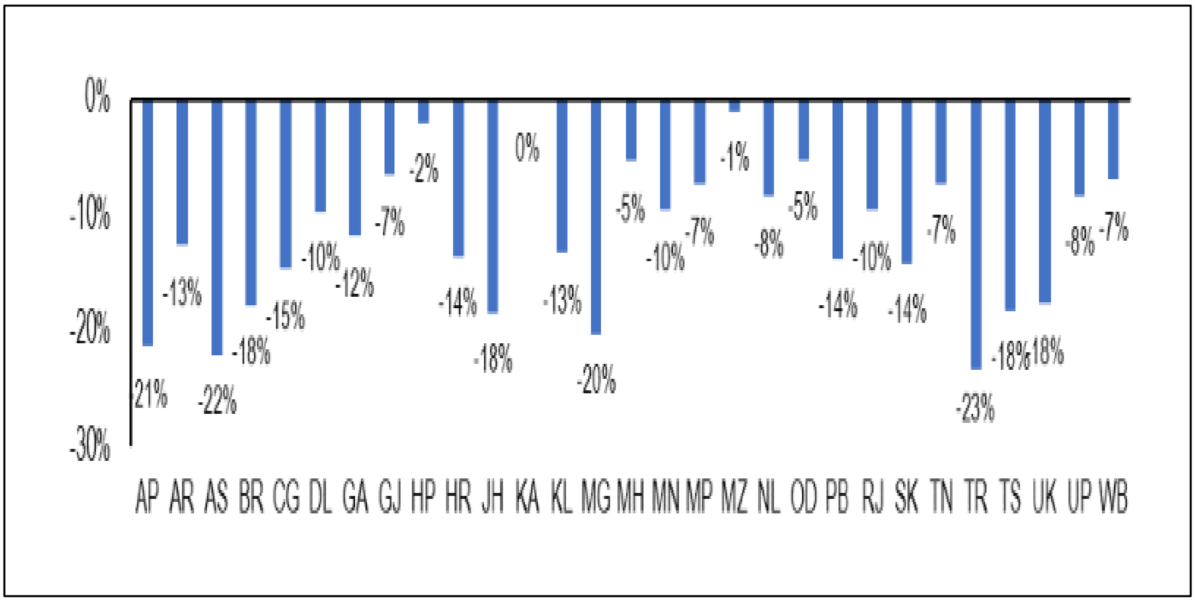


Source: RBI, State Finances: A Study of Budgets

4.11 The budget of state government provides three sets of numbers: (i) budget estimates: an estimate for the upcoming financial year, (ii) revised estimates: revision in the budget estimates for the ongoing financial year, and (iii) actuals: the final audited amount for the previous year. The state legislature approves the budget for the coming year based on the budget estimates. The revised estimates may provide a more realistic picture of the government's finances in the ongoing year as they are made with reference to the actual transactions already recorded that year. Actuals may fall short of or exceed budget estimates, and this comparison helps understand the credibility of a proposed budget.

4.12 Analysis of the budgets of state government for the period 2015-20 shows that states raised 10% less revenue than budgeted during 2015-20 (figure 12)**.** During the 2015-20 period, states raised 10% less revenue than their budget estimates. States such as Tripura (23%), Assam (22%), and Andhra Pradesh (21%) saw a relatively higher shortfall in revenue during this period (Figure 19). States can borrow more to make up for this shortfall, so that they can spend as budgeted. However, as borrowing is limited by FRBM laws, many states cut their expenditure to meet the borrowing limits.

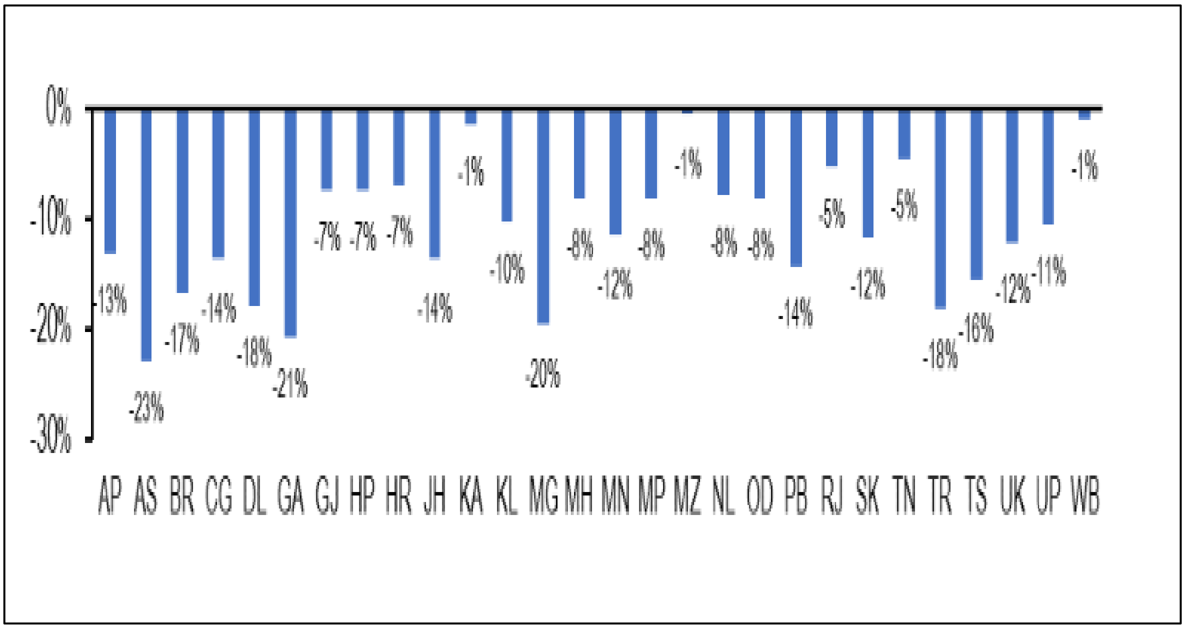
Figure 12: Shortfall in Revenue Receipts of States during 2015-20



Source: PRS, State of State Finances

4.13 It also important to note that States spent 9% less than what they budgeted (figure 13). During the period 2015-20, on average, states underspent their budget by 9%. States such as Assam (23%), Goa (21%), and Meghalaya (20%) saw higher underspending during this period. States such as Karnataka and West Bengal saw the least variance in the budget and actual spending figures. Average underspending during this period in case of revenue expenditure is 8%. As a large part of the revenue expenditure cannot be cut, there is a disproportionately higher underspending in case of capital outlay, at 17%.

Figure 13: Underspending by States during 2015-20



Source: PRS, State of State Finances

5. Priority Areas for Corrective Actions

5.1 ***Subsidies**:* In its annual report, the Reserve Bank of India (RBI) had cautioned about the rising subsidies burden that has stretched state governments. In addition, there has been rising expenditure which is expanding contingent liabilities. The fiscal health of states like West Bengal, Kerala, Rajasthan, Punjab and Andhra Pradesh warrants a careful assessment as these states are primarily social welfare focused. State governments' expenditure on subsidies has grown at 12.9% and 11.2% during 2020-21 and 2021-22, respectively, after contracting in 2019-20. Jharkhand, Kerala, Odisha, Telangana and Uttar Pradesh have seen the most considerable rise in subsidies over the last three years. As a result, states' share of subsidies in total revenue expenditure has also risen from 7.9% in 2019-20 to 8.2% in 2021-22. States like Gujarat, Punjab and Chhattisgarh spend more than 10% of their revenue on subsidies.

5.2 Power Sector has been an area of mounting crises and rising frictions between the Centre and states. Power Ministry data shows that states and union territories owed more than 1.1 trillion rupees to generating companies. In contrast, the total money owed to the DISCOMS stood at 1.4 trillion. Most DISCOMs serve as the weakest link in the supply chain of the power sector. *The UDAY (Ujwal Discom Assurance Yojana) Scheme* launched in November 2015, envisaged state governments to take over 75% of DISCOMS debt and interest rate reduction for the balance 25% of debt by way of state government-backed bonds. However, the off-balance sheet borrowings and losses have limited the success of the scheme. Although it is quite evident that we are still far away from the illusionary end point of DISCOMS being financially stable. Electricity Amendment Bill, 2022 proposes welcome correctives to longstanding problems of the power sector. The Central government, envisages bringing in the principle of open access by allowing consumers the right to choose their electricity provider, regardless of who controls the physical infrastructure[6]. But the states have expressed displeasure as they feel that the Centre is encroaching into their domain in power sector governance.

5.3 ***Freebies***: Some states have started delivering a portion of their subsidies as 'freebies'. While there is no precise definition of freebies, it is necessary to distinguish them from public/merit goods, such as the public distribution system, employment guarantee schemes and states' support for

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[6] 'Electricity (Amendment) Bill 2022 would lead to healthy and ethical ....
https://www.thehindubusinessline.com/news/national/electricity-amendment-bill-2022-would-lead-to-healthy-and-ethical-competition/article65784324.ece

education and health. It is difficult to define freebies & welfare schemes as there is a thin difference between freebies and entitlements. Freebies do not differentiate between those who can afford to pay and those who can't, thus alleviating the crucial distinction between who should be and those who shouldn't be the beneficiaries. Entitlement or the welfare on the other hand, is a bonafide benefit for those who can't afford. Some freebies may benefit the poor if properly targeted with minimal leakages, but their advantages must be evaluated against the large fiscal costs and inefficiencies they cause by distorting prices and mis-allocating resources.

Table 2: Estimate of Freebies Announced

Freebies Announced by the States in 2022-23			
State	As a % of GSDP	As a % of Revenue Receipts	(As a % of Own Tax Revenue)
Andhra Pradesh	2.1	14.1	30.3
Bihar	0.1	0.6	2.7
Haryana	0.1	0.6	0.9
Jharkhand	1.7	8.0	26.7
Kerala	0	0	0.1
Madhya Pradesh	1.6	10.8	28.8
Punjab	2.7	17.8	45.4
Rajasthan	0.6	3.9	8.6
West Bengal	1.1	9.5	23.8

Source: RBI

5.4 As shown in Table 2, the RBI has estimated the major financial assistance/cash transfers, utility subsidies, loan or fee waivers and interest free loans announced by the states in their latest budget speeches (i.e., for 2022-23). It can be found that the expenditure on freebies range from 0.1 - 2.7% of GSDP for different states. The freebies have exceeded 2 per cent of GSDP for some of the highly indebted states such as Andhra Pradesh and Punjab. Therefore, it is high time that States work towards power sector reforms, prevent leakage expenditure in subsidies payments, and avoid fiscally unwise decisions to improve their financial health. It is therefore needed that the governments must strike a balance between fiscal deficit and welfare spending.

6. Macro-economic Implications of Federal Divergence

6.1 Points of departure from co-operative federal structure has important implications on the growth of the economy. As stable policy environment is a pre-condition for investments and growth, deviations in the policy space between Centre and states and among states affects economic growth through different channels. It should be noted that some effects could immediate and short term, while others play out in the long term and would have persistent effects on the economy. We identify two short term and two long term impacts. In the short term two issues that arise are related to 'holding-up' and increase in 'transaction costs'.

6.2 'Hold-up' problem: A situation where two parties may be able to work most efficiently by cooperating, but refrain from doing so because of concerns that they may give the other party increased bargaining power and thus reduce their own profits. When multiple parties make nonrecoverable relationship-specific investments that generate a joint surplus to be divided through *ex-post* bargaining, underinvestment may occur. Since the final allocation is determined by the interplay of *ex-post* bargaining power of all participating parties, each agent is unlikely to fully appropriate the return from his investment. Therefore, agents refrain from investing at the efficient level for fear of being 'held-up' by their counterparts. This underinvestment is referred to as the "hold-up problem" in the economic literature. It is a common phenomenon in bilateral transactions that rely on incomplete contracts.

6.3 In a federal system competition between states and Centre is usually regarded as unhealth competition as it is usually manifested in public expenditure. When state governments compete on their public expenditure, they skew their expenditure structures in favor of more short-term welfare schemes, causing them to provide lower levels of public goods. This undersupply of public goods and services to households is exacerbated to the extent that expenditure competition occurs on multiple schemes. Some expenditure heads are to be shared between Centre and states, in this case, the familiar hold-up problem applies: once Centre's investments are in place, state governments treat them as given resulting in two possibilities; either they devise a parallel scheme or they under-invest in the existing scheme, with the fear of that public might attribute the credit of the scheme to the Centre. In both cases there would be under-investment, lower aggregate investments in the former and lower scheme specific investment in the latter.

6.4 Increased transaction costs: Transaction costs refer to the costs involved in market exchange. These are costs incurred that don't accrue to any participant of the transaction. They are sunk costs resulting from economic trade in a market. The three types of transaction costs are: Search and information costs which are associated with looking for relevant information and meeting with agents with whom the transaction will take place. Bargaining costs which are related to coming to an agreement that is agreeable to the parties involved in drawing up a contract. Policing and enforcement costs which are costs associated with making sure that the parties in the contract keep their word and do not default on the terms of the contract.

6.5 Competition between Centre and states in creating welfare schemes and institutions leads to an increase in transaction costs as there exists a positive relationship between such competitive processes and low transparency. It leads to bargaining inefficiencies and generate incentives to misappropriate powers. Economic activities suffer due to increased transaction costs as an outcome of federal divergence due to poor access to information and inefficient coordinating mechanisms leading to worse instead of better policy outcomes.

6.6 A long-term impact of friction in the federal system is the possibility of 'race to the bottom'. Conventionally race to the bottom is through tax subsidies to attract investment. However, in recent times a new form of it has emerged among Indian states through subsidized welfare provisioning. Left to choose their own individual policies without external constraints, the separate entities, that is states would engage in welfare competition. Decentralized units (states) will engage in interdependent behavior that will be detrimental to all. The problem is that if one state announces a slew of highly subsidized welfare schemes others may be compelled to follow suit for fear of being left out. If left unchecked, this can quickly escalate and make everyone worse off, including those they are primarily intended to benefit. Subsidies and other government measures can hurt over the long run by encouraging complacency stifling innovation, with flow-on effects on states' growth potential. Further, there exists an opportunity costs for these welfare subsidies, which could go a long way to improving education, transportation and other public services that would have a far better shot at promoting real economic growth.

6.7 Another long-term impact is the unobserved under performance of states. Federal frictions lower the potential growth rate of the economy by having lower investments. Investments flows slow down due to high transaction costs combined with lower infrastructure quality in states which indulge in welfare competition. This leads to a situation of potential growth rate itself being pulled down. As the observed growth might not decline immediately, there emerges a problem of 'latent under performance' of the state's economy in the long term.

7. The Way Forward: Sequencing Fiscal Correction

7.1 In order to tackle the fallout of fiscal loosening by states, a two-tier approach is proposed, there are two components, first is a three-step fiscal correction process and second a series of nudges to reform states on three areas. The details of these summarized below.

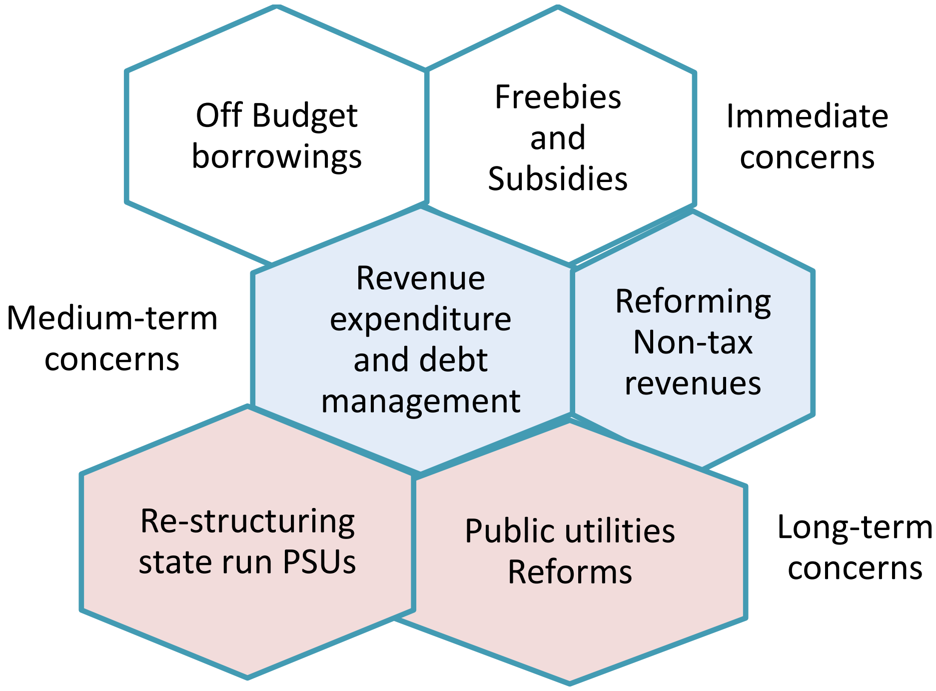

Figure 14: Fiscal Correction Roadmap

7.2 In the first step of the fiscal correction process two immediate concerns need to be addressed. First, there is need to push for 'fiscalisation' of off-budget finances. States have been borrowing outside the budget, which is guaranteed by the states governments and adds to the total liability of the state. By bringing in off-budget borrowings to the budget, there will be more more transparency in state budgets. The Centre has already moved in this direction and it is important for the states to follow this. Second, there is need to reform the subsidy system prevailing in the states. The reform measures need to encompass four aspects; (a) focus more on the targeting of subsidies to the needy segments of the population, (b) prevention of transition of subsidies into freebies, which is gaining popularity in many states leading to 'welfare competition'; (c) prevention of the transition of subsidies from merit to non-merit goods, with clear list of merit goods and (d) a move to direct benefit transfer system (DBT), by the states, for which the necessary infrastructure is already in place.

7.3 In the second step, medium term concerns need to be addressed, the revenue, expenditure, debt management and reforming the non-tax revenues. A one-time relaxation of the FRBM limits could be allowed for states which take up the reform process diligently. Use of higher limits for foreign portfolio investments (FPI) in state development loans (SDL) could be an instrument for reforms and for pushing for transparency in the debt and expenditure management. The implicit guarantee by RBI backing loans leads to reduced borrowing cost for states. Ceiling for this is to be allowed till a pre-decided GSDP to Debt and Fiscal deficit level. In the context markets have to be allowed to play more active role and the Centre could enforce financial discipline through them through higher spreads. For all these reforms, a Debt Sustainability Index of various states need to worked out and published so that investors would be guided by this and state would be forced to reform public finances, bringing more transparency and accountability.

7.4 In the third step comprehensive re-structuring of the state-run Public Sector Units (PSU) and state level public utilities reforms need to be undertaken. In view of the growing resource crunch at the state level, it has become necessary to carry out reforms in State PSUs at a pace faster than witnessed till now to prevent further drain on resources caused by loss making enterprises. While deciding whether to retain, restructure or privatize the State PSUs, the States may keep in view the criterion followed by the disinvestment process of the Centre. State should withdraw from the manufacturing and trading & services sector. Enterprises in the welfare and promotional sectors should be retained while the financial and utility enterprises should be restructured. In the case of promotional enterprises, the manufacturing part will have to be divested and the purely promotional part of activity will have to be retained. Disinvestment exercise in each State could be handed over to an independent body, created through an independent legislation. Enterprises belonging to the welfare category should also be run on commercial basis failing which they should be reconverted into departmental enterprises.

7.5 Apart from the above-mentioned reforms, the states need to be constantly nudged on three issues. They are depicted in figure 15.

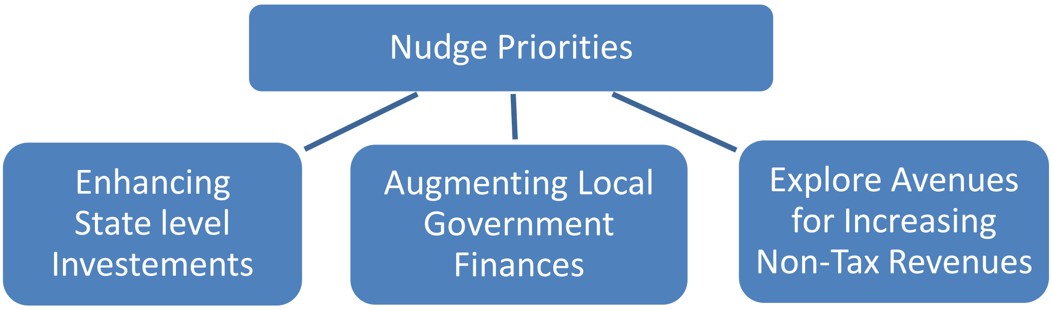

Figure 15: Areas for Constant Nudge

7.6 **Nudge Priority 1**: Investments: In terms of the data available for Q2 FY22, 87.6 percent of total foreign direct investment flows are accounted by 5 states. Karnataka 37.55, Maharashtra 26.26, Delhi 13.93, Tamil Nadu 5.10 and Haryana 4.16 are the respective states. There is need to disperse FDI inflows to other states for which the states have devise strategies. We propose that states should immediately take the following five steps:

(a) Streamline clearance committees
(b) Create land banks to avoid delays
(c) Engage with local industrialists
(d) Identify and reach out to more investors
(e) Use homegrown companies to advertise abroad

7.7 **Nudge Priority 2**: Augment local government finances: Article 243-I of the Constitution requires the state governments to appoint State Finance Commission (SFCs) from 1994 after every five years. State government transfers to local governments are to be governed by the mandate of their current SFC. Accordingly, states should have constituted their Sixth State Finance Commission by now. The 15th Finance Commission observed that most state governments did not constitute SFCs in time and did not give due importance to the recommendations of the SFCs. The Commission made it mandatory for all states to constitute SFC and act upon its recommendations by March, 2024 to receive any local body grants thereafter. Further we propose that the Centre should initiate discussions on the next Finance Commission and continuously engage with states to reform the 7th Schedule and Concurrent list of the Constitution.

7.8 The 15th Finance Commission has recommended grants worth Rs 1.21 lakh crore over five years for urban local bodies. To receive grants from the year 2022-23 onwards, states will need to show consistent improvement in property tax collection. To meet the eligibility criteria, the property tax in the previous year should grow in tandem with the average growth rate of the state's own GSDP in the most recent five years. The 15th FC observed that property tax collection forms the bedrock of local government revenue across the world. However, the property tax collection level in India is significantly lower (0.2% of GDP) as compared to some of the developed countries. The 15th FC highlighted the following as some factors leading to low property tax revenue: (i) undervaluation of property, (ii) incomplete property tax records, (iii) policy inadequacy, and (iv) inefficient administration. In 2017-18 Maharashtra, Gujarat, and Telangana were some of the states with a comparatively higher level of property tax collection by their urban local bodies. Property tax collection of urban local bodies as % of GSDP was less than 0.05% of respective GSDP in case of 14 out of 25 states (for which data is available). This is an area warranting reforms.

7.9 **Nudge Priority 3**: Increase non-tax revenues: States need to look closely at their non-tax revenues which are not insignificant at around 10 per cent of States' total revenue collection. The three main administrative non-tax receipts heads -general services, social services and economic services, account for about 80 per cent of States' own non-tax revenue. To augment additional revenues from non-tax sources, the fees/user charges for the various services provided by the State government need to be reformed. States must focus on meeting the cost of public services through proper pricing, wherever feasible. It is essential to understand and appraise the performance of some of the non-tax sources of States with a view to examining their trends, identifying the factors responsible for their growth or lack of growth, exploring the scope for rationalizing their price structures and, thereby, improving the overall budgetary position of the States as well as efficiency in resource use.

7.10 It is important that States become more proactive in raising non-tax revenues as they are making substantial commitments on welfare schemes. To push this a reduction of the share of unconditional transfers and using revenue deficit grants and other tools under Finance Commission as conditional transfers could be an option. Grants & compensation can be linked partially to GSDP growth targets to create a system of incentives and rewards.

7.11 This report maps out some of the issues that have emerged as areas of frictions in the federal system in recent times and puts forth some possible ways of minimizing such frictions. This in our view requires constant engagement with the states and build an atmosphere of mutual trust, which are pre-requisites for a harmonious federal system.