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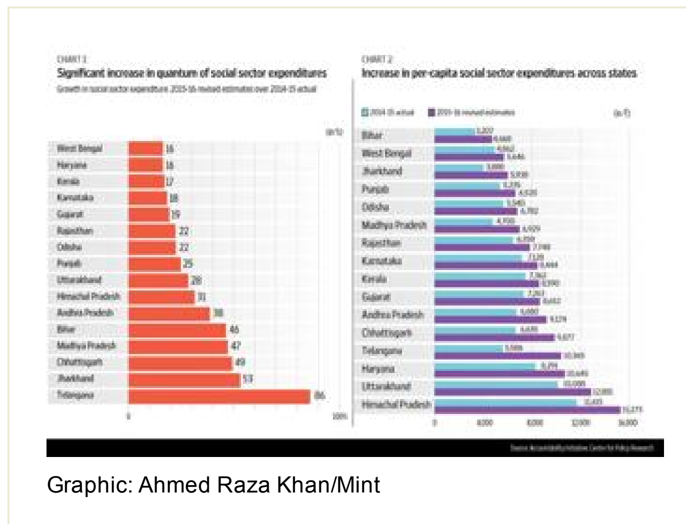
Trust in states' fiscal responsibility vindicated

Contrary to fears of fiscal profligacy expressed by some following the FFC award, the states have maintained fiscal prudence



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The Fourteenth Finance Commission (FFC) had stated explicitly in its report that its recommendations for federal fiscal arrangements were based on trust—an assumption that state governments would conduct themselves with a due sense of fiscal responsibility. The evidence now available indicates that the judgement has been largely vindicated.

The FFC recommendations announced in early 2015 elicited widely differing reactions. Referring in particular to the increase in the states' share of the divisible pool of tax revenues from 32% to 42%, many commentators described the recommendations as "game changing", as radically altering federal fiscal relations, empowering states, and so forth. There were others who felt that the recommendations dangerously altered the fiscal balance of power in favour of states, transferring huge additional resources to them. Fears were expressed that states were fiscally irresponsible. That they would now fritter away resources on handouts or poorly designed projects that allow for malfeasance and leakage, thereby putting fiscal stability at risk. It was also argued that with greater devolution, the poorer states would be the worst sufferers.

What FFC had in fact attempted was to restore a long recognized imbalance between the assigned constitutional responsibility of states, the state list of the Seventh Schedule under Article 246, and the actual allocation of the divisible pool of resources between the Union and state governments. Earlier, finance commissions had also moved the system towards reduction of this imbalance. FFC simply pushed the envelope further in the same direction and quite sharply, taking advantage of its more liberal terms of reference compared with some of the earlier finance commissions.

In doing so, however, FFC was quite mindful of the Union government's resource requirements to deal with the subjects on the Union list, or those on the concurrent list for which the Union government has a leading responsibility. FFC also recognized that the Union government may have to act even on subjects in the state list if issues of national interest were involved or there were spillover effects beyond state boundaries. It, therefore, ring-fenced adequate fiscal space for the Union government to fulfil its responsibilities. This fiscal space includes not just 68% of tax revenues but also all the cesses and surcharges, user fees, interest receipts and large dividends from public sector enterprises, including public sector financial institutions, and the Reserve Bank of India (RBI). It also includes the proceeds from divestment of government equity in central public sector enterprises. None of these are part of the divisible pool.

Thus, FFC did not try to increase the share of total resources transferred to states but simply altered its composition. It raised the share of untied transfers through tax devolution as opposed to tied transfers, especially in the form of top-down, micro-designed centrally sponsored schemes (CSS). Many states had earlier complained about excessive Union government recourse to "one size fits all" CSS transfers. After scrutinizing the implications of the FFC award, some states now started complaining that they were getting less transfers through the CSS route. The Union government had indeed trimmed some of the earlier CSS transfers in its 2015-16 budget in line with the FFC award.

The change in the composition of transfers in favour of untied tax devolution as compared to tied transfers has indeed fiscally empowered states quite significantly. Hence the question of fiscal responsibility of states. The claim that states are less fiscally responsible than the Union government is puzzling because the decision makers who are taking expenditure decisions at the Union level today are the same persons who took similar decisions at the state level yesterday. The bureaucratic elite engaged in top-level decision-making in the Union government mostly belong to the Indian Administrative Service, whose cadres are engaged in similar top-level decision making in states. Each of them belongs to a state cadre, and their assignments with the Union government are, in fact, inter-changeable with their assignments in their respective state cadres. Similarly, those leading the political-level decision making in the Union government today were leading decision making in their respective states till yesterday. For example, the Prime Minister, the home minister, and the defence minister in the present Union government all led the decision making as chief ministers in their respective states. To claim, therefore, that state governments are somehow less capable or less fiscally responsible than the Union government requires considerable stretching of the imagination.

Moreover, the trust FFC placed in the fiscal responsibility of the state governments was grounded in hard experience. It is well known that a few outliers notwithstanding, most states have been quite fiscally prudent, especially since the enactment of their respective state level Fiscal Responsibility and Budget Management (FRBM) Acts. State governments have to be fiscally responsible because the Union government and RBI effectively control states' borrowing programmes and thereby enforce a hard budget constraint on states in line with their respective

FRBMs. No institution is in place as of today to enforce similar discipline on the sovereign, i.e., the Union government.

Having said all that, I should also make clear in the interest of transparency that I cannot claim to be a non-partisan, objective, observer in this debate. Being a member of FFC makes me an interested party. Therefore, instead of my views and observations, it is best to anchor this article on hard evidence. Two recent studies are particularly relevant in this context, the RBI's report *State Finances A Study of Budgets of 2015-16*, released on 7 April 2016, and a study on *Role of Union and States in the Context of the 14th Finance Commission* prepared by Avani Kapoor and Vikram Srinivas of Accountability Initiative at the Centre for Policy Research, New Delhi.

Based on an analysis of 2015-16 budget estimates, the RBI study states that the aggregate share of state revenues financed by central transfers (devolution plus grants) did not increase but actually decreased by 0.3% of the gross domestic product (GDP) during the first year of the FFC award period. The study also points out that most state governments, 13 out of the 17 analysed, have succeeded in compressing their total expenditure relative to gross state domestic product (GSDP) following implementation of their FRBM Acts. Moreover, though the level of capital outlay remains quite low, most states have also managed to raise their expenditure on capital outlay, relative to GSDP, in the post-FRBM period.

This is despite the large preemption of resources for committed expenditure on the revenue account. While judicious debt management has brought down interest obligations to around 15% of revenue receipts, other items of committed expenditure such as salaries and pensions have continued to burgeon. The RBI report cites an estimate by N.R. Bhanumurthy, Sukanya Bose, Parma Devi Adhikari (*Targeting Debt and Deficits in India: A Structural Macroeconometric Approach*, National Institute of Public Finance and Policy Working Paper No. 2015-148, published in May 2015) that the Seventh Pay Commission recommendations could add an additional 0.9% of GDP to the revenue and fiscal deficits during the FFC period, 2015-16 to 2020-21. The two major concerns the RBI study flags is the large dispersion across states around the modest improvements in capital and development expenditure and the persisting low levels of expenditure on education and health.

The Accountability Initiative study cited above is quite encouraging in this context. Comparing the revised budget expenditure for 2015-16, the first year of the FFC period, with the actual expenditure for 2014-15 in a set of 16 states, it points out that there have been very significant increases in total social spending in all states during 2015-16, ranging from a minimum of 16% in West Bengal to a maximum of as much as 86% in Telangana, with a median increase of over 25% (*see chart 1*). FFC had provided for an equity enhancing revenue deficit grant to ensure no state, however poor, would fall short by more than 20% of the average per capita public spending by states by the end of its award period. It is, therefore, heartening to see that the low-income states covered in the study have all substantially increased their social spending. Rajasthan and Odisha increased their social spending during the year by 22%, Bihar by 46%, Chhattisgarh by 49% and Jharkhand by as much as 53%. The increase in social spending is clearly visible even in per capita terms (*see chart 2*).

Thus, contrary to fears of states' fiscal profligacy expressed by some following the FFC award, the states analysed in these studies have all maintained fiscal prudence. At the same time all these states, including the low-income states, have substantially increased their allocations for social services. Clearly, the trust placed by FFC in their sense of fiscal responsibility has been fully vindicated by the states.

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