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Editorial
Penalising performance?

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Today India is more ambitious and forward looking than ever before. The ultimate outcome, however, would be contingent on the performance of the states. But our policy towards the states appears to be one of "only carrot" and not "carrot and stick"; equity considerations are at the fore and efficiency at the back. As a result, under the cooperative fiscal federalism, those states that work towards the national ambitions are restrained as they are receiving a steadily dwindling share of taxes collected by the Centre. What is more, the Centre works towards shrinking the divisible pool by raising the share of cesses and surcharges in total tax collections. Is there a need for change in our outlook?

Dreaming with India

India is presently the fifth largest and the fastest growing economy in the world and attracts much global attention. By 2029 India will be overtaking Germany and Japan to become the third largest in the world. The new dream is to become a developed country by 2047. Presently, as per the World Bank criterion India, with a per capita income of around $2,256, is a lower middle income country. The per capita income should cross $4,095 to join the middle income group and overcome the challenges of middle-income trap, that today's middle-income countries are confronted with, to become a high income county with per capita income exceeding $12,695. A higher income per se need not necessarily make it developed. Challenges remain. India now holds the first position in global multidimensional poverty index, ranks 140 out of 156 in global gender gap index, rank in HDI is 132 out of 191 and in global SDG index the rank is 121 out of 163. Our destination is far away and the road ahead is rather rocky and curly. The states have a key role in Smoothening and straightening the road. Our Chief Minister turned Prime Minister could not have been more committed, correct and perceptive in the statement "when the states grow India grows".

Whether the states are made to grow?

The existing centre-state financial relations in our country is one wherein the states, although having the key role in accomplishing the national vision, are being restrained from performing. As observed by the 15th Finance Commission, the states together account for over 62% of the national expenditure while their share in total revenue is only about 37%. Keeping 62% of the revenue with the Centre presumes that the social marginal product of a rupee spent by the Centre is higher than that of the states and therefore spending by the Centre works better for the national vision. There is hardly any credible empirical evidence to support this. Since the states have built up enormous capacity to address development problems and there are numerous instances wherein states have shown to be more efficient in terms delivering development outcomes, this perception has to change sooner than later. It is said that 41% of the tax revenue is shared with the states. But only less than 30% has been actually shared in 2021-22 (RE). This is because the share of cess and surcharges in the total tax revenue of the Centre, which are not to be shared with the states, has been increasing overtime. To be more specific, their share in the total tax revenue of the Centre stood at as high as 23% in 2021-22 (RE), up from 6.5% in 2009-10. A nearly fourfold increase within a short span of 12 years. If this trend continues there would be very little left behind for sharing with the states by the Finance Commission for enabling them to work for the national dream.

Stick for the performers

Unfortunately the states that incur heavy expenditure for realising the national dream get penalised. Tenth FC provided for 3.9% of the central taxes for Kerala, 6.6% for Tamil Nadu and 5.3% for Karnataka. These three states, holding first, second and third position respectively in SDG index, witnessed a sharp decline in their share of central taxes to 1.9%, 4.1% and 3.7% during the 15th FC. Kerala, with its share more than halved had the hardest hit although she holds first rank in HDI and SDG index, apart from being internationally acclaimed for building a vibrant start-up ecosystem and building a knowledge economy, working in tandem with the national agenda. With the declining contribution from the Centre, the states have hardly any other option than borrowing. But the performers, very often than not, are beaten up with the FRBM stick. Any inquiry into the root of the problem will lead us to the doorsteps of the criterion used by the Finance Commission for distributing the sharable pool. Given the perspective of our Prime Minster, one could be optimistic that the 16th Finance Commission will redesign the criteria keeping in mind the national dream.

From bad to worse

The recently released data for 17 major states by CAG with respect to the fiscal performance of states during 2022-23 tends to suggest that the situation has gone from bad to worse. Invariably, those states which performed better in terms of revenue receipts are the ones with higher growth either in the grants in aid from Centre, share in union taxes or both. While the annual growth rate in the grants in aid received by Kerala was -9.1%, and that of Tamil Nadu grew only by 7.8%, Karnataka (23%), Maharashtra (32%), Chhattisgarh (29%), Uttar Pradesh (53%) and Telangana (53%) recorded significantly higher growth.

However, Tamil Nadu and Kerala survived thanks to their high growth (22.3% and 22.1% respectively) in their own tax revenue, significantly lower only to Maharashtra (25.6%) and Gujarat (28.4%). For Kerala, the share of own taxes in the total tax revenue recorded the highest increase of 2.5% to reach the highest level of 85.5% among the Indian states. With its stellar performance in mobilizing own tax revenue and prudent expenditure measures, the state displayed an excellent fiscal consolidation record. The revenue deficit declined (-74%) at a much higher rate than the all state average (-49%) and the primary deficit also declined (-96%) at a faster rate than all state average (-11%). When it comes to fiscal deficit (borrowing) the rate of decline in Kerala has been as high as -47%. Yet, the state is being penalised once again. The Centre imposed a sharp cut in her borrowing limit in the name of off-budget borrowing for infrastructure development while the Centre presumably has been following the same strategy for some of its prime projects like national highway development.

To cut the long story short, we need to reconcile the fact that the states today are different from what they were at the time of independence. Hence we need to reimagine the role of states in Indian development and redesign the centre state financial relations within the framework of a dynamic cooperative fiscal federalism. Otherwise we are unlikely to realise the much desirable dream of transforming India to a developed country by 2047.

(This is a modified version of the article published in Financial Express on 16 June 2023)

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