Federal Fracture: A nation in crisis*

C.P. Chandrasekhar

Indian federalism is on the verge of breakdown. Ministers from opposition-ruled States have taken to the streets in New Delhi to protest against discrimination by the Centre. And the Prime Minister, who leads the use of a divisive majoritarian agenda for political gains, has attacked the protestors saying they are breaking up the country by using the narrative of a North-South divide for political purposes.

The fact is that opposition parties leading state governments are under siege. Central agencies are being used to scare and incarcerate State level opposition party leaders. Central directives and schemes are being used to undermine State level initiatives and systems, in areas such as education and food distribution. And an aggressive effort to force a distorted fiscal regime on the States is undermining their ability to pursue their own development agenda.

States governed by parties that are not part of the National Democratic Alliance (NDA) coalition ruling at the Centre claim to be feeling the heat even more, because they are being discriminated against in the distribution of discretionary transfers from the Centre to the States. Not subject to the discipline that comes from being NDA members, these parties have decided to express their frustration in New Delhi, with chief ministers and/or cabinet ministers joining agitations in forms characteristically adopted by protesting farmers, trade union members and other marginalised sections.

On February 7, a slew of cabinet ministers of the Congress-led Karnataka government, fronted by its chief minister Siddaramaiah, staged a protest at New Delhi's Jantar Mantar, the location of myriad agitations staged against the central government at its doorstep. Siddaramaiah claimed that they were protesting "gross injustice" in the devolution of taxes and grants-in-aid from the Centre to the States.

A day later Pinarayi Vijayan, Communist Party of India (Marxist) leader and chief minister of the Left Democratic Front government in Kerala, and his cabinet colleagues, along with MLAs, MPs and ministers from the CPI(M) and other non-NDA parties like the Aam Aadmi Party and the Dravida Munnetra Kazhagam heading state governments in Delhi and Tamil Nadu, staged a similar protest. The Kerala chief minister, however, made it clear, that it was not only opposition-led state governments that were being squeezed, but all state governments, including those led by the BJP or its allies in the NDA.

The conflict over resources in India's quasi-federal political structure is by no means new. The potential for it was sensed even by the framers of the Constitution, who recognised that the division of taxation rights and spending responsibilities between the two principal tiers of government in India's vast democracy, was asymmetrical. While the central government was capable of mobilising a much larger share of gross tax revenues than the states, the latter had to shoulder a larger range of developmental responsibilities that in themselves would yield limited or no revenues. In 2021, for example, 37 per cent of the combined revenues of the Centre and the States was collected by the States whereas, 62.4 per cent of expenditures were incurred at the State level. It is to address this asymmetry that the Constitution provided for what were meant to be independent Finance Commissions, set up once in five years, to recommend measures to devolve resources from the Centre to the states and ensure a

fair distribution of the devolved resources between differentially developed states with different capacities to mobilise their own resources through taxation.

Following a complex history of that system of resource sharing, four kinds of flows have emerged as central today. The first is a statutorily defined share for the States in a defined set of tax revenues garnered by the Centre, with the principles governing the share devolved and distributed to individual States recommended by successive Finance Commissions. The second is a set of statutorily mandated grants, especially the revenue deficit grant to identified States to cover the gap in their revenue account post-Devolution. Grants-in-aid to the States have fallen from a total of Rs. 1,95,000 crore in 2015-16 to Rs. 1,65,000 crore in 2023-24.

Besides these statutory transfers, there are forms of discretionary spending, earlier substantially mediated by the Planning Commission, which gave the States some say in such spending. With the abolition of the Planning Commission, such transfers have been made solely at the discretion of the Centre. One such set of flows are the Centre's share of expenditure in centrally sponsored schemes implemented in individual states, with the state governments meeting a specified proportion of the projected expenditure. The other significant vertical flows is through central sector schemes that are implemented by the Centre in the jurisdiction of individual States, with all the expenditure being met by the central government.

Over time, Finance Commissions have recommended increases in the share of divisible taxes to be devolved to the State governments. The last major increase was recommended by the Fourteenth Finance Commission, which raised the Ftates' share to 42 per cent from 32 per cent. There are allegations, based on statements from the pro-government CEO of Niti Ayog who served in the Prime Minister's office during the relevant time, that at the beginning of his first term in 2014, Prime Minister Narendra Modi tried to get the Fourteenth FC to reduce the share of the States in the divisible pool of taxes. But the then head of the Commission, Y. V. Reddy, held firm. The Fifteenth FC retained the 42 per cent figure, allocating 1 per cent of that for Jammu and Kashmir and Ladakh, that had been reduced to Union Territory status following the abrogation of Article 370. While State governments welcomed the 14th FC's recommendation on revenue sharing, they have not been happy with the actual experience with devolution. This is mainly because successive central governments have tweaked the pattern of taxation, to keep a rising share of revenues out of the pool of tax revues defined as divisible. That meant that the States do not receive a share of such revenues.

Especially contentious here is the use of cesses and surcharges. Cesses and surcharges are meant to be special purpose imposts levied to generate revenues to cover specific expenditures. Surcharges are are so named because they are imposed, for example, on top of income and corporate taxes. Given these features, such levies are not included in the divisible pool, since they are targeted imposts. Both are meant to be temporary by nature but are most often not withdrawn once imposed by the Centre. They have been increasingly used, especially under the last two NDA governments, to garner tax revenues for the Centre that it need not share with the states.

The share of revenues from cesses and surcharges stood at 11.5 per cent of Gross Tax Revenues when UPA 1 was formed and remained at 11.6 per cent at the end of that term. Under UPA2, the ratio rose to 12.4 per cent and then to 13.5 per cent in the first year of the first Modi government. Then after a fall to 12.2 per cent in the next year,

the ratio has consistently risen to more than 20 per cent. The claim that cesses are meant for specific expenditures is only a fig leaf. For example, receipts from the cess on petrol and diesel was initially to accrue to the Central Road Fund (CRF) set up to finance the construction of national highways, state roads, and such infrastructure. However, in 2018, the CRF was renamed as the Central Road and Infrastructure Fund (CRIF) and brought under the Ministry of Finance, allowing these resources to be used for other infrastructure projects. This increased the flexibility with which these resources could be deployed by the Centre.

Besides this overall loss for all states put together, individual states find that their share in revenues transferred has fallen over time, and that they have been penalised for good performance. Horizontal devolution is determined by Finance Commissions using parameters such as income distance (from an average), population and demographic, nutritional, health and fiscal performance. Thus, earlier one of the parameters that was considered when determining the horizontal distribution of devolved taxes among states is population, with more populous states getting the benefit of higher transfers. Till the Fourteenth Finance Commission (14th FC), the population considered was that enumerated by the 1971 Census. That vintage figure was retained because using later figures would work against states that had a better record in terms of reduced population growth resulting from lower fertility. The 14th FC also used the 1971 population figures but gave some weight to the 2011 figures, since it felt that it would be inappropriate to altogether ignore the 2011 Census. However, when the Fifteenth Finance Commission was constituted in 2017, the terms of reference required it to use the data from Census 2011. That shift, besides other factors, are seen to have affected some states adversely. The calculations of the shares of individual States arrived at by the 15th FC saw, for example, the shares of Karnataka declining from 4.71 per cent to 3.65 per cent and that of Kerala from 2.5 per cent to 1.92 per cent.

A consequence of the loss of revenues on these counts is that states have become overly dependent on centrally sponsored schemes to undertake welfare expenditures through initiatives such as the MGNREGS, PM Awas Yojna, Jal Jeevan Mission, and National Health Mission. Though centrally sponsored and often accompanied by mandatory attribution of the scheme to the Centre or the Prime Minister, a higher proportion of the expenditure on these schemes is now required to be met by the State governments on a sharing principle. Earlier the state-central ratio in expenditure on the schemes was 40:60. That has been changed to 50:50. As a result the states must allocate more funds for activities under these schemes if they are to avail of the benefit of partial central funding. Cash-strapped States can avail of spending under these schemes, in the design of which they have no role to play, only to a limited extent.

Finally, there are transfers which occur from the centre to the state through central sector schemes funded fully and implemented according to the discretion of the Centre. Central sector schemes include PM Kisan, Crop Insurance Scheme, Regional Connectivity Scheme, and Production Linked Incentive scheme. Spending on such schemes fully controlled by the Centre has reportedly increased from Rs. 5,21,000 crore in 2015-16 to Rs. 14,68,000 crore in 2023-24. There has been a perception, backed by evidence, that the distribution of expenditure on central sector schemes across states has been linked to the degree of Centre-friendly relations of the party in power in the State governments.

To top all of this, the Centre has increasingly resorted to restricting borrowing by the states to somewhere around the equivalent of 3 per cent of State Domestic Product. This ability of the Centre to set ceilings on borrowing by State governments stems originally from a constitutional provision that prescribes that a state cannot raise a new loan without the consent of the Centre, if there is any part of a previous loan made to the State by the Centre, or in respect of which a guarantee has been given by the Centre, that is outstanding. Since debt outstanding is always the situation, this amounts to giving the Centre the right to curb borrowing by state governments.

Factors for which the states too must share some, even if not all, responsibility have also contributed to the crisis facing the states in recent years. One was the decision of the States, following pressure from the Centre exerted through the FCs and influenced by the hold of neoliberal ideology over even non-BJP parties that ruled in many of them, to enact state level Fiscal Responsibility and Budget Management Acts that set ceilings on their borrowing relative to the state's GDP. The self-imposed legislative target of eventually bringing State level borrowing to around 3 per cent of State level GDP, incorporated into all of the State-level FRBM Acts has provided the Centre a benchmark around which ceilings are imposed. Even when special circumstances force the centre to relax the ceiling, raising it to 4.5 per cent or 5 per cent of Gross SDP as it did during the Covid pandemic, enhanced borrowing has been made conditional on the implementation reform measures such as participation in the "One Nation One Ration Card" scheme, working to increase urban local body revenues, adopting certain ease-of-doing-business measures, and changing policy with respect to governance and pricing in the power sector.

The Finance Minister of Kerala, K.N. Balagopal, argues that the State has been deprived by as much as Rs. 57,400 crore in Central transfers and loan approvals in 2023-24 alone. Based on that claim, the LDF government had moved the Supreme Court last December, charging the Centre with conscious fiscal discrimination.

The other development adversely affecting the fiscal position of the states, was the implementation of the Goods and Services Tax (GST) regime in which act even state governments ruled by non-BJP parties were complicit. Under the GST regime, state governments ceded, to a substantial degree, the rights they had to impose state taxes of their own given their special circumstances. Neoliberal ideology was used to dress up the GST regime as one that would not just be 'revenue neutral', but improve the 'efficiency' of the indirect tax regime and enhance revenues at both the Central and State levels. Influenced by those arguments, State governments were willing to endorse the scheme in return for the offer that till the new regime stabilises, by June 2022, they would be compensated for any shortfall in revenues relative to a level reflecting a 14 per cent annual growth of collections from taxes that were to be subsumed under the GST. They were also willing to agree to a voting structure in the GST Council, which determines pattern and level of good and services taxation across States, that in practice gave the Centre veto power in decision making.

Using an estimate from the National Institute of Public Finance and Policy, which placed the annual average revenues realised from taxes subsumed under GST during 2012-13 to 2016-17 at Rs. 7.70 lakh crore, it is possible to compare actual receipts from GST collections during the period 2018-19 to 2022-23, with levels reflecting an annual 14 per cent. This points to a shortfall relative to 'promised' revenues of between 19 and 33 per cent, with the shortfall in 2022-23 being around 26 per cent. Not surprisingly, compensation for the shortfall financed with the compensation cess

and additional borrowing by the Centre post-Covid was crucial for the states. It follows that, the end of the practice of providing compensation after five years, even though the promised stabilisation and growth of revenues under the regime has not been realised, has led to significant fiscal stress in most States.

The GST regime has clearly failed to live up to its promise. Not only has the growth in aggregate revenues fallen short of the 14 per cent promise, but the revenue shortfall is strangely higher for the States than the Centre. The States, however, are trapped since they have ceded their right to taxation across a broad range of taxes. Not surprisingly, many of them had demanded extension of the compensation arrangement beyond June 2022. The central government refused to accede to that demand.

The final blow, as it were, has come in Kerala, where the Centre has reinterpreted Article 293 of the Constitution, to impose a ceiling on the State's Net Borrowing, or borrowing from all sources and through all state linked channels. The Centre's claim is that Article 293 covers all borrowing on the public account. That is deemed to include money collected through means such as small savings, security deposits, provident funds and treasury deposits, that are not part of the consolidated fund and are deposited in the 'public accounts' of the State. More importantly, in Kerala's case, it has been defined to include borrowing by the Kerala Infrastructure Investment Fund Board (KIIFB), a public entity established by statute. This has been done by including in State government borrowing levels the borrowing by state-owned enterprises where the principal and/or interest are serviced out of the budget, or though assignment of taxes or cess or any other State revenue. The latter is the case with KIIFB, a major channel for spending on state infrastructure, since it receives by statute a share of the revenues from the State's Motor Vehicle Tax and cess on petroleum products. In 2018, an assessment by the Centre-controlled Comptroller and Auditor General of the State's Finance Audit Report contended that KIIFB's borrowing must be included when computing the level of the State's borrowing. Based on that the Centre has frozen borrowing by Kerala. The State governmnent has challenged this contention. When applied, in combination with borrowing ceilings specified by the Centre, it limits the State government's resource mobilisation abilities to an extent where it cannot fully meet budgeted current expenditures.

The issue, however, is not one of mere competition for resources between the Centre and the states. Even with the BJP gaining control over the Lok Sabha and a number of State governments, its desire for extending control remains unsatiated. It had made this clear with its drive to establish a Congress-mukt" or Congress-free political landscape in the country. That has now been extended to one of establishing an opposition-free political space. To realise this objective, it has not only sought to undermine the legitimacy of individual opposition politicians with charges of corruption or "anti-national" activity, but of opposition-ruled State governments by eroding their ability to adopt economic policy measures and initiatives that could win them political legitimacy. Expenditures on building State infrastructure or social expenditures on subsidised food provision, a modicum of social protection, and employment guarantee schemes, do contribute to winning a party in power in a State a degree of political legitimacy. The attack on the fiscal capacity of the State governments helps limit such expenditures, even while Central claims on expanding infrastructural investments and social sector spending are advanced, with an increase in 'central' schemes, especially those attributed to the patronage of the highest authority, the Prime Minister. Even to the extent that State governments manage to

outlay resources for welfare measures, Central spokespersons have attacked these as "populist" measures reflective of a "revdi" (sweet gifts) culture that seeks to win political legitimacy at the expense of much-needed fiscal consolidation.

This political agenda, in which the Centre is at liberty to spend, and the States are fiscally shackled, has recently been weaponised. The open declaration now is that citizens of a particular State will be privileged in Central spending if they vote for and elect a BJP-led government at the State level. The right to development has been subordinated to electoral behaviour that ensures a "double-engine sarkar", or a State-level government that is politically aligned to the one at the Centre and is, therefore, favoured by the latter. Developmental spending would not be the result of a constitutionally structured transfer of resources from the Centre to the States but depend on the political character of the State government. That leaves opposition-ruled States with no option other than taking to the streets to protest discrimination.

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