A Fragile Federation under Strain*

C.P. Chandrasekhar

Among the many damages wrought by the inapposite Central government policy response to the Covid pandemic in India is that on the fragile framework of economic cooperation between the Centre and the states. It is clear that the real task of mitigating the effects of the pandemic on the health and lives of citizens has fallen on the states. That is inevitable. As India prepares to lift the lockdown to stall the economic collapse it has caused and face the inevitable spike in the number Covid-positive cases, "the key to success … would be the preparedness of local governments in suppressing and managing outbreaks at the community level", as David Nabarro, the World Health Organisation's (WHO) Special Envoy on Covid-19 said. Only state governments and decentralized governance structures can handle the task of managing the pandemic.

Yet the Centre has been presenting itself as leading the battle against the virus. Two moves have been central to that propaganda offensive. The first was the legal sanction it gave its self-assumed role of leader, by declaring the pandemic a disaster and invoking provisions of the Disaster Management Act. Armed with those powers, it promptly resorted to the issue of mandatory, but frequently revised, "guidelines", followed that by transporting Central teams to monitor the performance of ostensibly recalcitrant state governments. There was to be no doubt as to who was calling the shots. The second move was to declare, with no preparation and warning, a stringent nation-wide lockdown, covering badly affected and unaffected parts alike, which has had hugely adverse effects not merely on the economy but on the livelihoods and lives of the poorest sections, especially migrant workers.

Setting aside the debate on whether such actions were justified, the least that could be expected of an agency that wants to concentrate in its hands the emergency political powers that it claims are needed in the midst of this crisis, is that it also shoulders the collateral responsibilities. Principal among the latter is the responsibility to hugely hike expenditures from its own budget and to transfer substantial additional resources to the states faced with collapsing revenues at a time when their expenditures are rising sharply, since they are the ones called upon to address the Covid-induced crisis on the ground. Most states have made requests for large transfers from the Centre.

Expenditure at the central and state levels are needed to ensure large scale testing, tracing and isolation, to ramp up medical facilities needed by those who fall ill, to protect health workers dealing with those infected, to provide relief to those who have lost their jobs or all or part of their earnings, to support small and medium business threatened with bankruptcy, and to restore employment, stimulate demand and revive economic activity as the lockdown is relaxed. Since it is the states that have to carry much of the burden of dealing with the crisis, the Centre must give priority to mobilizing and transferring a large proportion of the additional resources needed to the states. Support was crucial because even prior to the Covid crisis, over 2019-20 as a whole, slowing growth and a failed GST regime had led to shortfalls in states' share in central taxes of more than Rs. 1.25 lakh crore and reduced states' own tax collections by 1.6 per cent relative to the previous year. This meant that many states were approaching or even exceeding their fiscal deficit target limit of 3 per cent. With revenues collapsing starting April, this tendency would intensify, unless expenditures are reduced precisely at a time when they cannot but increase. Yet, central fiscal support is near-completely absent, even to the extent where state governments are being required to pick up food from the FCI at market prices, and the Centre is not even willing to cover the rail fares of migrants departing from different states, as they return home because they have no jobs, no incomes and no places to stay.

The resources required are huge. The state that has been the most successful in addressing the pandemic, among those prone to its spread because of international travel by students, workers and tourists, is Kerala. With a well-developed public health system and experience with dealing with the Nipah virus, it was also one which could appropriately plan to contain the pandemic. That state assessed that in the first instance it would need to spend an additional Rs. 20,000 crore on containment and relief. Other states, much larger in size, had provided estimated expenditures that are much less but still would have to significantly step up their budgets as the war on the pandemic is waged.

These are huge sums that need to be spend when not only is support from the Centre missing, but when their own revenues have collapsed. Delhi obtained Rs. 320 crore as revenues in April 2020 as against Rs 3,500 crore in the same month of the previous year. The corresponding figures for Kerala are around Rs 150 crore and Rs 1,500 crore respectively. Moreover, the states are facing difficulty borrowing their way out of the crisis. To start with, there are strict limits set on their borrowing relative to their state domestic product set by the unequal financial powers given to central and state governments. But more important, when they choose to frontload borrowing permitted over 2020-21, they find that there is not much enthusiasm for state government bonds in the market, pushing interest rates for borrowing by Kerala, for example, to close to 9 per cent. With revenues collapsing, the Centre not offering the required support and interest rates soaring, the governments that must respond to the Covid-pandemic are trapped in a fiscal crisis.

There is an easy way out for the interim when the crisis is faced up to. That is for the Reserve Bank of India to print money and buy into the bonds of the State governments at relatively low rates of interest, or for the Central government to borrow from the Central bank and make transfers to the states, which is the easier and better option. Even conservative economists who normally oppose such “monetization” of government deficit-spending now agree that this is the only way to go. But, neither the central bank, nor the government that de facto controls its decision making, are willing to accept the obvious.

In sum, Covid-19 has severely intensified a disproportionality that is built into the distribution of powers and responsibilities characteristic of the Indian federal arrangement. There has always been a recognition that while the state governments were crucial players in the design and implementation of economic policy in India, there was considerable disproportionality between the capacity to mobilize resources at the central and state levels and the spending responsibilities that these tiers of government had to shoulder. The Finance Commissions were to decide on what proportion of resources raised by the Centre had to be transferred to the states to address this disproportionality. As has been repeatedly pointed out, in the process of centralization of power within India’s quasi-federal framework, two among many tendencies have been operative. First, an effort by the Centre to increasingly mobilize resources through means of imposts that do not require the resulting revenues to be included in the pool of revenues that must be shared with the states. Second, efforts, in violation of what the Constitution originally envisaged, to frame the terms of reference of the Finance Commissions in ways that make them agencies that can impose fiscal austerity, defined as 'discipline', by limiting states' right to borrow and linking transfers to them to performance with respect to fiscal austerity targets.

That the Centre is failing to fulfill its own direct responsibilities is clear from the fact that the only Covid-package it has announced is part a revamp of already existent schemes, and part a small increase in new expenditures. The combined total of these two sets of expenditures is short of one percentage point of GDP, which is anywhere between one-fifth and one-tenth of what estimates suggest is actually needed. More than a month and a half after that package was announced, a promised second or third package was yet to be revealed, let alone implemented. The Centre has clearly shirked on its direct fiscal responsibility.

Besides shirking when it comes to its own responsibilities, the Centre is in the middle of the crisis holding back on resources that are rightfully due to the states and those that the states need to be provided with given their dominant role in addressing the adverse impact of the pandemic on health and the economy, and therefore on livelihoods and lives. The Centre has been delaying transferring the statutory share of the taxes collected by the Centre to the states. It has not been paying the states the compensation due to them as per agreement because of shortfalls in GST revenues that accrue to them relative to what was projected for the first five years of the GST regime. The Centre's justification for reneging on the compensation, that the resources available in the compensation cess fund are not adequate to compensate the states is without basis, given the understanding that in the event of any such shortfall the Centre would borrow money, compensate the states and extend the duration over which the cess is levied in order to garner the funds to pay back the debt incurred.

And, to rub salt on their wounds, when, after much delay, the Centre released a second instalment of Rs. 6,195 crore due to the states as part of the Rs. 74,340 crore fiscal deficit grant awarded to them by the 15th Finance Commission in its interim report for 2020-21, the Finance ministry statement said: "This would provide them additional resources during the Corona crisis." The fiscal deficit grant had nothing to do with the Covid-crisis and was legitimately due to the states. Most recently, the Centre has made clear that it would not cover the states' share of the expenditure in Centrally sponsored flagship schemes, which would bring many of these to a halt. In fact, the Finance Ministry has directed the concerned central ministries to check whether the states were in a position to cover their share of outlays in order to utiilize funds released by the Centre for these schemes. It is only if they are convinced that they have been utilized should additional funds be allocated.

As a consequence of all this, as of now, as the case load is set to spike in India, the state governments are collapsing into a fiscal and developmental crisis, and grasping at straws like state levies on petroleum products and alcohol, that are still outside the GST regime. But that is small recompense for the revenue losses they are running up, undermining their ability to continue the war against the virus.

The fall out of this Centre-made crisis in the middle of a larger and near-unprecedented health-cum-economic emergency is likely to be three-fold. The first is pressure on at least some state governments to contemplate exit from the GST regime that has deprived them not just of revenues but of even minimal fiscal flexibility in the middle of a great crisis. The second is the strengthening of incipient tendencies for states to work around or even break from the social compact established by the Constitution that includes the increasingly fragile power and revenue sharing relationship which no more works. And the third, is a huge setback to the small “gain” India has recorded in postponing the main force of the Covid crisis, which was meant to give the country the time to build the wherewithal to test, trace, isolate and treat adequately to slow the pace of infection, while the world awaits the coming of a vaccine.

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