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TRUE COOPERATIVE FEDERALISM

BUDGET FY22 IS EXPECTED TO CALL FOR HIGHER BORROWING THAN ALLOWED UNDER THE FRBM LAW. THE CENTRE MUST ALLOW STATES A SIMILAR RELAXATION IN VIEW OF THE PANDEMIC

What states want from the Union Budget

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Views are personal

THE STATES HAVE A much bigger stake in the Union budget than is commonly acknowledged, not just because the budget determines the quantum of central transfers to states, but importantly because the Centre's fiscal stance has implications for the states' revenues and expenditures, and hence for their overall development outcomes. The sates are more anxious than usual about the forthcoming Union Budget as their fiscal positions are strained, possibly more so than that of the Centre, even as they have to be on the frontlines of combating the raging Covid-19 pandemic.

Tax devolutions from the Centre are an important source of revenue for states as they constitute more than a quarter of their total revenues. The forthcoming central budget will be accompanied by the government's decision on the award of the Fifteenth Finance Commission, which has already submitted its report to the President. The most important recommendation of the Finance Commission pertains to the ratio for sharing the divisible pool of taxes between the Centre and the states. As of now, states get 41% of the divisible pool of taxes as per the award of the Commission for 2020-21. Even if the Finance Commission has retained that proportion, as is widely expected, states are apprehensive that the base of the divisible pool itself might actually shrink if there is a separate 'carve-out for defence expenditure' as asked for by the Centre in setting the terms of reference for the Finance Commission. Should that materialise, states will feel aggrieved as central support by way of tax devolution will shrink at a time when they are already quite fiscally stretched.

The Centre's broader fiscal stance will also determine how much states can borrow from the market and at what rate of interest. Both the Centre and states have borrowed much more this year than originally budgeted to make up for the shortfall in revenues and to meet additional expenditure in the wake of the pandemic. Keeping in view the pace of recovery and the continuing need for additional expenditure to support lives and livelihoods, the finance minister is expected to budget for higher borrowing than the limit mandated under the Fiscal Responsibility and Budget Management (FRBM) Act. The Centre must allow a similar higher borrowing limit to states to help them meet the unusually heavy expenditure to manage the pandemic.

The Centre has expanded cesses and surcharges—up from 2% of its gross revenues in 1980-81 to over 16% now—even after GST, with many being for purposes under the State List. It needs to commit to cap cesses at 5% of its gross revenues

Apart from the quantum of borrowing, states are also concerned about the higher interest cost. Although the combined market borrowing of the Centre and states was unusually large this year, the market accommodated it without any hiccups as private sector demand for credit was subdued. If private sector demand for credit picks up next year as indeed we want it to, yields on state bonds will spike placing an additional long term burden on state finances.

In order to allay market concerns about fiscal sustainability, the finance minister will likely indicate a glide path for reverting to the FRBM trajectory over the medium term. In determining the trajectory of the glide path, it is hoped that she will keep in view the fiscal position of the states as well as their expenditure commitments over the medium term.

Cesses and surcharges levied by the Centre do not go into the shareable pool of taxes; the Centre appropriates the entire proceeds. This creates a perverse incentive for it to levy cesses and surcharges rather than raise tax rates. In fact, till late-1980s, the Centre resorted to cesses and surcharges sparingly, and for the express purpose of developing identified commodities like tea, coffee, jute, mica, and *bidis*. Since then, they have proliferated with the result that their share in the gross revenue of the Centre shot up from 2.3% in 1980-81 to over 16% now.

The grievance of the states on this count has been aggravated by the fact that the Centre has continued with the expansion of cesses and surcharges even after the introduction of the GST which was expected to replace a plethora of taxes and levies. What is worse, many of the fresh levies by the Centre are for purposes which are in the State List under the Constitution. There is an urgent need for the Centre to wave an olive branch in this regard. One possible option will be for the finance minister to make a commitment in the budget to gradually roll back cesses and levies over a timeframe and bring them down to maybe no higher than 5% of the Centre's gross tax revenue.

States have for long been agitated about the proliferation of centrally-sponsored schemes (CSS). Numerous committees have recommended restricting the CSS to a few areas of national priority and providing the states with the option of choosing from among them. But all that has happened so far is grouping of the schemes under 28 umbrella heads. This budget should initiate the process of substantive restructuring of CSS and offering states a bouquet of optional schemes.

Back in 2017, while launching the GST, then Union finance minister, the Arun Jaitley, hailed it as a historic step and a shining example of cooperative fiscal federalism. Disappointingly, in the three years since, that sunny optimism has given way to an unsavoury trust deficit as illustrated by the tension that built up a few months ago over the issue of Centre's compensation to states for the GST shortfall. It is misleading to look at the Union budget in a silo without recognising that over 60% of the combined expenditure of the Centre and states flows through the latter. The quantum and quality of states' expenditure has larger implications for the overall growth of the economy than we tend to acknowledge. The Union budget should start looking at states as partners in development. The first step in that direction is to bridge the accumulated trust deficit, a task to which the finance minister should commit herself in the forthcoming Union budget.