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Misconceptions in Indian fiscal federalism

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Abstract

We examine common views regarding weakening of rights of states and finds them to be misconceptions. Indian states get more resources and freedoms than in most federal countries. Some fiscal restraints on states borrowing are necessary to preserve overall macroeconomic stability and are found in all federal structures. Although lower per capita income states are awarded more of Finance Commission rule based transfers, more efficient states get more of conditional grants, as better facilities allow better utilization. Since they go more to better performing states conditionalities induce better performance, helping states escape low level traps and distorting choices such as in the electricity sector or in water supply. They have improved the quality of state spending. They should therefore be used more, along with raising voter awareness and convergence to best practices, for states to deliver on their responsibilities.

Keywords: Fiscal federalism, states, rights, responsibilities, India, conditionalities, Finance Commission

JEL Code: H77; H44; H30; H20

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1. Introduction

India has a federal structure. It is one country of many diverse states; not a union of many countries. Notable among the institutions that keep it together, are the finance commissions (FCs), independent constitutional bodies, appointed every 5 years, with the mandate to achieve uniform public services through appropriate Centre-State transfers.

Emotive issues come up often regarding rights of states. We discuss three. The first is that states should have more freedom to tax and borrow; the second that states get less than their fair share of central taxes; the third that richer states loose out since transfers are towards poorer states. Careful benchmarking with other countries and examination of data, however, suggests these issues are misconceptions.

Next we turn to the responsibilities of states, examining the consequences of their choices as shown in the data. There are wide variations across states but the states with debt exceeding the 30% ratio mandated in the fiscal responsibility and budget management (FRBM) Act also tend to be the ones with high revenue deficits and low capital expenditure. This is not fair to other states, since they either seek a higher share from the central pool, or raise inflationary pressures and country risk if deficits rise. It is not fair to themselves either, since lower growth and a higher share of interest payments reduces own revenue space and eventually the ability to spend. Indian general government debt and deficits including states are higher than in most peer countries. Uniform discipline is important because if some states get away with less other states also want to follow.

Conditionalities deliver more to better performing states and to the extent they induce better performance, they help states escape low level traps and distorting choices such as in the electricity sector or in water supply. So these should be priorities for the 16th FC. Citizens should see through divisive agendas and ask for delivery of services that would help more to participate in and create opportunity. Voter pressure could change the priorities of state governments, setting in new norms of performance that are required as much as are better incentives. For India to develop, states have to fully take part. As India grows, so does the stakes in and the rewards from cooperative fiscal federalism.

The remainder of the paper is structured as follows. Section 2 lays out the facts on and rationale for the rights of and restrictions on states. Section 3 brings out the consequences of state policy choices while Section 4 examines ways to induce better outcomes before Section 5 concludes.

2. Rights of states: perceptions versus facts

FCs transfers aim to attain vertical equity between the Centre and states and horizontal equity across states. But in the early period after independence securing finances for plans took priority. The Planning Commission acquired a role in the transfer of resources.

Acemoglu and Robinson (2012) argue only countries with broadly inclusive political and economic institutions succeed in the long run since inclusive institutions generate the creative destruction and innovation that sustains wealth even while they temper extractive state power. India started out with highly inclusive political institutions since it adopted democracy with universal suffrage at independence. Few democracies had that advantage. In the West voting rights were initially restricted to white males. Inclusive politics should have led to inclusive economic policies with good public services like health and education that are essential to enhance human capital equitably. But a heterogeneous electorate allowed politicians to cultivate vote-banks and populist schemes instead of delivering better public services and governance.

The neglect of public goods such as health, education and environment hurt the poor more, since the rich can pay for private substitutes. Many such services need to be delivered at the 3rd Tier, so a major bottleneck was patchy decentralization. Since heterogeneous levels of development persist across states and the constitution gives overlapping responsibilities to the Centre in health and education, central sponsored schemes (CSS) can boost delivery. For example, central grants are substituting for lack of state devolution to the 3rd Tier.

While tax devolution is a right, conditionalities can be imposed on grants. States prefer a free hand, where they can do what they want with the money. Moreover, there can be inefficiencies or lack of fit in centrally designed schemes. But citizens also have the right to uniform public services. If such delivery remains inadequate after all these years, we need to think of alternative ways to fulfil the objective. Today when India seems to finally be on the path of development, building human capital is critical. This may also justify creating incentives for states to deliver. We examine if incentives would dilute the rights of states.

The first issue taken up is, does the Centre have too much of tax and borrowing rights in the Indian federal structure? This is a complaint often heard from states.

2.1 Tax and borrowing rights

Outcomes, however, suggest that restraints on states fiscal freedoms are among least severe in the Indian federal structure. In 2022 Indian subnational debt at 28% of GDP was the fourth highest in the

world. The OECD average is 20%. The yield spread of SDLs (state development loans) is the least in India. All SDLs have the same rate near G-secs. This helps states to borrow. Since an RBI automatic debit mechanism makes states borrowing risk free, more indebted states can borrow at the same rate as others. In 2022 Mexican yield spread for sub-national borrowing was 4.5% and in S. Africa it was 1.5%.

Theoretical principles of federalism (for example the Tiebout principle of subsidiarity) support giving more elastic taxes, such as on incomes, to the Centre. Otherwise migration away from states with higher taxes and competitive cuts in tax rates could decrease tax collection. The FC is there to compensate by transferring resources to the states.

In addition, macroeconomic instability results with no limits on state borrowing. For example, Brazil and Argentina had hyperinflation and default on foreign debt in periods of unconditional central bailouts when sub national debt was routinely added on to national debt and serviced by printing money. The US changed after a similar experience. States overspent after the Centre bailed them out from their war of independence debt. As regions competed to spend and borrow more, deficits rose sharply. Market discipline was imposed and helped to improve finances since their risk premium rose in high debt periods.

So the constitutional right given to the Centre to impose borrowing limits on states with high debt is required[1]. Yet half a dozen states habitually exceed FRBM Act debt limits of 30%.

Moreover, research found states own tax effort was less than potential, even after controlling for all the variables that affected their tax potential such as population density, industrialization, infrastructure and so on. The gap rose with unconditional transfers and reduced with conditionalities such as imposed by the FRBM Act (Garg et. al. 2017). Post-pandemic state GST (SGST) has proved to be elastic. Revenue increased from Rs 2.6 trn in FY18 to Rs 8.4trn in FY24BE with double digit growth in the last year (RBI, 2023). A large rise in revenues is possible with data-based collection at the point of sale. The effort is still uneven across states, however. SGST revenue growth was 30% in Delhi and only 5% in Kerala. While tax rates are collectively set in the GST Council, implementation and collection is a function of state effort.

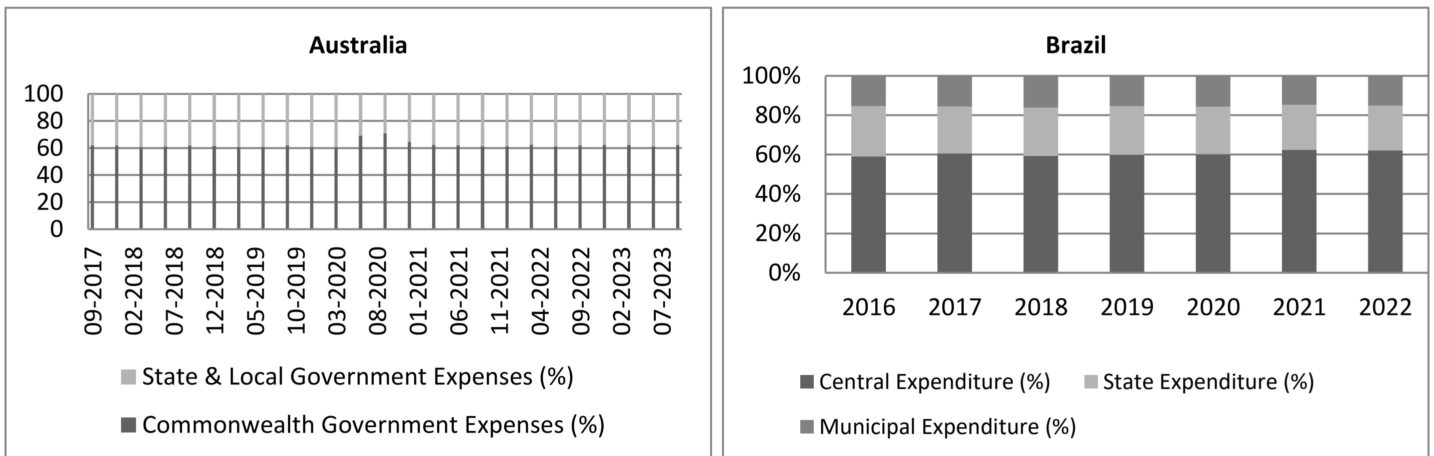
2.2 Transfer of resources from the Centre

[1] Kerala went to the Supreme Court arguing that Article 293 allows the centre to impose restrictions only on borrowing from the centre, not on market or PSU borrowing. The Centre's response was then restrictions would be easily side-stepped, endangering macro stability. Moreover, the Article would be redundant without the broader interpretation since as a lender the Centre can always impose restrictions on its own lending. While Kerala was not given the requested rise in borrowing limits, questions on interpretation were referred to a constitutional bench.

Again, the facts show Indian states spending share is higher than in most other federal structures. Over 2015-20, states average share of general government expenditure was 63.9% while in other large federal countries such as Brazil (40.2), Indonesia (37.9%), US and Australia it was about 40%, with the Centre spending about 60% (RBI, 2023). Figure 1 shows this share over time for 3 countries.

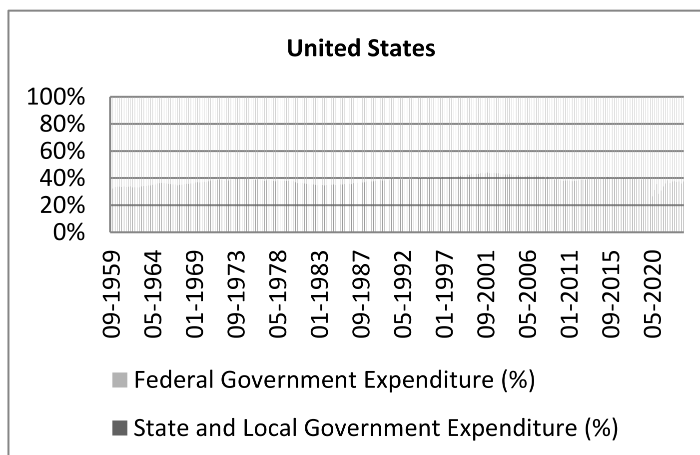
The share of states own taxes, however, was only 36.7%. It was large transfer of resources from the Centre that enabled them to spend more than they taxed. Shareable taxes and states tax share rose steadily. When only central income and excise taxes were shared, states share in each rose from 55% and 40% respectively to 77.5% and 47.5% from the 1st to the 10th FC. After the 80th constitutional amendment in 2000 (to Article 270) made all central taxes except cesses and surcharges (exempt under Articles 268 and 269) shareable, the 11th FC set a share of 29.5%. This had risen to 41% by the 15th FC due to a 10% jump awarded by the 14th FC.

Figure 1: Distribution of expenditure between the Centre and states



Source: Australian Bureau of Statistics

Source: National Treasury Secretariat



Source: Bureau of Economic Analysis

The actual devolution of central taxes, however, stayed at about 32% in the early 2020s. But there were additional transfers, almost equal in magnitude. For example, in 2022-23, tax devolution was at 3.5% GDP but central grants almost matched this at 3.2%. Of this, FC grants were 0.8% and CSS accounted for 1.8%. While the average share of central taxes is about 26% of states revenue receipts that of grants is about 21%. The share of FC grants in central grants is about 25%. So the actual transfer of resources from the Centre to the states is higher than that recommended by any FC.

States, however, believe their tax share should rise. They have a higher expenditure responsibility and have less elastic taxes, so they must be helped to achieve desired expenditure levels. FC tax devolution is formula based, non-discretionary and predictable, giving them the freedom to decide on spending. They may have a better sense of what is required to be spent. Spending should be closer to the recipient. CSS are uniform across states and designed by the Centre. Conditionalities in CSS can add to delays.

Even the 14th FC, which increased the tax share by 10%, did not expect the already high aggregate share to rise. It wanted a fall in CSS and rise in untied, predictable tax devolution. CSS were being rationalized at this time.

CSS were restructured, but then rose again. This proved necessary since delivery of public goods, such as health, education and environment that are in the concurrent list of the constitution, remain neglected. Reasons for this include most states preference for transfers to interest groups and for subsidies over investment, caps on user charges that reduce the quality of public services and cause distortion in resource allocation as in the electricity sector. This hurts the poor more, since the rich can find private substitutes.

While many taxes are best collected at the Centre, the principle of subsidiarity also says expenditure is best made close to the point of delivery where accountability to the user of public services can be higher. For public goods this is often at the 3rd tier, but decentralization of funds and functionaries to the 3rd tier mandated by the 1990s 73rd and 74th Amendment remains patchy across states. The equity and quality in public services provision, promised to every citizen, remains inadequate.

Many of the CSS schemes seek to improve local public services and incentivize states to do more. Electronic direct benefit transfers (DBT) now enable central funds to be directly credited to citizens in many states. But benefit taxation is also required to provide public goods. User charges are a major area where states still have to make efforts. Larger expenditure responsibilities tend to be followed by higher tax effort. Ring fencing productive expenditure, therefore, could also raise revenue effort.

Tax devolution is a right, although the formula changes slightly with successive FCs after extensive consultations. Conditionalities can be imposed only on grants and these remain important for public service delivery. CSS schemes and other grants to local bodies, 60% of which are for water and sanitation, are substituting for lack of devolution to 3rd Tier. States may prefer a free hand but their citizens have a right to uniform public services. Building human capacity is very important in India's current growth juncture and this requires improvement in public services. The 15th FC award, for example, steadily reduces the share of revenue deficit grants and increases the share of grants to local bodies (total share 43.6%) partly to compensate for the absence of delegation by states.

Since conditionality is only feasible through grants they have to continue to form a large share in the devolution of resources from the Centre to the states.

The Centre increased the share of cesses in its tax revenue from 6.4% in 2014-15 to 17.7 in 2020-21. This is also regarded as unfair. But these partly finance grants. In 2022-23, 21% of state revenue receipts were from grants and 26% from tax sharing. Some of the rise in central cesses took advantage of the fall in international oil prices in 2014. States raised their own oil taxes.

Imposition of central schemes is disliked. But states can often make their own add-ons, customize and own them. In Odisha, where local political cadres are more active, the schemes are known as state schemes. Bihar has customized CSS schemes to achieve the largest fall in multi-dimensional poverty. The central Ayushman Bharat (AB) has been renamed Mukhyamantri Jan Arogya Yojana. There are active enrolment drives.

There is a lot states can do to raise own revenue also. It was feared that states would suffer if GST compensation ceased to be paid. States were agitating for this to continue. They received 14% tax revenue rise annually for the negotiated 5 year period from to July 2017 to July 2022, even though actual nominal GDP and tax revenue growth was negative during the first pandemic year and low in 2019. But robust recovery, sharp rise in SGST and states share of CGST meant tax revenue rose at 22.5 and 25.7% in 2021-22 and 2022-23, knocking out the rationale for continued compensation. Seven out of 31 states, whose rate of growth is lower, need to reduce leakages in collection of GST (RBI, 2022).

2.3 North-South: Direction of transfers

It is often alleged that South and West states have to subsidize the poorer North and East. But net resource flows have differed in the past and will change again in the future. States gain much more than just resources participating in a vibrant growing common market. For example, Britain has suffered as a consequence of Brexit. There is also protection in a fragile nuclear neighbourhood.

Figure 2a: Share of total taxes

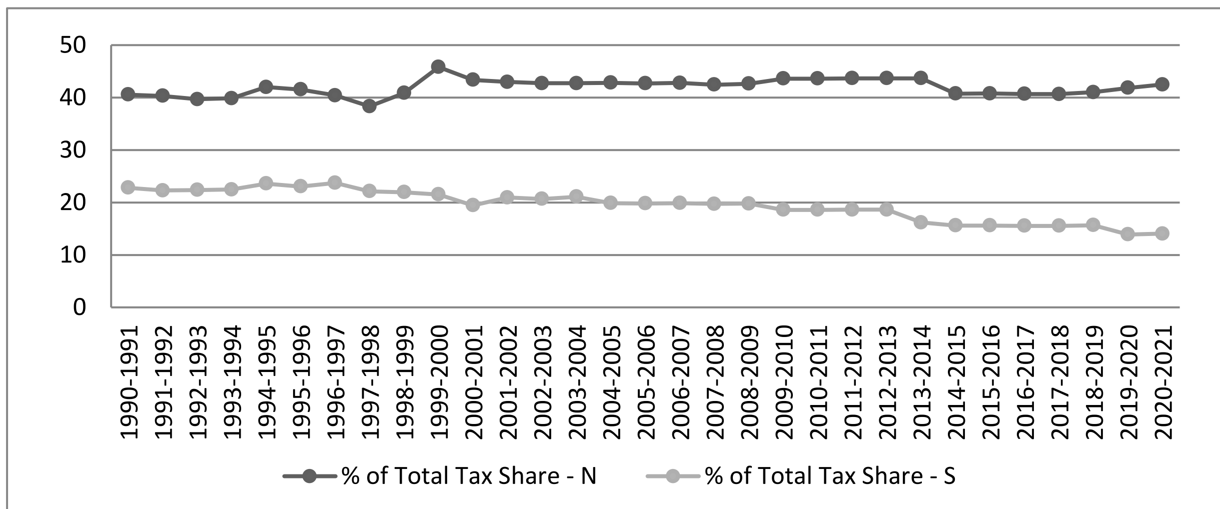


Figure 2b: Share of grants from the Centre

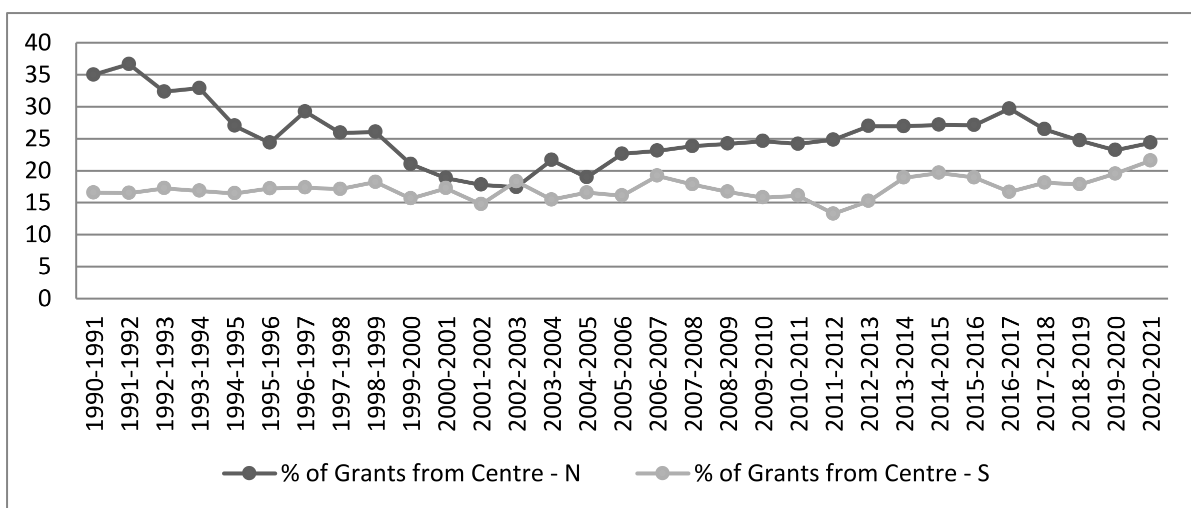
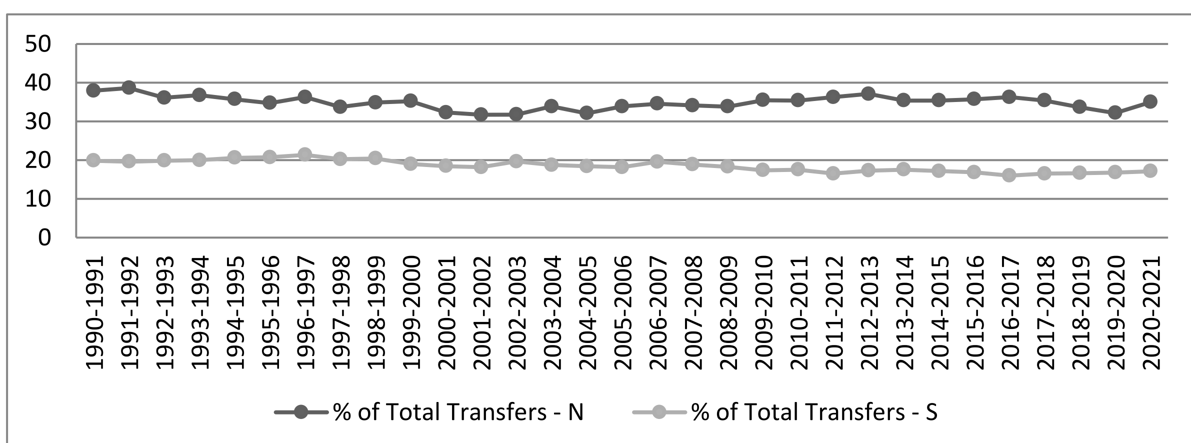


Figure 2c: Share of total transfers



Source: Reserve Bank of India

Moreover, facts again belie common perceptions. Data from 4 populous northern states: Bihar, MP, Rajasthan, UP and 4 southern states, where in 2024 an opposition government was in charge: Andhra Pradesh, Karnataka, Kerala, Tamil Nadu, shows since 2000, while the formula-based share of

taxes fell for the southern states (Figure 2a), the share of discretionary grants from the Centre rose for them and fell for the northern states (Figure 2b). As a result, the share of total transfers to the southern states was constant (Figure 2c).

Since northern states are more populous and southern states are more prosperous, on equity grounds, which dominate FC transfers, the North should get more. Yet, although their share in total transfers was constant (Figure 2c), since 2013 grants per capita are higher for the south (Figure 3a) and therefore total transfers per capita are also higher for the South (Figure 3b). This is the effect of rising conditional transfers. More efficient states get more of these. For example, the four southern states have more than 50% of Ayushman Bharat (AB) patients (Kaunain, 2024). Their better medical facilities increase the use of the AB scheme (Hooda, 2024). So southern states, especially, should not be complaining about conditionality since that delivers them more resources. It is inconsistent to complain about conditionality as well as a relatively lower resource share.

Figure 3a: Grants per capita: North v South

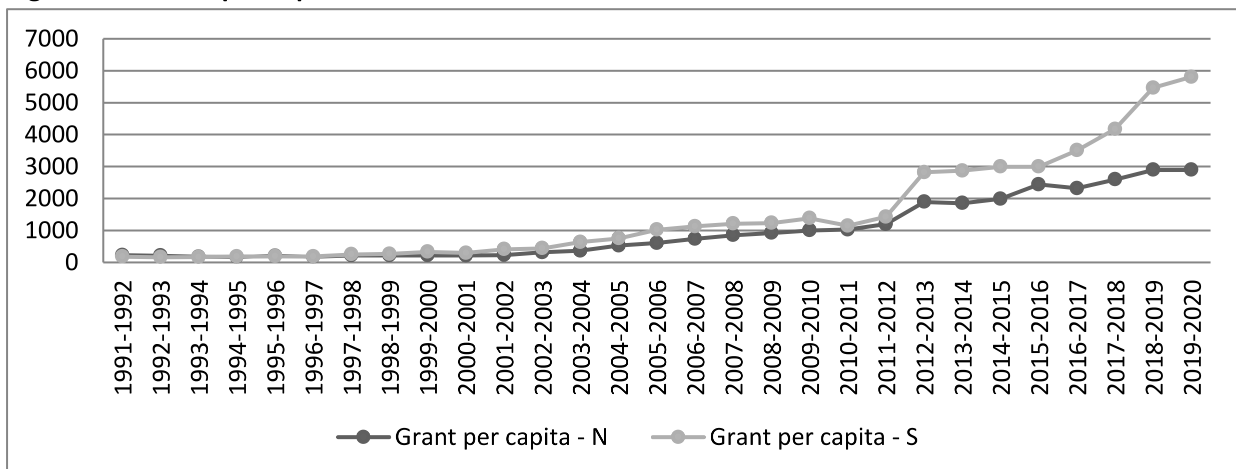
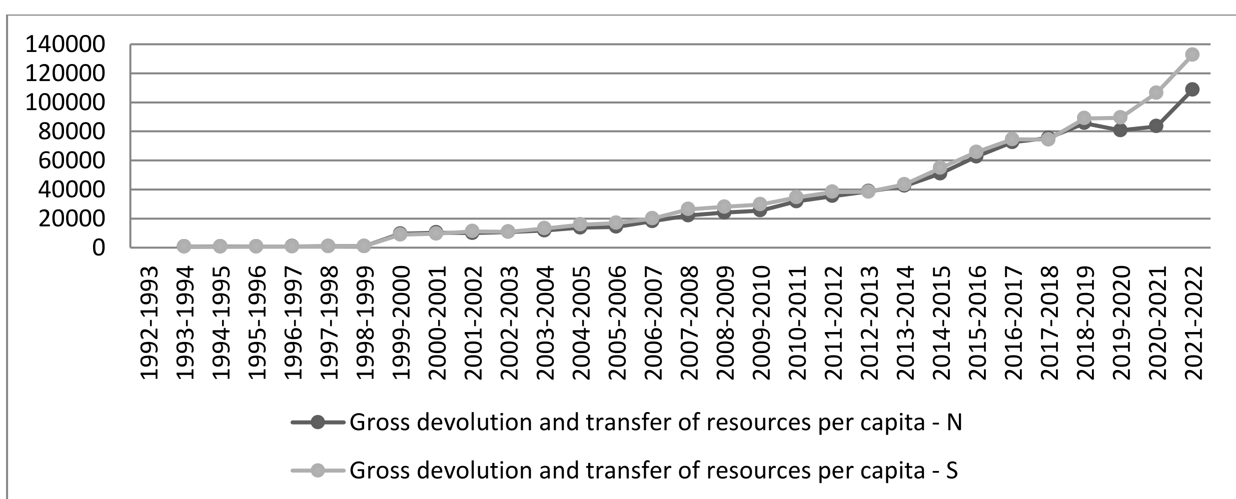


Figure 3b: Total transfers per capita: North v South



Source: CEIC Database (Taken from RBI)

The general point is that devolution and transfers are made on complex criteria to meet differing objectives. Even if a state gets less on one criterion it will probably gain on some other. Moreover, the situation is not static and changes over time. It is, therefore, not correct to come to a conclusion based on any one criterion and covering a short period of time.

Next, we turn from examining rights to responsibilities of states and outcomes.

3. What the data tell us about choices and consequences

States with debt exceeding the FRBM mandated 30% in 2024 were Andhra Pradesh, Bihar, Himachal Pradesh, Kerala, Punjab, Rajasthan, Tamil Nadu and West Bengal (Table 1). Those with high debt since the 2010s are Andhra Pradesh, Himachal Pradesh, Punjab and West Bengal.

Table 1: Outstanding liabilities of select states (as a % of GSDP)

	2014	2021	2024
Andhra Pradesh	42.3	36.9	33.5
Assam	17.4	25.4	26.6
Bihar	27.9	40.1	37
Chhattisgarh	12.6	28.8	24
Gujarat	23.3	22.5	18.2
Haryana	19.9	33.2	29.9
Himachal Pradesh	35.7	44.4	44.2
Kerala	27	40.3	36.9
Madhya Pradesh	21.9	30.2	28.7
Maharashtra	18.8	20.9	18.6
Odisha	17	26.1	13.9
Punjab	30.8	47.9	47.6
Rajasthan	23.3	40.3	35.7
Tamil Nadu	18.5	31.8	31
Telangana	….	28.8	27.8
Uttar Pradesh	28.3	36.5	28.6
West Bengal	36.7	43	38.3
NCT Delhi	7.3	1.2	1.7

Source: Extracted from RBI (2023)

States with high debt also tend to be the ones with high revenue deficits and low capital expenditure, partly because the share of interest payments in receipts rises. In FY24BE this was highest for Punjab at 22.3 while for Odisha, with the best fiscal parameters, it was only 3.9.

Expenditure on development and social sector generally exceeds capital outlay (Table 2), but high debt and low capital outlay (CO) are correlated since capital outlay is the least committed and therefore easiest to cut. The states with low CO percentages to GSDP (less than 1.5%) in 2021-22 include the indebted states of AP, Kerala, Punjab, Rajasthan, Tamil Nadu and West Bengal.

One feature in state data is that RE tends to be less than BE with the largest shortfall in CO. Therefore, while the BE given in the last column of Table 2 tends to be higher, it may not be realized.

Table 2: Types of expenditures of select states (per cent)

	2021-22			2023-24(BE)		
	Dev/GSDP	SSE/GSDP	CO/GSDP	Dev/GSDP	SSE/GSDP	CO/GSDP
Andhra Pradesh	10.5	7.7	1.4	13.3	10.1	2.1
Assam	15.8	9.9	4.9	15.2	10.8	4.2
Bihar	20.3	15.5	3.6	19	14.6	3.4
Chhattisgarh	15.5	9.9	2.6	18.3	12.2	3.7
Gujarat	6.8	4.3	1.5	7.5	4.3	2.7
Haryana	8.3	5.6	1.3	8.9	5.9	1.6
Himachal Pradesh	16.1	9.9	3.4	14	9.4	2.4
Kerala	8.9	6.5	1.5	7.3	5.5	1.3
Madhya Pradesh	14.7	9.2	3.6	13.9	9.3	3.7
Maharashtra	8	5.3	1.5	8.9	6.2	1.9
Odisha	14.6	10	3.4	18.4	11.2	5.9
Punjab	8.9	4.9	1.3	10	5.6	1.4
Rajasthan	13.8	9.3	2	13.9	9.5	2.4
Tamil Nadu	9.1	5.6	1.8	8.2	5.2	1.6
Telangana	11.4	6.3	2.6	16.1	9.1	2.7
Uttar Pradesh	13.1	8.6	3.6	16	10.2	5.5
West Bengal	11	9.2	1.3	11.1	9	2
NCT Delhi	5	3.6	0.9	5	3.7	1

Note: GSDP: Gross State Domestic Product, DE: Development Expenditure, SSE: Social Sector Expenditure, CO: Capital Outlay.
Source: Extracted from RBI (2023)

Poor fiscal management is not fair either to own citizens or to other states. It can lead to low growth traps requiring persistent transfers at the expense of other states, or raise national deficits, inflation and risk premiums.

The automatic gap-filling approach that used to be followed under the perspective that it is the duty of the Centre to ensure requirements of citizens are met created poor incentives for states. Some states habitually spent wastefully and taxed less than potential. They did not want to annoy their voters by taxing them. After mismanaging their finances they would seek to draw more from the central pool. Energy would be spent in fighting the Centre for more and justifying demands, rather than in managing better. Deficits, especially if they were central, were regarded as a valid means of spending.

3.1 The Odisha turnaround

The Odisha story illustrates the importance of a long-term political vision and the change that is possible. It used to be among the poorest states. The government could barely manage to pay its wages and salaries bill in the 1980s and 1990s and had nothing left after that. The turnaround began with a new forward-looking government in 2000 that took a long-term view[2] and today it comes at the top of most state rankings of fiscal parameters.

Improved tax efficiency raised tax collection by 1%. There was better expenditure management. For example, there were non-negotiable golden rules such as to use debt resources only for capital, not for revenue expenditure. For example, no subsidy was provided to the power sector to support revenue, only for capital expenditure. The latter began to rise after 2012. Better composition of expenditure, budget processes and treasury modernization resulted in a revenue surplus and fiscal deficit within the mandated FRBM limits. Odisha's contingent liabilities are few and its public debt is low and falling.

This led to its economy growing faster than the national average. Its per capita income (at $2000) has risen almost to the national average from only 60% of it in 2003. Social indicators, access to sanitation, drinking water and electricity have all improved. Critics argue that a poor state like Odisha should have borrowed and spent more instead of sticking to the FRBM. But better fiscal parameters allowed it to spend more and raise growth compared to the period before the 2000s.

Even so, Odisha has a large tribal population; urbanization and enrolment in higher education remain relatively low. The next step requires investment in education to further develop human capital and encourage innovation. The number of institutions and universities has to rise. There is

[2] Apart from the data and literature I thank without implicating Jugal Mohapatra, long-term finance secretary of the state, for insights on Odisha's experience. He can be heard at the end of this you tube video https://www.youtube.com/watch?v=1Q28FNG-tow&ab_channel=OdishaEconomicAssociation

much room for improving governance and independence of state universities[3]. Spending has to be smart and well-targeted.

But most states governments have a short-term view, focused on pampering voters to win the next election. How can outcomes be improved more generally?

4. Inducing better outcomes

Many states tend to reduce investment in order to fund populist freebies while staying within their budget constraints, thus reducing productivity and growth. Punjab is an example that has fallen from the top to the bottom rank in states due to excessive use of such policies. Multiple schemes create duplication and waste but are rarely shut, even when a new government comes in, since each gives rise to some interest groups that want continuity.

Freebies can be defined as recurring hand-outs that do not build capacity and/or create distortions thus sustaining dependence and poverty. Continuous payments required are largely financed by cutting investment, the quality of public services, or shifting problems to future governments. The poor suffer the most since they depend on public services, while the rich develop alternatives. Continuing poverty maintains vote banks. One reason reviving the old pension scheme is a popular election sop is because it will have a large impact on government expenditure but only after 2050, shifting the burden to future governments and tax-payers. How did such policies get entrenched?

4.1 Past choices

India at independence had full political inclusion but this did not lead to the full economic inclusion seen in mature democracies where good health and education facilities, physical and social infrastructure developed on voter demand. One reason was poverty, caste, religious and regional heterogeneity allowed use of identity politics instead to cultivate vote banks.

Excessive centralization under the British was initially strengthened due to concerns for national integration. The constitution mandated an inter-state council but a strong central government in the early years and the emphasis on planning denied it the weight it required. Plan schemes took attention away from general public services for the average citizen, on which the first Finance Commission had focused. In particular, the many services under state jurisdiction were neglected.

[3] The UGC took Utkal University to the Courts after the State decided it had the right to appoint faculty. As a result new recruitments were frozen.

Intense multi party competition coincided with the large international oil price shocks of the seventies and intensified competitive populism to attract voters. Prices for many public services were kept constant. Low or no user charges resulted in cross subsidies, distortions, deterioration in quality of public services. Or indirect charges, not obvious to voters, such as higher prices of intermediate goods, made India a high cost economy. The rich turned to private providers creating further revenue losses. Interfering in prices is one of the worst forms of freebies as it distorts resource allocation and ends up hurting the very people it says it is helping.

Table 3 shows subsidies on products that are captured in the state domestic product data. The last column shows subsidies reported by the state to RBI. Again states with high subsidy ratios tend to be the more indebted ones with low investment, since their choices hurt revenues and growth. Absolute product subsidies also depend on population size and so were highest for UP and MP. Since these often imply distorting prices and therefore resource allocation, states with high product subsidy ratios tend to have lower shares of GDP coming from transport, storage and communication services pointing to poorer infrastructure as a consequence of prioritizing subsidies.

Table 3: Subsidies and their impact

	Transport storage, communication, services, ratio to NSDP, average 2010-22	Subsidy on products (2021-22); ratio to NSDP	Subsidy on products as a ratio of MP subsidy 21-22	Subsidy reported to RBI/NSDP
Andhra Pradesh	7.93	1.95	0.35	2.39
Assam	4.76	2.25	0.15	0.87
Bihar	5.7	2.22	0.14	2.88
Chhattisgarh	3.63	……..	…….	9.52
Gujarat	4.24	2.05	0.73	1.86
Haryana	4.77	1.16	0.17	1.89
Himachal Pradesh	3.26	2.36	0.07	1.12
Kerala	6.77	1.4	0.21	0.74
Madhya Pradesh	4.75	6.5	1.00	6.59
Maharashtra	4.93	1.8	0.92	0.00
Odisha	4.88	2.93	0.32	1.17
Punjab	4.46	3.39	0.37	3.86
Rajasthan	4.65	3.77	0.71	3.64
Tamil Nadu	5.26	1.75	0.61	9.80
Telangana	5.51	2.08	0.36	2.20
Uttar Pradesh	6.97	3.9	1.14	1.98
West Bengal	5.16	3.91	0.79	2.42
Delhi	11.08	1.22	0.19	0.89

Note: NSDP: Net State Domestic Product
Source: States NSDP data and RBI (2023)

When per capita incomes are low and the tax base narrow price and consumption-based welfarism has large direct and indirect costs. Food subsidies are an example. As long as the share of food in the household budget is high, policy needs to focus on investing to increase agricultural productivity, since stable agricultural prices are important for non-inflationary growth. This is what East Asia did and it partly explains their successful growth transition. Food prices were allowed to rise and agriculture subsidized only after food budget shares fell. India unfortunately early opted for a system of subsidies to farmers as well as to consumers that distorted prices for both, harming productivity and resource allocation.

Given the one billion plus population, this was very expensive and reduced space for government investment in agriculture. It also kept inflation high as procurement prices rose each year. India is facing multiple cases because in 2017 per capita income ($ 1000 in constant US 1990 $) crossed the level after which World Trade Organization rules disallow support through price interventions that distort resource allocation. Improving conditions for all industry is WTO compatible but industry specific support is not. It is in our own interest to remove price distortions and shift to providing subsidies through DBT.

One of the worst consequences of such price distortions was in the electricity sector.

4.2 Freebie traps in electricity distribution

The Congress party was the first to use electricity subsidy as a political tool during the 1977 elections in Andhra Pradesh. It offered farmers flat-rate tariffs based on the capacity of the pump rather than on metered consumption. The idea spread like wildfire through the 80s. Power subsidies in Punjab are responsible for wasting water, growing inappropriate crops that necessitate burning of residue and smother Delhi in smog in November every year. Cross subsidization by higher tariffs on industrial and commercial consumers hurt development and future revenues. Lack of investment made power supply unreliable. Free electricity often meant no electricity. Freebies are never free, but sometimes their costs are not obvious.

4.2.1 Reversing ill effects

A series of reforms were attempted. Unbundling of production and distribution in the 1990s and the Electricity Act (EA) of 2003 succeeded in improving production and transmission. By 2014 India had a national grid. But distribution remained the weak link hurting the whole sector.

The EA sought to create an open market for electricity, allowing procurement at cheapest prices and sale anywhere at mutually agreed prices. Competition should have brought down prices. But states sabotaged this in order to preserve their cross subsidies and the monopoly of State Electricity Boards. They used their ability to route power through State Load Dispatch Centres as an instrument to deny open access to large consumers even while continuing to impose a cross-subsidy surcharge (CSS) on them. The EA had allowed CSS, but with the understanding that it would be eliminated. The National Tariff Policy (2016) had articulated the necessity of shifting to direct subsidies to support poorer consumers. But states continued with distorting tariffs. They also misused what was supposed to be an emergency provision (Section 11) in the Electricity Act, to prevent State power producers from supplying outside state borders. Other ‘open access charges’, imposed on flimsy grounds, helped preserve the market for inefficient state distribution companies (discoms).

High transmission and distribution losses, unpaid bills, continuing political interference, no investment to upgrade outdated distribution systems and poor maintenance of equipment meant discom losses mounted reaching trillions of rupees. A number of central restructuring cum bailout schemes failed to improve matters. In 2015 Uday sought to reduce moral hazard by aligning discom and State finances. Special state bonds were issued to cover 75% of discom debt along with supportive measures to improve operational efficiency. Despite taking on discom debt, states remained reluctant to increase tariffs. They were able to arm twist banks to finance the sector and force gencos to suffer large pending dues as payments were delayed.

In mid-2022 the Ministry of Power passed Late Payment Surcharge (LPS) Rules. These helped discoms with loans to clear their legacy monthly instalments failing which a LPS and disincentives such as progressive withdrawal of open access to the national network was applied. There would be no LPS on past outstanding dues under timely payment of instalments. For example, in August 27 defaulting discoms were barred from buying electricity to meet their short-term requirements from power exchanges. Thereafter, 11 states paid. The plan was to reduce long-term access of defaulters by 10 per cent every month. Power Finance Corporation, the nodal agency for implementation, used an automated process with online portals to monitor regular payment of bills and identify defaults. A remarkable recovery of outstanding dues followed. By March 23 they had dropped 39%. Finally, decades of damage were being reversed.

Much more needs to be done, of course. Aggregate technical and commercial discom losses were down from 22% in 2020-21 to 13% in 2022-23, but the global average is 8%. Only a tenth of expenditure is collected as revenue (Barnwal and Ryan, 2024, pp. 38). Without adequate funds discoms do not invest adequately in metering and leakages continue. Performance varies across

states and now discoms are rated. Some are doing well. States that reform their power sector will get more of the green finance flowing in.

4.3 Effective ways to impose discipline

But it does seem that while state governments can bully parties dependent on them for business, discipline and incentives imposed by independent central/constitutional institutions does work.

There are many other examples of conditionalities that have worked. The 12FC offered incentives to join the FRBM. The package of carrots and sticks was able to lower interest payments and reduce state debt. The 13th FC gave conditional grants to the 3rd tier. The 14FC, however, argued conditionality reduces utilization and instead made payments for capacity building. But a minimum threshold of capacity has to be reached at some stage, even as further improvement continues. The 15th FC used conditionalities again, also putting weight for tax effort. Central FC grants to the 3rd tier were made conditional on online accounts (eGramSwaraj) in order to build local capacity and accountability. In 2023 almost 90% of India's 2.55 lakh panchayats had these accounts (RBI, 2024).

State capex is the first to be cut and was low after the pandemic. Central incentives such as interest free long term loans (almost grants) conditional on capex induced a double digit rise in states' capital spending over 2022-24. Growth in investment planned for FY24BE was 20.5% after33.8% growth in FY23RE.

But still 10 out of 21 states spent less than than-budgeted amounts on capex, which itself varies. CEIC data shows FY23 capital expenditure/total expenditure in UP was 28% but only 1.8% in Punjab and 1.5% in Kerala. Karnataka's CO fell below BE with its free bus rides and other sops. But these cannot substitute for basic infrastructure such as water supply. The severe water scarcity faced in 2024 was partly a result of poor investment and unplanned urbanization.

The 73rd and 74th Amendments to the Indian Constitution list 29 delivery items for local bodies. Delivery remains poor, however, partly since state governments have not empowered local bodies with adequate funds and functionaries. Panchayats get 95% of their funds from grants, with 80% from the Centre. Water and sanitation included in the list account for 60% of central grants (RBI, 2024).

The Election Commission can help voters understand that freebies are never free by asking parties to estimate costs of poll promises and also to clarify what tax will rise or what expenditure will be cut to finance them. Independent analysts are making such estimates helping raise voter awareness. For example, estimates of poll promises by the 2023 Uttarakhand government put them at such a large

share of revenues that a cut in capex and the quality of public services would be inevitable. In the 2024 national elections parties made many populist promises to voters without indicating how they would be financed. But a national debate ensued about the types of taxes required for the redistributive promises to be fulfilled. Large arbitrary taxes on a small percentage cannot indefinitely finance almost a billion people. Such policies were tried and failed in the 1960s and in socialist regimes. Wealth creation stops and capital flight occurs. India has considerable scope to raise tax buoyancy by closing loopholes and increasing the tax base. The income tax surcharge on high income tax brackets yields more revenue than the wealth tax ever did.

The earlier belief that governments can spend any amount and print money to finance it is giving way to an understanding of budget constraints. Voters are beginning see through short-term gains to the long term costs. Freebies are also a race to the bottom that does not help parties get re-elected since other parties are forced to compete in offering such sops if they work in some elections. But voters have rejected such unfunded offers in the 2023 state and 2024 national elections. Parties will do better competing through constructive development schemes.

5. Conclusion

Contrary to perceptions, Indian states get more resources and freedoms than in most federal countries. But state spending is often of poor quality. Some restraints on borrowing are required to preserve overall macroeconomic stability.

FC tax devolutions are formula based and settled after intensive discussions. They are rights of states. Other factors enter but equity has the dominant share (50%); so more transfers do go to poorer states as they should. Although lower per capita income states are awarded more of FC transfers, more efficient states get more of conditional grants, which compensate. Since grants can include conditionalities, they go more to better performing states and also induce better performance, helping states escape low level traps and distorting choices such as in the electricity sector or in water supply. So it is not in states own interest to resist conditionalities.

An FC award in line with broad principles of justice, such as linking incentives to delivering constitutional responsibilities, would generate less resistance and improve outcomes. Research on response patterns to conditionalities across different states could help to fine-tune such policies.

As per capita incomes rise, voters gain more from better public services than from divisive agendas and dependencies. Better facilities enable participation in and creation of new opportunities

allowing India's demographic advantage to fructify. Rising voter awareness and demand for sustainable delivery from their governments can also help India to finally reach economic inclusion. A long-term vision has clearly worked for Odisha. If voters ensure this is in place, convergence to best practice in fiscal systems and processes, use of technology in taxation and expenditure management can follow and improve outcomes.

The FC will have to keep pushing for more decentralization and local capacity building, which is becoming more urgent as India urbanizes. States have neglected this across party lines. But as more urban centres develop there may be less urgent to keep metros as captive revenue sources, allowing independent and empowered municipalities to develop. A revived state fiscal council can perhaps reach agreement and lay out a road map much as the GST Council did.

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