Why Southern States are Unhappy With the Union Government’s Fiscal Federalism

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A “financial embargo” silently imposed by the central government on Kerala and some of the Southern and Opposition-governed states has unleashed a new war between the centre and the states creating a polarised normative axis in redefining the North-South divide debate.

The political economy of *actual* fiscal devolution observed over the last few years has experienced extensive ‘politicisation’ by the Modi government.

As argued recently, this has been observed in the way the government has squeezed some states’ fiscal freedom to borrow. In the backdrop of the grave financial crisis that state governments are facing currently, Kerala Finance Minister K N Balagopal said that his state's net borrowing limits have been reduced by Rs 4,000 crore.

Recently, the Telangana and Tamil Nadu governments too made similar observations about the need to preserve constitutionally safeguarded state autonomy in being able to manage fiscal priorities.

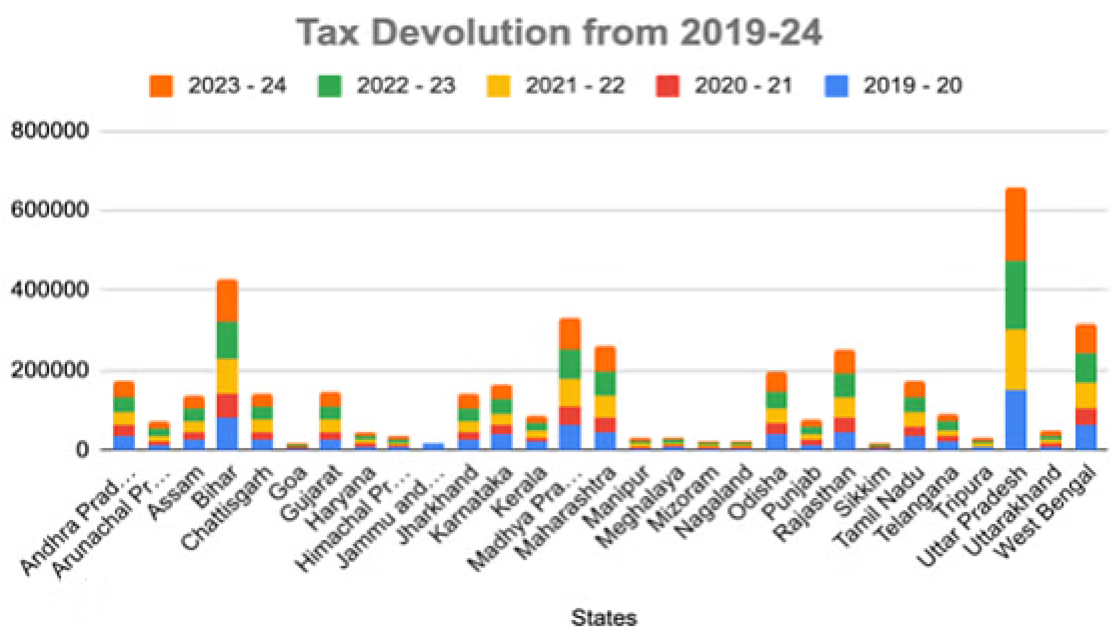
The numbers below also reflect the contemporary realities of center-state finances.

On the Actual Devolution of Funds in Centre-State Financial Relations

Our research team at *InfoSphere*, Centre for New Economics Studies (CNES), O P Jindal Global University, recently completed a study observing the centre-state fiscal relationship more closely. A detailed version of our findings was earlier discussed here.

The factsheet shared by the Ministry of Finance triggered a further investigation by our team studying the available data (from 2019 onwards) on tax devolution-share from the centre to the state governments, drawn from government sources.

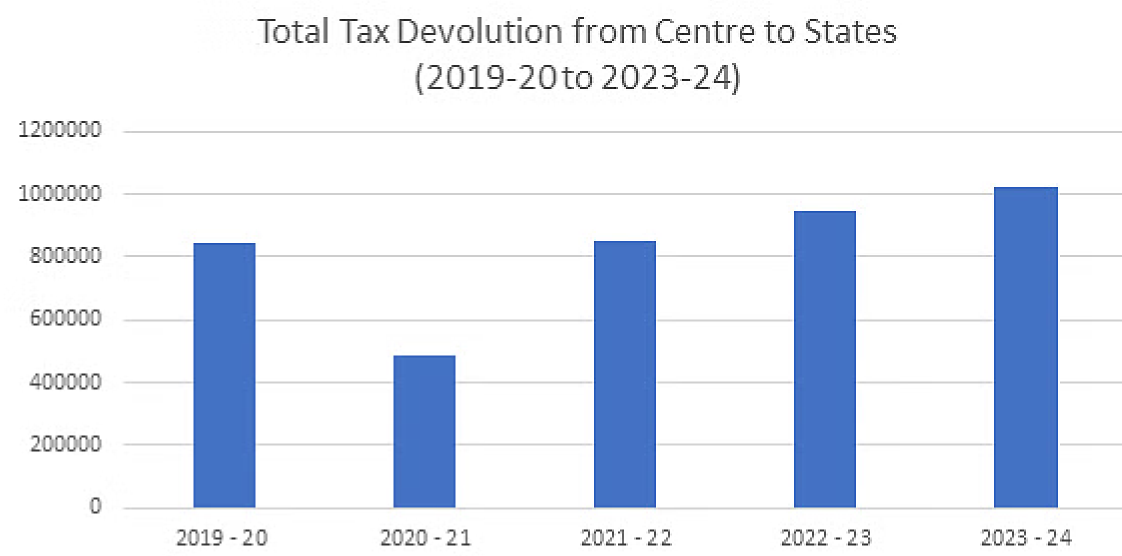
Some observations follow:



Tax devolution from 2019-24.

Source: Authors Calculations (InfoSphere, CNES)

The figure above presents the overall net tax devolution proceeds (in Rs crores) from 2019 onwards transferred by the central government to all state governments. These exclude union territories.



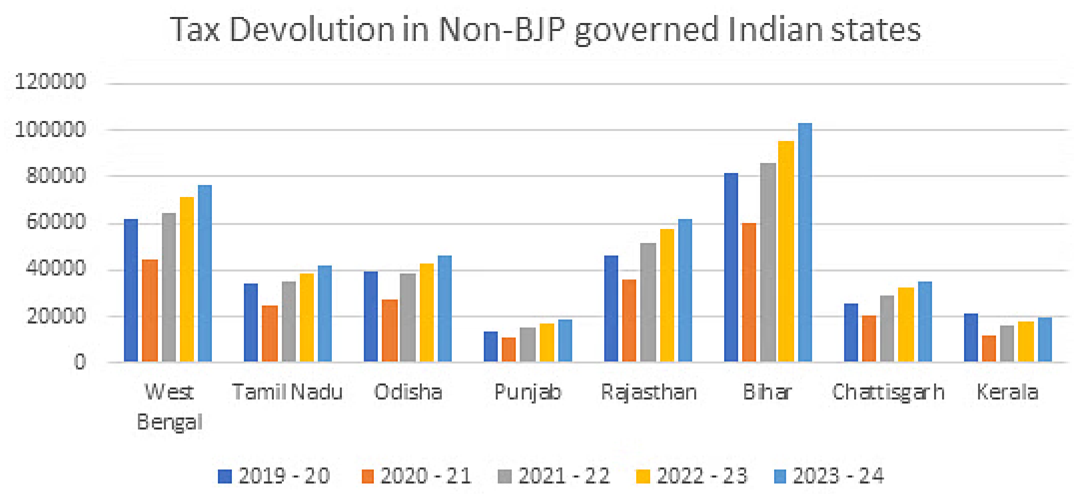
Total tax devolution from the centre to the states 2019-20 to 2023-24.

Source: Authors Calculations (InfoSphere, CNES)

The figure (above) gives a macro-trend of tax devolution from the centre on a year-to-year basis. This is a function of the accrued fiscal revenue capacity of the central government over the last few years. The pandemic year (2020-21) was tough for the fiscal purse of the government as a whole and as a result, saw the lowest tax devolution level from the centre to the states.

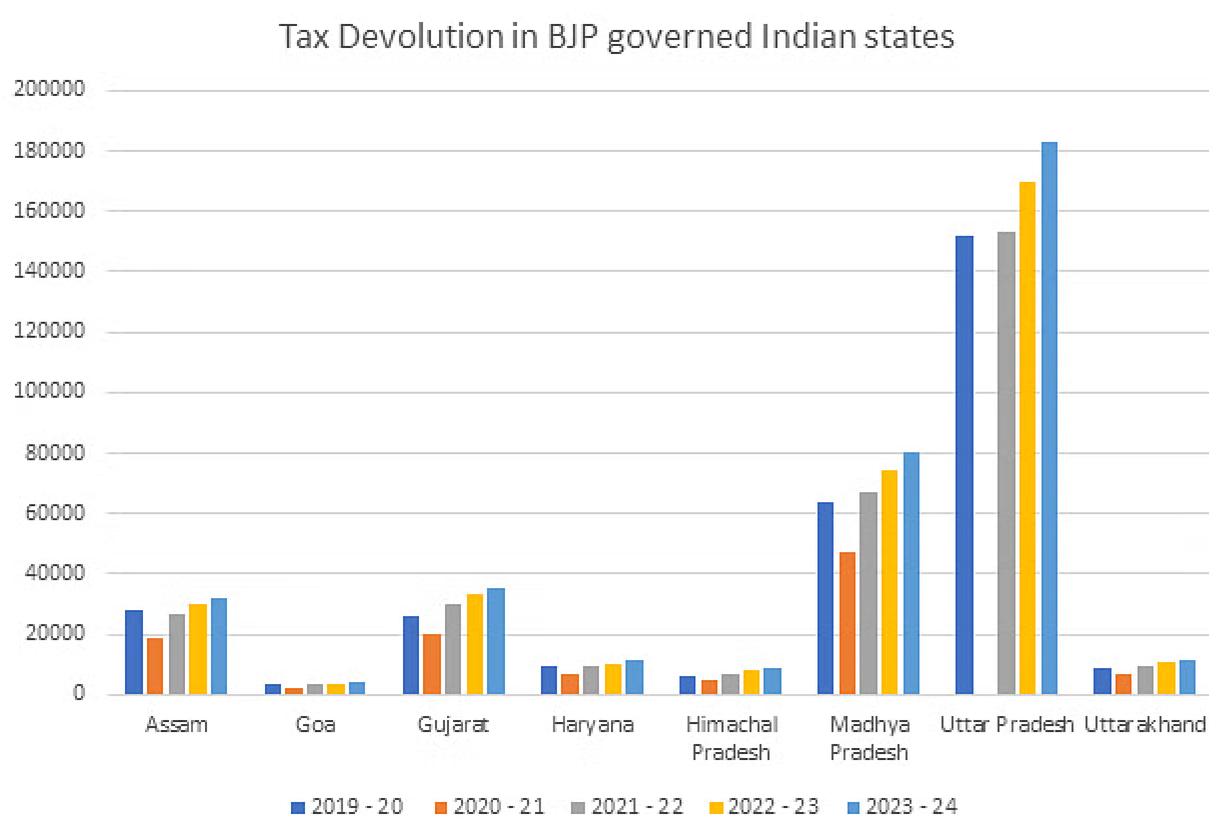
> This made more states borrow extensively to cover healthcare and other pandemic-induced costs from these ‘borrowed resources’, thereby seeing their fiscal deficit-debt levels rise.

The figures below provide a 'select' look at the centre to state tax devolution levels for a few Opposition-governed vs BJP-governed states (refer here for a source on this).



Tax devolution in non-BJP governed states.

Source: Authors Calculations (InfoSphere, CNES)



Tax devolution in BJP governed states.

Source: Authors Calculations (InfoSphere, CNES)

States like Bihar and UP get most of the tax-devolution share from the centre, largely because of their spatial, demographic, and socio-economic needs.

> But states like Haryana, Punjab, and Kerala haven’t seen any critical growth in their tax-devolution share over the last five years.

Further, states like Tamil Nadu, Chhattisgarh, Himachal, and Uttarakhand, haven’t seen any drastic shift in their net devolution share too, even though states like Tamil Nadu, given their strong GSDP (Gross State Domestic Product), contribute a lot more to the central government’s tax revenue share.

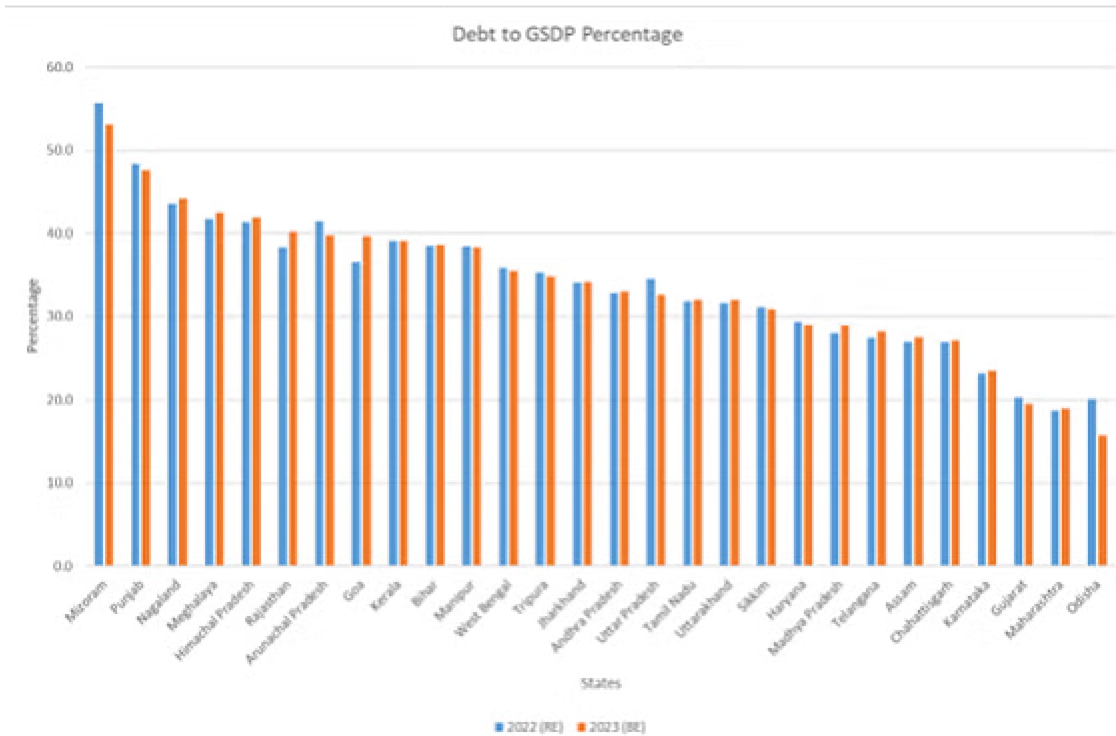
On the States’ Fiscal Position and Debt-Landscape

One of the key responsibility areas for the 16th Finance Commission (headed by Arvind Panagriya) would be to also provide a suitable fiscal consolidation strategy for high-debt affected states to reduce their indebtedness while balancing their spending priorities and welfare needs.

A few debt numbers below provide an illustrative account of Indian states’ fiscal position.

State-government debt Levels: The debt-to-GDP ratio at the state level is crucial for assessing specific financial conditions and policies. This localised ratio significantly influences credit ratings, budget decisions, and fiscal strategies, allowing states to uphold long-term financial stability and responsible fiscal management.

It is calculated by dividing a state's total outstanding debt by its GDP and multiplied by 100 to express it as a percentage, monitoring and managing this ratio empowers states to make informed economic policy choices.

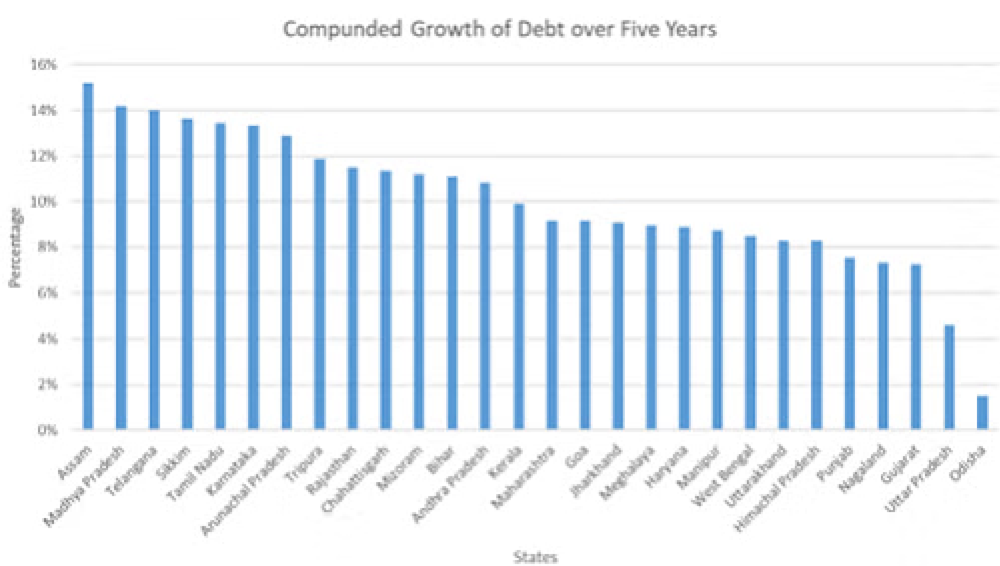


Debt to GSDP percentage.

Source: Authors Calculations (InfoSphere, CNES)

Outstanding Debt to GDP Percentage for Indian States: Mizoram currently grapples with the highest debt-to-GDP ratio among Indian states, standing at 53%, according to recent budget estimates.

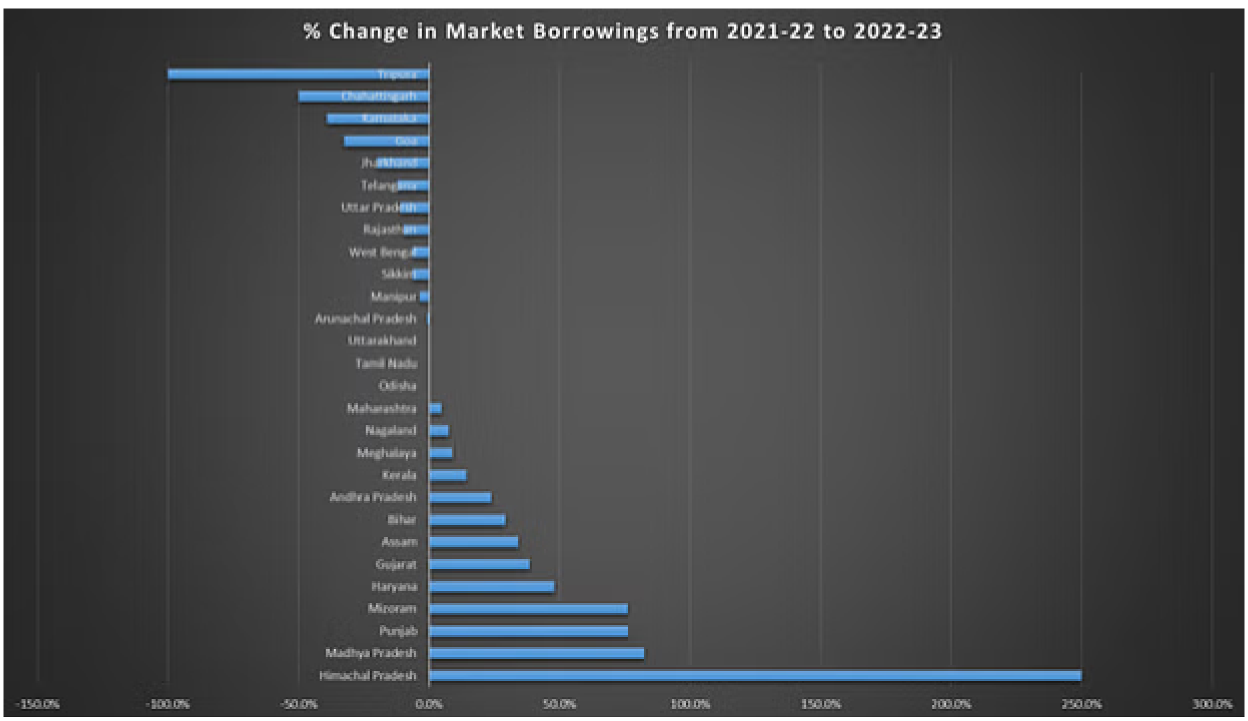
Following closely are the states of Punjab and Nagaland with ratios of 44% and 47%, respectively. Notably, investments in infrastructure development, social welfare programs, and public services can strain state finances.



Odisha maintains a low level of accrued debt by adhering to a stricter fiscal discipline. The state abides by annual budget deficit targets, averting elevated interest rates and decreasing borrowing expenses. Although the state is a key producer of paddy, it manages to avoid incurring a substantial subsidy cost, unlike Punjab, which has unpredictable rainfall patterns while producing a substantial amount of India's wheat.

> Odisha's capacity to uphold budgeted spending without making compromises, especially in the face of economic constraints, enhances the maintenance of fiscal discipline. Conversely, Punjab is experiencing strains on various fiscal fronts, which underscores the contrasting financial approaches among different states in India.

As observed for Assam, increasing debt has been driven by loans for developmental projects, sourced from financial institutions and the central government. Critics from the Opposition argue that CM Himanta Biswa Sarma's populist measures are exacerbating the financial pressure. Concerns have arisen due to outstanding payments to contractors and a legislative decision to elevate the debt-to-GSDP ratio.



Percentage change in market borrowings of states from 2021-22 to 2022-23.

Source: Authors Calculations (InfoSphere, CNES)

As seen above there has been a 250% increase in market borrowings for the state of Himachal Pradesh, which is associated with fiscal mismanagement under the previous BJP administration, favouring extensive borrowings over resource mobilisation.

> Deputy CM Mukesh Agnihotri ascribes the state's precarious financial condition to the central government's lack of supportive measures, denying additional resources. The current government inherited significant direct liabilities, primarily debt, leading Himachal to be ranked as the fifth highest debt-stressed state by the Reserve Bank of India.

Madhya Pradesh and Punjab, as noted earlier, are also grappling with elevated market borrowing to address their respective state expenditures.

Conclusion

What role has the central government, which by law is assigned more fiscal capacity and discretion to raise and spend tax-based revenue resources, played in supporting states through spending?

- The central government has merely maintained status-quo when it comes to giving states what they need, they haven't transferred more or envisioned to transfer more tax revenue to enable a state's welfare and revenue requirements
- The central government under the Modi administration (since the last few years, read 2019 onwards from our data) has increasingly seen a gradual erosion in its fiscal capacity and willingness to support states that need more revenue for growth and welfare
- Poor quality government data makes it extremely difficult for anyone to effectively analyse the potential gains/losses being made from the allocated tax-devolution proceeds

This is a marked sign of a 'fiscally weak' and 'insecure' central government, that is content to project empty riddles of economic 'optimism' built merely around rhetorical hope.

*(Deepanshu Mohan is a Professor of Economics and Director, the Centre for New Economics Studies (CNES), Jindal School of Liberal Arts and Humanities, O P Jindal Global University. This is an opinion piece and the views expressed above are the author's own. **The Quint** neither endorses nor is responsible for them.)*

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