"NAVIGATING INDIA'S FISCAL FEDERALISM IN A POST-PANDEMIC ERA" – PAPER - III

The COVID-19 pandemic reshaped the global economic landscape, and India was no exception. With the world facing unprecedented economic challenges, governments were forced to respond swiftly, leading to an increase in public debt across countries. India, a large federal democracy, had to navigate through these challenges while balancing the fiscal responsibilities between its Centre and states. As the dust settles, questions regarding India's fiscal architecture and the nature of fiscal federalism have become more relevant than ever. This article delves into the post-pandemic fiscal architecture in India, the nature of fiscal federalism, the role of public debt, and the ongoing challenges, offering suggestions to create a more harmonious fiscal framework.

The Post-Pandemic Fiscal Architecture in India

The pandemic-induced economic shock required governments worldwide to adopt aggressive fiscal measures. India was no different, as it implemented large-scale stimulus packages to mitigate the pandemic's impact on its citizens and economy. Public debt surged as a result, and by 2021, India's debt-to-GDP ratio had increased to 89%, up from 70% in 2018. This surge highlights the need for a rethinking of the country's fiscal architecture.

Before the pandemic, India's fiscal policy was primarily deficit-focused, with the government aiming to reduce fiscal deficits as a measure of fiscal responsibility. However, in 2018, the N.K. Singh Committee recommended a shift in focus toward managing public debt. Debt sustainability became the anchor of fiscal policy, with deficits being a means to that end. This shift was crucial, as managing public debt ensures long-term fiscal sustainability.

In the post-pandemic world, India must continue to prioritize public debt management. The pandemic's fiscal response has widened the debt-to-GDP ratio, but simply focusing on annual deficits may not be enough to ensure fiscal sustainability. Instead, a longer-term approach that ensures public debt remains on a declining path is necessary. This entails creating fiscal space for future economic shocks and reducing the overall debt burden, which is a key challenge for both the central and state governments.

Nature of Fiscal Federalism in India

India's fiscal federalism is complex, with financial responsibilities distributed between the central and state governments. The Centre has broader taxation powers, while states have significant spending responsibilities, particularly in areas like health, education, and social welfare. This system requires a delicate balance of resource allocation and expenditure.

The Centre collects a significant portion of the taxes and then redistributes them to states through mechanisms like the Finance Commission. States also have their own revenue sources, but their dependence on central transfers remains substantial. This interdependence creates challenges in times of economic stress, such as the pandemic, where states face significant spending pressures but limited revenue generation capacity.

Role of Public Debt in Fiscal Condition

Public debt plays a crucial role in determining a country's fiscal health. In India, public debt surged during the pandemic as the government ramped up spending to provide relief to its citizens and stabilize the economy. By 2021, India's public debt had peaked at 89% of GDP but had slightly reduced to 82% by 2022. Managing this debt burden is essential for ensuring long-term fiscal sustainability.

For India, both central and state governments are responsible for managing their respective debts. However, the Centre's larger debt stock means it has a greater role in overall debt management. The government must ensure that the debt-to-GDP ratio follows a declining path to create room for future fiscal challenges. This requires balancing growth, expenditure, and revenue generation.

Status of Public Debt - Centre & State

While India's total public debt stands at around 82% of GDP, the breakdown between central and state debt reveals significant differences. The Centre holds a larger portion of this debt, with estimates suggesting that central government debt stood at approximately 58% of GDP by 2023-24. In contrast, state government debt is around 28% of GDP.

The difference in debt levels between the Centre and states can be attributed to their differing roles and fiscal capacities. The Centre has broader taxation powers, allowing it to raise more revenue and carry more debt. On the other hand, states are more constrained in their ability to raise revenue, which limits their capacity to manage larger debt levels.

Fiscal Federalism Issues in India

India’s fiscal federalism faces several challenges. One key issue is the mismatch between the spending responsibilities of states and their revenue-raising capacities. While states are responsible for significant public service delivery, their tax collection is limited, leading to an overreliance on central transfers.

Another issue is the divergence in debt dynamics between the Centre and states. While the Centre’s debt-to-GDP ratio is expected to decline gradually, the same is not necessarily true for the states. If state deficits remain at current levels (around 3% of GDP), their debt levels could continue to rise, even as the Centre's debt ratio declines. This divergence poses a risk to the overall fiscal health of the country.

Furthermore, the uniform fiscal deficit threshold of 3% of GDP for all states does not take into account the significant heterogeneity between states. States with lower economic growth rates and higher debt levels may struggle to comply with this rule, while states with higher growth rates and lower debt levels may have unused fiscal space.

Measures for Harmonious Fiscal Federalism

To address these issues, several measures can be implemented to create a more harmonious system of fiscal federalism in India:

1. **Differentiated Fiscal Rules for States:** Not all states are in the same fiscal situation. States with higher debt levels and slower growth may need more stringent fiscal rules, while states with lower debt levels should be allowed greater flexibility to use their fiscal space for developmental purposes.
2. **Improved Revenue Generation for States:** States should be encouraged to enhance their revenue-generating capacities through better tax administration, broadening the tax base, and exploring new sources of revenue. This can reduce their dependence on central transfers and allow them more fiscal autonomy.
3. **Market Discipline:** One reason for the divergence in state debt dynamics is the lack of market discipline. All states borrow at similar rates, regardless of their fiscal health, due to perceptions of an implicit sovereign guarantee. Introducing independent state debt ratings and removing the implicit guarantee could create incentives for states to manage their debt more responsibly.
4. **Debt Sustainability Analysis:** Regular debt sustainability analyses should be conducted for both the Centre and states to ensure that public debt remains on a sustainable path. This can help identify states that are at risk of fiscal distress and require additional support or fiscal adjustments.

5. **Horizontal Transfers:** To ensure equity, lower-income states with higher debt levels should receive additional transfers from the Centre to compensate for their fiscal constraints. This can be achieved through horizontal transfers recommended by the Finance Commission.

Suggestions

India's fiscal federalism faces significant challenges in the post-pandemic world. The pandemic has increased public debt levels, requiring both the Centre and states to adopt prudent fiscal policies to ensure long-term sustainability. However, the one-size-fits-all approach to fiscal rules for states may not be effective in addressing the diverse fiscal situations across the country.

To create a more harmonious system of fiscal federalism, India needs to adopt differentiated fiscal rules that account for the varying debt dynamics and growth rates of states. Strengthening market discipline, improving state revenue generation, and conducting regular debt sustainability analyses are crucial steps toward ensuring that both central and state debts remain manageable.

Conclusion

In conclusion, India's post-pandemic fiscal architecture must be dynamic, responsive, and equitable. A more nuanced and flexible approach to fiscal federalism can help balance the responsibilities of the Centre and states, ensuring that public debt remains sustainable and creating fiscal space for future economic shocks. By embracing these reforms, India can strengthen its fiscal foundations and continue on a path of sustainable economic growth.

FIVE PILLARS OF A POST–PANDEMIC FISCAL ARCHITECTURE

Pillar I: Re–establishing debt/GDP as the anchor, so that consolidated (Centre + state) debt/GDP is put on a declining path in the coming years

Pillar II: Deciding on burden sharing between the centre and states so that central and state debt dynamics do not offset each–other

Pillar III: Establishing risk–based fiscal rules across states to ensure debt is inter–temporally sustainable and cross–sectionally convergent over time

Pillar IV: Injecting market discipline into state borrowing costs to serve as an automatic corrective mechanism

Pillar V: Avoiding trying to target an annual debt/GDP target but instead optimising over the cycle

MAIN PRACTICE QUESTIONS

1. **"Discuss the key challenges of fiscal federalism in India in the post-pandemic context. How can differentiated fiscal rules for states address the divergence in debt dynamics across the Centre and states?"**

2. **"Examine the role of public debt in India's fiscal sustainability. What measures can be implemented to ensure harmonious fiscal federalism and reduce the fiscal burden on both the Centre and states?"**

ANSWER GUIDELINES

Question:1.

"Discuss the key challenges of fiscal federalism in India in the post-pandemic context. How can differentiated fiscal rules for states address the divergence in debt dynamics across the Centre and states?"

1. Introduction:

- Begin with a brief introduction to fiscal federalism in India, emphasizing the sharing of financial responsibilities between the Centre and states.
- Mention how the COVID-19 pandemic affected fiscal dynamics in the country, increasing public debt.

2. Key Challenges of Fiscal Federalism in Post-Pandemic India:

- **Increased Public Debt:** Explain how both central and state debts surged due to pandemic-induced spending.
- **Imbalance in Revenue and Expenditure:** Highlight how states are responsible for significant public service delivery but rely heavily on central transfers.
- **Divergence in Debt Dynamics:** Discuss the mismatch in debt levels between the Centre and states, with the Centre's debt expected to decline while state debts remain high.
- **Uniform Fiscal Deficit Rules:** Mention the 3% fiscal deficit threshold for states, which does not account for the differing growth rates and fiscal situations of individual states.

3. Differentiated Fiscal Rules for States:

- **Explanation of Differentiated Rules:** Introduce the concept of differentiated fiscal rules based on each state's fiscal health and growth prospects.
- **Categorization of States:** Discuss how states with high debt and low growth may need more stringent fiscal rules, while low-debt, high-growth states can be given more flexibility.
- **Benefits of Differentiation:** Highlight how such an approach can ensure that fiscal policies are better tailored to the unique conditions of each state, thereby promoting overall fiscal sustainability.

4. Conclusion:

- Summarize the importance of differentiated fiscal rules in addressing the fiscal challenges of Indian states and ensuring long-term debt sustainability across the federal structure.
- End by stressing that fiscal federalism needs to be dynamic and adaptable to evolving economic realities.

Question:2

"Examine the role of public debt in India's fiscal sustainability. What measures can be implemented to ensure harmonious fiscal federalism and reduce the fiscal burden on both the Centre and states?"

1. Introduction:

- Start with a definition of public debt and its significance in a country's fiscal policy.
- Briefly outline the current scenario of India's public debt post-pandemic, with emphasis on the increase in the debt-to-GDP ratio.

2. Role of Public Debt in Fiscal Sustainability:

- **Debt as a Fiscal Anchor:** Explain how public debt acts as an anchor for long-term fiscal sustainability, guiding policies that prevent fiscal instability.
- **Debt-to-GDP Ratio:** Discuss the importance of managing the debt-to-GDP ratio, and the need for it to follow a declining trajectory to create fiscal space for future economic shocks.
- **Centre vs. State Debt:** Elaborate on the difference between central and state debts, with the Centre holding a larger share of public debt, and states being more vulnerable due to limited revenue sources.

3. Measures to Ensure Harmonious Fiscal Federalism:

- **Differentiated Fiscal Rules:** Explain how implementing risk-based, differentiated fiscal rules for states can help manage debt levels according to their economic conditions.
- **Market Discipline:** Discuss the need to introduce market-based borrowing rates for states, removing the perception of an implicit sovereign guarantee. This will incentivize states to be fiscally responsible.

- **Strengthening State Revenue Generation:** Highlight the importance of improving state revenue collection through better tax administration and broader tax bases, reducing their dependence on central transfers.
- **Horizontal Transfers for Equity:** Mention how the Finance Commission can ensure fairness by providing additional transfers to lower-income states with higher debt burdens, thereby addressing equity concerns without compromising sustainability.

4. Conclusion:

- Recap the central role of public debt in India's fiscal policy, emphasizing the importance of coordinated efforts between the Centre and states.
- Suggest that a combination of differentiated fiscal rules, improved revenue generation, and market discipline will help ensure harmonious fiscal federalism, reducing the overall fiscal burden on the country.