IV Way Forward

4.1 Downside risks confronting the Indian economy in the train of the slowdown that set in from early 2018-19 precipitated by COVID-19, which has produced the steepest quantity contraction in the Indian economy in its history in Q1 of 2020-21. With states at the forefront of the fight against the pandemic, their finances have taken a body blow in the first half of 2020-21. State governments' gross fiscal deficit is projected to widen in 2020-21 beyond 4.0 per cent of GDP in the baseline scenario. Given the clear inter-linkages between growth and tax revenues and considering the fact that tax revenues fall faster than GDP when growth is negative (Belinga *et. al.*, 2014 and OECD, 2020a), tax revenues are likely to be reduced for the next few years. Pandemic related spending, particularly on health and other support measures for households and firms are likely to keep these expenditures high; prolonging the 'scissor effect'. In addition, states' fiscal position is likely to be affected by a surge in contingent liabilities (guarantees). In this milieu, state governments may have to face the difficult choice of putting investment projects on hold, but, given the multiplier associated with capital spending, this will inevitably entail growth losses in a vicious circle feeding itself.

4.2 The visitation of the pandemic stalls a critical phase in the implementation of targeted structural reforms by the states - overhaul of the Agriculture Produce and Marketing Committee (APMC); restructuring of state marketing boards; land leasing for agriculture; ease of doing business (EoDB); improving logistics for exports, and simplification of labour regulations and labour reforms through amendments to Factories Act and Industrial Disputes Act, to call a few. States are also engaged in re-building the social and economic infrastructure, including public health, urban and digital infrastructure. The pandemic has underscored their criticality and momentum must not be lost.

4.3 The pandemic may also leave lasting scars on federalism in India. It will have a bearing on inter-generational transfers, with lower discretionary spending or higher taxation in future. States' indebtedness is set to rise, and if it is not accompanied by an acceleration in growth, fiscal sustainability will become the casualty, overwhelming the modest gains of the prudence in recent years.

4.4 What could be the key elements of a virtuous post-pandemic fiscal response by states? First, reprioritising expenditures towards more productive high multiplier capital projects has to be made centre-stage and insulated from being sacrificed repeatedly at the altar of the expediency of shortsighted fiscal arithmetic. Investing in health care systems and social safety nets in line with the states' demographic and co-morbid profiles and strengthening urban infrastructure have to be an integral part of the fiscal strategy. Protecting human capital is as important as investing in physical capital formation, with equally strong Keynesian multipliers. In this context, expanding states' spending on health towards achieving the universal health coverage goal of 2.5 per cent of GDP at the aggregate level must be brought forward in the agenda of fiscal priorities of states. States with limited fiscal space can focus on low gestation and high labour intensity projects that also crowd in private business.

4.5 Second, improving revenue mobilisation has to be frontloaded to make up for the tax base and accruals lost in the pandemic. Clearly, the revival of strong growth is the best way to boost tax revenues, but in order to make up for lost ground, concomitant engines have to be directed to harnessing efficiency gains *via* improving tax compliance, and greater digitalisation of the tax administration to expand the tax base (RBI, 2019a; RBI, 2020).

4.6 Digitalisation can give dual benefits. First, it will help states lower cash dependence and physical access to banking infrastructure in times of social distancing and build resilience against future epidemics. Second, digitalisation can foster improvements in direct benefit transfer systems, including through e-governance initiatives. Digital platforms can also be utilised to reduce tax evasion and to expand the tax base. It is estimated that the direct benefit of digitalising government payments could create gains of 0.5-0.8 per cent of GDP for India (Lund, S. *et al.,* 2017) and pave the way for the formalisation of the economy. It will also help in job creation in the digital space.

4.7 The future of sub-national finances in India will be shaped by inter-state coordination and close engagement between various layers of sub-national administrations and health authorities. A cohesive national agenda built up on these blocks can mitigate vertical as well as horizontal imbalances and promote co-operative federalism. In this endeavour, special attention will be needed for ULBs, the weakest link and lagging behind similar bodies in other parts of the world in terms of capacity to raise resources, including financial autonomy to do so. Empowering local governments with higher resources and enabling them to raise resources has to be mainstreamed into the fiscal fabric of governance, including improving their market access. Viewing from the spatial lens, setting up uniform and timely database collection systems across states with regard to – nature of employment and migrant workers, health infrastructure and human resources, local government capabilities and resources – could be the first step towards identifying and prioritising the associated service gaps.

4.8 Good house-keeping will require maintaining fiscal transparency on assessing and quantifying the fiscal risks, particularly from ‘below the line’ items. Fiscal transparency also encompasses provision of ready access to reliable, comprehensive, timely, understandable, and internationally comparable information on government activities, so that the electorate and financial markets could accurately and easily assess the government’s financial position as well as the true costs and benefits of its activities. Linking higher borrowing with financing capital expenditure, and central transfers to transparent fiscal would bring in incentive-compatibility.

4.9 Keeping in mind the inter-generational burden of debt, it is important for states to chart out a glide path back to fiscal rectitude. Like the centre, states may also consider revising their fiscal legislations by bringing in the desired counter-cyclicality and by incorporating debt as a medium-term anchor. No fiscal rule is static and the cross-country evidence suggests that fiscal rules should improvise on the basis of experience and new developments, so long as goal posts are not moved as a matter of expediency stemming for camouflaging breaches. By and large, while states have succeeded in adhering to their fiscal discipline targets, their fiscal policy has failed to act as a macroeconomic stabilising tool.

Budgetary constraints on fiscal spending have made their fiscal policies pro-cyclical. Laying down a transparent institutional mechanism in terms of revised FRLs, coupled with productive incentive systems, has potential to move states towards playing an effective balancing role in supporting growth while meeting their debt-deficit targets.

4.10 The next few years are going to be challenging for the Indian states. They need to remain empowered with effective strategies to drive through these difficult times. Sub-national fiscal policy has to be judicious and calibrated. Across states, maintaining overall stability, quality of spending and credibility of budgets may distinguish one state's resilience from another.