

States, freebies and the costs of fiscal profligacy

(GS Paper 2, Polity and Governance)

Context:

- With the illustration of Punjab through not unique, in fact, many States are pursuing the freebie culture, some even more aggressively than Punjab, let's look at freebie culture in India.
- Concerned by an increasing number of States that are embarking on this financially ruinous path, senior bureaucrats reportedly flagged the issue at a meeting with the Prime Minister, telling him that 'some States might go down the Sri Lankan way'.

Case of Punjab:

- During the campaign ahead of the Punjab Assembly election, the Aam Aadmi Party (AAP) promised a sum of ₹1,000 per month to every woman in the State.
- Arvind Kejriwal, emphasised that under AAP's 'Mission Punjab' for the Punjab polls 2022, if there were three adult women in a household (daughter-in-law, daughter, mother-in-law), each of them would get ₹1,000.
- When questioned how Punjab, already reeling under heavy debt, could afford this, he said something to the effect that if there is good political management, money would not be a problem.



Checks on Electoral promises:

Electoral promises of this kind raise several questions:

- Is borrowing and spending on freebies sustainable?
- Is this the best possible use of public money?
- What is their opportunity cost — what is it that the public are collectively giving up so that the government can fund these payments?
- Should not there be some checks on how much can be spent on them?

Concerns:

- Ideally, governments should use borrowed money to invest in physical and social infrastructure that will generate higher growth, and thereby higher revenues in the future so that the debt pays for itself.
- On the other hand, if governments spend the loan money on populist giveaways that generate no additional revenue, the growing debt burden will eventually implode and end in tears.

Issue raised by senior bureaucrats with the PM:

- There is an argument that this concern is being exaggerated.
- If looked at any analysis of State Budgets by the Reserve Bank of India or any think tank, the State finances are in good, if indeed robust, health, and that all of them are scrupulously conforming to the Fiscal Responsibility and Budget Management (FRBM) targets.
- This is a misleading picture. **Much of the borrowing that funds these freebies happens off budget**, beyond the pale of FRBM tracking.

Burden on State exchequer:

- The typical modus operandi for States has been to **borrow on the books of their public enterprises**, in some cases by pledging future revenues of the State as guarantee. Effectively, the burden of debt is on the State exchequer.
- The **Comptroller and Auditor General of India (CAG)** had in fact pointed out that in respect of some States 'if extra-budgetary borrowings are taken into account, **the liabilities of the government are way above what is acknowledged in the official books**'.

Placing short-term gains ahead of long-term sustainability:

- The obvious motivation for States in expanding freebies is to use the exchequer to **build vote banks**. A certain amount of spending on transfer payments to provide safety nets to the most vulnerable segments of the population is not only desirable but even necessary.
- The problem arises when such transfer payments become the **main plank of discretionary expenditure**, the spending is financed by debt, and the debt is concealed to circumvent the FRBM targets.
- The **more States spend on transfer payments**, the **less they have for spending on physical infrastructure** such as, for example, power and roads, and on social infrastructure such as education and health, which can potentially improve growth and generate jobs.

Institutional checks, balances:

Legislature:

- In theory, the first line of defence has to be the legislature, **in particular the Opposition**, whose responsibility it is to keep the Government in line.
- But the Opposition does not dare speak up for fear of forfeiting vote banks that are at the end of these freebies.

CAG audit:

- Another constitutional check is the CAG audit which should enforce transparency and accountability.
- In practice, it has lost its teeth since audit reports necessarily come with a lag, by when political interest has typically shifted to other hot button issues.

Market:

- It can signal the health or otherwise of State finances by pricing the loans floated by different State governments differently, reflecting their debt sustainability.
- But in practice this too fails since the **market perceives all State borrowing as implicitly guaranteed** by the Centre, never mind that there is no such guarantee in reality.

Suggestions:

Amendment to FRBM:

- First, the **FRBM Acts of the Centre as well as States need to be amended** to enforce a more complete disclosure of the liabilities on their exchequers.
- Even under the current FRBM provisions, governments are mandated to disclose their contingent liabilities, but that disclosure is restricted to liabilities for which they have extended an explicit guarantee. The provision should

be **expanded to cover all liabilities** whose servicing obligation falls on the Budget, or could potentially fall on the Budget, regardless of any guarantee.

Enhancing Centre's role:

- Second, under the Constitution, **States are required to take the Centre's permission when they borrow**. The Centre should not hesitate to impose conditionalities on wayward States when it accords such a permission.
- States slapped with conditionalities will of course balk and allege political motives.
- The challenge for the Centre will be to act transparently and in accordance with well-defined, objective and contestable criteria.

Financial Emergency:

- Finally, there is the draconian provision in the Constitution of India which allows the President to declare financial emergency in any State if s/he is satisfied that financial stability is threatened.
- This has never been invoked so far for fear that this will turn into a political weapon of mass destruction. But the provision is there in the Constitution for a reason.
- After all, the root cause of fiscal irresponsibility is the lure of electoral nirvana. It will stop only if the political leadership fears punishment.
- It is therefore important to ensure that the prospect of a financial emergency in case of gross and continuing fiscal irresponsibility is not just an abstract threat but a realistic one.

Way Forward:

- The Centre has embarked on course correction over the last few years. It should complete that task in order to command the moral authority to enforce good fiscal behaviour on the part of States.