

The flypaper effect: It will be important to note efficacy of Budget in integrating climate change commitments

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The final report of the fifteenth Finance Commission will be tabled in the Parliament soon. One of the pertinent questions is whether India's finance commissions have used equalisation as an instrument for increasing forest cover and ecological sustainability. The 14th FC is the first-ever Commission to integrate an environmental variable in the tax-transfer formula, assigning a weight of 7.5%. However, it was articulated to mitigate "cost disabilities". Subsequently, 15th FC (interim report) also retained the criterion with an increased weightage of 10% in the unconditional fiscal transfers, using the "dense forest cover" inter-state data.

As the environmental variable is incorporated in the "unconditional" fiscal transfers, the prioritisation of climate change in expenditure functions of the state government is significant to have effectiveness of such transfers on the environment. Unlike the thirteenth finance commission, the latest commissions have not designed any "conditional" fiscal transfers to climate change commitments.

Empirically, it would be interesting to examine if there is any "flypaper effect" at the local level from such environmental fiscal transfers. The narrative of flypaper effect is "money sticks where it hits". The flypaper effect, in this context, examines if exogenous environmental fiscal transfers lead to significantly higher local government spending on climate change commitments than an equivalent amount of citizen income.

The channels in which the flypaper effects work can be either the fiscal illusion (the median voters are unable to differentiate between the heterogeneous sources of revenue) or the bureaucratic behavioral sets, for instance, if they prioritise the climate change commitments in their expenditure functions as an outcome of political institutions and the associated incentives of elected representatives. The preliminary evidence on the relationship between the inter-state share of intergovernmental fiscal transfers and the environmental variables is slightly positive. This reiterates the efficacy of environmental fiscal transfers.

Climate change commitments require long-term fiscal policy instruments, such as climate-responsive budgeting within the ministry of finance; along with environmental fiscal transfers. In India, despite having Climate Action Plans at national and subnational government levels, a roadmap towards comprehensive climate-responsive budgeting as a PFM (Public Financial Management) tool for accountability has not yet been fully developed. As such, the public expenditure towards climate change is highly fragmented and highly sectoral in India. On the monetary policy front, the European Central Bank has started integrating climate change into monetary policy reaction function. A few experts have even proposed 'Carbon Central Banks' (bit.ly/36eISAw). However, [RBI](#) has not yet initiated such deliberations on climate change.

With the advent of fiscal decentralisation, many countries have focused on environmental commitments at the subnational government level. The "principle of subsidiarity" says that the responsibility for providing a particular service should be assigned to the jurisdiction "closest to

people". Such decentralised decisions in climate change commitments is getting attention worldwide ex-post to Paris accord on climate change. However, the interjurisdictional competition to attract mobile capital by trading (lowering) environmental regulations lead to "race to bottom" and "pollution havens". Empirical evidence reveals this continuous tension between 'principle of subsidiarity' and the "race to the bottom".

In the intergovernmental fiscal framework, three functions of environmental quality have been developed (bit.ly/3plFSZC). The first considers environmental quality as a pure "international" public good for which a global solution is required, irrespective of its location.

The second case considers environmental quality as a pure "local" public good". The 'principle of subsidiarity' is directly applicable to this second case. The third case, which is most common in practice, deals with the effects of interjurisdictional externalities, including water and air pollution. The governments have tried to "internalise these externalities" through legal negotiations and fiscal instruments.

It is pertinent to analyse the final report of fifteenth Finance Commission to understand how the tax transfers to subnational governments for the next five years have integrated environmental variables. Equally important is how efficacious the Budget FY22 in integrating the climate change commitments.

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