Fiscal Health of the States

This editorial is based on **A macro view of the fiscal health of States** which was published in The Hindu on 05/07/2023. It talks about the fiscal health of Indian States.

For Prelims: Reserve Bank of India's (RBI), Annual Study on State Finances, Covid-19 Pandemic, Fiscal Deficits , GDP, GST(Goods and Services Tax), Finance Commissions, Human Capital

For Mains: Fiscal Challenges Faced by Indian States, how can Indian States Reduce their Revenue Deficits

In India, the States mobilize more than a third of total revenue, **spend 60% of combined government expenditure**, and have a **share in government borrowing** that is **around 40%.** Given the size of the fiscal operation of States, an up-to-date understanding of their finances is critical in order to draw **evidence-based inferences on the fiscal situation of the country.**

However, **due to the absence of aggregation** of individual **State Budget data**, a consolidated view of general government finances is not readily available. Every year, this data becomes available only after the publication of the Reserve Bank of India's (RBI) Annual Study on State Finances, which has **revealed the fiscal situation of States based** on key data from their **individual budgets for 2023-24.**

The data are from **17 major States that account for more than 90%** of the total spending of all States. Therefore, the fiscal issues from their budgets reflect the State finances in India. Indian States have shown remarkable fiscal consolidation after the Covid-19 pandemic, but they still face fiscal challenges in containing their revenue deficits.

How have Indian States Performed in Fiscal Consolidation?

- **Fiscal Consolidation:**
    - Fiscal consolidation **refers to the process of reducing fiscal deficits and public debt** by adjusting expenditure and revenue policies.
    - Indian States **have achieved significant fiscal consolidation** after the **Covid-19 pandemic**, reducing their **fiscal deficits** from **4.1% of GDP(Gross Domestic Product) in 2020-21 to 2.9% of GDP in 2023-24 (BE).**
- **Fiscal Consolidation is Significant:**
    - States managed to be **fiscally prudent despite a contraction** in revenues during the peak of Covid-19.
    - States coordinated with the Union Government **to provide emergency provision for health spending** and livelihood during the pandemic.
    - States **reprioritized expenditure and quickly contained** the fiscal deficit.
    - States benefited from **improved** GST(Goods and Services Tax) **collection and higher tax devolution** due to buoyant central revenues.

- States also **witnessed recovery in non-GST revenues** after the pandemic.

What are the Fiscal Challenges Faced by Indian States?

- Despite the r**eduction in fiscal deficit**, Indian States still face fiscal challenges, especially in **containing their revenue deficits,** which have **not declined proportionately** with fiscal deficits.
    - Revenue deficit **refers to the excess of revenue expenditure over revenue income in a financial year.**
    - **Revenue Related Challenges:**
        - The impact of the **Covid-19 pandemic on the economic activity** and tax collection.
        - The **uncertainty and volatility of GST revenue and compensation.**
        - The **dependence on tax devolution** from the Union and its formula-based allocation.
        - The erosion of fiscal autonomy due to the subsumption of various taxes under GST.
        - The **limited scope for raising non-tax revenues** such as user charges, fees, etc.
        - The **compliance and administrative issues** in collecting own taxes such as property tax, stamp duty, etc.
- **Major Revenue Deficit States:**
    - Out of 17 major States, **13 States have revenue deficits**, and **seven States have revenue deficits** as the main driver of their fiscal deficits.
        - These States are Andhra Pradesh, Haryana, Kerala, Punjab, Rajasthan, Tamil Nadu, and West Bengal.
        - They also **have large** debt to GSDP ratios.
- **Expenditure Related Challenges:**
    - The **rising demand for public health and education** services due to the pandemic and demographic factors.
    - The **need to invest in infrastructure and urban development** to support growth and employment.
    - The **fiscal implications of various welfare schemes** and subsidies for the poor and vulnerable sections.
    - The **burden of pension and salary liabilities** for the public sector employees.
    - The **contingent liabilities** arising from guarantees, loans, etc. given to public sector enterprises and other entities.
    - The **sustainability and servicing of the debt stock** accumulated over the years.

What are the Factors for Re-emergence of Revenue Deficit?

- Pressure on **revenue expenditure due to Covid-19 pandemic** and other **social welfare schemes.**
- **Slowdown in economic growth** and tax revenues **due to structural and cyclical factors.**
- **Inadequate compensation for GST** shortfall by the Union Government.
- Rigidities in revenue expenditure **due to committed liabilities,** such as salaries, pensions, interest payments, etc.

How can Indian States Reduce their Revenue Deficits?

- Indian States can reduce their revenue deficits by various measures, such as:
    - **Reducing public expenditure**, especially **on non-productive or unnecessary items,** such as excessive subsidies, administrative costs, etc.
    - Increasing revenue, especially **from tax and non-tax sources**, such as improving tax compliance, widening the tax base, **rationalizing tax rates, or increasing the income of** public sector undertakings**,** etc.
    - Achieving faster economic growth, which can boost revenue collection and reduce expenditure on social welfare schemes.
    - Linking **interest-free loans or grants** from the Union Government to revenue deficit reduction targets, which **can create an incentive** for fiscal discipline.

- Implementing performance incentive **grants for revenue deficit reduction**, based on the approaches **suggested by previous** Finance Commissions.

What are the Benefits of Reducing Revenue Deficits for Indian States?

- Improving the **fiscal health and sustainability** of State finances and reducing their debt burden.
- Enhancing the **quality of expenditure and increasing the share of capital expenditure** in total expenditure.
- Boosting **public investment in infrastructure** and **human capital**, which can foster economic growth and development.
- Strengthening the credibility and confidence of investors and creditors in State finances.
- Ensuring **macroeconomic stability and coordination** with the Union Government.

What Should be the Way Forward?

- **Adopting a Credible and Sustainable Fiscal Adjustment Plan:**
  - Balance short-term and long-term fiscal objectives
  - Take into account economic and institutional context of each State.
  - Identify and implement cost-cutting and revenue-enhancing measures.
- **Improving Fiscal Transparency and Accountability:**
  - Provide timely and reliable data on budgetary performance and outcomes.
  - Adhere to fiscal rules and targets prescribed by Finance Commissions and FRBM Acts.
  - Monitor and evaluate fiscal performance and outcomes regularly.
- **Enhancing Fiscal Capacity and Autonomy:**
  - Rationalize tax structure and administration
  - Diversify revenue sources
  - Leverage assets and resources
  - Access market borrowings at competitive rates
- **Fostering Fiscal Cooperation and Coordination:**
  - Resolve pending issues related to GST compensation and devolution
  - Harmonize fiscal policies and indicators
  - Participate in intergovernmental forums and mechanisms.
  - Share best practices and experiences

What is FRBM Act?

- **About**;
  - It was enacted in August 2003.
  - It aims to make the Central government responsible for ensuring inter-generational equity in fiscal management and long-term macro-economic stability.
  - The Act envisages the setting of limits on the Central government's debt and deficits.
  - It limited the fiscal deficit to 3% of the GDP.
  - To ensure that the States too are financially prudent, the 12th Finance Commission's recommendations in 2004 linked debt relief to States with their enactment of similar laws.
  - The States have since enacted their own respective Financial Responsibility Legislation, which sets the same 3% of Gross State Domestic Product (GSDP) cap on their annual budget deficits.
- It also mandates greater transparency in fiscal operations of the Central government and the conduct of fiscal policy in a medium-term framework.
- The Budget of the Union government includes a Medium-Term Fiscal Policy Statement that specifies the annual revenue and fiscal deficit goals over a three-year horizon.
- The rules for implementing the Act were notified in July 2004. The rules were amended in 2018, and most recently to the setting of a target of 3.1% for March 2023.
- The NK Singh committee (set up in 2016) recommended that the government should target a fiscal deficit of 3% of the GDP in years up to March 31, 2020, cut it to 2.8% in 2020-21 and to 2.5% by 2023.
- **Relaxation under the FRBM Act**
  - Escape Clause:

- Under Section 4(2) of the Act, the Centre can exceed the annual fiscal deficit target citing certain grounds.
  - National security, war
  - National calamity
  - Collapse of agriculture
  - Structural reforms
  - Decline in real output growth of a quarter by at least three percentage points below the average of the previous four quarters.

Drishti Mains Question:

Indian States have shown remarkable fiscal consolidation after the Covid-19 pandemic, but they still face fiscal challenges in containing their revenue deficits. Discuss the causes and consequences of revenue deficits for Indian States.

UPSC Civil Services Examination Previous Year's Question (PYQs)

Prelims:

Consider the following statements: (2018)

1. The Fiscal Responsibility and Budget Management (FRBM) Review Committee Report has recommended a debt to GDP ratio of 60% for the general (combined) government by 2023, comprising 40% for the Central Government and 20% for the State Governments.
2. The Central Government has domestic liabilities of 21% of GDP as compared to that of 49% of GDP of the State Governments.
3. As per the Constitution of India, it is mandatory for a State to take the Central Government's consent for raising any loan if the former owes any outstanding liabilities to the latter.

Which of the statements given above is/are correct?

(a) 1 only
(b) 2 and 3 only
(c) 1 and 3 only
(d) 1, 2 and 3

Ans: (c)

Mains:

Q: Public expenditure management is a challenge to the Government of India in the context of budget-making during the post-liberalization period. Clarify it.**(2019)**

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