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ISSUE BRIEF

State Finances in India: A Snapshot

Harjas Kaur

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Every year, the national focus on the country's budget misses taking into account the release of the individual states budgets.

ABSTRACT

Every year, the national focus on the country's budget misses taking into account the release of the individual states budgets. In light of the recent state budget releases and the 15th Finance Commission's recommendations, this issue-brief analyses which sectors face budget cuts and how they impact state growth. It also becomes important with the ongoing pandemic to evaluate how state shortages must be met and whether the shortages merit any changes in policies.

Keywords: Finance Commission, fiscal target, revenue receipts, capital expenditure

INTRODUCTION

In October 2020, the XV Finance Commission [FC] released the interim report for the distribution of taxes between the centre and the states for the years 2021-26. The rising concern amongst the southern states stems from the criteria used to devolve the revenues amongst these states (Daniyal 2020). This concern comes at a time when most states are facing revenue shortages and are struggling to generate employment and meet their fiscal targets[1] due to the negative economic growth of the country (Howindialives 2020).

The annual financial statements of the estimated receipts and expenditures laid in every state by the Governor, as per Article 202 of the Constitution of India, can be used to analyse the position of state finances (Constitution of India 2020: 205).

State budgets have been facing shortfalls in their revenue amidst a widening deficit gap since before the pandemic (XV Finance Commission 2020a). With the ongoing pandemic, states have witnessed significant cuts in their share of the central taxes. This comes after a 24.5% contraction in the collection of both tax and non-tax revenues in the first six months of the fiscal year 2020 (FE Online 2020). Conditions worsened for the north-eastern states of Mizoram, Nagaland, Manipur, and Arunachal Pradesh. They failed to raise even 11% of the total revenue from their own revenue sources (XV Finance Commission 2020b). The shortfalls in revenue have led to cuts in overall expenditure and have affected the country's GDP growth.

Amidst this, the share of tied funds[2] grants-in-aid was increased from 11.97% to 19.65% as per the 15th FC's recommendations (Paul and Irava 2021). The states exercise lesser fiscal autonomy in allocating these tied funds to various sectors. Since all the states, put together, have higher spending than the centre, it becomes important to analyse the state budgets and the steps taken to meet the fiscal targets set up by states.

This issue brief discusses the status of revenue collection in the Indian states in recent years. The paper also evaluates the impact of Covid-19 on the states' revenue. While further analysing the status of secondary sources of funds for the states, such as from FC and market borrowings, and their ability to meet the states' demand.

REVENUE OF THE STATES

A state's revenue collection depends mainly on tax and non-tax sources. Within the total revenue, a state's share of tax revenue is 46% as of 2020 (Mishra and Sidhartha 2020). This tax revenue consists of the Goods and Services Tax, Value Added Tax, excise duty, property tax, capital gains tax, and vehicles tax (Mishra and Sidhartha 2020). This budget ultimately contributes to the development of

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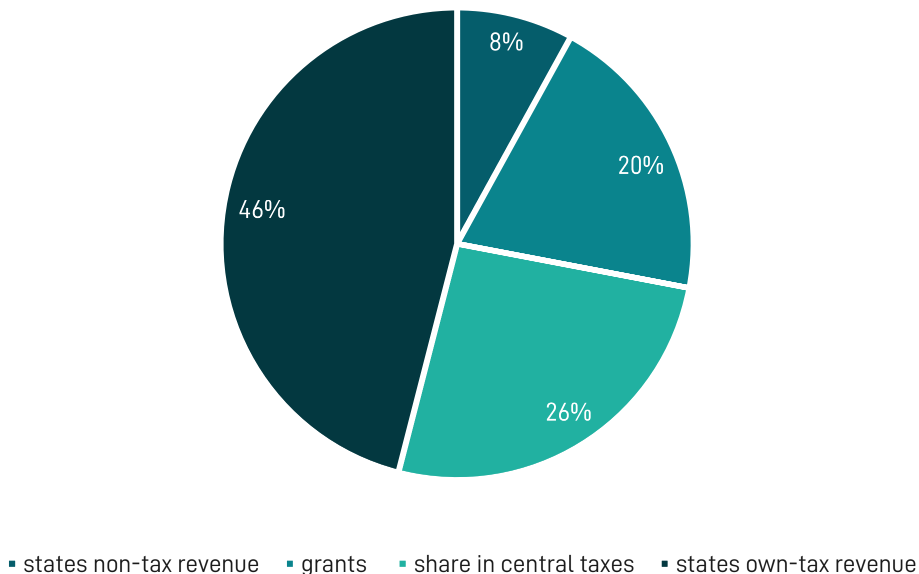
[1] Fiscal Responsibility and Budget Management [FRBM] Act, 2003 sets fiscal targets for states to manage public funds and reduce fiscal deficit.

[2] Conditional funds that are under stringent control of the centre over the purpose of their usage by the state.

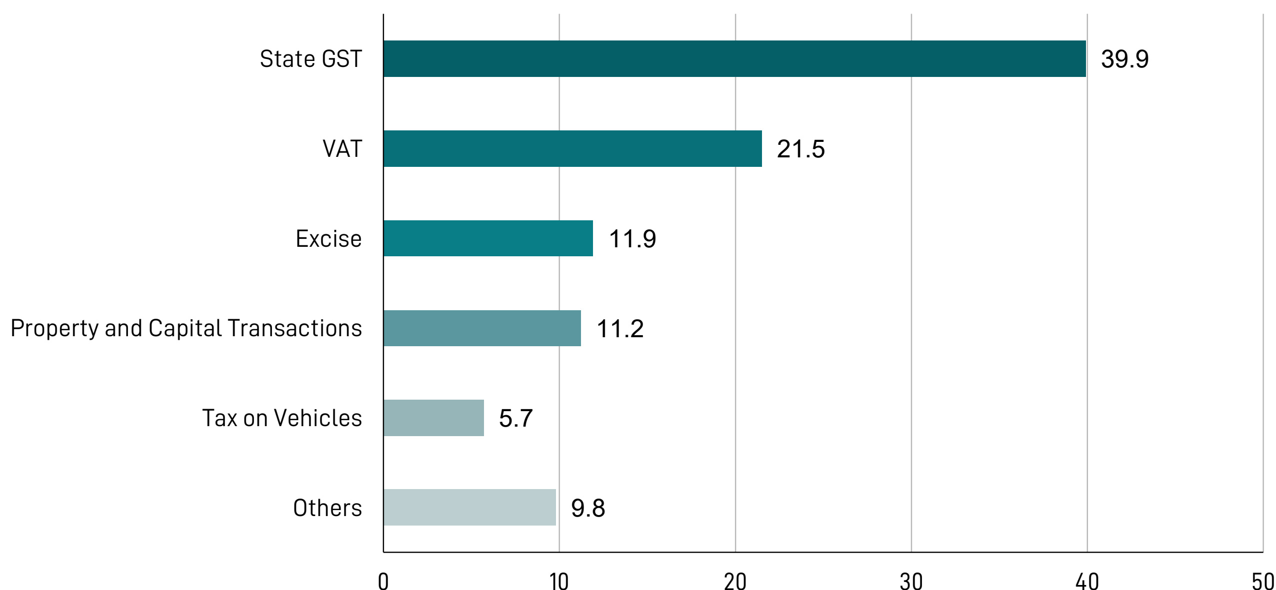
sectors mentioned in the State List of the Seventh Schedule (Seventh Schedule n.d.).

Figure 1: Sources of the States' Revenue (in %)



Source: Mishra and Sidhartha (2020)

Figure 2: Source of states' own tax revenue (% share)



Source: Mishra and Sidhartha (2020)

The next biggest source of revenue for the states is the share in central taxes, divided amongst them by the Finance Commission. The devolution amongst the states is based on a criterion and its revision. The criteria for horizontal devolution, that is, distribution of tax revenue amongst the states as per FC's Terms of Reference [ToR], is as follows:

Table 1: Horizontal Devolution Criteria and Weights

Criteria	Weight (%)
Population	15.0
Area	15.0
Forest and Ecology	10.0
Income Distance	45.0
Tax & Fiscal Efforts	2.5
Demographic Performance	12.5
	100

Source: 15th FC (2020a)

In the financial year [FY] 2020, the centre is projected to transfer 55% of its collected tax revenue to the states (Howindialives 2020). This amounted to only 38% of the total revenue collected by all the states combined (ibid). Although there has been an increase in aggregate receipts of state governments and UTs over the years, the story of individual states is entirely different.

Due to the ToR of the 15th Finance Commission, states like Karnataka, Kerala, Andhra Pradesh, and Telangana saw the most considerable reductions since the 14th FC's recommendations (Daniyal 2020). The criteria for devolution of revenues amongst states includes population data of 2011; this criterion has negatively affected southern states that have successfully implemented family planning measures to control their population levels since 1971 (Paul and Irava 2021). The FC tried to solve this problem by reducing the "population" weightage in the criteria from 27.5% to 15% (TNN 2020).

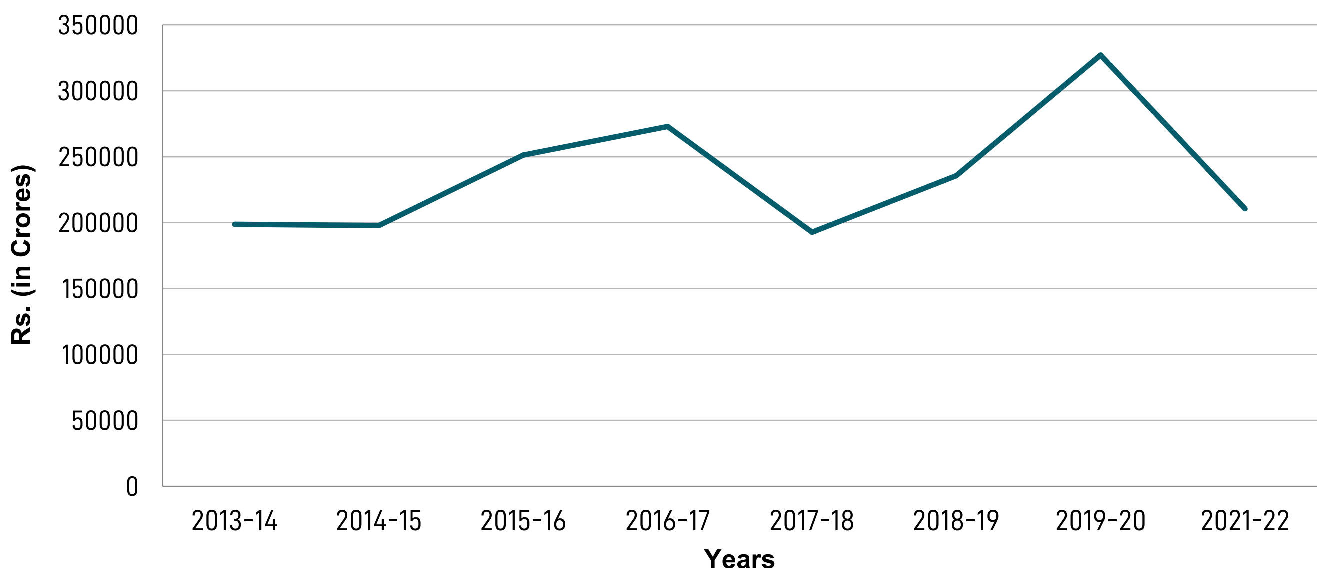
The dependability of states on Central transfers varies according to the level of development they have achieved and their ability to collect taxes. In places like Mizoram, Nagaland, Manipur, and Arunachal Pradesh, the revenue generated is lower than the average of the rest of the states. Moreover, these states rank at the lower end of the SDG Index, with Mizoram at 12th rank, Nagaland at 20th, Manipur at 16th, and Arunachal Pradesh at 22nd in the country (NITI Aayog 2021). However, factors like less population and low demographic performance levels lead to lesser devolution of central shares towards these states, even though they are dependent on the Union government for more than 80% of their total revenue receipts.

The pandemic worsened the revenue collection as the Indian states had to deal with the largest reverse migration yet in the country. This led to ramping up of state expenditures and decreased tax receipts, thereby creating pressure on the fiscal viabilities of the states. RBI used the term "scissors effect" to describe the pandemic since expenditures surged and revenues collapsed. Loss of revenue was observed "due to demand slowdown, coupled with higher expenditure

associated with pandemic" (Reserve Bank of India [RBI] 2020: 19). Off-budget loans and guarantees have further increased the deficit gap of states. Initially, states had budgeted for higher tax collection by broadening the tax base. However, 2020-21 saw a large shortfall in the divisible pool of central tax transfers to the states, which cover 25-29% of their revenue (RBI 2020: 16). The tax revenue to GDP ratio observed an increase, with higher devolution offset by lower state's own tax revenue through the financial years 2016-2019 (RBI 2020: 17-18).

Non-tax revenue comprises interest receipts, dividends and profits, fiscal services, general services, social and community services, economic services, and grants-in-aid contributions (Ministry of Finance [MoF] n.d. a). The non-tax revenue improved from 2017-18 to 2018-19 since higher collection from general services and petroleum became possible (MoF n.d. b). However, as observed in figure 4, the trends in non-tax revenue collection have been volatile over the years.

Figure 3: Trends in Non-Tax Revenue Receipts of States



Source: RBI (2020)

The pandemic slump in states tax collection via taxes on commodities and services impacted the states' tax revenue negatively. Furthermore, during the first quarter of 2020-21, revenue collection from the State Goods and Services Tax [SGST] saw a 47.2% decline (RBI 2020). Such a drastic shortfall in revenue receipts raised the states' expectations of revenue deficit grants from the FC (RBI 2020).

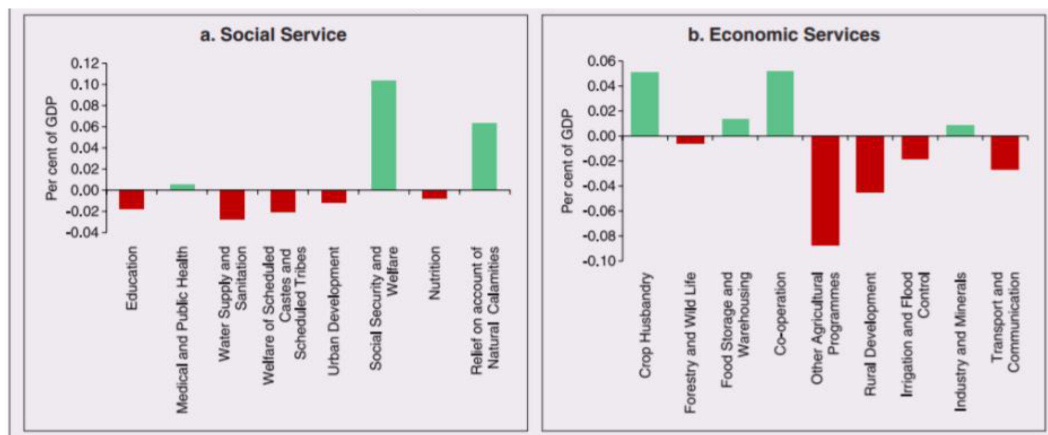
EXPENDITURE

Despite a lower revenue collection, states maintained their revenue spending close to that in 2018-19. This was possible because of the re-allocation of funds towards the developmental expenditure, i.e. relief for natural calamities, medical and public health, energy, transport, and communication. However, this re-allocation was made possible by cutting down spending on education, social

security and welfare, housing, rural development, and agricultural programs (RBI 2020: 20).

The rise in revenue expenditure[3] in 2018-19 was largely on a non-developmental front. There were significant cuts in expenditure on services provided by the states, as seen in figure 4.

Figure 4: Data on Revenue Expenditure Components - 2018-19 vis-a-vis 2017-18



Source: RBI (2020)

In 2018-19, education, water supply, sanitation, and nutrition were the key social services that saw a major decrease in their revenue allocation when compared to 2017-18. This had a greater impact on the states whose aim was to provide these necessities to the public to help meet their SDG targets by 2030. Additional cuts were made in economic services in sectors like agriculture, rural development, and transportation. There exists a positive and statistically significant correlation between the share of spending on economic services and overall GDP (Devarajan, Swaroop, and Zou 1996). Therefore, cuts in states' productive spending had a negative impact on the economic services and the overall GDP.

During 2019-20, all states cut their capital expenditure[4] [CapEx] not only against the budgeted levels but also compared to the previous years. This had an overall negative impact on the development and employment levels of the states. This further affected their GDP growth. Monthly data on revenue expenditure during April-June 2020 did not show any increase in spendings compared to the previous years' spendings. However, despite receiving one-eighth of their budgeted revenue, states were able to provide policy measures to contain the impacts of Covid-19 (RBI 2020:22).

To drive CapEx in the states, the centre announced the "scheme of financial assistance to states for capital expenditure" for the FY 2021-22. Under this scheme, the states were given a special interest-free 50-year loan for a CapEx of Rs.12,000 crores (PIB Delhi 2021). However, Rs. 12,000 crores remains a small amount of the actual total budgeted CapEx of Rs. 6.5 lakh crores (RBI

[3] Revenue expenditure are the short-term expenses that are required and spent on projects and policies of the government in a given year.

[4] Use of the purchased assets in generation of new revenues and spending it for creating new facilities required for generating new employment opportunities.

2020: 43). States' primary spending is an indicator of discretionary spending[5], which is majorly driven by policy recommendations. This discretionary spending has increased since 2015 through Ujwal DISCOMS Assurance Yojana [UDAY], farm loan waivers, and income support schemes initiated by the centre for short-term solutions. Even post-UDAY, the state-owned power companies continued to raise liabilities by 1.5% of GDP over the years, through losses incurred, thereby leading to an increase in states' outstanding liabilities (RBI 2020: 51). Finally, states do not fully execute capital spending due to budget shortfalls, leading them to cut their capital expenditure by almost 0.5% of the GDP. This is done in order to meet fiscal targets set by the Fiscal Responsibility and Budget Management [FRBM] Act, 2003 (RBI 2020).

SHORTFALLS, DEFICIT, GRANTS, AND BORROWINGS

The Gross Fiscal Deficit[6] [GFD] saw a decline during 2017-18 and 2018-19, mainly due to cuts in expenditure (RBI 2020). According to the statistics released by the Comptroller and Auditor General [CAG], the consolidated GFD of states stood at 2.8% of the GDP in 2020-21. In the revised estimates[7] for 2019-20, GFD stood at 3.2% of the GDP. The RBI reports indicate that the contraction was possible owing to cuts in capital expenditure and revenue, which also compensated for the shortfalls in tax collection. India's capital spending has, on many occasions, fallen short of the initially budgeted targets to meet the fiscal deficit targets. The state governments have tackled the problem of meeting their fiscal targets through market borrowings, withdrawal from public accounts, and cash withdrawals constrained by the provisions of Article 293[8] of the constitution (RBI 1999). With market borrowings sharing burden as much as 65.7% in 2016-17, 84% in 2017-18, 80.6% in 2018-19, 74.9% in 2019-20, and 89.5% in 2020-21. the share of market borrowings has doubled in the last five years (RBI 2020).

As the net borrowings by the states have increased, the gross market borrowings have seen the highest increase of 32.7% in the recent past (RBI 2020). While states like Odisha and Haryana met their targets with their own funds, UP, Gujarat, and Punjab over-borrowed despite the revenue consolidated by FC to these states. UP borrowed 20% more than the budgeted amount, even after registering a fiscal surplus in 2019-20 (RBI 2020). Higher borrowings lead to serious implications on interest rates, decreasing the availability of funds for starting new businesses and incapacitating the state to generate employment.

The centre in 2020 provided the Atma Nirbhar package to the states, thereby allowing an increase in borrowing limits from 3% to 5%. Under this scheme, the Department of Expenditure also provides for 1% of additional borrowing for four

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[5] Discretionary spending is the total expenditure less interest payments that are mandatory.

[6] When a country's spendings is more than its earnings it creates a gap called fiscal deficit.

[7] Budget estimates give projection before the start of a year, whereas revised estimates are made available towards the end of the fiscal year.

[8] Article 293 states the constitutional provision relating to raising of loans and issuing of guarantees can be given by states as per the limits fixed by the legislature of the concerned State. However, when states raise a loan prior consent from the Government of India is required, whereas consent is not required when giving a guarantee.

specific sectors: universalisation of “one nation one ration card”, ease of doing business, power distribution, and urban local body revenue reforms. However, this additional borrowing is likely to be used for the revenue shortfall rather than to meet the states’ expenditure requirements. Furthermore, borrowed resources are budgeted to finance the revenue deficit to the extent of 75%. The remaining 25% is budgeted for CapEx, even though the government claims that the CapEx is 26.2% higher than that of 2020-21 (Pattnaik 2021).

According to the FRBM Act, 2003 states must partner with the union government to manage their debt to GDP ratio[9] on sustainable levels. The grants to states revolve around four specific themes: social sector– education and health, rural economy– agricultural and rural roads, governance and administrative reforms, and power sector (XV Finance Commission 2020a). Revenue deficit is considered an important goal while creating policies for grants-in-aid. As per the FC’s recommendations, 1.92% of the gross revenue receipts of the Union were to be allocated to the states as grants (XV Finance Commission 2020b). In practice, the actual amount of grants awarded has remained lesser than the recommendations. Moreover, conditioning grants towards tied funds and centrally sponsored schemes [CSS], with the lack of timely release of grants during the award period remains a challenge.

Following the pandemic, the FC’s recommendations prioritised giving grants amounting to more than Rs.1 lakh crore to the health sector. Keeping the federal structure in mind, these health grants are also provided to local governments in the states. State governments had stepped forward by sending proposals for state-specific grants to improve their health infrastructure. FC met these demands by providing Rs. 4,800 Cr. Incentive grants were also given to the states to improve learning outcomes in school using the Performance Grading Index [PGI] (XV Finance Commission 2020a).

Out of the total grants recommended for cities, “40% of the grants is untied while 60% is tied to the national priorities of drinking water, rainwater harvesting, solid waste management and sanitation” (XV Finance Commission 2020a). States vary in terms of their geographic, economic, social, and developmental positions. Hence, tied grants make it difficult for states to prioritise the problems they face.

WAY FORWARD

As recommended by the FC, the central and the state governments need to focus on debt consolidation by adjusting their debts to the targeted levels approved by the FRBM Act (XV Finance Commission 2020a). However, to achieve these fiscal targets, changes in FRBM are also required to have a counter-cyclical impact on the economy. Keynes had advocated that when output falls below the economy’s potential, the government must raise the expenditure to aggregate demand and generate a push for economic activity. Since deficit targets are made annually, debt-deficit law can be introduced. Said introduction would grant states the ability to achieve their deficit targets over a couple of years (Kamila, Bansal, and Mishra

[9] Ratio of a country’s debt to its gross domestic product, which indicates a country’s capability for paying back its debts.

2021). States must also act as important players in restructuring the FRBM Act. An inter-ministerial group with representatives from states should examine debt sustainability and its implementation.

In an open economy, it is essential to minimise distortions in tax policy, ensure proper pricing of public goods and services provided by the state government, and efficiently provide for the needs of the citizens to ensure proper development in states (Rao 2002). Since GST is the primary source of revenue for the states, reforms in the GST policy become essential. The GST Council must take up its role as a constitutional body, consider the tax changes proposed to them by the states, and put them to test. This needs to be done, keeping in mind the economic growth in the long-run rather than the effect it will have on revenues in the short-run.

Furthermore, when FC consolidates grants and aids to states according to the criteria for horizontal devolution, states give individual recommendations on the weightage of each factor taken into account by FC. FC must take those recommendations into account as states divide the weightage for each factor according to the levels of development they have individually achieved. The FC has also recommended the setting up of State FCs , which many states have not complied with (Nahata 2021). Thus, implementing SFCs should be made mandatory for the states to have a more state-focused approach while forming grants.

An active fiscal policy is required to take India out of this cycle of debt and rising borrowings. Pro-cyclical[10] fiscal policies might lead to higher debts and increased reliance on expansionary policies such as loan waivers by the government. Therefore, for long-run economic recovery,a counter-cyclical policy[11] needs to be implemented that will gradually decrease the debt-to-GDP ratio. It will boost growth with multi-year public investment packages towards the states when the private sector is in a slump (Department of Economic Affairs 2021). Despite structural reforms in the supply-side of the economy, structural problems remain within the sectors of agriculture, MSMEs, labour laws, and others. These problems have already been identified within each sector. Thus, individual policies addressing them need to be implemented.

As Covid-19 has put a constraint on service sectors - particularly the wholesale and retail trade, hospitality, arts and entertainment saw larger contractions than the manufacturing sector. These services are the employment generators that directly impact income and demand in any economy (Department of Economic Affairs 2021). Hence, state expenditure needs to be reprioritised towards more productive capital expenditures, where investments in healthcare and social security nets and strengthening of state infrastructure follow suit in accordance with individual state priorities.

[10] Policies that are expansionary during a boom and contractionary during recession, making the economy highly volatile.

[11] These policies are opposite of pro-cyclical, thus expenditure increased during a recession and contractionary policies followed during a boom.

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